Current Gain vs. DCF
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Current Gain vs. DCF

What is the difference between wealth maximization and short run profit maximization? Let's give an example.

Holding a tree uncut because its growth rate > the i.r. is an example of wealth maximization at the expense of short run profit maximization. Wealth maximization is maximizing the present value of your assets by investing them in ways that yield returns greater than or equal to the discount rate. Any durable investment, indeed, represents sacrificing short-run cash flow for later gains.[1]

How might the difference be reconciled? It's wonderfully simple. Count unrealized gains as current revenues, and subtract unrealized losses from revenues. This is a logical extension of what is now called accrual accounting, as opposed to cash flow accounting.

Confusion is introduced by the U.S. tax code, because it lets you deduct (and also overstate) depreciation, but does not make you add unrealized gains to taxable income. This, however, is bad accounting. It is the result of heavy lobbying, and a bias, and should not confuse you when defining real income, apart from tax considerations.

Various deceptive practices in business and finance let firms avoid marking to market (MTM), thus concealing losses and gains, for whatever reasons - usually discreditable and corrupt, but enforced openly by social pressure, domination, and hypocrisy. Again, recognize the social phenomenon and know when to play along silently, but don't fall for the fallacy. Fortunes have been made by recognizing the difference between what social leaders say, and what they do.

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[1]Every year there arises a new crop of Jeremiahs who lament what they claim is a modern tendency to sacrifice the future to the present. If this is true, would consist in depleting the total capital stock by overconsuming and undersaving, not in choosing short over long investments. Intertemporal allocation of capital is a different matter from maintaining the aggregate supply of capital.

Many corporations routinely retain half their profits from distribution and plow them back. Their sin often lies in misallocating capital, not in depleting it.