

Essentials of Investments (BKM 7th Ed.)
Answers to Selected Problems – Lecture 5

Chapter 8:

1. Zero. If not, one could use returns from one period to predict returns in later periods and make abnormal profits.
2. c. “The January Effect” implies that one can predict January prices based on past January prices. This is a predictable pattern in returns which should not occur if weak-form EMH is valid.
3. c. This is a classic filter rule which should not be profitable in an efficient market.
5. c. The P/E ratio is public information and should not predict abnormal security returns.
13. a) The grandson is referring to the small-firm effect (which can also be described as the January effect).
b) 1 - Building a portfolio of only small firms results in increased risk, as the portfolio is less diversified.
2 - Because the anomaly has existed in the past is not a predictor that the anomaly will exist in the future.
3 - After the results of these studies became publicly known, investors may bid up the prices of these securities to reflect the now-known opportunity.
14. No, this is not a violation of the EMH. Microsoft’s continuing large profits do not imply that stock market investors who purchased Microsoft shares after its success already was evident would have earned a high return on their investments.
15. No, this is not a violation of the EMH. This empirical tendency does not provide investors with a tool that will enable them to earn abnormal returns; in other words, it does not suggest that investors are failing to use all available information. An investor could not use this phenomenon to choose undervalued stocks today. The phenomenon instead reflects the fact that dividends occur as a response to good performance. After the fact, the stocks that happen to have performed the best will pay higher dividends, but this does not imply that you can identify the best performers early enough to earn abnormal returns.
17. a. Consistent. Half of managers should beat the market based on pure luck in any year.
b. Inconsistent. This would be the basis of an "easy money" rule: simply invest with last year's best managers.
c. Consistent. Predictable *volatility* does not convey a means to earn abnormal returns.

- d. Inconsistent. The abnormal performance ought to occur in January when earnings are announced.
 - e. Inconsistent. Reversals offer a means to earn easy money: just buy last week's losers.
24. You should buy the stock. In your view, the firm's management is not as bad as everyone else believes it to be. Therefore, you view the firm as undervalued by the market. You are less pessimistic about the firm's prospects than the beliefs built into the stock price.
26. The market may have anticipated even greater earnings. Compared to prior expectations, the announcement was a disappointment.