

Solution

1. In an efficient market, which of the following should happen when good news hits the market?
 - a. Stock prices should not change. In an efficient market, the news is already impounded in the price.
 - b. Stock prices should jump on the news announcement and be flat thereafter.**
 - c. Stock prices should jump on the news announcement and continue to drift up in the periods after.
 - d. Stock prices should jump on the news announcement but then reverse themselves and drift down.
 - e. Stock prices should drop on the news announcement.

Explanation: In an efficient market, there should be a price reaction to new information but there should be no drifts in the price before or after the announcement.

2. If you notice that prices start drifting up before good news reaches the market, what would you view it as a sign of?
 - a. An efficient market that starts impounding information into prices even before the information is public.
 - b. A slow learning market, because drifts are consistent with slow learning.
 - c. A market where insiders are trading ahead of information, legally or otherwise.**

Explanation: Insider trading is most cynical and most likely explanation for the prices drifting before the announcement.

3. If you want to try to trade ahead of news announcements, which of the following variables will you need to track?
 - a. Trading volume on the stock
 - b. Stock prices
 - c. Activity in options listed on the stock
 - d. Earnings revisions and recommendations from analysts
 - e. All of the above**

Explanation: You are looking for anything that may indicate that insiders are trading ahead of information. Trading volume and option activity are therefore good places to start and that activity will cause prices to blip up. Analysts who are close to the action may also be getting inklings of the news that is yet to come and revising their numbers (and recommendations).

4. If you believe that markets over react to news, which of the following actions would you take to generate excess returns?
 - a. Buy immediately if stock prices jump significantly on a news announcement.

- b. **Buy immediately if stock prices drop significantly on a news announcement.**
- c. Buy immediately if stock prices are flat on a news announcement.

Explanation: If investors over react, the stock price should drop too much after bad news, thus making the stock a good investment for a contrarian investor.

5. If you believe that the market price for an asset has adjusted appropriately to a news announcement, but you feel that the volatility has increased too much (given the news), which of the following volatility trading strategies would you adopt?
- a. Buy the stock
 - b. Sell short on the stock
 - c. Buy options on the stock, while minimizing price exposure.
 - d. **Sell options on the stock, while minimizing price exposure.**

Explanation: If you believe that the variance/volatility built into the market is too high, options will be over valued. You should therefore sell options, minimizing your price exposure (since you are not making a price bet) by selling calls and puts on the stock (a straddle) at the same time.