

Fama's 3 Forms of Market Efficiency

Eugene Fama identified three forms of market efficiency in his PhD thesis in the 1960's:

- Weak form market efficiency, also known as the random walk model.
- Semi-strong form market efficiency.
- Strong form market efficiency.

Weak-form Market Efficiency

If the market is weak-form efficient:

- Current prices reflect all past price information. Past prices provide no guide to future prices.
- Prices are a **random walk**: they rise on good news and fall on bad news.
- Investors cannot earn abnormal returns using simple trading rules such as 'buy if the price has fallen' (contrarian strategy). Or 'buy if the price has risen' (momentum strategy).
- Technical analysis will not lead to abnormal returns.

Empirical evidence indicates that markets are generally weak-form efficient.

Semi-strong-form Market Efficiency

If the market is semi-strong-form efficient:

- Current prices reflect all publicly available information, including trading information, annual reports and press releases.
- Investors cannot earn abnormal returns by trading on public information, such as something searchable on Google.
- ‘Fundamental analysis’ of annual reports and publicly available news and data will not lead to abnormal returns.

Strong-form Market Efficiency

If the market is strong-form **efficient**:

- Current prices reflect all information, including private information that only insiders are aware of.
- Investors could **not** earn abnormal returns regardless of the information they possessed.

Most people consider markets to be strong form **inefficient**, so insider traders can make abnormal returns.

Empirical evidence indicates that markets are strong-form **inefficient** because insiders can and do earn abnormal returns.

Markets are **not** supposed to be strong form efficient because if they were, (illegal) insider-trading would be rampant.

Questions on Market Efficiency

[http://www.fightfinance.com/?qna=242,243,100,119,338,105,48,63,339,340,416,417,464,](http://www.fightfinance.com/?qna=242,243,100,119,338,105,48,63,339,340,416,417,464)