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## **Traditional, modern and new approach to finance**

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## **Abstract**

In the last half of the century financial theory went through turmoil of change. As the end result it became some sort of natural science wannabe, a social science that wanted to exercise exactness and discover universal “truth” while at the same time address social issues with ultimate preciseness. In this paper we wish to draw parallel between traditional and new approach to finance and at the same time reject modern approach to finance as being an appropriate one.

## **Introduction**

1950s are usually marked as the beginning of the “revolution” in corporate finance. Basic concepts of financial decision-making have been completely rewritten and then new or what we now refer to as modern financial theory has been developed in the next 30 years. This modern financial theory has gradually and logically resulted in a development of the number of tools intended and ultimately used in financial and investment decision-making. The theory was thought to be very close to natural science because of its mathematical roots (concepts) and therefore universally applicable in more developed market economies. As a result the theory and its “products” were being exported from United States, where they originated, to other more or less developed market economies. The first serious opposing views of the modern financial theory were raised during 1980s. Fifteen years later we are probably on the verge of the new “revolution” in finance. “New” financial theory has not been developed yet and there are many dilemmas still ahead of its development, but we can already observe outlines of its design.

In this paper we wish to present some of the major problems modern financial theory is faced with when it comes to its use in practice, as well as potential benefits of the “new” financial theory for financial decision-making. Focus of this paper is on decision-making process of an investor with respect to allocation of savings and on decision-making processes undertaken in companies (capital budgeting, capital structure and dividend policy). First, we will present traditional approach to decision-making in finance, followed by methods used in financial decision-making modern financial theory has developed. In the last part of this paper, we will present outlines of the “new” financial theory.

We will show that “traditional” researchers and practitioners in the area of finance relied on experiences in practice in order to describe investor and company behavior and suggest what might be the right investment decisions to be undertaken by investors and right decisions undertaken by companies. Researchers did not claim their findings and suggestions to be universally applicable. Traditional approach to finance was positivistic and non-universal in its nature. On the contrary “modern” researchers relied on the neoclassical economic theory to derive what we now refer to as modern financial theory. Rational human being became the focal point of all the assumptions on how the human beings make decisions. Modern financial theory was thought to have bridged the gap to natural sciences by becoming normative,

universal and exact. Over the time usefulness of modern financial theory came under question. We will show how researchers started looking into its assumptions only to discover what should have been obvious from the beginning: the assumptions do not hold in reality. “New” approach to finance was therefore starting to emerge. It considers human being not to be a mechanical, omniscient and egoistic wealth maximizer, but rather a being that is complex, social, political and stochastic in its nature. We claim that new approach to finance is in principal positivistic and non-universal in its nature, pretty much the same way as traditional approach was.

### **Traditional approach to finance**

Traditional financial theory or approach to finance was positivistic in its nature (e.g. it represented an attempt to explain why things are as they are) as it was rather collection or review of “rules” used by investors and managers in decision-making process than consistent and complete explanation of reasons leading to and consequences following the financial decisions. The aim of the traditional approach to finance was to discover and encompass financial decisions that proved worthy in practice over longer period of time and afterwards establish characteristics of chosen assets or companies that made those very same decisions. At that time it seemed to be a way to constructs some kind of rules of decision-making in finance.

Approach to decision-making when it came to *investments* as explained by Graham and Dodd (1951) became very popular at the time. Their rule or rather suggestion on how to efficiently choose among financial assets was to buy the assets that were under-priced and sell those that were over-priced, which is obviously a no-brainer in the sense of what to do once you know which assets are mispriced. The real question is how to discover the mispriced assets. Graham and Dodd for example identified characteristics of the companies stocks that may cause stocks to be mispriced (e.g. P/E ratio, market-to-book value, etc.).

When it came to decisions on *capital structure* traditional approach passed on belief that each company has some sort of “normal” debt capacity based on its characteristics (Donaldson, 1961). A “Normal” debt capacity referred to the amount of debt company could take in order to lower its cost of capital, since cost of debt was relatively low and unchanged (or little changed) up to the point of “normal” indebtedness. Cost of common equity also remained

mostly unchanged to the point of “normal” amount of debt contracted by the company. Since it was not possible to determine what the “normal” debt capacity is, the decision-making process was based on the experience and “gut feeling” of financial managers of a company. On the other hand, this so called “gut feeling” was in part based on certain “golden rules” of financing (e.g. matching maturity of liabilities and assets) and in part on value of company’s assets (mainly real estates), expected future ability to repay debt, the way company managed debt in the past, etc.

Traditional approach to *dividend policy* was very clear – companies should distribute as much of net income as possible in the form of cash dividends, since investors prefer dividends to future capital gains. As it was stated by Gordon (1959), investors believe future capital gains to be more uncertain than dividends, having therefore lower present value than dividends. However, there were limitations of such dividend policy: investors do not like reductions in dividend payments, companies need enough cash to pay out dividends, good investment opportunities reduce possibilities to pay out dividends, etc. Lintner (1956) seems to have successfully explored some of these limitations. Based on findings from field investigations (as he obviously refers to empirical studies in his paper) he set up a theoretical model of corporate dividend behavior and tested its adequacy and reliability. He found managers to give serious consideration to perceptions of shareholders and only change dividend rate after they were convinced that such change was positively desirable by shareholders. Question of dividend payment was only addressed together with analysis of the existing dividend rate. Similarly to findings of Gordon Lintner concluded that most managers believed shareholders prefer a reasonably stable rate, which is reflected in the stock price premium on stability or gradual growth in dividend rate.

With respect to *capital budgeting* decisions traditional approach favored a payback period and an internal rate of return as decision-making criteria. Payback period criteria is based on simple logic that sooner the initial investment outlay is paid back, sooner will investment yield a return on invested capital and less uncertain will the financial outcome of the investment decision be, because near future is more predictable. Another important part of reasoning concerning payback period criteria were internally generated funds for new investments. Sooner the investment repaid itself (shorter payback period), sooner the new investments could be financed without raising new external capital, which seem to be an important issue with many companies. Basic concept of an internal rate of return criteria,

which was very extensively presented by Dean (1951), posts that average annual investment yield (IRR) must be greater than average annual costs of its financing. The greatest problem was how to estimate the cost of equity. At the beginning, it was being set at the rate, observed in comparable companies, while later the well known Gordon model was being used, adjusted for the risk of specific investment project being undertaken.

It seems that “traditional” researchers and practitioners were aware that their findings were not universally applicable and were subject to space and time, as well as many other factors that are most likely to change within space and time. Graham and Dodd expressed this in their 1961 edition of *Security Analysis* (preface): *“All our previous editions were written and published under market conditions quite different from those of 1960-1961...In the original (1934) publication our cautious viewpoint was almost compulsory in the light of 1929-1932 debacle. In fact it took a certain amount of courage for us to assert that there was such a thing as sound investment in common stock. When we revised the book in 1940 we had the benefit of the market decline in 1937-1938 to justify our conservative standards, and they were similarly acceptable in 1951 after the bear market in 1946-1949...Thus we are not able to proceed in 1960-1961 with the same comforting assurance as formerly that our standards are in accordance with both long-term and recent-term experience.”*

It seems as well that awareness of the origins of their findings and ambitions they had with respect to those findings was also clear to authors. Again Graham and Dodd put it down eloquently (1961, preface): *“We did not claim that these conservative criteria of “value” or “justified price” proceeded from mathematical laws or other a priori principles. They were definitely empirical in their origin...If we persist in clinging to our old, highly conservative standards of common stock appraisal, we risk not only the certain charge of old-fogyism, but a real possibility of failing to recognize important changes in the underlying structure of common stock values.”* Similar remarks are expressed in the foreword of Donaldson’s *Corporate Debt Capacity* (1961) by Bertrand Fox: *“Since the objective has been to develop a framework for decision making by corporate borrowers, no attempt is made to develop refined methods of measurement of risk or to construct a set of generalized standards of debt capacity.”*

Comment made by Lintner (1956) in our opinion clearly establishes consciousness of division between method and methodology and demonstrates positivistic approach in traditional

research in finance (1956, p. 80): “...*the companies were not selected as a sample upon which to draw statistical conclusions; rather they were deliberately selected to encompass a wide variety of situations and to build in opportunities for significant suggestive contrasts between the policies of companies similar in several respects but differing in other important characteristics.*”

Traditional approach was therefore primarily based on actual behavior of investors and managers. It attempted to define characteristics of financial assets and companies that affect the behavior and decision-making process as well as the way they affect them. It did not assume some sort of universal rational behavior of the people (was not normative in its nature), but rather extracted “best practices” (was positive in its nature) with respect to decision-making processes by observing actual behavior of people in given environment and time.

### **Modern financial theory**

The beginnings of the modern financial theory in finance are marked with contributions made by Markovitz (1952), Kendall (1953), Modigliani and Miller (1958) and Sharp (1964). Foundations, on which the modern financial theory was put on, were drawn from the neoclassical economic theory, which assumes rational behavior of the individuals. That effectively meant that universal financial theory could be derived under certain assumptions:

- I. Individuals behave in completely rational way, which means:
  - a. Individuals undertake financial decisions that maximize their welfare.
  - b. The welfare is at its maximum, when the utility of the consumption is at its maximum.
  - c. The utility of the consumption is at its maximum, when the consumption is at maximum (its present value).
  - d. The consumption is at its maximum, when value of investor’s financial assets (or company’s value) is at its maximum.
  - e. The value of financial assets is maximized when with respect to each other:
    1. Expected returns are maximized.
    2. Expected returns occur in the nearest possible future.

3. Probability that expected returns materialize is maximized (risk is at its minimum).
- f. Individuals can:
1. Accurately measure risk and
  2. being risk averse
  3. can translate measured risk into additional required return from an investment (risk premium) and
  4. can trade financial assets at prices that equal additional expected returns with additional required returns.

II. For financial markets and corporate governance following assumptions were derived:

- a. All financial assets are perfect substitutes. Since people trade them on the basis of expected return, their prices depend only on expected returns, time line in which they occur and risk, associated with them. Price is formed given the last three determinants, which means that supply and demand do not affect the price, but are rather outcome of the listed three determinants of the price at which each financial asset is traded.
- b. Capital markets are efficient in the informational sense, meaning that all the relevant information (except insider information) is properly reflected in the prices of financial assets. This in effect means that financial assets cannot be over or undervalued, but are rather traded at their “fair” values.<sup>1</sup>
- c. Company is governed by its owners (shareholders), which means that objective of the company is the same as the objective of its shareholders – to maximize value of shares.

There are also a number of other assumptions that had to be adopted in order to make modern financial theory consistent and applicable. This was the result of completely different approach by the modern financial theory than the traditional was.

While traditional approach derived its findings on the basis of experiences in practice, modern financial theory based itself on the abstract and simplified universal model of human behavior. The very desired property of such an approach was the possibility of its

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<sup>1</sup> It is of course forbidden to trade on the insider information, which can therefore have no effect on prices of financial assets.

mathematical description and derivation, particularly useful when it came to modeling. Derived models should be able to explain what kind of decisions investors and companies undertake in different situations and most importantly anywhere, where rules of market economy apply.<sup>2</sup> Models were also meant as decision-making tools for investors and managers.<sup>3</sup>

Under the assumptions of the modern financial theory Graham's and Dodd's approach to *investments* proved to be completely false, because there are no under or overvalued financial assets, since capital markets are efficient. All that is left for investors in order to increase their welfare is to:

1. According to individual degree of risk aversion they choose the share of their portfolio to invest in "risk-free" assets (e.g. government securities).
2. Appropriately diversify the remaining share among risky assets, thereby reducing the inherent risk.<sup>4</sup>

Investors can use models, which are based on the assumption that appropriate measure of risk is variance (covariance) of returns on investment, in order to appropriately diversify their investments. Past data on returns are most commonly used to calculate variance of returns. The newest additions to this theory take into account other factors that affect asset's risk aside from variance of the returns (see Fama and French, 1992 and Davis, Fama and French, 2000 for example). These factors were supposed to measure the probability of financial distress on part of the issuers of securities. Incorporating these factors into otherwise widely used models proved to be very complex, making such "upgraded" models not of much use in practice. It is also very likely that interpretation of these additional factors may be wrong, as we will show in the next section.

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<sup>2</sup> Companies, controlled by their shareholders, cannot undertake financial decisions opposite to wishes (demands) of their shareholders (e.g. decisions that would not lead to value maximization).

<sup>3</sup> There is, however, a question why should investors and managers of companies even need models, if they behave in rational way and know everything.

<sup>4</sup> This reasoning, no matter how elegant and logical it may be, represents the first problem of modern financial theory. Prices cannot be "appropriate" or "fair" by "nature" in any given moment. As new information becomes available, investors have to establish prices not to be "appropriate" or "fair" anymore and make them "appropriate" or "fair" by trading on the new information. This in effect means that investors do pick under and overvalued assets to trade with, which is very much in contrast with modern financial theory that simply assumes the price-adjusting process to occur momentarily.

With respect to financial and investment decisions made in companies, modern financial theory follows the assumption II.a., which states that all financial assets are sold at “appropriate” prices. This means that companies can obtain additional needed capital at any given time. In that case decisions regarding capital structure, dividend policy and capital budgeting are independent – for example: investment project can be equity financed while at the same time dividend payout ratio is increased, since company can secure equity needed by issuing new equity (as opposed to retaining larger part of earnings). Different analytical methods and models have been constructed and offered to be used in practice based on independence among financial and investment decisions that modern financial theory is advocating. In the next three paragraphs we present approach and conclusions made by modern financial theory regarding capital structure, dividend policy and capital budgeting.

The conclusion reached by modern financial theory regarding *capital structure* of the company is generally the same as the conclusion presented by traditional approach (e.g. there is an optimal capital structure), but on the basis of completely different logic. Since investors behave in completely rational way, increases in indebtedness of a company increase its risk and, therefore, required return on debt and on cost of equity. Additional indebtedness has no positive effect for companies from the perspective of financing costs. But there are positive tax effects and negative effects arising from costs of increasing probability of financial distress. These effects are different among companies, which means that there is an optimal capital structure for each company. When it was clear, that considering only taxes and costs of financial distress as imperfections of the capital market did not explain much of the differences among capital structures of the companies some other “imperfections” were considered like: difficulties in raising additional equity in the capital market, lack of information about companies by investors, asymmetric information among existing and new shareholders, etc. Theoretically, these additional factors mainly cause companies to be less indebted than without taking them into account (the “target” capital structure as opposed to “optimal”). Although, on the basis of this theory, models were derived to help companies in establishing the “target” capital structure that maximizes share value of the company, these models are not very successful. The main reason being the fact that “imperfections” dealt with in the models fall short of the real world variety of “imperfections” and their changing importance.

There is no clear conclusion made by the modern financial theory regarding *dividend policy* except the one that is stating traditional approach to be wrong. Investors behave rationally and are indifferent from the risk perspective, whether they receive return from stocks in the form of dividends or capital gains, since risk of the entire return is affected by financing and investment decisions made in companies and not the form in which returns are distributed (dividends vs. capital gains). Investors are not indifferent only in cases, when dividend payout has certain “side effects” that reduce entire return (different tax treatment of dividends and capital gains, difficulties in raising additional equity in capital market, etc.).<sup>5</sup> “Side effects” can be positive as well, but most authors believe that combined effect is either negative or neutral at least. Since the results of combined effects are inconclusive, it was not possible to develop models for determining appropriate dividend payout ratio. For the time being modern theory is suggesting that companies have to make dividend decisions by taking into account all the effects of different dividend policies “appropriately”. Using the logic of modern financial theory this is quite impossible to in the companies if the best “brains” in financial research are not able to do it.

Concerning *capital budgeting* decisions modern financial theory rejected internal rate of return and payback period as appropriate criteria. Based on its assumptions, modern financial theory recognized only the net present value criteria as the only appropriate decision-making method that leads to increase in share price. This conclusion is pretty much straightforward and logical, since value of share will increase only when present value of investment gains (cash inflows) is greater than present value of investment expenditure (cash outflows). For a very long time net present value criteria as decision-making rule for capital budgeting seemed to be infallible. Lately however logic of so called real options was being developed that can make projects with negative net present value acceptable when effect of real options tied to realization of the project is accounted for. However, applicability of real options logic in practice is quite limited due to its complexity.

In the last half of the century modern financial theory has become absolutely dominant (academicians developing it have received six Nobel prices) and has built impressive library of analytical tools and methods, which were offered to be used in practice, where they were graciously accepted and being used in decision-making processes whether it comes to

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<sup>5</sup> More in Mramor (2000, p. 168 – 178).

investors or companies. These tools and methods are however only a part of the analysis investors and companies perform, which means that actual decisions are many times different than suggested by modern financial theory and its models. There is also a number of questions related to behavior of investors and companies modern financial theory cannot explain:

1. Why are returns of individual financial assets and portfolios of financial assets different from those, calculated using models supplied by modern financial theory (CAPM, APT, etc.)?
2. Why are highly profitable companies not more indebted as suggested by modern financial theory? (capital structure puzzle)
3. Why can modern financial theory explain only about 40% of differences in the levels of indebtedness among companies in different countries (Booth et al. 2001)?
4. Why do companies pay out dividends even when this is less beneficial to investors (through higher taxes on dividends as compared to capital gains for example)? (dividend puzzle)
5. Why do companies many times undertake different projects than suggested by calculations using net present value criteria (even when real options value is taken into account)?

Modern financial theory also does not address questions when it comes to companies other than large public corporations. Many times the goal of a company is not shareholder value maximization but rather maintaining certain lifestyle, employing family members and friends, doing good deed for a society, etc. In terms of numbers, such companies prevail.

Even though it seems modern financial theory has approached finance and decision making processes in finance in good faith (in order to broaden the understanding of finance and offer more precise tools to be used in decision making in finance), we can only conclude today that many times leap of faith is more than necessary when it comes to use of modern financial theory in practice. Despite maybe noble intentions of some researchers it seems that modern financial theory or rather its own postulations took the wrong turn somewhere down the road as being allured by universality and beauty of logics implied in natural sciences thus forgetting that essential focus point in finance is human being whose behavior cannot be accurately modeled since it is stochastic in its nature. The real question thus remains whether corrections of assumptions on which modern financial theory rests are enough by themselves to align financial theory with practice. Of course, we may also be wrong concerning noble

intentions. The modern approach might as well be only an extension of neoclassical “imperialism” and should be analyzed from the view of political economy – the theory used by dominating interest groups to increase its wealth.<sup>6</sup>

### **“New” approach to finance**

Because of the obvious weaknesses of modern financial theory an effort is put into search for new solutions. Most financial researchers, who try to gradually improve modern financial theory, undertake first direction of research. Their approach is based on gradual relaxation of very restrictive assumptions of modern financial theory in order to draw theory closer to reality (practice). Second group of researchers, which is greatly outnumbered by the first group, but is expanding quickly, strives to develop so called “new” financial theory by approaching finance on completely different basis. The origin of “new” financial theory is a critique of modern financial theory in a sense that modern financial theory is based on completely unrealistic assumptions and, therefore, can not explain the reality and hence can not offer appropriate decision-making solutions to be used in practice. Let us review the most important points of this critique.

Basic assumption of the modern financial theory is rational (logical, intellectual) behavior of human beings (investors, managers). Problem with this assumption is a definition of what rational behavior is. Previously we have named six statements that describe rational behavior. By joining together first four postulates, we can derive next statement: “Person’s welfare is maximized, when value of person’s financial assets is maximized”. Last two postulates claim that value of financial assets solely depends on their expected returns and risk. Such claims represent insipidness of human behavior. Number of economical and other (psychological, sociological, etc.) research papers have shown (what we otherwise know already) human welfare to depend on many factors, maximizing consumption of material goods to be only one of them and usually not being the most important one. It can therefore pretty easily be shown that investors take into account other (or even mostly other) factors when selecting which financial assets to trade. When buying shares of “their” company, managers take into account relevance of a control over company and different social status, workers for example look to keep the employment in a company, other investors consider ecological and ethical position

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<sup>6</sup> Such a conclusion is not hard to reach as in order for one interest group to gain, other interest groups should behave in a certain way (the basic premise of the modern approach).

of a company, its political determination, etc.<sup>7</sup> Therefore it is not only expected returns and risk that affect prices of financial assets. It is also false to assume financial assets to be perfect substitutes, since each financial asset has certain properties that investors are willing to trade on.<sup>8</sup>

Even if we do not take into account other factors than returns and risk of financial assets, it is completely unrealistic to expect or assume humans to be mechanical creatures that can accurately measure (systematic) risk of each financial asset and translate measured risk into exact required return as well as perfectly forecast future returns based on available information.<sup>9</sup> This implies that capital markets are not “efficient” as assumed by modern financial theory. Financial asset prices do not equal present values of future expected cash returns, because prices are influenced by other factor than returns, time line of returns and risk of returns. Even if they were influenced only by the stated three factors, prices would still not reflect true present value of expected returns, because investors cannot properly calculate them. (Mramor et al., 2001).

“New” financial theory also criticizes the assumption made by modern financial theory, which states goal of a company to be maximization of its shareholders wealth. First, shareholders (owners) do not seem to be in control of companies (e.g. are not dominant group), as suggested. Number of theories dispute shareholder governance of companies. One set of theories addresses other groups within companies as being dominant or governing company: managers – post-Keynesian theory (Gordon, 1994 for example), employees – theory of employee-governed company (Mramor and Valentinčič, 2000 for example). Second set of theories addresses high dependency among different groups within company, of which each has high degree of influence. Dominancy of one group over the other results in less than optimal situation for a company and can even prove to be lethal for the existence of a

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<sup>7</sup> Under the term company we refer to non-financial and financial (e.g. banks, insurance companies) companies.

<sup>8</sup> Probably the first explicit empirical evidence proving financial assets to be influenced by other factors than returns, time line of returns and risk is given by Daniel and Titman (1997) and Daniel, Titman and Wei (2001). So far they have managed to empirically verify that investors prefer larger companies and companies with higher market-to-book ratios. Reasons for such preferences and what other factors may influence asset prices are still to be determined.

<sup>9</sup> No less unrealistic is the assumption of rational behavior of investors when observed as a group even when individual investor is not behaving rationally. This implies that marginal buyer and seller (two that determine the price) have to behave rationally even though other investors may not. It is an argument that fails to prove logical.

company (Zingales, 2000, Chang, 1997 for example). Even if assumptions of modern financial theory of shareholders governance over a company do hold, their welfare is not necessarily (or mostly is not) maximized, when a share value is maximized. As we stated before, such assumption completely denies human being as a social being. There are number of factors that affect human welfare (social status, interpersonal relations, etc.) that many times require individuals to strive to optimize their wealth rather than maximizing it.

In the last couple of years real progress was made in developing so-called behavior finance theory. Its main assumption is that people do not behave in a way assumed by modern financial theory. Development of behavior finance theory seems to be headed two ways. On one hand it seems to be accepted by modern financial theory as evolutionary step towards improvement of modern financial theory, which admits that people sometimes do tend to overreact in their “rational behavior” thus creating deviations of actual outcomes as compared to predictions made by models. Since deviations are only temporary and directed both ways (overreaction and underreaction), proponents of modern financial theory argue human behavior still to be rational in the long run (Fama, 1998).

“New” financial theory claims just the opposite. People do not behave rationally but rather normally and only when we understand the actual way people behave (not the assumed way), we would be able to explain their financial and investment decisions. Excellent demonstration of differences in approaches made by modern and “new” financial theory can be found in Frankfurter and McGoun (2000). They successfully argue that universal models explaining financial behavior of any given company in any given space and (or) time do not exist. Behavior depends on number of sociological, psychological, anthropological, cultural, historical, political and other factors that differ in space and time. This in effect suggests present analytical methods based on modern financial theory to be inappropriate.

Let us demonstrate this obvious shortfall of analytical methods based on modern financial theory with the following example. Based on the assumptions of modern financial theory managers consider investment and financial decisions independently. The critique of modern financial theory clearly shows close dependence between investment and financial decisions in companies. Companies are not able to sell their financial assets to investors at “fair” prices per se, since there are many other factors (nature of which is very variable in time) that affect prices of financial assets aside from expected cash flows, their time line and risk associated

with them. This in effect causes prices of financial instruments, issued by companies, to be very favorable at certain times, very unfavorable at other times or there could be even situations when companies are not able to sell their financial assets at all.<sup>10</sup> This could mean that companies would not be able to undergo excellent investment project if they distribute much of their net income to shareholders and are not able to raise additional external capital. It could also mean that otherwise very good project would eventually prove to be not acceptable since market conditions dictate very unfavorable prices of financial assets (hence high cost of capital). Analytical methods that do not account for such factors are unsuitable. In reality there are no managers that do not think of how projects will be financed when they undergo investment decision process, or do not think of their project opportunities when they undergo dividend decision process, etc.

## **Conclusion**

People do not value financial assets solely with respect to expected cash flows, their time line and risk, but rather take into account many other factors. Value of the company can not therefore be based solely on risk – return relationship for its shareholders, since it is a nexus of complex contracts based on different interests represented by groups with different and changing bargaining powers. Which factors affect financial decisions and what is their weight is, in contrast to universality of modern financial theory, different in time, place and depends on a number of cultural, historical, institutional, anthropological, political, sociological, psychological and other factors. For the time being we are only able to address these factors (characteristics) as either favored or disliked by individuals.

If individuals consider these phenomena to be important, different financial assets cannot be perfect substitutes, which means that supply and demand conditions do affect prices of financial assets even when there is no new information regarding those very same financial assets. Analytical techniques based on modern financial theory do not take into account those factors, making decisions based on them inappropriate. In reality individuals (and managers indeed) do consider other factors when making investment and financial decisions, but their approach is mostly intuitive and more or less successful. Without any doubt we are in need of

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<sup>10</sup> This is almost certain for small and sometimes even for medium sized companies that are not able to raise external capital – banks are not willing to approve loans even at very high interest rates and there are no investors that are willing to become additional owners of those companies by supplying new equity capital.

a more comprehensive financial theory and it is our opinion that we are now on the verge of its development.

The development most probably will not be “evolutionary” by simply supplementing modern financial theory, since its basic assumption of rational behavior (something that is mechanically perfect) of individuals or groups is entirely inappropriate. By abandoning this assumption the whole structure of modern financial theory is shattered and development of new theory is needed. In the same way as 1950s are referred to as “revolution in finance” that lead to modern financial theory, we now expect “new revolution in finance” to pave its way towards **new finance**, with a logic much closer to reality and therefore needs of practice in finance.

Although nature and methods of research have changed over the last fifty years, we believe there is a parallel between traditional and new approach to finance. “New” approach to finance seems to be non-mechanical, non-universal and non-normativistic in its nature, pretty much in the same way as traditional approach seemed to be more intuitively than purposely “aware” of human dimension of finance, space and time limitations and its own positivism.

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