Andreas Krause

Market efficiency

Information acquisition

- Some investors may want to acquire information to make additional profits
- Information will be costly and the additional profits should cover these costs
- Their trading behaviour will affect asset prices and may reveal some of the information
- If information is revealed through their behaviour, this might reduce their profits

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Performance of investments

- If investors are generating higher profits, they do not necessarily perform better
- To assess the performance of an investor, the risks they are taking need to be taken into account
- Investors can exploit differences between asset values and prices only if they generate sufficiently high returns
- We will look at how such returns can be evaluated

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Definition of market efficiency

A market is efficient if prices include all relevant information

Weak form efficiency: Prices reflect information from past prices

Semi-strong form efficiency: Prices reflect all publicly available information

Strong form efficiency: Prices reflect all available information, including private information

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Information acquisition and market efficiency
LIVERMORE
TRADING GROUP
NEW YORK STOCK EXCHANGE

Implications of market efficiency

- If markets are efficient, no one can make profits from information, making costly information acquisition unprofitable.
- This leads to the paradox that markets which are too efficient, cannot exist.

? If a market is not perfectly efficient, would all investors acquire information?

! Firstly, the inefficiency must be large enough such that information costs can be recovered, and secondly if all investors are informed, they will have no one to trade with.

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The importance of performance measurement

- If exploiting market inefficiencies, investors could generate higher returns than holding the asset
- However, relying on information is also risky as information can be wrong
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Performance evaluation

Assessing investment performance

- Investors need to take into account the risks of their trading strategies to determine whether they are profitable
- Which performance measure is chosen, will depend on the risk that is relevant to an investor

? After taking into account the systematic risks taken, an investor shows a higher return than the market. Is he able to exploit market inefficiencies?

! The investor might have taken on additional risks that need to be compensated. While it looks like the investor is successful, it might be compensation for idiosynratic risks

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Summary of key results

- Efficient markets do not allow investors to generate profits and efficient markets cannot exist
- Even if markets are not efficient, investors need relevant information to make profits
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