BS2551 Money Banking and Finance

Seminar 1 Solutions

A) The trading profit of the 3%, does not encounter for the trading costs. If the profit is greater then the trading cost then EMH is violated. If its less then 3%, EMH is also violated. If its equal to 3% then EMH holds.

B) The EMH holds. This is because if the stock market has a positive return, investors will make profits. Some investors earning more then others implies that they invest in stocks with higher uncertainty, which is encountered by greater returns.

C) EMH is violated. This is because a positive return is due to an anomaly in the stock market that enables investors to make abnormal profits above trading costs.

2) In the long run the market corrects itself due to arbitrage, implying that the EMH holds. In the short term arbitrage occurs until the market corrects itself. Arbitrage is defined as riskless profit, if arbitrage can be still be made after the inclusion of trading costs then EMH is violated in the short run.

3) If markets are efficient NPV=0, because once risk has been accounted for and stocks are priced correctly the NPV must be zero, since it saying that you get what you pay for.