

Short Introduction to Corporate Finance

The *Short Introduction to Corporate Finance* provides an accessibly-written guide to contemporary financial institutional practice. Professor Rau deploys both his professional expertise and his experience of teaching MBA and graduate-level courses to produce a lively discussion of the key concepts of finance, liberally illustrated with real-world examples. Built around six essential paradigms, he creates an integrated framework covering all the major ideas in finance over the past half-century. Ideal for students and practitioners alike, it will become core reading for anyone aspiring to become an effective manager.

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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 exorbitant¹ 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 thing³, 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

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to trust a financial advisor who promises to handle the (very necessary⁴) 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 jargon⁵, 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.”

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