Chapter 27
Efficient Market Hypothesis for Islamic Capital Markets

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ABSTRACT

This study has two important findings firstly, the theoretical results related to the efficient market hypothesis; and secondly, the results of application. The theoretical results show that if the market price of an asset includes all the information that influences its price, then that market is an efficient market. According to the efficient market hypothesis, investors cannot earn gains above the market return. Since stock share prices are unpredictable, it is assumed that when the information that the market had already been expecting is finally announced, the stock share prices will not change. That is because this announcement does not contain any information that can change the prices. The results obtained from the application show that the existence of abnormal return is valid for Islamic Stock Markets. Therefore, the findings mediate against the efficient market hypothesis. However, when the size of abnormal returns is observed, the results are almost equal to market returns. This finding supports the efficient market hypothesis. Islamic stock markets are integrated with the world at least as much as the non-Islamic global markets are. Islamic stock markets act together with the non-Islamic global markets. The risks and returns that the Islamic and non-Islamic stock markets provide to the investors are very close to each other. In conclusion, the efficient market hypothesis maintains its explanatory power for both Islamic stock markets and non-Islamic global stock markets. Islamic markets offer new investment opportunities on a global scale.

INTRODUCTION

One of the foremost research subjects of finance is the analysis of price movements experienced in the stock share market. When one invests in a stock share, two types of gains are expected: First is the dividend at the end of the period, and the second is the capital gain due to stock share price increase. As it is true both for whole financial and non-financial assets, stock share price is dependent upon cash
flow that is expected to be generated in the future. Whether it be a stock share price’s current value or another asset’s current price, it is calculated by the cash flows that are expected to be generated in the future (with an appropriate discount rate). The importance of current price calculation is that it enables an investor to decide whether or not to invest. The investor will decide to buy the low-priced asset if its current value (calculated according to this method) is below the market value of the asset, or else the investor will decide to keep it if he or she already has this asset. Otherwise, the investor will make the decision to sell a high-priced asset. Independent of the direction of the decision, in actuality the investor is buying the expectation.

When this approach is considered from the aspect of financial assets, there are no assets in which expectations hold importance. Therefore, it is important to know how those expectations are formed. The fundamentals of how expectations are formed lie in the theory of rational expectations. According to this theory, when available information is used fully, the expectations will be optimally realized. The source of expectations is previous experience. The Efficient Market Hypothesis (EMH) is a version of the theory of rational expectations incorporated into the domain of financial markets. According to the efficient market hypothesis, the prices of financial assets reflect the total information available. When new information arrives to a market, asset prices quickly achieve a state of balance again. What enables this is the arbitrage mechanism.

In the beginning, the first findings supported the efficient market hypothesis. However, later studies provided proof that this hypothesis is not always true. One of the first proofs that supported the efficient market hypothesis is the claim that investors cannot achieve a gain above the market return. The second is that the stock share prices do what is termed a random walk. In such a case, the stock share prices cannot be guessed. The third is that achieving a gain above the market return is totally dependent on chance. The fourth is that if there is an efficient market, then technical analysis is but a waste of time.

Despite all this, one of the first proofs against efficient market hypothesis was the observation that small companies achieve gains above the market return. The second is that in the period between December to January, stock share prices provide a gain above the market return. The third is that in certain periods, stock share markets experience extreme volatility. The fourth is the observation that the shares that perform bad perform better in the future, whereas the shares with good performance perform worse in the future. The final proof is that each new piece of information arriving into the market does not have an immediate effect on prices. Therefore, in periods that experience such cases, the stock share return will be above the market return. In other words, the investor will achieve an abnormal return.

The scope of this study is the validity of the efficient market hypothesis. This is subject to diverse discussions regarding Islamic markets and the definition of possible price anomalies in these markets. For this purpose, the relationship between the Islamic stock market exchanges of five important countries (Qatar, Turkey, Saudi Arabia, Egypt, and Jordan) and stock exchanges from non-Islamic global markets (the USA, Germany, Japan, Australia, Israel, and the BRIC countries) is explained. The results are shared in the model analysis.
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