



## Unit - 4

### Efficient Market Theory (EMT)

The Efficient Market Theory is a fundamental concept in financial economics that posits that financial markets efficiently incorporate all available information into asset prices. Proposed by Eugene Fama in the 1960s, EMT suggests that it is impossible to consistently outperform the market because asset prices already reflect all known information. Here are key principles and implications of the Efficient Market Theory:

#### 1. Three Forms of Market Efficiency :

- Weak Form Efficiency: Prices reflect all past trading information, including historical prices and trading volumes. Therefore, technical analysis techniques such as analyzing past price movements or volume patterns are ineffective in consistently predicting future price movements.

- Semi-Strong Form Efficiency: Prices reflect all publicly available information, including not only past trading data but also fundamental information such as earnings reports, news, and economic indicators. Consequently, neither technical analysis nor fundamental analysis can consistently generate abnormal returns.

- Strong Form Efficiency: Prices reflect all information, both public and private. This implies that even insider information cannot be used to consistently achieve abnormal returns, as it is already incorporated into asset prices.

#### 2. Implications for Investors :

- Active vs. Passive Investing: According to EMT, it is difficult for active fund managers to consistently outperform the market since prices already reflect all available information. Therefore, proponents of EMT often advocate for passive investing strategies such as index funds or Exchange-Traded Funds (ETFs), which aim to replicate the performance of a market index rather than actively picking individual stocks.



- Random Walk Hypothesis: EMT suggests that asset prices follow a random walk, meaning that future price movements cannot be predicted based on past price movements. This challenges the notion of market timing and the efficacy of technical analysis.

- Efficient Market Hypothesis and Behavioral Finance: While EMT assumes rationality and efficiency in market participants, behavioral finance critiques this assumption, arguing that investors may exhibit biases and irrational behavior that lead to market inefficiencies and anomalies.

### **3. Critiques of Efficient Market Theory :**

- Market Anomalies: Critics of EMT point to various market anomalies, such as momentum effects, value investing strategies, and anomalies related to market psychology, as evidence of market inefficiency.

- Adaptive Market Hypothesis: Some scholars propose alternative theories, such as the Adaptive Market Hypothesis, which integrates elements of EMT with insights from behavioral finance. This theory suggests that markets are neither perfectly efficient nor completely inefficient but rather adaptively efficient, with periods of efficiency and inefficiency depending on market conditions and participant behavior.

Overall, while Efficient Market Theory provides a foundational framework for understanding financial markets, it remains a subject of ongoing debate and research within the field of finance. Investors and academics continue to explore the implications of market efficiency, its limitations, and the interplay between rationality and irrationality in financial decision-making.