**Testing the Weak Form Efficient Market Hypothesis: An Interpretive Study of Market Efficiency via Literary Lens**

# Abstracts

The Efficient Market Hypothesis (EMH.) is among conventional finance's most hotly contested topics. Eugene Fama first put forth this theory in 1965; it holds that no investor can make excess profit without engaging in high-risk assets since the stock prices rapidly reflect all the information instantly. Many studies have challenged the idea of EMH since it is not only the rationality of investors on which investors founded the judgements but also other elements like individual and personal opinions, behaviour, and heuristics that affect their decisions. Market anomalies, like bubbles, crashes, momentum, and calendar impacts, have consistently challenged the core idea of EMH. This paper aims to investigate the validity of a weak form of efficient market hypothesis in the modern environment by extensively analysing empirical findings from several research projects. By examining foundational works supporting and contradicting the theory, this study aims to investigate the paradox: if markets are efficient, why do irrational events like bubbles and crashes exist? Our results imply that although Weak Form EMH is a good theoretical framework, it does not take into account behavioural biases, constraints to arbitrage, or changing market dynamics in the current situation.

**Keywords:** Behavioural Finance, Random Walk Theory, Effective Market Hypothesis (EMH), Momentum Effect, Adaptive Market Hypothesis (AMH)

1. **Introduction**

The Efficient Market Hypothesis (EMH), introduced by economist Eugene Fama in 1970, fundamentally changed our comprehension of financial markets by proposing that asset prices immediately absorb and reflect all available information [17,18]. This view holds that markets naturally neutralise any informational advantage, so investors cannot regularly generate excessive returns. EMH separates three degrees of market efficiency [19,20]:

* **Weak Form Efficiency**: Asset prices completely account for historical data, including prior trading volumes and price swings. This assumption makes technical analysis based on previous data trend identification useless since price changes follow a random walk. In other words, future price changes are statistically random and unrelated to historical trends.
* **Semi-Strong form Efficiency**: Prices quickly change to reflect all publicly available data, including news events, economic indicators, and earnings reports. Under this situation, as markets absorb fresh data almost instantly, neither technical chart analysis nor basic valuation techniques (evaluating corporate financials) can consistently produce excess profits.
* **Strong Form Efficiency**: The most extreme version implies prices reflect every kind of information, even private insider knowledge. This hypothesis assumes that markets run with perfect rationality; in this case, all players—retail investors, institutions, and corporate insiders—act as precisely informed "rational agents," removing any arbitrage opportunity to earn excess profit.

**Figure**-1: **Efficient Market Hypothesis**

Credit: Prepared by the researcher

However, multiple pieces of evidence are visible against these perfect presumptions in the real practical world. For example, while the 2008 Global Financial Crisis exposed terrible mispricing of mortgage-backed securities, the Dot-com bubble of the 1990s saw tech stocks soar despite a lack of earnings. Assets like Bitcoin still show erratic price movements (e.g., 80% declines in months), challenging logical explanations. Such events strike our minds with a few important questions: Why do speculative bubbles develop even if markets are very efficient? Why do collisions and market crashes happen so often?

This research work attempts to investigate whether structural constraints (e.g., transaction costs, information asymmetry) and behavioural biases, such as herd mentality, overconfidence, etc., cause exploitable patterns or if stock prices follow randomness. By aggregating seminal research works, their empirical findings and theoretical criticisms, this paper aims to assess whether Weak Form EMH remains a valid framework or if changing market dynamics need a paradigm shift. Ultimately, it tries to balance the theoretical grace of EMH with the chaotic reality of financial markets, in which both reason and irrationality coexist.

1. **Research Objectives**
2. Analyse empirical data for/against Weak Form EMH critically.
3. Examine the behavioural and theoretical justifications for market oddities.
4. Sort the conundrum of efficiency vs irrationality.
5. **Review of the literature: Argument in Favour of Weak Form EMH**

This section integrates foundational theoretical and empirical efforts, from early mathematical models to modern defences against behavioural arguments, that have reinforced the premise of the Weak Form Efficient Market Hypothesis (EMH), which holds that past price and volume data cannot forecast future stock returns; therefore historical analysis is pointless.

**3.1 Foundational Theories: Random Walk Origins**

Weak Form EMH's conceptual foundation is based on Louis Bachelier's revolutionary 1900 doctoral thesis, "*Théorie de la spéculation*." Analysing French government bond prices, Bachelier simulated price changes using Brownian motion, concluding that past trends had negligible predictive ability over future price movements. The random walk hypothesis holds that price fluctuations are statistically independent of past trends. After being neglected for decades, Bachelier's theories became popular in the 1960s when researchers searched for empirical models to clarify market behaviour. Paul Samuelson's article, "*Proof That Properly Anticipated Prices Fluctuate Randomly (1965)*," systematically formalised Bachelier's intuitive concepts through mathematical expressions. Samuelson used the martingale theory to show that price changes must not be predictable in an efficient market, where prices reflect all known information instantly. This theoretical advancement reinforced the connection between market efficiency and the infeasibility of continually outperforming the market via historical data analysis.

**3.2 Empirical Verification through Literature: Testing the Random Walk**

Eugene Fama, in his work "The Behaviour of Stock Market Prices” (1965), conducted a comprehensive empirical investigation of the Weak Form Efficient Market Hypothesis by examining daily returns of 30 Dow Jones Industrial Average stocks from 1957 to 1962, employing serial correlation tests to assess the relationship between past and future price movements. His results showed insignificant correlations between past and future price movements, which supported the random walk theory about stock prices. Fama concluded that technological study depending on pattern recognition in historical data is statistically meaningless. Likewise, Alfred Cowles' study, "Can Stock Market Forecasters Forecast?" (1933), validated Fama's findings. Cowles evaluated the predictive efficacy of 16 financial magazines and market analysts over a period of 4.5 years (1928–1932) by comparing their stock selections to market indices. Surprisingly, only 9% of predictions came true, and no one's predictions consistently beat the market. Cowles' study empirically established that even seasoned professionals and experts cannot consistently generate market-beating returns based on past performance analysis.

The 1973 book "A Random Walk Down Wall Street" by Burton Malkiel introduced these concepts to the general public. Using U.S. stock data from 1926 to the 1960s and analysing the efficacy of technical trading rules (e.g., moving averages, filter rules) against passive "buy-and-hold" strategies, Malkiel showed that after considering transaction costs, active trading techniques failed to outperform passive trading. His writings popularised the case for index funds, contending that rather than following false trends, average investors should welcome market efficiency.

**3.3 Modern Defence for EMH: Harmonising Anomalies**

Critics of EMH pointed towards ‘*calendar inconsistencies’* and ‘*momentum effects*’ by the late 20th century as proof against EMH. However, supporters like Eugene Fama tried to maintain the integrity of EMH and reinterpreted these anomalies inside the efficiency paradigm. Reviewing decades of anomaly studies in “*Market Efficiency, Long-Term Returns, and Behavioural Finance*” (1998), Fama contended that High momentum equities might have hidden dangers that balance their excess returns. Hence, it indicates unobserved risk variables (e.g., liquidity risk) rather than inefficiencies. The argument was further reinforced by Fama and French's 1988 paper, "Permanent and Temporary Components of Stock Prices." On U.S. stock returns (CRSP data, 1926–1985), they broke out prices into permanent (fundamental) and transient (noise) components using variance ratio tests. However, short-term pricing showed noise-driven volatility and long-term patterns returned to basics, which is consistent with Weak Form EMH's contention that past noise cannot forecast future movements. Michael Jensen attempted to strike a pragmatic balance between EMH and market anomalies in his work "Some Anomalous Evidence Regarding Market Efficiency (1978)". Examining anomalies such as the ‘Size effect’ and ‘January effect’, Jensen agreed with their existence but discounted them as statistically negligible or exploitable only with prohibitively large transaction costs. He concluded that markets were "efficient enough" for practical investing, highlighting EMH's resiliency in the face of empirical flaws.

**3.4 Synthesis: Foundation of Weak Form EMH**

Weak Form EMH contends that anomalies are either statistically minor, economically unimportant, or due to risk, not that they are absent. This structure has great ramifications since it supports passive investing and warns against the appealing attraction of technical analysis. These research works, together, create a strong case for Weak Form EMH. Bachelier and Samuelson's theoretical analysis proved the connection between randomness and efficiency. Fama, Cowles, and Malkiel showed that historical data lacks predictive ability across several datasets. Modern supporters of EMH, such as Fama (1998), see anomalies as compensation for risk rather than as the result of market failure.

The literature study emphasises that, in an era of algorithmic trading and behavioural finance, although Weak Form EMH are flawed, it remains a pillar of financial theory that shapes academic research and investment practices.

1. **Review of the Literature: Argument Against Weak Form EMH**

Although theoretically graceful, the Weak Form Efficient Market Hypothesis (EMH) has received increasing theoretical and empirical criticism over the years. By exposing systematic anomalies, behavioural biases, and structural market inefficiencies, this section critically reviews studies that challenge the EMH.

**4.1 Empirical Anomalies: Indices of Predictability**

1. **Momentum Effect**

The most significant challenge to the Weak Form Efficient Market Hypothesis emerged from Jegadeesh and Titman's 1993 study, “*Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency*.” Examining U.S. stock returns from 1965 to 1989 (CRSP database), they kept equities for three to twelve months after classifying them into deciles based on historical three to twelve-month performance. After taking the risk into account, the results were startling: prior "winner" stocks beat "losers" by about 1% every month. This momentum effect proved that past prices might forecast future returns, directly refuting the random walk theory. These anomalies continued across markets and asset classes, including foreign equities and commodities, challenging the universality of the Weak Form EMH.

1. **Mean Reversal** **Phenomenon**

The 1985 study “Does the Stock Market Overreact” by DeBondt and Thaler revealed long-term reversals in stock values. They tracked their performance for three to five years after building portfolios of extreme previous "winners" and "losers" using CRSP data from 1926 to 1982. Remarkably, loser portfolios beat winners by 25% over five years, implying that investors excessively react to news and drive prices away from fundamentals before the final correction. This mean-reversion phenomenon, where prior trends reverse, emphasises how psychology may skew price efficiency.

1. **Calendar Affects**

Calendar anomalies suggested that investors could use temporal patterns—directly challenging the randomness assumption of Weak Form EMH.

1. **January Effect (Rozeff & Kinney, 1976):** Examining monthly NYSE returns from 1904 to 1974, Rozeff and Kinney found in January that small-cap stocks produced unusual returns of 3.5% ascribed to tax-loss harvesting and window dressing by institutional investors.
2. **Weekend Effect (French, 1980):** Contrary to the concept of price independence across trading days, French’s examination of daily U.S. stock returns (1953– 1977) exposed notably negative returns on Mondays.

**4.2 Behavioural Critiques: Psychology of Irrationality**

1. **Prospect Theory (Kahneman & Tversky, 1979)**

Daniel Kahneman and Amos Tversky's Prospect Theory transformed banking by elucidating how cognitive biases skew decision-making. Their studies revealed that investors:

* Show Loss aversion psychology and overweight losses against profits.
* Anchor judgements to current pricing levels (purchasing equities close to 52-week highs).
* Show herd behaviour, hence enhancing bubbles and trends.

Under its rational-agent perspective, Weak Form EMH cannot explain the predictable price patterns created by these biases reflected in momentum and reversals.

1. **Excess Volatility (Shiller, 1981)**

Robert Shiller's landmark study of 1981, “Do Stock Prices Move Too Much to Be Justified by Subsequent Changes in Dividends?” calculated the present value of future dividends against S&P 500 values (1871–1979). He discovered that stock price volatility outpaced dividend volatility by five times, a discrepancy that rational models could not balance. Shiller's research highlighted how speculative bubbles, fuelled by irrational exuberance, cause market instability.

**4.3 Structural Constraints: Technical Analysis and Market Frictions**

1. **Technical Trading Rules (Brock et al. 1992)**

Brock, Lakonishok, and LeBaron tested stock market strategies like moving averages and support-resistance levels in their work ‘Simple Technical Trading Rules and the Stochastic Properties of Stock Returns” based on Dow Jones Industrial Average data (1897–1986). Their instructions such as, "buy when the price crosses above a 200-day moving average," produced statistically significant excess returns after they controlled for data-snooping bias using bootstrap simulations. These results directly refuted Weak Form EMH by proving mechanical principles using past data may outperform the market.

1. **Restraints on Arbitrage (Shleifer & Vishny, 1997)**

The notion of limits to arbitrage put forth by Andrei Shleifer and Robert Vishny helps to explain why mispricings endure even among logical traders. Arbitrageurs are discouraged from rectifying inefficiencies by transaction fees, short-selling restrictions, and career dangers. For instance, short-selling tech stocks were outrageously costly during the Dot-com bubble, allowing prices to stray from reality. This structural analysis brought attention to EMH's practical fragility in assumptions.

**4.4 Early Difficulties: Predictability and Filter Rules**

1. **Filter Guidelines (Alexander, 1961)**

Sidney Alexander's study based on U.S. stock data (1897–1959), “Price Movements in Speculative Markets: Trends or Random Walks,” tested filter rules (e.g., buy if a stock climbs 5% from a trough). After considering transaction expenses, he discovered that these guidelines produced annual excess returns of 1–3%, countering the random walk theory. Alexander's writings prepared the field for later technical analysis criticisms.

1. **Foreign Exchange Markets (Sweeney, 1988)**

In his work “Some New Filter Rule Tests: Methods and Results,” Richard Sweeney extended the critical analysis of EMH regarding money markets. Using daily exchange rate data (1973–1981), testing filter rules such as ‘buy if a currency gains 1% intraday’ found statistically significant profits, demonstrating that inefficiencies went beyond equity markets.

**Figure-2: Critical Arguments Against Weak Form EMH**

**Credit:** Prepared by the researcher

**4.5 Synthesis: The Case Against EMH Weak Form**

These findings statistically expose financial market anomalies and deep-seated inefficiencies inculcated in human psychology and market structure. For example, the 2008 financial crisis, where mortgage-backed assets were overly mispriced for years, showcases how EMH's assumptions fall apart in times of collective irrationality. These studies, taken together, demolish the Weak Form EMH's assertion of price volatility: These anomalies are pervasive: Calendar effects, momentum, and reversals persist decades throughout markets. Behavioural biases, such as investor irrationality, overreaction, loss aversion, and herding, create systematic distortions. Structural realities limit efficiency by preventing price adjustment from transaction costs, arbitrage risks, and liquidity limits.

Although Weak Form EMH is a basic theory, this review emphasises that it insufficiently captures the complicated real-world markets. The persistence of anomalies and the emergence of behavioural finance call for a more sophisticated knowledge of efficiency—one that welcomes adaptive markets, changing rationality, and the permanent stamp of human psychology.

**5.1 Case Studies: When Markets Resist Efficiency**

For the Weak Form Efficient Market Hypothesis (EMH), the existence of speculative bubbles and catastrophic market collapses creates a basic contradiction. Why do asset values periodically stray from fundamentals, only to drop dramatically, if markets are efficient and prices follow a random walk? Some examples of EMH failures are:

1. **The Dot-Coms Bubble (1995–2000)**

Driven by wild internet-based speculations on the transforming potential of technology, Nasdaq-listed equities jumped by 582% in the late 1990s. Companies like Pets.com and Webvan attained billion-dollar values despite low incomes and profits. The Nasdaq fell 78% by 2002, wiping over $5 trillion in market value. Defying the fundamental assumptions of EMH, investors chased narratives over fundamentals, rejecting conventional valuation measures like P/E ratios, sharply contradicting EMH's presumption of rational pricing. Root causes of the dot-com bubble.

1. Fearing exclusion from supposed "ground-floor opportunities," investors followed colleagues.
2. Analysts expected unlimited expansion for technology companies, discounting concerns about scalability and competitiveness.
3. Rising prices drew media attention and attracted additional speculative money, influencing mispricing feedback loops.
4. **Global Financial Crisis-2008**

The downfall in ' Credit Default Swaps’ (CDS) and mortgage-backed securities (MBS) exposed systematic mispricing stemming from EMH's blindness. Moody's applied EMH's reliance on historical data incorrectly, which assigned AAA ratings to subprime MBS based on historical default rates. When house values dropped, these assets lost 80–95% of their value, which triggered a global recession. Principal faults in the global financial crisis-2008 are as follows:

1. The models thought that regional diversification would help mitigate risk, so they did not take into consideration the possibility of national housing reductions.
2. It was very costly to short-sell MBS, which allowed mispricings to keep accumulating.

**3) GameStop-2021**

Retail investors on Reddit's WallStreetBets forum collaborated together to exert pressure on institutional short-sellers and raise GameStop's stock price by 1,500% in a matter of weeks. The episode examined how social media and democratised trading systems like Robinhood could enhance behavioural biases, creating volatility away from reality.

**6. Critical Examination of EMH: Evidence and Market Reality**

This part summarises the EMH’s empirical, theoretical, and pragmatic aspects, thereby providing a complex assessment of whether markets are really efficient or just "efficient enough”. The argument over the Weak Form Efficient Market Hypothesis (EMH) is a microcosm of more general conflicts in financial theory between “rationality and irrationality, stability and chaos, and predictability and randomness”.

**6.1 Passive vs. Active Approaches**

1. **The Victory of Passive Investing:** For ordinary investors, the emergence of index funds—such as the S&P 500 ETF from Vanguard—validates EMH. Malkiel's 1973 dictum, "a blindfolded monkey throwing darts can pick stocks as well as experts," has been generally accurate. After fees, almost 90% of U.S. active equities funds underperformed their benchmarks between 2000 and 2020 (SPIVA Report, 2021).
2. **Exceptional Adaptive Active Strategies:** Narrow strategies excel in inefficiencies:
3. **Quantitative Hedge Funds**: Using momentum and mean reversion algorithms, Renaissance Technologies' Medallion Fund produced ~66% annual returns (1988–2018).
4. **Behavioral Funds**: Companies such as Fuller & Thaler Asset Management target mispriced equities by using cognitive biases—such as anchoring.

These findings show that Weak Form EMH holds asymptotically, that is, mature, liquid markets (e.g., S&P 500) perform better than fledgling or fractured ones (e.g., cryptocurrencies).

**6.2 Restraints on Arbitrage and Market Microstructure**

Shleifer and Vishny (1997) showed in their study that often rectifying mispricings is not feasible, as assumed by the EMH. For example;

* While high-frequency trading (HFT) companies take advantage of minute inefficiencies, their approaches are not feasible for ordinary investors due to high transaction costs.
* High-end brokers like Robinhood have the informational access and capability to manipulate short sales during the GameStop frenzy (2021) like events, thereby enabling prices to stray from fundamentals, but ordinary investors have limited informational access and capabilities to manipulate the market.

**Market Microstructure:** Contemporary markets are separated into distributed platforms, dark pools, and exchanges, which constitute a type of market microstructure. Information asymmetry arises due to this complexity: high-frequency trading firms (HFT) with integrated servers exploit millisecond delays, whereas retail traders lag far behind. These structural disparities contradict the EMH's premise of equal access to information.

**6.3 The Adaptive Market Hypothesis (Dynamic Equilibrium Efficiency) an Alternative to EMH**

The Adaptive Market Hypothesis (Andrew Lo, 2004) provides a flexible perspective on efficiency.   
According to the Adaptive Market Hypothesis (AMH), efficiency is a continuous process influenced by innovation, competition, and evolution. AMH contends that markets evolve like biological ecosystems, where stakeholders (such as retail traders and algorithms) fight for survival, unlike EMH's static rationality. The core tenets of AMH are as follows:

1. Market efficiency is a dynamic concept that fluctuates between efficiency and inefficiency. For instance, under stable regimes,’ prices reflect fundamentals and efficiency (e.g., in the post-2009 bull market). Wheras during disruptive shifts (like AI trading), arbitrage opportunities arise when rules or new technologies upset the equilibrium.
2. Ecological Competition: Depending on the state of the market, strategies either succeed or fail. In trending markets, momentum trading is effective; in reversals, it is ineffective.
3. Behavioural Moulding: Although investors grow from their errors, their evolutionary impulses cause biases (such as loss aversion) to endure.

## Reconciling the Paradox: EMH Vvs AMH

The coexistence of efficiency and irrationality becomes explicable through AMH’s lens. Adopting AMH brings us one step closer to a realistic view of markets that acknowledges the potential for rationality and insanity.

1. **Bubbles as Adaptive Responses**: Speculative manias arise when new information (e.g., the internet’s potential) overwhelms historical data, triggering heuristic-driven decisions.
2. **Crashes as Evolutionary Resets**: The Market collapses and purges maladaptive strategies (e.g., excessive leverage), restoring equilibrium.
3. **Role of Technology**: High-frequency trading (HFT) enhances liquidity in stable times but exacerbates flash crashes (e.g., 2010’s “Flash Crash”) during stress.

The weak form of EMH is most suitable for static market conditions that cannot capture the context of dynamic equilibrium affected by legislation, technology, and competition. Real-life market circumstances are conditional rather than absolute truth. Early markets (pre-1980s) matched closely with EMH, but the emergence of behavioural finance, algorithmic trading, and distributed finance (DeFi) has upset this balance. The most convincing approach versus EMH comes from the Adaptive Market Hypothesis (Lo, 2004), which holds that markets change through invention and crisis cycles rather than being entirely efficient or illogical. AMH is helpful for Investors to be aware that efficiency varies depending on circumstances. While proactive strategies may be beneficial during inefficiencies in emerging markets (like cryptocurrency), passive tactics are effective in more established markets (like the S&P 500). AMH can be a torchbearer for Regulators to establish measures to prevent systemic mispricings (such as stress testing and circuit breakers) without impeding innovation. Academics may simulate market ecology or the coevolution of stakeholders, laws, and technologies to understand better how the stock market functions in the real world.

**Conclusion**

The Weak Form Efficient Market Hypothesis (EMH) is a perplexing hypothesis in the field of finance, and it is not entirely true or false. Supported by decades of empirical data confirming the inefficacy of technical analysis and the emergence of passive investment, its basic idea that ‘*historical price data cannot forecast future returns’* remains a pillar of modern finance. Rooted in Bachelier's (1900) random walk theory and Fama's (1965) empirical validations, Weak Form EMH's intellectual rigidity democratised investing, thereby transforming finance. The importance of EMH is evident by the fact that index funds have grown so much that they now control about $15 trillion worldwide. EMH sets free common investors from the notion that beating the market requires talent or insider knowledge by showing that most active strategies fall short of outperforming passive benchmarks after expenses. However, the theory falls short when faced with the messy reality of human psychology, structural market frictions, and the show-off of speculative bubbles. EMH's rationalist presumptions fall short in describing actual events. The Dot-Com bubble, the 2008 financial crisis, and the wild volatility of Bitcoin all show that markets are not sterile rooms of rational people but places where fear, greed, and story-driven speculation happen. By demonstrating that cognitive biases—loss aversion, herding, overconfidence—distort price discovery, behavioural economists such as Kahneman and Tversky (1979) and Shiller (1981) destroyed the illusion of universal rationality. These distortions are reflected in consistent deviations from EMH's assertion of unpredictability, including momentum (Jegadeesh & Titman, 1993) and mean reversion (DeBondt & Thaler, 1985). The crisis of 2008 exposed the dangerously naive assumption of EMH on self-correcting markets.

Essential protections against systematic risks resulting from irrationality are circuit breakers, stress tests, and openness requirements. The Adaptive Market Hypothesis presents a convincing way to balance this conflict. AMH considers markets as changing ecosystems and recognises that context determines efficiency rather than a fixed set of assumptions. Markets evolve via continuous invention, competition, and extinction cycles—a dynamism not easily captured by EMH's stationary perspective. It reminds us that competition, creativity, and education help us to acquire efficiency rather than it is innate. Markets change dynamically always, sometimes logically, sometimes chaotically, just as organisms adapt to live. The weak form of EMH should be better understood as a useful approximation, a beginning point for research, rather than a law of nature. Its most important contribution is encouraging a more sophisticated conversation on market dynamics that accepts rather than dismisses complexities. The ultimate issue is not whether markets are efficient but how, when, and for whom efficiency holds. This complex knowledge, rooted in literary findings and inquiry, might direct the next generation of theorists, investors, and legislators across the always-changing terrain of global finance.

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