Watson French
WEALTH MANAGEMENT

Term of the Week- Efficient Market Hypothesis (EMH)

The efficient market hypothesis is a key theory in finance and the basis of the theory is that all information is priced into markets as soon as it becomes available, and therefore it is not possible to consistently outperform the market over the long term.

There are different forms of the theory for which academic research has demonstrated varying degrees of evidence.

Weak-form suggests that investors cannot use technical analysis (studying chart and price patterns) to outperform the market; semi-weak form suggests investors cannot use fundamental analysis (studying companies' financial statements and business operations) to outperform; and finally, strong form says all public and private information is accounted for in a stock price and it is not possible to outperform the market.

A believer in the EMH would therefore only use index tracking funds in their portfolio and to generate higher returns, their only option is to invest in riskier investments.

There are various drawbacks of the theory – firstly by example, in that investors like Warren Buffett have consistently outperformed the market over the long term, and market bubbles have inflated prices in the past and subsequently burst (something which should not happen in an efficient market).

Some markets are more efficient than others due to factors such as availability of information, liquidity, regulation, laws and capital controls, and transaction costs.

For example, emerging markets are less efficient than, say, the US equity market because liquidity is lower and there is a greater asymmetry of information in emerging markets. Those who can access this information therefore have a greater advantage than those that cannot and can take advantage of price discrepancies in the indices.

This theory is particularly important at the present time due to the rise, and ease, of retail investors accessing the stock market. The psychological behaviour known as herding is more common with retail investors as they may have less market knowledge than institutions. We saw during April and May global stock markets, the US in particular, fell on the announcement of President Trump's tariff announcements, and subsequently recovered these losses over the next month, despite elevated downside risk and questions over valuations.

Institutional investors have not fully returned to the market and much of this rise was driven by retail investors ‘buying the dip’. With retail investors spending a median time of just six minutes of research before buying a stock (research by professors Toomas Laarits and Jeffrey Wurgler at New York University’s Stern School of Business), the efficient market hypothesis is once again under question.

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May 2025
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