Chapter 7
The Stock Market, the Theory of Rational Expectations, and the Efficient Markets Hypothesis

Multiple Choice

1) Stockholders’ rights include
(a) the right to vote.
(b) the right to manage.
(c) primary claims on all cash flows.
(d) ownership of bonds.
(e) all of the above.
Answer: A
Question Status: New

2) Stockholders’ rights include
(a) the right to manage.
(b) the right to change personnel policy.
(c) the right to veto management’s decisions.
(d) primary claim on all of a company’s assets.
(e) residual claim on all cash flows.
Answer: D
Question Status: New

3) Stockholders are residual claimants, meaning that they
(a) have the first priority claim on all of a company’s assets.
(b) are liable for all of a company’s debts.
(c) will never share in a company’s profits.
(d) receive the remaining cash flow after all other claims are paid.
(e) have a higher claim on cash flow than bond holders.
Answer: C
Question Status: New
4) A stockholder’s ownership of a company’s stock gives her the right to
   (a) vote and be the primary claimant of all cash flows.
   (b) vote and be the residual claimant of all cash flows.
   (c) manage and assume responsibility for all liabilities.
   (d) vote and assume responsibility for all liabilities.
   (e) manage and be the residual claimant of all cash flows.

   Answer: B
   Question Status: New

5) Dividends are paid from
   (a) liabilities.
   (b) debts.
   (c) net earnings.
   (d) both (a) and (b) of the above.
   (e) none of the above.

   Answer: C
   Question Status: New

6) Payments of net earnings to shareholders are called
   (a) dividends.
   (b) capital gains.
   (c) profits.
   (d) loans.
   (e) interest.

   Answer: A
   Question Status: New

7) Periodic payments of net earnings to shareholders are known as
   (a) capital gains.
   (b) dividends.
   (c) profits.
   (d) all of the above.
   (e) both (a) and (b) of the above.

   Answer: B
   Question Status: New

8) Dividends are periodic payments of net earnings to
   (a) employees.
   (b) managers.
   (c) creditors.
   (d) shareholders.
   (e) all of the above.

   Answer: D
   Question Status: New
9) The value of an investment can be found by computing the present value of all future
(a) debts.
(b) sales.
(c) liabilities.
(d) cash flows.
(e) risks.
Answer: D
Question Status: New

10) The value of any investment is found by
(a) computing the present value of all future sales.
(b) computing the present value of all future liabilities.
(c) computing the future value of all sales.
(d) computing the present value of all future cash flows.
(e) computing the future value of all future expenses.
Answer: D
Question Status: New

11) In the one-period valuation model, the value of an investment depends upon
(a) only the present value of the expected sales price.
(b) only the present value of the future dividends.
(c) the actual value of the dividends and expected sales price received in one year.
(d) the future value of dividends and the actual sales price.
(e) the present value of both dividends and the expected sales price.
Answer: E
Question Status: New

12) In the one-period valuation model, the current stock price increases if
(a) the expected sales price increases.
(b) the expected sales price falls.
(c) the required return increases.
(d) dividends are cut.
(e) both (a) and (c) occur.
Answer: A
Question Status: New

13) In the one-period valuation model, an increase in the required return
(a) increases the expected sales price of a stock.
(b) reduces the dividend payment.
(c) reduces the expected sales price of a stock.
(d) reduces the current price of a stock.
(e) increases the current price of a stock.
Answer: D
Question Status: New
14) Using the one-period valuation model, assuming a year-end dividend of $0.11, an expected sales price of $110, and a required rate of return of 10%, the current price of the stock would be
   (a) $110.11.
   (b) $121.12.
   (c) $100.00.
   (d) $100.10
   (e) $100.11
   Answer: D
   Question Status: New

15) Using the one-period valuation model, assuming a year-end dividend of $1.00, an expected sales price of $100, and a required rate of return of 10%, the current price of the stock would be
   (a) $90.91
   (b) $91.00
   (c) $91.82
   (d) $92.00
   (e) $101.00
   Answer: C
   Question Status: New

16) Using the one-period valuation model, assuming a year-end dividend of $0.50, an expected sales price of $50, and a required rate of return of 10%, the current price of the stock would be
   (a) $50.50.
   (b) $50.00.
   (c) $45.91.
   (d) $45.00.
   (e) indeterminate.
   Answer: C
   Question Status: New

17) Using the one-period valuation model, assuming a year-end dividend of $1.00, an expected sales price of $100, and a required rate of return of 5%, the current price of the stock would be
   (a) $110.00.
   (b) $101.00.
   (c) $100.00.
   (d) $96.19.
   (e) $95.23.
   Answer: D
   Question Status: New
18) Using the one-period valuation model, assuming a year-end dividend of $11.00, an expected sales price of $110, and a required rate of return of 10%, the current price of the stock would be
(a) $121.
(b) $110.
(c) $100
(d) $99
(e) $91
Answer: B
Question Status: New

19) In the generalized dividend model, if the expected sales price is in the distant future
(a) it does not affect the stock price.
(b) it is the most important determinant of the current stock price.
(c) it is equally important with dividends in determining the stock’s price.
(d) it is less important than dividends but still affects a stock’s price.
(e) it is more important than dividends in determining a stock’s price.
Answer: A
Question Status: New

20) In the generalized dividend model, a future sales price far in the future does not affect the current stock price because
(a) the present value cannot be computed.
(b) the present value is almost zero.
(c) the sales price does not affect the current price.
(d) the stock may never be sold.
(e) the company may suffer bankruptcy.
Answer: B
Question Status: New

21) In the generalized dividend model, the current stock price is the sum of
(a) the actual value of the future dividend stream.
(b) the present value of the future dividend stream.
(c) the present value of the future dividend stream plus the actual future sales price.
(d) the future value of the dividend stream plus the sales price.
(e) the present value of the future sales price.
Answer: B
Question Status: New

22) Using the Gordon growth model, a stock’s price will increase if
(a) dividends are reduced.
(b) the growth rate of dividends falls.
(c) the required rate of return rises.
(d) the expected sales price rises.
(e) the dividend growth rate increases.
Answer: E
Question Status: New
23) Using the Gordon growth model, a stock’s price will increase if
   (a) the dividend growth rate increases.
   (b) the future sales price increases.
   (c) the required rate of return increases.
   (d) all of the above occur.
   (e) both (a) and (b) of the above.
   Answer: A
   Question Status: New

24) Using the Gordon growth model, a stock’s price will increase if
   (a) the future sales price falls.
   (b) the required rate of return falls.
   (c) the dividend growth rate falls.
   (d) the current dividend falls.
   (e) none of the above.
   Answer: B
   Question Status: New

25) In the Gordon growth model, a decrease in the required rate of return
   (a) increases the current stock price.
   (b) increases the future stock price.
   (c) has no effect on stock prices.
   (d) reduces the current stock price.
   (e) reduces the future stock price.
   Answer: A
   Question Status: New

26) Using the Gordon growth formula, if \( D_1 \) is $1.00, \( k_e \) is 12% or 0.12, and \( g \) is 10% or 0.10, then the
   current stock price is
   (a) $10.
   (b) $20.
   (c) $30.
   (d) $40.
   (e) $50.
   Answer: E
   Question Status: New

27) Using the Gordon growth formula, if \( D_1 \) is $2.00, \( k_e \) is 12% or 0.12, and \( g \) is 10% or 0.10, then the
   current stock price is
   (a) $20.
   (b) $50.
   (c) $100.
   (d) $150.
   (e) $200.
   Answer: C
   Question Status: New
28) Using the Gordon growth formula, if \( D_1 \) is $1.00, \( k_e \) is 10% or 0.10, and \( g \) is 5% or 0.05, then the current stock price is

(a) $10.
(b) $20.
(c) $30.
(d) $40.
(e) $50.

Answer: B

Question Status: New

29) Using the Gordon growth formula, if the current stock price is $25, \( k_e \) is 12% or 0.12, and \( g \) is 10% or 0.10, then \( D_1 \) is

(a) $0.25.
(b) $0.50.
(c) $0.75.
(d) $1.00
(e) $1.25.

Answer: B

Question Status: New

30) In asset markets, an asset’s price is

(a) set equal to the average of the price all buyers are willing to pay.
(b) set equal to the highest price a buyer is willing to pay.
(c) set equal to the lowest price a seller is willing to accept.
(d) set by the buyer willing to pay the highest price.
(e) set equal to the highest price a seller will accept.

Answer: D

Question Status: New

31) New information about an asset can result in a decrease in the asset’s price due to

(a) an expected decrease in the level of future dividends.
(b) a decrease in the required rate of return.
(c) an expected increase in the dividend growth rate.
(d) an expected increase in the future sales price.
(e) none of the above.

Answer: A

Question Status: New

32) A change in perceived risk of a stock changes

(a) the expected dividend growth rate.
(b) the expected sales price.
(c) the required rate of return.
(d) the current dividend.
(e) all of the above.

Answer: C

Question Status: New
33) A stock’s price will fall if there is
   (a) an increase in perceived risk.
   (b) an increase in the required rate of return.
   (c) an increase in the future sales price.
   (d) all of the above.
   (e) both (a) and (b) of the above.
   Answer: E
   Question Status: New

34) A monetary expansion _____ stock prices due to a decrease in the _____ and an increase in the _____.
   (a) reduces; future sales price; expected rate of return
   (b) reduces; current dividend; expected rate of return
   (c) increases; required rate of return; future sales price
   (d) increases; dividend growth rate; future sales price
   (e) increases; required rate of return; dividend growth rate
   Answer: E
   Question Status: New

35) A monetary contraction _____ stock prices due to a decrease in the _____ and an increase in the _____.
   (a) increases; dividend growth rate; required rate of return
   (b) increases; current dividend; future sales price
   (c) reduces; required rate of return; dividend growth rate
   (d) reduces; dividend growth rate; required rate of return
   (e) reduces; dividend growth rate; future sales price
   Answer: D
   Question Status: New

36) Terrorist attacks on the United States caused a(n)
   (a) decrease in stock prices due to lower expected growth and greater risk.
   (b) decrease in stock prices due to lower expected dividend growth and reduced uncertainty.
   (c) decrease in stock prices due to lower future sales prices.
   (d) increase in stock prices due to higher expected dividend growth.
   (e) increase in stock prices due to an increased required return.
   Answer: A
   Question Status: New

37) An increase in uncertainty due to threat of war will
   (a) increase stock prices due to a higher required return.
   (b) not affect stock prices.
   (c) increase stock prices due to a lower required return.
   (d) depress stock prices due to a higher required return.
   (e) depress stock prices due to a lower required return.
   Answer: D
   Question Status: New
38) Dishonest corporate accounting procedures caused stock prices to
(a) remain unchanged.
(b) decrease due to lower expected dividend growth and lower required return.
(c) decrease due to lower expected dividend growth and higher required return.
(d) increase due to higher expected dividend growth and lower required return.
(e) increase due to higher expected dividend growth and higher future sales price.
Answer: C
Question Status: New

39) Economists have focused more attention on the formation of expectations in recent years. This increase in interest can probably best be explained by the recognition that
(a) expectations influence the behavior of participants in the economy and thus have a major impact on economic activity.
(b) expectations influence only a few individuals, have little impact on the overall economy, but can have important effects on a few markets.
(c) expectations influence many individuals, have little impact on the overall economy, but can have distributional effects.
(d) models that ignore expectations have little predictive power, even in the short run.
Answer: A
Question Status: Previous Edition

40) The view that expectations change relatively slowly over time in response to new information is known in economics as
(a) rational expectations.
(b) irrational expectations.
(c) slow-response expectations.
(d) adaptive expectations.
Answer: D
Question Status: Previous Edition

41) If expectations of the future inflation rate are formed solely on the basis of a weighted average of past inflation rates, then economics would say that expectation formation is
(a) irrational.
(b) rational.
(c) adaptive.
(d) the result of none of the above.
Answer: C
Question Status: Previous Edition
42) According to adaptive expectations,
   (a) expectations of inflation are viewed as being an average of past inflation rates.
   (b) expectations of inflation are viewed as being an average of expected future inflation rates.
   (c) expectations formation indicates that changes in expectations occur slowly over time as past data change.
   (d) only (a) and (b) of the above.
   (e) only (a) and (c) of the above.
Answer: E
Question Status: Previous Edition

43) The adaptive expectations view
   (a) regards expectations of inflation as being an average of past inflation rates.
   (b) has been criticized on the grounds that people will use more information than just past data on a single variable to form their expectations of that variable.
   (c) holds that expectations change relatively quickly.
   (d) only (a) and (b) of the above.
   (e) only (a) and (c) of the above.
Answer: D
Question Status: Previous Edition

44) The major criticism of the view that expectations are formed adaptively is that
   (a) this view ignores that people use more information than just past data to form their expectations.
   (b) it is easier to model adaptive expectations than it is to model rational expectations.
   (c) adaptive expectations models have no predictive power.
   (d) people are irrational and therefore never learn from past mistakes.
Answer: A
Question Status: Previous Edition

45) If expectations are formed adaptively, then people
   (a) use more information than just past data on a single variable to form their expectations of that variable.
   (b) often change their expectations quickly when faced with new information.
   (c) use only the information from past data on a single variable to form their expectations of that variable.
   (d) do none of the above.
Answer: C
Question Status: Previous Edition

46) The assumption that people use only the information from past data on a single variable to form their expectations of that variable is called the
   (a) adaptive expectations hypothesis.
   (b) Lucas critique.
   (c) Ricardian equivalence theorem.
   (d) rational expectations hypothesis.
Answer: A
Question Status: Previous Edition
47) In rational expectations theory, the term “optimal forecast” is essentially synonymous with
(a) correct forecast.
(b) the correct guess.
(c) the actual outcome.
(d) the best guess.
Answer: D
Question Status: Previous Edition

48) If additional information is not used when forming an optimal forecast because it is not available at
that time, then expectations are
(a) obviously formed irrationally.
(b) still considered to be formed rationally.
(c) formed adaptively.
(d) the result of none of the above.
Answer: B
Question Status: Previous Edition

49) According to rational expectations theory, forecast errors of expectations
(a) are more likely to be negative than positive.
(b) are more likely to be positive than negative.
(c) tend to be persistently high or low.
(d) are unpredictable.
Answer: D
Question Status: Study Guide

50) Rational expectations forecast errors will on average be _____ and therefore _____ be predicted
ahead of time.
(a) positive; can
(b) positive; cannot
(c) negative; can
(d) zero; can
(e) zero; cannot
Answer: C
Question Status: Study Guide

51) Reasons why an expectation might fail to be rational include the fact that
(a) people might fail to use available information in making their expectation the best guess
possible of the future.
(b) people may be unaware of available information.
(c) people might fail to use information that is not yet available.
(d) both (a) and (b) of the above are true.
Answer: D
Question Status: Previous Edition
52) People have a strong incentive to form rational expectations because
(a) they are guaranteed of success in the stock market.
(b) it is costly not to do so.
(c) it is costly to do so.
(d) none of the above are true.
Answer: B
Question Status: Previous Edition

53) If market participants notice that a variable behaves differently now than in the past, then, according to rational expectations theory, we can expect market participants to
(a) change the way they form expectations about future values of the variable.
(b) begin to make systematic mistakes.
(c) no longer pay close attention to movements in this variable.
(d) give up trying to forecast this variable.
Answer: A
Question Status: Previous Edition

54) The assumption that people make the best economic forecast they can, given the information available to them at the time, is called the
(a) adaptive expectations hypothesis.
(b) Lucas critique.
(c) Ricardian equivalence theorem.
(d) rational expectations theory.
Answer: D
Question Status: Revised

55) According to rational expectations,
(a) expectations of inflation are viewed as being an average of past inflation rates.
(b) expectations of inflation are viewed as being an average of expected future inflation rates.
(c) expectations formation indicates that changes in expectations occur slowly over time as past data change.
(d) expectations will not differ from optimal forecasts using all available information.
Answer: D
Question Status: Previous Edition

56) According to rational expectations,
(a) people often change their expectations quickly when faced with new information.
(b) people will use more information than just past data on a single variable to form their expectations of that variable.
(c) expectations will not differ from optimal forecasts (the best guess of the future) using all available information.
(d) all of the above are true.
(e) only (a) and (b) of the above are true.
Answer: D
Question Status: Previous Edition
57) According to rational expectations,
   (a) people will use more information than just past data on a single variable to form their expectations of that variable.
   (b) expectations will not differ from optimal forecasts (the best guess of the future) using all available information.
   (c) because people use all available information, the prediction represented by the expectation will always be perfectly accurate.
   (d) all of the above are true.
   (e) only (a) and (b) of the above are true.

   Answer: E
   Question Status: Revised

58) According to rational expectations,
   (a) expectations will not differ from optimal forecasts using all available information.
   (b) because people use all available information, the prediction represented by the expectation will always be perfectly accurate.
   (c) the forecast using all available information must be correct on average.
   (d) only (a) and (b) of the above are true.
   (e) only (a) and (c) of the above are true.

   Answer: E
   Question Status: Previous Edition

59) Which of the following statements are true about rational expectations?
   (a) The evidence from studies using survey data is not as supportive of rational expectations as is the evidence from financial markets.
   (b) Survey evidence does indicate that if there is a change in the way a variable moves, then the way expectations of this variable are formed will change as well.
   (c) The stock market crash of 1987 indicates that the efficient markets hypothesis is not a valid theory.
   (d) All of the above.
   (e) Only (a) and (b) of the above.

   Answer: E
   Question Status: Previous Edition

60) Announcements of money supply increases in countries experiencing rapid rates of inflation are often followed by immediate interest rate increases. This behavior is consistent with which of the following?
   (a) Expectations of higher inflation in the near future
   (b) A tight current monetary policy
   (c) Rational expectations
   (d) Both (a) and (b) of the above
   (e) Both (a) and (c) of the above

   Answer: E
   Question Status: Study Guide
61) You observe that interest rates fall after an announcement by the Federal Reserve that the money supply has expanded over the past week. You might speculate that
(a) market participants expect a surge in inflation in the next few months.
(b) market participants don’t expect inflation to surge any time soon.
(c) the efficient markets hypothesis has been refuted.
(d) both (a) and (c) of the above are true.
Answer: B
Question Status: Revised

62) You observe that interest rates rise after an announcement by the Federal Reserve that the money supply has expanded over the past week. You might speculate that
(a) market participants expect a surge in inflation in the next few months.
(b) market participants do not expect inflation to surge anytime soon.
(c) the efficient markets hypothesis has been refuted.
(d) none of the above are true.
Answer: A
Question Status: Revised

63) You observe that both short-term and long-term interest rates fall after an announcement by the Federal Reserve that the money supply has expanded over the past week. You might speculate that
(a) market participants expect a surge in inflation in the next few months.
(b) the efficient markets hypothesis has been refuted.
(c) market participants do not expect a surge in inflation in the next few months.
(d) both (a) and (b) of the above are true.
Answer: C
Question Status: Revised

64) You observe that both short-term and long-term interest rates rise after an announcement by the Federal Reserve that the economy appears to be growing rapidly. You might speculate that
(a) market participants expect a surge in inflation in the next few months.
(b) the efficient markets hypothesis has been refuted.
(c) market participants do not expect a surge in inflation in the next few months.
(d) both (b) and (c) of the above are true.
Answer: A
Question Status: Revised

65) You observe that both short-term and long-term interest rates rise after an announcement by the Federal Reserve that the economy appears to be growing rapidly. You might speculate that
(a) market participants expect a surge in inflation in the next few months.
(b) the efficient markets hypothesis has been refuted.
(c) market participants expect the Fed to increase the money supply more rapidly to lower interest rates.
(d) both (a) and (c) of the above are true.
Answer: A
Question Status: Revised
66) Expectations of _____ have a major impact on bond prices and interest rates through the _____
effect.
(a) money growth; Fisher
(b) money growth; Pigou
(c) inflation; Fisher
(d) inflation; Pigou
Answer: C
Question Status: Previous Edition

67) Expectations about the likelihood of _____ are probably the most important factors in determining
the _____ structure of interest rates.
(a) bankruptcy; time
(b) bankruptcy; risk
(c) inflation; time
(d) inflation; risk
Answer: B
Question Status: Previous Edition

68) Expectations play a key role in the theory of asset demand and the determination of interest rates.
According to the _____ effect interest rates _____ when money growth _____.
(a) Fisher; rise; increases
(b) Fisher; fall; increases
(c) Fisher; rise; decreases
(d) Pigou; rise; increases
(e) Pigou; fall; decreases
Answer: A
Question Status: Previous Edition

69) Expectations play a key role in the theories that attempt to explain the risk and term structure of
interest rates. For example, expectations of future _____ interest rates play a central role in the
determination of _____ interest rates.
(a) short-term; long-term
(b) long-term; short-term
(c) market; government
(d) government; market
Answer: A
Question Status: Previous Edition

70) The theory of rational expectations, when applied to financial markets, is known as
(a) monetarism.
(b) the efficient markets hypothesis.
(c) the theory of strict liability.
(d) the theory of impossibility.
Answer: B
Question Status: Revised
71) The efficient markets hypothesis
   (a) is an application of rational expectations to the pricing of financial securities.
   (b) is based on the assumption that prices of securities fully reflect all available information.
   (c) holds that the expected return on a security equals the equilibrium return.
   (d) holds that all of the above are true.
   (e) holds that only (a) and (b) of the above are true.
   Answer: D
   Question Status: Previous Edition

72) Another way to state the efficient markets condition is: in an efficient market,
   (a) unexploited profit opportunities will be quickly eliminated.
   (b) unexploited profit opportunities will never exist.
   (c) arbitrageurs guarantee that unexploited profit opportunities never exist.
   (d) both (a) and (c) of the above occur.
   Answer: A
   Question Status: Revised

73) According to the efficient markets hypothesis, the current price of a financial security:
   (a) is the discounted net present value of future interest payments.
   (b) is determined by the highest successful bidder.
   (c) fully reflects all available relevant information.
   (d) is a result of none of the above.
   Answer: C
   Question Status: Revised

74) According to the efficient markets hypothesis, the best strategy for betting on an athletic tournament,
   such as the NCAA basketball tournaments, is to
   (a) randomly pick the winners in each round.
   (b) watch as many games as possible on television so you are as well informed as the “experts.”
   (c) select the teams by your favorite mascots.
   (d) select the highest seeded team to win each round.
   (e) always select the underdog to win.
   Answer: D
   Question Status: New

75) During the past decade, the average rate of monetary growth has been 5%, and the average inflation
   rate has been 5%. If the Federal Reserve announces that the new rate of monetary growth will be
   10%, the rational expectation forecast of inflation will be
   (a) 5%.
   (b) between 5 and 10%.
   (c) less than 5%.
   (d) 10%.
   (e) more than 10%.
   Answer: D
   Question Status: New
76) If the optimal forecast of the return on a security exceeds the equilibrium return, then:
(a) the market is inefficient.
(b) an unexploited profit opportunity exists.
(c) the market is in equilibrium.
(d) only (a) and (b) of the above are true.
(e) only (b) and (c) of the above are true.
Answer: D

77) The efficient markets hypothesis suggests that if an unexploited profit opportunity arises in an
efficient market,
(a) it will tend to go unnoticed for some time.
(b) it will be quickly eliminated.
(c) financial analysts are your best source of this information.
(d) prices will reflect the unexploited profit opportunity.
Answer: B

78) Another way to state the efficient markets condition is: in an efficient market,
(a) unexploited profit opportunities will never exist as market participants ensure that they are
instantaneously dissipated.
(b) unexploited profit opportunities will not exist for long, as market participants will act quickly to
eliminate them.
(c) every financial market participant must be well informed about securities.
(d) only (a) and (c) of the above.
Answer: B

79) Financial markets quickly eliminate unexploited profit opportunities through
(a) changes in dividend payments.
(b) changes in tax laws.
(c) changes in asset prices.
(d) accounting conventions.
(e) changes in monetary policy.
Answer: C

80) Assume you own a ranch and graze your cattle on land leased from the Bureau of Land Management
(BLM) at a price below the equilibrium price. If the price for leasing the BLM land increases, the
value of your ranch will
(a) fall since ranching is no longer profitable.
(b) be unaffected, since the value of the land does not depend on the price of grazing rights.
(c) rise since the value of BLM land rises.
(d) rise since the value of BLM land falls.
Answer: A
81) Since the efficient market hypothesis assumes that all relevant, publicly available information is discounted in asset price as soon as it is released
(a) investors cannot construct systematically profitable trading rules based only on this information.
(b) investors have no incentive to buy stock based on favorable information, since the market will have already discounted it.
(c) investors have an incentive to buy stock based on favorable information, since the market takes time to discount it.
(d) both (a) and (b) of the above.
(e) both (a) and (c) of the above
Answer: D
Question Status: Study Guide

82) The number and availability of discount brokers has grown rapidly since the mid-1970s. The efficient markets hypothesis predicts that people who use discount brokers
(a) will likely earn lower returns than those who use full-service brokers.
(b) will likely earn about the same as those who use full-service brokers, but will net more after brokerage commissions.
(c) are going against evidence suggesting that full-service brokers can help outperform the market.
(d) are likely to be poor.
(e) are likely to outperform the market by a wide margin.
Answer: B
Question Status: Study Guide

83) If a mutual fund outperforms the market in one period, evidence suggests that this fund is
(a) highly likely to consistently outperform the market in subsequent periods due to its superior investment strategy.
(b) likely to under-perform the market in subsequent periods to average its overall returns.
(c) not likely to consistently outperform the market in subsequent periods.
(d) not likely to outperform the market in any subsequent period.
(e) not likely to under-perform the market in any subsequent period.
Answer: C
Question Status: Study Guide

84) Studies of mutual fund performance indicate that mutual funds that outperformed the market in one time period
(a) usually beat the market in the next time period.
(b) usually beat the market in the next two subsequent time periods.
(c) usually beat the market in the next three subsequent time periods.
(d) usually do not beat the market in the next time period.
Answer: D
Question Status: Previous Edition
85) Sometimes one observes that the price of a company’s stock falls after the announcement of favorable earnings. This phenomenon is
(a) clearly inconsistent with the efficient markets hypothesis.
(b) consistent with the efficient markets hypothesis if the earnings were not as high as anticipated.
(c) consistent with the efficient markets hypothesis if the earnings were not as low as anticipated.
(d) consistent with the efficient markets hypothesis if the favorable earnings were expected.
Answer: D
Question Status: Previous Edition

86) According to the efficient markets hypothesis
(a) one cannot expect to earn an abnormally high return by purchasing a security.
(b) information in newspapers and in the published reports of financial analysts is already reflected in market prices.
(c) unexploited profit opportunities abound, thereby explaining why so many people get rich by trading securities.
(d) all of the above are true.
(e) only (a) and (b) of the above are true.
Answer: E
Question Status: Revised

87) Important implications of the efficient markets hypothesis include:
(a) future changes in stock prices should, for all practical purposes, be unpredictable.
(b) stock prices will respond to announcements only when the information in these announcements is new.
(c) sometimes a stock price declines when good news is announced.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Revised

88) You read a story in the newspaper announcing the proposed merger of Dell Computer and Gateway. The merger is expected to greatly increase Gateway’s profitability. If you decide to invest in Gateway stock, you can expect to earn
(a) above average returns since you will share in the higher profits.
(b) above average returns since your stock price will definitely appreciate as higher profits are earned.
(c) below average returns since computer makers have low profit rates.
(d) a normal return since stock prices adjust to reflect expected changes in profitability almost immediately.
(e) none of the above.
Answer: D
Question Status: Study Guide
89) Assume a stock’s price falls after higher quarterly profits are announced. This occurrence is
(a) clearly inconsistent with the efficient markets hypothesis.
(b) possible if market participants expected lower profits.
(c) consistent with the efficient markets hypothesis.
(d) not possible.
Answer: C
Question Status: Study Guide

90) That favorable earning reports do not always result in increases in stock prices suggests that
(a) the stock market is not efficient.
(b) people trading stocks sometimes incorrectly estimate companies’ earnings.
(c) stock prices tend to be unbiased measures of future corporate earnings.
(d) all of the above are true.
(e) both (a) and (c) of the above are true.
Answer: B
Question Status: Study Guide

91) To say that stock prices follow a “random walk” is to argue that
(a) stock prices rise, then fall, then rise again.
(b) stock prices rise, then fall in a predictable fashion.
(c) stock prices tend to follow trends.
(d) stock prices cannot be predicted based on past trends.
Answer: D
Question Status: Previous Edition

92) To say that stock prices follow a “random walk” is to argue that
(a) stock prices rise, then fall.
(b) stock prices rise, then fall in a predictable fashion.
(c) stock prices tend to follow trends.
(d) stock prices are, for all practical purposes, unpredictable.
Answer: D
Question Status: Previous Edition

93) The efficient markets hypothesis predicts that stock prices follow a “random walk.” The implication
of this hypothesis for investing in stocks is
(a) a “churning strategy” of buying and selling often to catch market swings.
(b) turning over your stock portfolio each month, selecting stocks by throwing darts at the stock
page.
(c) a “buy and hold strategy” of holding stocks to avoid brokerage commissions.
(d) following the advice of technical analysts.
(e) to do none of the above.
Answer: C
Question Status: Study Guide
94) At times stockbrokers have paid newspaper reporters for information about future articles. This behavior suggests that
(a) your stockbroker’s hot tips will help you outperform the market.
(b) financial analysts’ reports contain information that will help you outperform the market.
(c) insider information may help ensure returns that exceed the market average.
(d) each of the above is true.
(e) both (a) and (c) of the above are true.
Answer: C
Question Status: Study Guide

95) Rules used to predict movements in stock prices based on past patterns are, according to the efficient markets hypothesis,
(a) a waste of time.
(b) profitably employed by all financial analysts.
(c) the most efficient rules to employ.
(d) consistent with the random walk hypothesis.
Answer: A
Question Status: Previous Edition

96) Tests used to rate the performance of rules developed in technical analysis conclude that
(a) technical analysis outperforms the overall market.
(b) technical analysis far outperforms the overall market, suggesting that stockbrokers provide valuable services.
(c) technical analysis does not outperform the overall market.
(d) technical analysis does not outperform the overall market, suggesting that stockbrokers do not provide services of any value.
Answer: C
Question Status: Previous Edition

97) Which of the following accurately summarize the empirical evidence about technical analysis?
(a) Technical analysts fare no better than other financial analysis—on average they do not outperform the market.
(b) Technical analysts tend to outperform other financial analysis, but on average they nevertheless under-perform the market.
(c) Technical analysts fare no better than other financial analysis, and like other financial analysts they outperform the market.
(d) Technical analysts fare no better than other financial analysis, and like other financial analysts they under-perform the market.
Answer: A
Question Status: Previous Edition
98) The small-firm effect refers to the
   (a) lower than average returns earned by small firms.
   (b) fact that small firms earn returns equal to large firms.
   (c) abnormally high returns earned by small firms.
   (d) fact that small firms earn low returns after adjusting for risk.
   (e) fact that small firms generally earn negative returns.
   Answer: C
   Question Status: New

99) The January effect refers to
   (a) the fact that most stock market crashes have occurred in January.
   (b) the fact that stock prices tend to fall in January.
   (c) the fact that stock prices have historically experienced abnormal price increases in January.
   (d) the fact the football team winning the Super Bowl accurately predicts the behavior of the stock market for the next year.
   (e) the fact that stock prices are excessively volatile only in the month of January.
   Answer: C
   Question Status: New

100) A phenomenon closely related to market overreaction is
    (a) the random walk.
    (b) the small-firm effect.
    (c) the January effect.
    (d) mean reversion.
    (e) excessive volatility.
    Answer: E
    Question Status: New

101) Excessive volatility refers to the fact that
    (a) stock returns display mean reversion.
    (b) stock prices can be slow to react to new information.
    (c) stock price tend to rise in the month of January.
    (d) stock prices fluctuate more than is justified by dividend fluctuations.
    (e) all of the above.
    Answer: D
    Question Status: New

102) Mean reversion refers to the fact that
    (a) small firms have higher than average returns.
    (b) stocks that have had low returns in the past are more likely to do well in the future.
    (c) stock returns are high during the month of January.
    (d) stock prices fluctuate more than is justified by fundamentals.
    (e) markets overreact.
    Answer: B
    Question Status: New
103) Evidence in support of the efficient markets hypothesis includes
(a) the failure of technical analysis to outperform the market.
(b) the small-firm effect.
(c) the January effect.
(d) excessive volatility.
(e) all of the above.
Answer: A
Question Status: New

104) Evidence against market efficiency includes
(a) failure of technical analysis to outperform the market.
(b) the random walk behavior of stock prices.
(c) the inability of mutual fund managers to consistently beat the market.
(d) the January effect.
(e) all of the above.
Answer: D
Question Status: New

105) Evidence against market efficiency includes
(a) the January effect.
(b) the excessive volatility of stock prices.
(c) the random walk behavior of stock prices.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: E
Question Status: New

106) Evidence against market efficiency includes
(a) the January effect.
(b) the small-firm effect.
(c) the excessive volatility of stock prices.
(d) all of the above.
(e) both (a) and (c) of the above.
Answer: D
Question Status: New

107) The efficient markets hypothesis suggests that allocating your funds in the financial markets on the advice of a financial analyst
(a) will certainly mean higher returns than if you had made selections by throwing darts at the financial page.
(b) will always mean lower returns than if you had made selections by throwing darts at the financial page.
(c) is not likely to prove superior to a strategy of making selections by throwing darts at the financial page.
(d) is good for the economy.
Answer: C
Question Status: Previous Edition
According to the efficient markets hypothesis, purchasing the reports of financial analysts
(a) is likely to increase one’s returns by an average of 10%.
(b) is likely to increase one’s returns by about 3 to 5%.
(c) is not likely to be an effective strategy for increasing financial returns.
(d) is likely to increase one’s returns by an average of about 2 to 3%.
(e) guarantees negative returns.
Answer: C

Which of the following types of information most likely allows the exploitation of a profit
opportunity?
(a) Financial analysts’ published recommendations
(b) Technical analysis
(c) Hot tips from a stockbroker
(d) Insider information
Answer: D

Which of the following types of information most likely allows the exploitation of a profit
opportunity?
(a) Financial analysts’ published recommendations
(b) Technical analysis
(c) Hot tips from a stockbroker
(d) Newspaper articles
(e) None of the above
Answer: E

Which of the following types of information most likely allows the exploitation of a profit
opportunity?
(a) Financial analysts’ published recommendations
(b) Hot tips from a stockbroker
(c) Insider information
(d) All of the above
(e) Both (b) and (c) of the above
Answer: C
113) Although the verdict is not yet in, the available evidence indicates that, for many purposes, the efficient markets hypothesis is
   (a) a good starting point for analyzing expectations.
   (b) not a good starting point for analyzing expectations.
   (c) too general to be a useful tool for analyzing expectations.
   (d) none of the above.
   Answer: A
   Question Status: Revised

114) The advantage of a “buy-and-hold strategy” is that
   (a) net profits will tend to be higher because there will be fewer brokerage commissions.
   (b) losses will eventually be eliminated.
   (c) the longer a stock is held, the higher will be its price.
   (d) only (b) and (c) of the above are true.
   Answer: A
   Question Status: Previous Edition

115) For small investors, the best way to pursue a “buy and hold” strategy is to
   (a) buy and sell individual stocks frequently.
   (b) buy no-load mutual funds with high management fees.
   (c) buy no-load mutual funds with low management fees.
   (d) buy load mutual funds.
   (e) learn technical analysis.
   Answer: C
   Question Status: New

116) The efficient markets hypothesis indicates that
   (a) investors should not try to outguess the market by constantly buying and selling securities.
   (b) investors do better on average if they adopt a “buy and hold” strategy.
   (c) buying into a mutual fund is a sensible strategy for a small investor.
   (d) all of the above are sensible strategies.
   (e) only (a) and (b) of the above are sensible strategies.
   Answer: D
   Question Status: Revised

117) The efficient markets hypothesis suggests that
   (a) investors can use the advice of technical analysts to outperform the market.
   (b) investors let too many unexploited profit opportunities go by if they adopt a “buy and hold” strategy.
   (c) buying into a mutual fund is a sensible strategy for a small investor.
   (d) only (b) and (c) of the above are sensible strategies.
   Answer: C
   Question Status: Revised
118) The efficient markets hypothesis indicates that
   (a) investors can use the advice of technical analysts to outperform the market.
   (b) investors do better on average if they adopt a “buy and hold” strategy.
   (c) investors let too many unexploited profit opportunities go by if they adopt a “buy and hold” strategy.
   (d) investors do better if they purchase loaded mutual funds.
   Answer: B
   Question Status: Revised

119) The efficient markets hypothesis suggests that
   (a) investors should purchase no-load mutual funds which have low management fees.
   (b) investors can use the advice of technical analysts to outperform the market.
   (c) investors let too many unexploited profit opportunities go by if they adopt a “buy and hold” strategy.
   (d) only (a) and (b) of the above are sensible strategies.
   Answer: A
   Question Status: Revised

120) The efficient markets hypothesis suggests that
   (a) incorrectly valued assets are quickly discovered and traded until their prices reflect their correct underlying value.
   (b) most investors will not earn excess returns from paying for technical market analysis.
   (c) “buy and hold” a well-diversified portfolio of securities is the best strategy for most investors.
   (d) all of the above are true.
   (e) both (a) and (c) of the above are true.
   Answer: D
   Question Status: Study Guide

121) The behavior of which asset price(s) supports the efficient markets hypothesis?
   (a) Stocks
   (b) Bonds
   (c) Exchange rates
   (d) All of the above
   (e) Both (a) and (b) of the above.
   Answer: D
   Question Status: New

122) The tech stock crash of 2000 is evidence in support of
   (a) the efficient markets hypothesis.
   (b) a rational bubble.
   (c) rational expectations.
   (d) all of the above.
   (e) both (a) and (c) of the above.
   Answer: B
   Question Status: New
123) A situation when an asset price differs from its fundamental value is a(n)
(a) random walk.
(b) inflation.
(c) deflation.
(d) efficient market.
(e) bubble.
Answer: E
Question Status: New

124) In a rational bubble, investors can have
(a) irrational expectations.
(b) adaptive expectations.
(c) rational expectations.
(d) myopic expectations.
(e) autoregressive expectations.
Answer: C
Question Status: New

■ Essay Questions

1) Explain the Gordon growth model of stock pricing. Explain how changes in each component affect the current stock price. On what assumptions is the model based?

Answer: The basic model is
\[ P_0 = \frac{D_1}{k_e - g} \]
where
\[ P_0 = \text{the current stock price} \]
\[ D_1 = \text{the next period’s dividend} \]
\[ k_e = \text{the required rate of return} \]
\[ g = \text{the dividend growth rate} \]
Increases in the dividend or the dividend growth rate increase the stock price, while an increase in the required rate of return lowers the stock price.
The two assumptions that are the basis of the model are that dividends are assumed to grow at a constant rate, and that the dividend growth rate is less than the required rate of return.
2) Assume that your economics professor announces to your class that after thirty years of giving exams only on scheduled dates, this semester she will give only surprise quizzes. What is the rational expectation response to this new policy? Why does your self-interest require that you change your behavior? What would the consequences be for students who changed their expectations about exams adaptively?

Answer: Instead of being able to study for exams on known dates, students must now be prepared for an exam at any possible time. Students must study regularly, before each class. Self-interest dictates that students change their behavior, as their grade depends upon it. Students who change their behavior adaptively don’t adjust until they have experienced one or more surprise quizzes, which in all likelihood hurt their grades.

3) List and explain three examples of evidence in favor of the efficient markets hypothesis, and three examples of evidence against market efficiency.

Answer: Supporting evidence, any three:
Investment analysts and mutual funds cannot consistently outperform the market.
Announcements of publicly available information do not affect stock prices.
Stock price follow a random walk, that is, future prices are unpredictable.
Technical analysis cannot generate superior returns.

Evidence against market efficiency, any three:
The small-firm effect, whereby small firms earn abnormally high returns.
The January effect, where stocks earn abnormally high returns in January.
Stock prices overact to news announcements.
Stock prices are excessively volatile relative to fundamentals.
Stock returns display mean reversion, where stocks earning low returns today tend to have high returns in the future, and vice versa.
Stock prices adjust rapidly, but not instantaneously to profit announcements.
Stock market crashes and bubbles are evidence against the strong form of the efficient markets hypothesis, and may be evidence against market efficiency in general.