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Raghavendra Rau
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Short Introduction to Corporate Finance

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RAGHAVENDRA RAU is the Sir Evelyn de Rothschild Professor of Finance at the University of Cambridge's Judge Business School. He is a director of the Cambridge Centre for Alternative Finance, past president of the European Finance Association, and past editor of the journal *Financial Management*. Professor Rau was Principal at Barclays Global Investors, then the largest asset manager in the world, from 2008 to 2009 and had a ringside view of the financial meltdown. His research has frequently been covered by the popular press, including the *New York Times*, the *Financial Times*, the *Wall Street Journal*, and the *Economist*, among others. He won the Ig Nobel Prize for Management in 2015, a prize awarded for research that makes people laugh, and then think.

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CAMBRIDGE
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University Printing House, Cambridge CB2 8BS, United Kingdom

One Liberty Plaza, 20th Floor, New York, NY 10006, USA

477 Williamstown Road, Port Melbourne, VIC 3207, Australia

4843/24, 2nd Floor, Ansari Road, Daryaganj, Delhi – 110002, India

79 Anson Road, #06–04/06, Singapore 079906

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www.cambridge.org
Information on this title: www.cambridge.org/9781107089808
DOI: 10.1017/9781316105795

First published 2017

Printed in the United Kingdom by Clays, St Ives plc

A catalogue record for this publication is available from the British Library

Library of Congress Cataloging-in-Publication data
Names: Rau, Raghavendra, 1967– author.
Title: Short introduction to corporate finance / Raghavendra Rau.
Description: New York : Cambridge University Press, [2017] |
Series: Cambridge short introductions to management
Identifiers: LCCN 2016044121 | ISBN 9781107089808 (hardback)
Subjects: LCSH: Corporations – Finance. | Management.
Classification: LCC HG4026 .R37468 2017 | DDC 658.15–dc23
LC record available at https://lccn.loc.gov/2016044121

ISBN 978-1-107-08980-8 Hardback
ISBN 978-1-107-46148-2 Paperback

Additional resources for this publication at www.cambridge.org/csi

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Preface

Finance is generally considered one of the most intimidating of the business areas, fit only for extremely quantitative people who are very comfortable with numbers. That belief is reinforced by the sheer amount of jargon typically used to describe concepts used in finance, such as mortgage-backed securities, mezzanine financing, reverse floaters, inverse repos, quantitative easing, and so on. Thanks to the fact that many people hate mathematics, finance professionals who are comfortable with the numbers successfully parlay the jargon into extremely high, possibly exorbitant[1] salaries. And when the finance firms go too far, taking excessive risks and plunging economies into recessions, the popular perception is that the government appears to bail them out, making it a win-win proposition for the bankers and a lose-lose proposition for tax payers.[2]

Do finance professionals deserve the resulting criticism? Or since their jobs are so difficult and complex, do they deserve the salaries they are paid? It turns out that most of finance is really not complex. At its core, finance is composed of a set of just six basic ideas. Five of these six ideas have won their originators Nobel Prizes. Everything in corporate finance can be explained by one or more of these basic ideas.

But what about the jargon? Most of this jargon is just that – jargon. Jargon is extremely useful. It can serve as a shortcut to tell other professionals precisely what a particular type of financial security is. However, with the sheer number of different terms for exactly the same thing[3], a more likely explanation for the explosion in jargon is that it helps completely baffle laypersons. In fact, to a layperson, the jargon might actually be comforting. If I want to get my car repaired, the more obscure the terms that the mechanic throws around, the happier I feel that I did not try to fix the car myself (and the more willing I would be to pay that big bill). In finance terms, the more incomprehensible the jargon is, the less willing you are to handle your financial activities yourself, and the more you will be willing to trust a financial advisor who promises to handle the (very necessary[4]) jargon for you. In this book, I am going to shoot myself in the foot by trying to avoid all unnecessary jargon. I will not always succeed in eliminating jargon[5], but I will try to define each technical term as intuitively as I can before using it later.

Despite the bad press which finance has attracted in recent years, these fundamental ideas have not changed. They represent the pinnacle of intellectual achievement in finance, arising from rigorous attempts to understand how to value investments. The emergence of the discipline and practice of corporate finance has fueled innovation and, growth and has significantly improved living standards in the long run.

My hope is that understanding these six seminal ideas at an intuitive level will help you understand the challenge, excitement, and promise of this expanding area of intellectual endeavor, and also expose you to the magic, daily relevance, and fun of the field.

To begin, I will further reduce the six ideas of finance into one basic homespun truth – **there is no free lunch in a competitive market** (or to put it into jargon, arbitrage is not possible in a perfectly competitive market). To put this yet another way, there is only one big idea in finance – no free lunch. No one gives you something for free.

That one big idea forms the basis for understanding everything we know about finance. To see how this is so, we begin in the first chapter by understanding who the major players are in finance and their motivations.

Notes

1. Not according to the finance professionals.
2. See note 1.
3. A simple example would be the yield to maturity for bonds and the internal rate of return for investments, both of which mean the same thing.
4. Or so he says.
5. Sometimes you do need clearly defined shortcuts because otherwise you end up constantly using very convoluted phrases for simple terms. Like calling email a rather cumbersome “courrier électronique” in French, later replaced by the just as rarely used “courriel.”

Acknowledgments

I would like to thank Bunny Rau, Kate Belger, Sanjeev Goyal, Andrew Karolyi, Mustafa Leeq, Raghu Rau, Scott Thayer, Naresh Verlander, and, especially, Kathy Kahle and Clive Gallier for detailed comments on early drafts of this manuscript.