***Wealth Creation: A Systems Mindset for Building and Investing in Businesses for the Long Term*. 2010. By Bartley J. Madden. John Wiley & Sons, Inc., www.wiley.com. 178 pages, $75.00.**

Reviewed by Janet J. Mangano and William A. Hayes.

In *Wealth Creation*, Bartley J. Madden provides a systems mindset for analyzing businesses over the long term that originated with his Cash Flow Return on Investment (CFROI) valuation model.[1] Since 1969, many institutional money managers have used this model as an integral part of their business and stock valuation process. In that year, Madden cofounded Callard, Madden & Associates, where his research was instrumental in developing the CFROI valuation model. Madden joined HOLT Value Associates in the early 1990s to commercialize the CFROI metric worldwide.

The book is theoretical in tone yet broad minded in its presentation. Madden describes the setting for using a wealth creation conceptual framework, the intellectual foundation underlying the systems mindset. He probes the PAK (perceiving-acting-knowing) loop, and the key take-away of this analysis is that the systems mindset recognizes the patterns that connect events rather than analyzing variables in isolation. It facilitates better solutions to problems, no matter what the subject. Additionally, it is cost-effective and minimizes unintended, adverse side effects.

Madden discusses the OODA (observation-orientation-decision-action) loop time cycle, which was originally used to explain success in aerial combat but now is used in maneuver warfare as well. Colonel John Boyd developed this loop to provide practical solutions to complex problems and to improve the thought process for making decisions. OODA-based decisions are shaped by feedback coming into the observing window. Both the PAK and OODA loops operate as a system, in which orientation shapes observation, decision, and action. Like the OODA loop, the PAK loop takes into account a total systems mindset instead of focusing on individual problems. In contrast to the OODA loop, the PAK loop underscores the importance of one's knowledge base in the perception of problems.

The heart of *Wealth Creation* is Chapter 4, "The Competitive Life-Cycle View of the Firm." The life-cycle framework differs from traditional life-cycle analysis, which deals with a company's growth, maturity, and decline. In Madden's life-cycle framework, a company's level of economic returns, relative to its cost of capital and reinvestment rate, is the key quantitative measure of wealth creation or dissipation. Competition and managerial skill are the key determinants of a company's long-term performance. The author also probes competition for capital, as opposed to competition for goods and services, when investors seek the highest expected returns adjusted for taxes and risk. Examples from real companies provide specific points of reference to the analysis of determinants of a company's long-term performance, as well as valuation of its stock.

Madden states that "experience with life-cycle track records not only provides investment insights grounded in sound economics but also encourages users to abandon the use of vague and misleading terms such as *growth stock* and *value stock*." Readers will be reassured to see that the competitive life-cycle framework provides a valid economic basis for understanding levels of and changes in stock prices over time when applied to the long-term histories of companies. Comparative analyses of the Bethlehem Steel Corporation versus Nucor Corporation, Digital Equipment Corporation versus IBM, and many other companies come to life as Madden examines such critical factors as CFROI return, the real asset growth rate, and the relative wealth index over many decades.

The author also emphasizes the importance of using a forward-looking discount rate rather than a capital asset pricing model (CAPM)/beta discount rate. A discount rate that is consistent with forecasting net cash receipts, defined as cash flows from operations less reinvestment, is preferable because the CAPM does not adjust for near-term changes in the environment, such as inflation and tax legislation. The CAPM is derived from historical data, and beta and the equity market risk premium over the risk-free rate are very difficult to estimate. The systems view also emphasizes sustained improvement through the value stream, which encompasses the entire production process of a product. Madden examines Toyota Motor Corporation's process, the epitome of sustained improvement, in depth.

The shareholder value review (SVR), designed to demonstrate how boards of directors fulfill their responsibility to shareholders, requires specific details about how the board and management connect financial performance to stock market valuation. It is intended to show that the board is a facilitator of wealth creation over the long term. Madden suggests that the SVR's life-cycle language

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would be a good replacement for the earnings-centric valuation language (such as intense focus on a single quarter's results) currently used by most corporations. *Wealth Creation* was published as the massive Toyota recalls, which were a huge disruption to wealth creation at Toyota (at least in the short term), were beginning. Are management and employees motivated to take responsibility for this widespread problem? The reader is left to await the answer and contemplate how the SVR would address such a complex problem.

The rigorous analytical discipline Madden brings to the analysis of companies, their stocks and bonds, and, ultimately, their viability as long-term generators of expanding revenues and profits is impressive. His work underscores the necessity of critically analyzing a company versus its industry peers to assess its current and long-term value for investment—or for disinvestment.

—J.J.M., W.A.H.

Notes

1. CFROI is a registered trademark of Credit Suisse Securities.

***Where Keynes Went Wrong: And Why World Governments Keep Creating Inflation, Bubbles, and Busts*. 2009. By Hunter Lewis. Axios Press, www.axiospress.com. 384 pages, $18.00.**

Reviewed by Jerry H. Tempelman, CFA.

Hunter Lewis's *Where Keynes Went Wrong: And Why World Governments Keep Creating Inflation, Bubbles, and Busts* is a basic critique of Keynesian economics offered from the perspective of the Austrian school of economics. Keynesian ideas spring from the work of John Maynard Keynes (1883–1946), the famous and influential British economist. Now a relatively obscure branch of the science, Austrian economics used to be the principal intellectual counterweight to the Keynesian school. Friedrich A. Hayek (1899–1992), the best-known proponent of the Austrian view, was awarded the 1974 Nobel Prize in Economics. The initial debate between the two schools took place during the first half of the 20th century, but it remains unresolved and has relevance for public policy to this day.

Keynesian economists believe that recessions are the result of a shortfall in consumer demand. When people save an increased portion of their income, doing so may be good for them individually; in the aggregate, however, it reduces the demand for consumer goods. In response to the decrease in demand, producers lower their production capacity, which entails employee layoffs and thus increases unemployment. Markets, including the market for labor, do not automatically clear, as the classical economists who preceded Keynes had maintained.

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To make up for the shortfall in private-sector demand, Keynesians argue, governments should increase their spending and finance the extra expenditures with borrowing. The increased demand encourages businesses to hire again, which reduces unemployment. The resulting fiscal government deficits do not pose a problem because, in effect, we owe the money to ourselves, and in any event, the deficits will be less than the increase in government spending given fewer unemployment benefit payments. In addition to these fiscal policy measures, the central bank should lower interest rates. Doing so reduces the cost of funding investments, which encourages business activity and thus leads, in turn, to the hiring of new employees. Accommodative monetary policy also helps prevent deflation. Deflation is undesirable because lower prices encourage consumers to further reduce demand in anticipation of even lower prices.

Economists from the Austrian school counter that although a reduction in demand may be a symptom of recession, it is not adequately explained by Keynesian economics. They explain reduction in demand by introducing the element of time into their analysis. People may reduce their present demand for consumer goods and use the savings to increase their future consumption. The savings today enable the funding of investments that allow an increase in production to help meet the future demand for more goods. The lower demand today need not cause unemployment: Workers can shift from industries that produce consumption goods to industries that produce capital goods.

If left unfettered by government action, interest rates reflect the relative importance people assign to current consumption versus future consumption. If the central bank pushes interest rates

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