Quotes from “Old and New Financial Paradigms”

The finance industry has become an unmanageable clutter of all kinds of theories (*i*.e. *old versus new theories)*

At root, however, it still revolves around the assumption that the capital market works pretty well (*i.e. capital market are efficient)*. The players in this capital market – financial investors and companies……

research leads to contradictory outcomes and hence to crises that can only be resolved by scientific breakthroughs (or revolutions). Until then, the paradigms inherent in the various theories …coexisted as "concrete solutions to problems that the expert community has accepted." The same holds true both for financial theory and the real world of finance.  
[i.e. old (traditional theories) versus new (neo-classical) finance theories]

Debt and equity are the two most important financial contracts (*in efficient capital markets*)

capital expenditures (*in inefficient markets*).

**Old or Traditional Finance**:

In the 1950s, business administration doctrine concentrated primarily on the relationship between finance and accounting. The business managers of the day believed that financing and investment transactions were reflected above all on the balance sheet. Creditors paid considerable attention to balance sheet ratios.

* A company's degree of indebtedness (gearing or leverage ratio), for example, was calculated from the ratio of debt to the carrying amount of equity.
* Metrics that set the carrying amount of profits in relation to the carrying amount of equity (the return on equity, ROE) and total assets (the return on investment, ROI) likewise rose to prominence at this time.
* ROE – annual profits divided by the carrying amount of equity – became an especially popular measure.
* DU PONT was the first to break ROE down into the product of three metrics. In the process, he established the doctrine of what became known as value drivers. In effect, value drivers are the knobs and controls that can be tweaked to maximize ROE.
* Today, management consulting firms all argue that their own definitions of Economic Value Added and cash flow before tax are the right ones, while the differences between EBIT and EBITDA drive many a student to despair.

The 1950s financial theory paradigm described above is today referred to as traditional finance theory or, somewhat disrespectfully, as "old finance". Traditional financial theory does not assume the existence of a capital market. Each and every financial contract is unique. Accordingly, the possibility of comparison with "customary market rates" does not exist in the world of traditional finance. To this day, this school of thought continues to influence the way people – especially practitioners – think about finance. Many entrepreneurs too are still guided by terms fashioned in this era. CEOs never tire of telling their people (for whom carrying amounts have been immutable yardsticks since time immemorial) that improving ROI is the overriding goal.

**New or Neoclassical Finance**

Triggered by confusing new events and mechanisms in the capital markets, especially in the English-speaking world, a scientific revolution occurred around 1960.

* The law of the market, as we know, is the law of one price. So how is it that, following the assumption of financial planning, different financing options can be offered on differing terms to one and the same company in one and the same capital market?
* Why should accounting, balance sheet ratios and their derivative metrics be so important when shareholders operating on the financial markets are more concerned with stock prices and market values? And what do paper profits say about a company if financial investors are interested only in the returns generated by value added and dividends relative to market value?

Since "old finance" was unable to answer these questions, a new paradigm emerged – and indeed had to emerge. It can be described like this: Assume a capital market that is working smoothly. Then explain every phenomenon in the finance industry in terms of how it would be valued in such a perfect (efficient) market. This paradigm is today referred to as the neoclassical theory of finance, because neoclassical economics generally puts the market at the center of all its theories

**Conclusions:**

Where is wealth best discovered (i.e. in which markets)? And by whom?

Where is wealth best accumulated (i.e. in which markets)? And by whom?