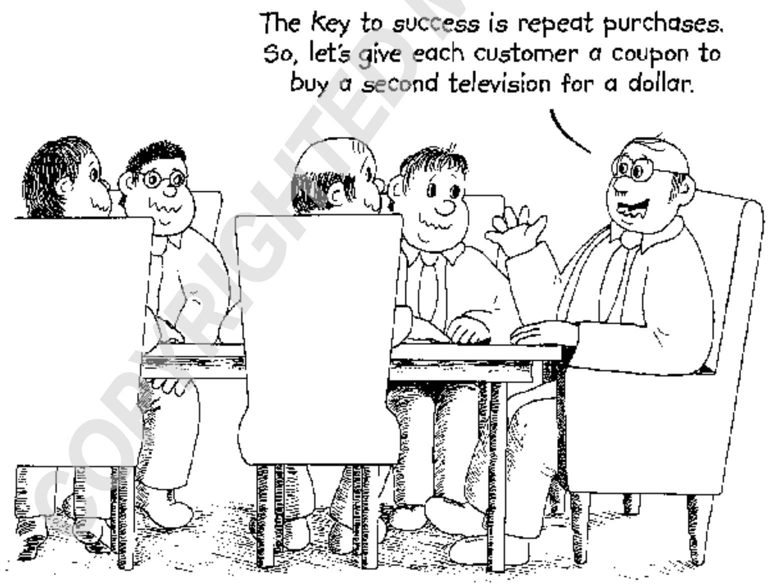
CHAPTER 1

Loyalty Myths That Subvert Company Goals



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Since we became a public company, we've had the highest retention of customers in the industry . . . we are not going to surrender that leadership position.[1]

—John Chapple, Chairman, CEO, and President, Nextel Partners, Inc.

No industry provides a better example of the misconception of customer loyalty as a pervasive corporate goal than the banking industry.

The 1990s was a decade of great turmoil for the U.S. banking industry. Competition was emerging from a host of new, nonbank businesses that were cherry-picking some of the retail banks' most profitable lines of business. Customers were beginning to be allowed to write checks on money market accounts obtained through their brokers, arrange auto financing through automobile manufacturers, buy annuities through their insurance agents, and obtain credit cards from credit card–only financial institutions operating nationally. At the same time, interstate banking was coming into existence, guaranteeing that larger national banks would begin to compete in what were previously relatively local or regional markets.

Not surprisingly, banks were desperately seeking a solution for increasingly tighter profit margins. In a 1991 *Journal of Retail Banking* article, Frederick Reichheld (a loyalty advocate we've previously mentioned) and Bain & Company colleague David Kenny prescribed the following remedy:

> Neither cost savings nor price increases will solve the branch profitability problem. To build sustainable profits, banks must "grow" deposits cost-effectively. And about the only way to do so is by raising customer retention rates.[2]

Reichheld and Kenny were by no means lone voices addressing the U.S. banking industry during this time. In fact, the Bank Marketing

Association (BMA) and its affiliate trade journal, *Bank Marketing*, were overflowing with appeals to compete on service for enhanced customer loyalty. The BMA was so convinced of the importance of loyalty in solving banks' profitability problems that in 1989 it established a separate organization, the Quality Focus Institute, with the stated aim of achieving "greater customer satisfaction and retention."[3]

THE PARABLE OF THE COSTLY CUSTOMER: FIRST NATIONAL BANK OF CHICAGO

During the early 1990s, First National Bank of Chicago (now Banc One) would definitely have been classified as suffering profitability problems. Despite having the largest market share in the Chicago area and the greatest reach of any Chicago institution, the bank's return on equity was a pathetic 5 percent, compared to the industry benchmark of 15 percent. To combat the problem, the company named Jerry Jurgensen, a former First Chicago CFO, to head the community banking group in 1993. As a numbers man, Jurgensen did not dodge the company's earnings problems. "First Chicago's profitability as a retail bank is a problem. It needs to earn more, there's no question about it."[4]

One of the first things that First Chicago did under Jurgenson's supervision was to examine the profitability of its customer base. What they found was not pleasant: only one-third of the customer base was generating an adequate return. The search for distinguishing characteristics between its profitable and unprofitable customers revealed that the profitable segment was more accustomed to using the self-service channels the bank offered. In a concurrent review, the bank examined the costs associated with its operations. It determined that interactions with its branch tellers were one of the most costly means of delivering its routine banking services. ATM and banking by telephone (the primary modes of self-service) were obviously far more cost effective. Weighing the costs of servicing its different customer groups, the bank resolved to persuade some of its low-balance customers to use the less costly interaction modes. As a result, on April 25, 1995, First Chicago announced that it would begin to charge some low balance checking customers $3 if they sought teller assistance (for transactions that could have been completed through an ATM or by bank-by-phone). "If they change their behavior, it's a win-win," Jurgensen said. "And if they don't, at least they're paying fairly for the way they use the bank."[5]

Not surprisingly, the public outcry was immediate and merciless. Magazine and newspaper articles excoriated First Chicago's decision. Some of the resulting headlines included:

"Thanks for Your Deposit. That'll Be $3" (*Business Week*, May 15, 1995).[6]
"Tack on $3 for that Trip to the Bank Teller" (*Chicago Tribune*, April 26, 1995.)[7]
"Fees from Hell: How Fiendish Is Your Bank?" (*Money*, July 1995).[8]
"Need a Teller? A Big Bank Plans $3 Fee" (*New York Times*, April 27, 1995).[9]

Other media joined the criticism, including the late humorist Erma Bombeck in an article entitled "Our Friendly Bankers Have Become Greedy Thieves."[10] Jay Leno's opening monologue on NBC-TV's *Tonight Show* skewered First Chicago. Leno's punch line: "For $3 you can talk to a human teller, and for $4, they'll talk dirty to you."[11]

Politicians and consumer groups leaped at the opportunity to denounce the bank. Representative Maxine Waters (D-CA) called for a boycott of the bank.[12] Waters and Joseph Kennedy (D-MA), both members of the House Banking Committee, threatened to postpone legislation to expand banking powers because of the banking community's seeming disregard evidenced by the fee.[13]

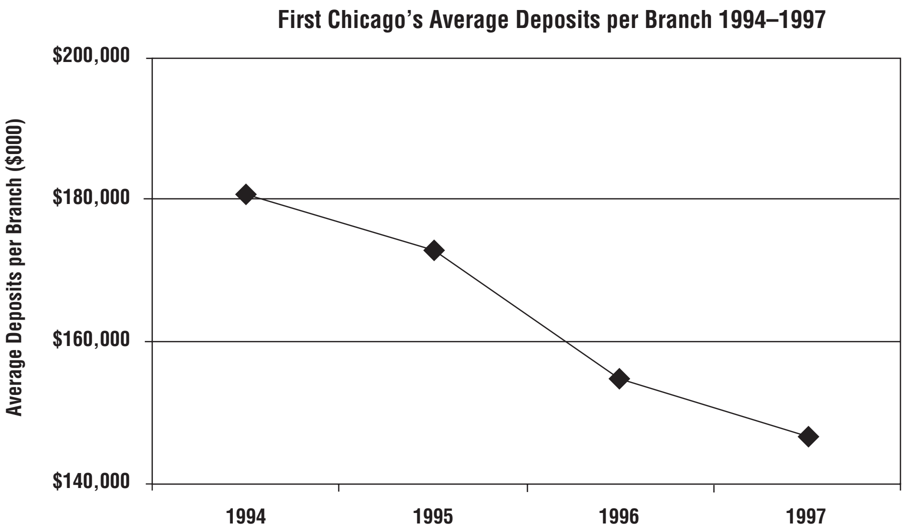
Competitors quickly moved to take advantage of the situation with advertisements lampooning the fee in aggressive attempts to woo First Chicago's customers. Harris Bancorp took out a full-page advertisement in the *Chicago Tribune* assuring "free and unlimited access to our tellers."[14] First Illinois Bank's advertisement declared: "There's no such thing as a $3 bill."[15] In yet another ad, under a photo of a bank teller, MidCity Financial Corporation's ad proclaimed, "At our banks, this is not an endangered species."[16] And another bank's television advertisement had a confused customer approaching a bank window and asking, "Are you a teller?" The response: "Yes, that will be $3 please."[17]

From the sublime to the ridiculous, several Chicago-area banks actually paid customers who visited teller windows.[18] Lake Forest Bank Trust Co. gave $3 to customers after their transactions were finished. Harris Bancorp gave out $1 bills to customers who asked if it charged teller fees. Northview Bank & Trust offered a $3 rebate for new accounts that required a teller transaction. And First American Bank offered $10 to customers for switching from First Chicago, supporting the offer with print ads questioning, "Why pay to bank there when we'll pay you to bank here?"

Competitors' cash incentives were hardly the only inducements for customers to switch banks in the wake of First Chicago's decision. An *American Banker* article reported that Chicago-area banks, in general, averaged less in fees than First Chicago per $100 of deposits.[19] Survey research conducted that same year for *U.S. Banker* magazine among depositors suggested that First Chicago's approach was guaranteed to erode loyalty to the bank. Nearly 54 percent of participants in the survey said that they would change banks if required to pay a $3 teller fee. First Chicago officials did admit to losing hundreds of checking customers (although they kept the exact number proprietary).[20] Examination of Federal Deposit Insurance Corporation data clearly showed that First Chicago's average deposits per branch declined following the initiation of the new teller fee plan. (See Figure 1.1.)[21]

First Chicago's approach was far from a conventional customer retention strategy. Ruth Susswein, then executive director of the consumer group Bankcard Holders of America, disparaged the difference between most banks' stated focus on building loyalty and First Chicago's fee-for-service strategy. "On one hand, banks are saying they want relationship banking so that consumers can do all their banking at one institution," she noted. "But on the other hand, they are tearing the relationship apart by tacking on all these 'nuisance fees.' What are customers getting if they can't go to a teller anymore?"[22] And given Reichheld and Kenny's assertion that for banks "about the only way to build sustainable profits" is "by raising customer retention rates,"[23] Jurgensen's strategy should have sent First Chicago into a death spiral. What exactly did happen?

FIGURE 1.1 Average Deposits at First Chicago



Source: FDIC Online.

In the first full month following the announced charges, self-service ATM transactions at First Chicago doubled, and then increased an additional 50 percent a year later. Teller transactions dropped by one-third. By the end of 1995, more than 80 percent of depositors' transactions were being conducted electronically, and more than two-thirds of all account deposits were being made through ATMs or automated clearing houses (ACH).[24]

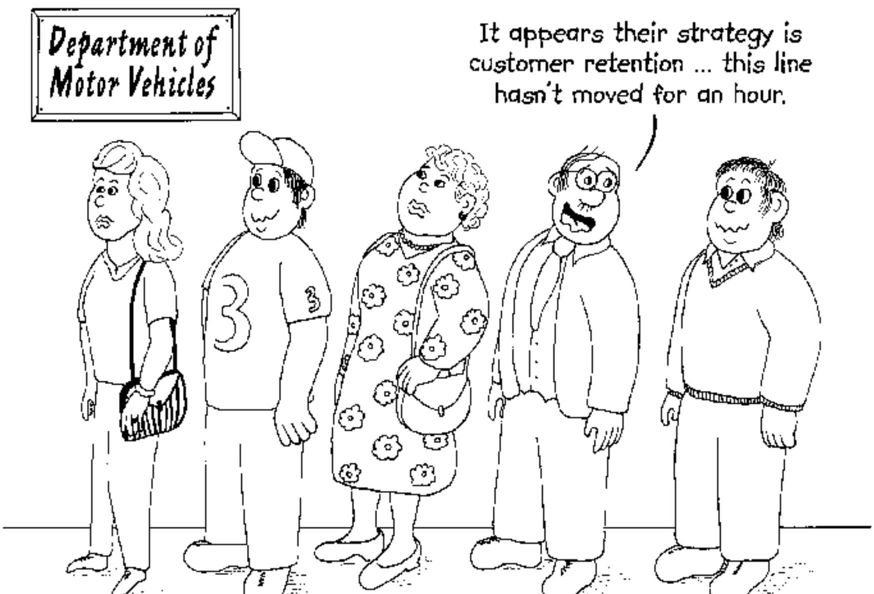
As a result, the bank made an adequate return on 44 percent of its customers (compared to only 33 percent before the change) and profits jumped 28 percent![25] Most observers were forced to admit that First Chicago's unorthodox approach to customer relationships had been highly successful. The title of a 1996 *Journal of Retail Banking Services* article summed up the general consensus: "First Chicago's Account Realignment Succeeds."[26]

It would be hard to find a more poorly received and seemingly anti-loyalty strategy than that of First Chicago's introduction of teller fees. Clearly it was designed to change customer behavior (either through the use of less expensive bank channels, or by encouraging customers to leave the bank), but First Chicago's success is also a testimony to the fallacy of loyalty myths as they influence and confuse company goals. Around the time that First Chicago was raising its profitability by instituting what most would consider an anti-loyalty strategy, the Bank Marketing Association was closing down its Quality Focus Institute because of a distinct lack of success stories and the corollary growing disillusionment among member banks at the lack of returns forthcoming from traditional customer loyalty initiatives.[27]

Jay Leno and others may have gotten the first laugh, but First Chicago laughed last and laughed best.

The Moral of the Costly Customer

To be profitable, businesses don't always have to blindly follow the folklore that urges the wholesale retention of all customers. A business should first understand which of its customers are profitable for it and



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why. Then it's appropriate to incent customers to engage in behaviors that are economically beneficial for the business. Just as was the case in the U.S. banking industry of the 1990s, ill-conceived customer loyalty objectives tend to pervade many companies' corporate goals today. The myths driving this orientation have become folklore in corporations worldwide and are so widely believed that they've been virtually unchallenged—until now. In contrast, organizations like First Chicago who aren't afraid to challenge myths have helped alert the marketing community to the fact that not all of the loyalty mandates from the so-called experts necessarily apply to their business, nor lead the way to greater profits.

LOYALTY MYTH 1: The Number One Goal of Any Firm Should Be Customer Loyalty

In 1960, Theodore Levitt wrote "Marketing Myopia," one of the most widely-quoted and reprinted *Harvard Business Review* articles.[28] The article warned of the dangers from firms shortsightedly focusing on their products and, in doing so, overlooking the needs of their customers. Levitt insisted, "the organization must learn to think of itself not as producing goods or services but as buying customers, as doing the things that will make people want to do business with it."

Without question, Levitt was absolutely correct. Firms exist to satisfy customer needs and wants and survive only by doing so. During the time of Levitt's article, however, many firms had lost sight of why they existed, arrogantly believing that "the market will buy whatever we choose to sell." This was during the same era that Japanese auto manufacturers were making inroads into the U.S. market by listening to consumers' concerns and building smaller vehicles. U.S. auto manufacturers continued to churn out large, gasoline-guzzling vehicles not because of their inability to make smaller cars, but because the profit margins were significantly higher on larger vehicles.

The world has changed a lot since then. Today most managers recognize that losing sight of customer needs is a recipe for disaster, though we might argue about how their firms actually address these needs.

Levitt's words still ring true, however. The problem is how the misinterpretation of Levitt's maxim has evolved in the modern era, which can loosely be summarized "customer loyalty is the number one goal of any firm." Though the emphasis may be exaggerated, business news stories demonstrate that the message is often forgotten. It is not difficult to find articles like the following:

- "Broke But Beloved," which begins "Say this for WINfirst, the troubled cable, telephone and Internet provider: It has very loyal customers. Since filing for Chapter 11 bankruptcy protection in March . . ."[29]
- "Loyal Following Couldn't Keep Jacksonville, Mich.–Based Jacobson's Going."[30]
- "Garden Botanika, Inc., the Redmond-based cosmetics and personal care products company, announced today it has filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code. . . . Garden Botanika remains an industry leader with high sales and extremely loyal customers."[31]

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In fact, many of the dot-com disasters could have reported similar results: loyal customers but no profits.

The fundamental purpose of any business is to identify and satisfy customer needs at a profit, an idea Theodore Levitt certainly embraced. The problem is that customer loyalty *can be purchased*, and frequently is! But to paraphrase an old saw, "You can't buy things for a dollar, sell them at 99 cents, and make up the difference in volume!"

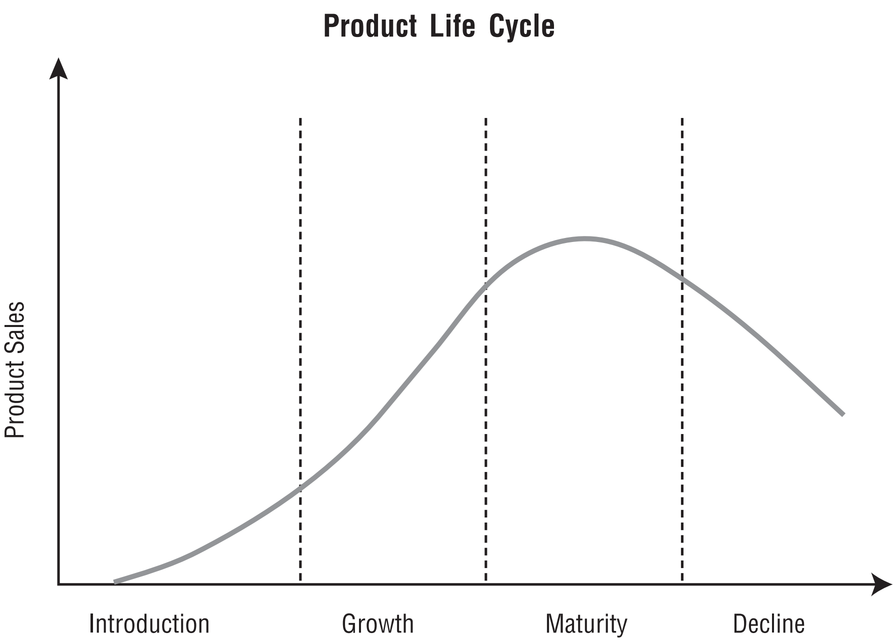
LOYALTY MYTH 2: Firms Should Emphasize Retention Efforts Rather than Acquisition Activities

The underlying logic of this myth rests on the trade-off between the costs of acquiring new customers and the costs of maintaining current ones. Conventional wisdom (seeded by the maxim "It costs less to retain a current customer than to win a new one") suggests that, all other things being equal (which is most often not the case), your odds are greater of receiving some return from investing in a current customer rather than chasing a potential one. This myth is further fueled by the beliefs that customers purchase more as their lifetimes lengthen (promising even greater than linear returns) and that they help recruit additional customers through positive word of mouth. Because marketing departments have traditionally overspent on advertising and have underspent on retention, the message also carries some novelty.

Even if the underlying reasoning were correct (which it is not, as will be demonstrated later in this book), it is ridiculously simplistic. Attracting and retaining customers are *both* critical processes. Economic success cannot be achieved by focusing exclusively on customer retention to the detriment of attracting new customers. Even with an ardent focus on retention, customers will defect and will need to be replaced. Therefore, a blind adherence to this myth will be nothing short of disastrous.

The most obvious flaw in this misconception is its complete disregard for the product life cycle (PLC). There are four generally accepted stages in a product's life cycle: introduction, growth, maturity/saturation, and decline.[32] A typical PLC pattern is depicted in Figure 1.2. Firms operating in each of these various phases have dif-

FIGURE 1.2 Product Life Cycle



ferent strategic objectives that weigh heavily on the cost of acquisition versus retention.

1. Introduction: With the launch of a new product, success hinges on building a critical mass of early adopters. In this stage, product awareness and acceptance are the key strategic objectives.
2. Growth: The product is now accepted by the larger market, so consumer demand increases and the market expands. In this stage, brand awareness and market share are the key strategic objectives.
3. Maturity/Saturation: The market for the product has reached saturation. Growth comes largely at the expense of competitors,

and therefore competition becomes intense. In this stage, defending market share and maximizing profits are the key strategic objectives.

4. Decline: Sales decline as the product becomes out-of-date or out of fashion. In this stage, firms must decide on one of three strategic objectives: (1) rejuvenate the product with new features/functions; (2) "harvest" the product (reduce costs and continue to sell to a loyal niche segment); or (3) discontinue the product.

Therefore, the best thing that can be said about myth 2 is that, like a broken clock, it is correct at some times of the day. When firms are in the introductory and growth phases of their offerings, customer acquisition is critical. Conversely, when products are in the maturity and decline phases, customer retention takes on much greater importance.

Firms ignore the differing strategic objectives of the product life cycle at their peril. We need only look to Apple computer to be reminded of this. Apple popularized the computer by making it available to the masses through the introduction of the Apple II in 1977, established a computer and operating system that made the computer usable by nontechnical people through the introduction of the Macintosh in 1984, and was the first to commercialize the laser printer. These innovations resulted in explosive growth in the market for computers, printers, and software. As a result, Apple grew quickly and profitably. But its growth rate was far less than the growth of the market, as Apple was content with having a highly loyal but small customer base.

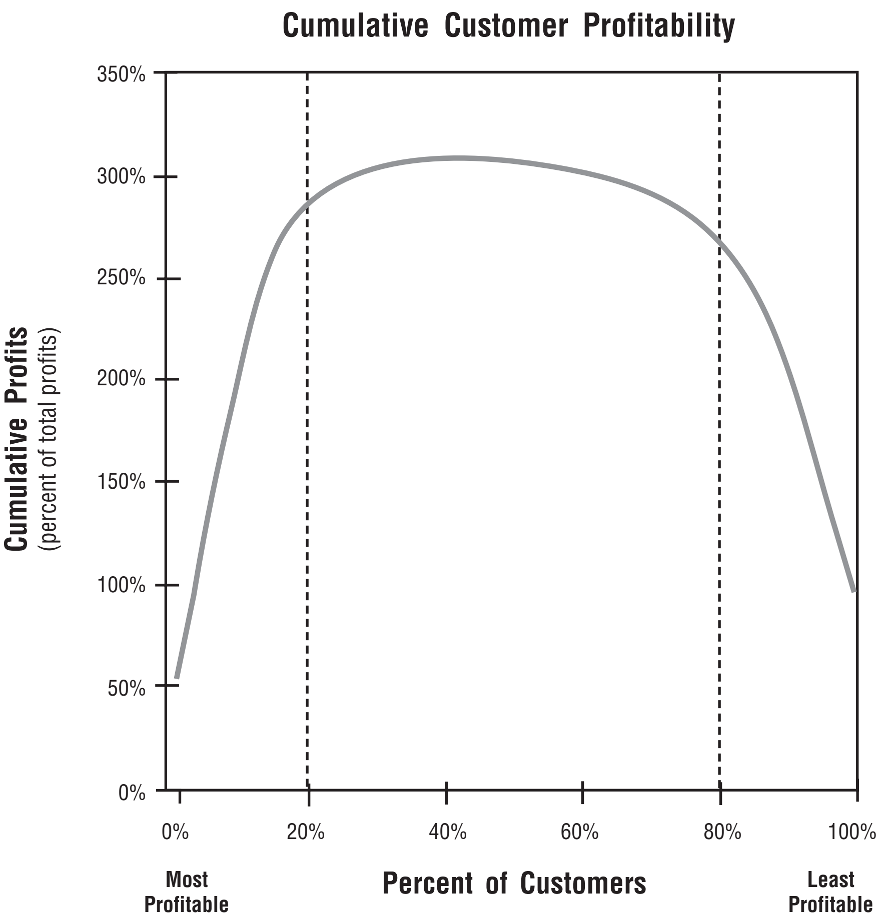
Apple disdained Microsoft's mass marketing strategy in favor of maintaining its highly profitable and opinionated market niche. "The only problem with Microsoft is that they just have no taste," Steve Jobs, Apple's co-founder, lamented. "They don't think of original ideas, and they don't bring much culture into their products."[33] This observation reveals a serious strategic blunder. While Apple computer users remain fiercely loyal, the firm's market share of computers and the operating systems that run them is relatively small, diminishing its ability to influence the market. There was even a time in the mid-1990s when Apple's ability to survive was in doubt. Fortunately, long-time adversary Microsoft Corporation and its chairman, Bill Gates, saved Apple with a $150 million investment. Apple had had the opportunity to be the dominant player in this market; that title now resides with Microsoft.

LOYALTY MYTH 3: Companies Should Strive to Make All of Their Customers Attitudinally and/or Behaviorally Loyal

The fundamental assumption underlying this myth is that all customers are or can be made to be profitable for a firm. An examination of customer profitability invariably reveals that while organizations will always have some highly profitable customers, they are also likely to have some highly unprofitable customers. We've labeled these groups (in the Introduction) as desired customers, break-even customers, and costly customers. For most firms, the desired customers (usually about 20 percent of all customers) will generate between 150 and 300 percent of total profits; break-even customers (the middle 60 to 70 percent of customers) about break even; and the least profitable, costly customers (10 to 20 percent of all customers), lose 50 to 200 percent of total profits! The "whale curve" in Figure 1.3 demonstrates this range. In short, 80 percent of a typical firm's customers do not provide an acceptable rate of return! Striving to retain them all is suicidal.

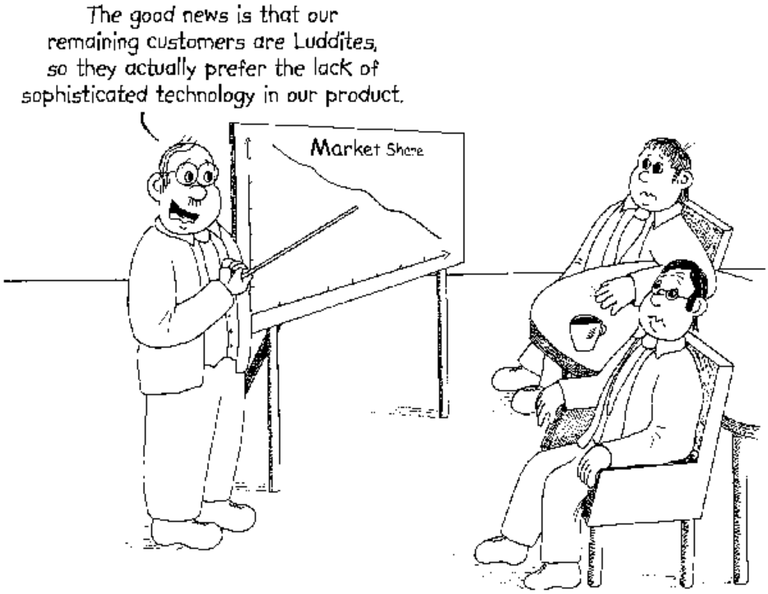
In the case of First Chicago, an examination of the profitability of the firm's customers revealed that only 33 percent generated an adequate rate of return (and this is a higher percentage than is typically seen for most firms). Even after changing its policies, that number did not come close to breaking 50 percent, as it topped out at only 44 percent of customers. Clearly, making the majority of customers more loyal is not a wise investment decision for most companies. Instead, managers must make reasoned decisions about which customers truly represent assets to their firms' financial health, and target their loyalty efforts to them.

FIGURE 1.3 Whale Curve



LOYALTY MYTH 4: Companies with More Loyal Customers Will Always Have Higher Market Shares

While it may seem counterintuitive, firms with the highest loyalty levels frequently do not have the highest market shares. Generally, organizations we tend to associate with having fiercely loyal customers represent smaller, exclusive groups: Harley Davidson owners, Fender



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Stratocaster owners, Jimmy Buffett fans, and so on. The intense loyalty of Macintosh computer users resulted in a *Sociology of Religion* scientific paper entitled "May the Force of the Operating System Be with You: Macintosh Devotion as Implicit Religion." The article described Mac owners' ardent devotion as follows:

> In the case of the Mac enthusiasts, I found deep religious symbolism that is fundamental to the strong devotion to their computer platform. Like a religion, the beliefs of the Mac devotees are founded on the distinction between the sacred and the profane. To many, there is a sacred bond between computers and people—they should work together in harmony, as Mac users often emphasize that Macintosh computers do not "fight back" as other computers do. And, if such a sacred bond between human and computer is maintained, Mac enthusiasts believe that computer technology will help improve humanity. Thus . . . the Macintosh computer, which

> symbolizes a spiritual passage to an utopian future, also ties its followers together. Moreover, the faith of Mac devotees in this utopian future is expressed through their practices, including their "evangelistic" efforts.[34]

Research regarding customer satisfaction and market share sheds insight into why there is often a disconnect between loyalty and market share. While satisfaction and loyalty are not the same thing, they are strongly correlated. The results of various studies on the satisfaction-market share relationship have been mixed, with some finding a positive relationship while others find a negative relationship.

There are several reasons proposed for negative relationships. Increases in market share may negatively impact customers' perceptions of quality both indirectly (for example, decreasing perceived value due to product overuse) and directly (for example, the loss of exclusivity). A negative correlation can also be a function of the type of market itself. In relatively homogeneous markets where customer needs are relatively similar, market share and loyalty will move together. In heterogeneous markets, market share leadership will not typically be associated with the highest levels of loyalty, as niche players who address the unique needs of smaller segments will naturally enjoy a more loyal following—at the expense of being less attractive to the total market.

LOYALTY MYTH 5: Companies Should Seek to Change Switchers into Loyal Customers

This myth flows from the logic that if customer loyalty drives profitability, then maximizing profits comes from making all customers loyal (Myth 3). But, as all managers know, different customer types derive value from their shopping experiences for different reasons. Two relatively universal customer segments most prone to switching are customers commonly referred to as *variety seekers* and *deal seekers*. The variety seeker is motivated by curiosity about and the desire for new experiences in product types and brands. The deal seeker is primarily motivated by price. Trying to change these customers is like trying to get a leopard to change its spots—it never works. The customers in these groups are who they are; they are unlikely to change.

The desire to alternate between brands or firms is simply innate in some customers. Despite this truism, firms engage in extensive promotional campaigns, hoping to graduate customers to higher levels of loyalty and profitability. These false hopes have helped to inflate promotional spending to an unbelievable size. The U.S. promotional marketing industry has expanded from $98 billion in 1998 to $233 billion in the year 2002.[35] The impact on companies has been staggering. For example, Kraft allocates approximately 42 cents of every dollar it earns to advertising and promotion. Given this extraordinary expense, one would expect customer loyalty to be at an all-time high. Thirty years ago, Kraft would have classified approximately 40 percent of its customers as loyal. Today, that number is somewhere around 15 percent.[36]

As most consumer package goods companies have discovered, the problem with chasing variety-seeking and deal-seeking customers is that it actually deteriorates customer loyalty across the board. Too many firms have trained their customers to respond to sales promotions by overusing these tactics. Once-loyal customers are actually becoming accustomed to deals and deal days, and are altering their behaviors by putting off scheduled purchases, waiting for deals or promotions.

LOYALTY MYTH 6: Efforts to Improve Customer-Centric Measures Are Properly Separated From Efforts to Improve Brand-Centric Measures

For most firms, marketing has largely focused on brand-centric objectives. Simplistically, brand-centric marketing can be thought of as manipulating the elements of the marketing mix (commonly referred to as the four P's: product, price, promotion, and place) to improve brand equity. In contrast, customer-centric marketing largely focuses on efforts to improve customers' perceptions of their experiences with a firm's products or services, or with the firm itself. In opposition to a brand-centric focus on acquiring more customers (conquest marketing), customer-centricity is aimed largely at retaining customers and developing loyalty with them (retention marketing). Figure 1.4 depicts the differences in these two approaches when it comes to conducting research.

While both brand-centric and customer-centric approaches are aimed at affecting customers' attitudes and behaviors, managers and researchers have tended to dichotomize these functions. Brand management efforts are usually considered separately from satisfaction management efforts in most firms and are frequently the responsibilities of different departments within the organization. Similarly, specialized scholarly journals have evolved for researchers dedicated to the focus of either brand-specific or customer-specific issues. This separation would be fine if customers actually distinguished between the two presentations of the firm. The problem is that brand-centric objectives are important to current customers (for example, reinforcing brand imagery in customers' minds), and customer-

FIGURE 1.4 Customer vs. Market Research

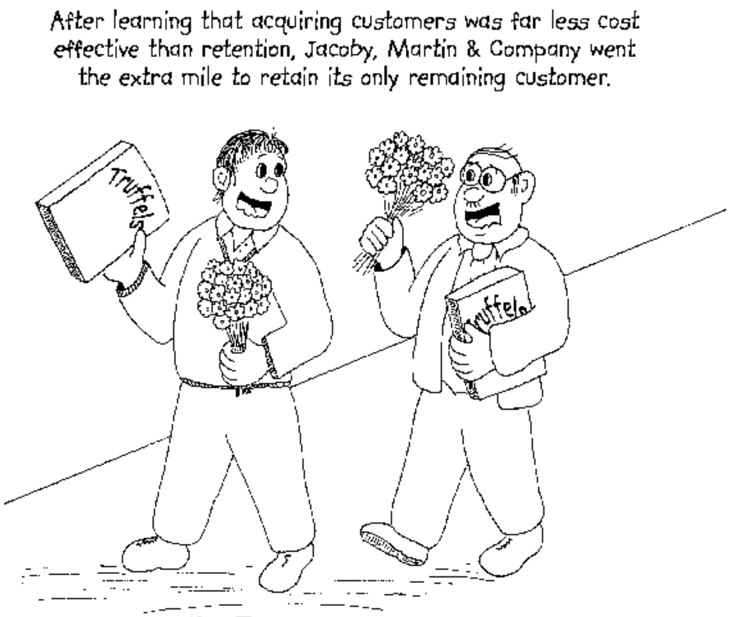
Differences between Customer Research and Marketing Research

	Customer Research	**Marketing Research**
Purpose	Data collection and communication	Data collection only
How many are included	Census (or as many as reasonably possible)	Sample
View of the population	Population is precious—needs retaining	Population infinite—no concern
How participation is encouraged	Offer opportunity to help improve product/service—high participant involvement	Offer financial incentive—low participant involvement
How information is analyzed	Keep data disaggregated—at the individual level	Aggregated data (e.g., sample averages, proportions, etc.)
Identification of participants	Information is linked to specific individuals, necessary for follow-up	Information collected anonymously
End result	Fix product/service and remedy individual participants' problems	Identify problems
Need for follow-up from survey participation	Requires follow-up—response to issues, questions	No follow-up, considered unethical

Source: Adapted from Douglas R. Pruden and Terry G. Vavra, "Customer Research, Not Marketing Research," *Marketing Research*, 12, No. 2 (Summer 2000), 14–19.

centric objectives are important to attracting new customers (for example, reputation for good customer service and responsiveness to customer needs).

Our own research confirms that brand-centric and customer-centric efforts need to be considered jointly; while each contributes to the share-of-spending (share-of-wallet) a customer allocates to a firm, they also act in a combined fashion.[37] This finding (previously not recognized) indicates that the interaction between the efforts can double the customers' share-of-spending when both are positive or halve it when both are low. This means firms need to find a way to manage both acquisition and retention efforts simultaneously and in a coordinated way if they wish to maximize their profits. This is not easy, as the two perspectives have different origins and different views of the function of marketing. But convergence of these two perspectives is essential, as those firms that do this well will reap substantially greater returns from their customers.



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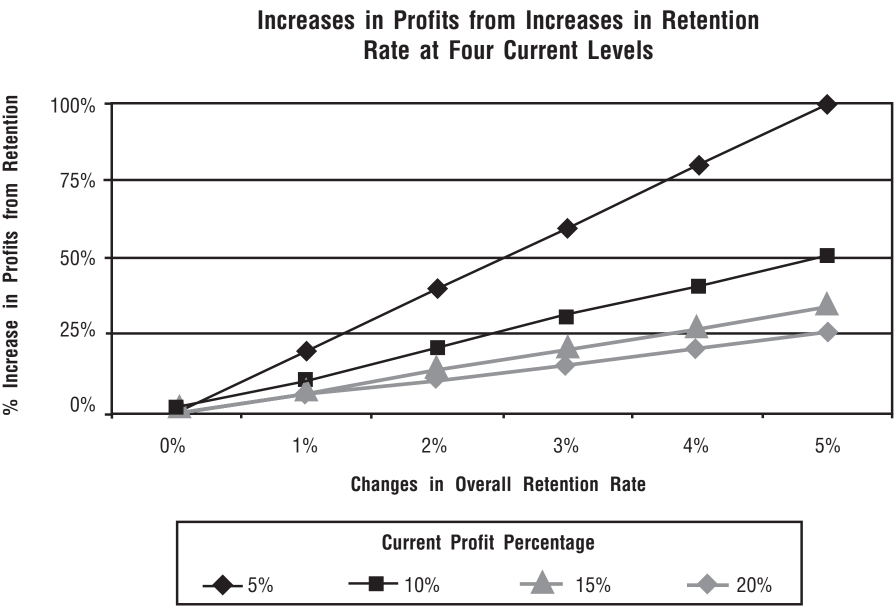
LOYALTY MYTH 7: Retaining 5 Percent More of a Company's Customers Will Increase Profits by 25 to 85 Percent

This myth comes directly from what many managers would consider an unimpeachable source: the *Harvard Business Review.* In 1990, Bain & Company consultant Frederick Reichheld and Harvard professor W. Earl Sasser Jr. published a landmark article, "Zero Defections: Quality Comes to Services."[38] The article claims "companies can boost profits by almost 100 percent by retaining just 5 percent more customers." Later in the article it refines the claim to "reducing defections 5 percent boosts profits 25 percent to 85 percent." Without question, this was a seminal article. Almost overnight it validated customer retention and spurred the quest for customer loyalty among firms worldwide. Unfortunately, despite publication in a prestigious journal, the promise is flawed on at least three basic levels.

1. The company needs to be generating relatively small current profit percentages to expect such a high percentage increase (25 to 85 percent). If we assume that there are no additional costs associated with increasing retention rates, and that each customer contributes equally to revenues, a firm would have to have a pathetic 5 percent rate of return in order to increase profits by 100 percent from a five percent increase in retention rates. More typical returns substantially lower the potential financial impact from improved retention, as shown in Figure 1.5.

2. The ability to generate further profits by improving retention is highly contingent upon a firm's current retention rate. If we take away the assumption that there are no additional costs associated with increasing the retention rate for customers, it becomes very likely that there will be diminishing returns. At some point it will no longer be cost effective to dissuade potential defecting customers from defecting. This means that for firms with relatively low retention rates (high churn), it will likely cost less to increase retention by 5 percent than it will for companies with already high customer retention rates. For virtually all firms, it will never be cost effective to retain 100 percent of customers. Therefore, depending upon where a firm is positioned

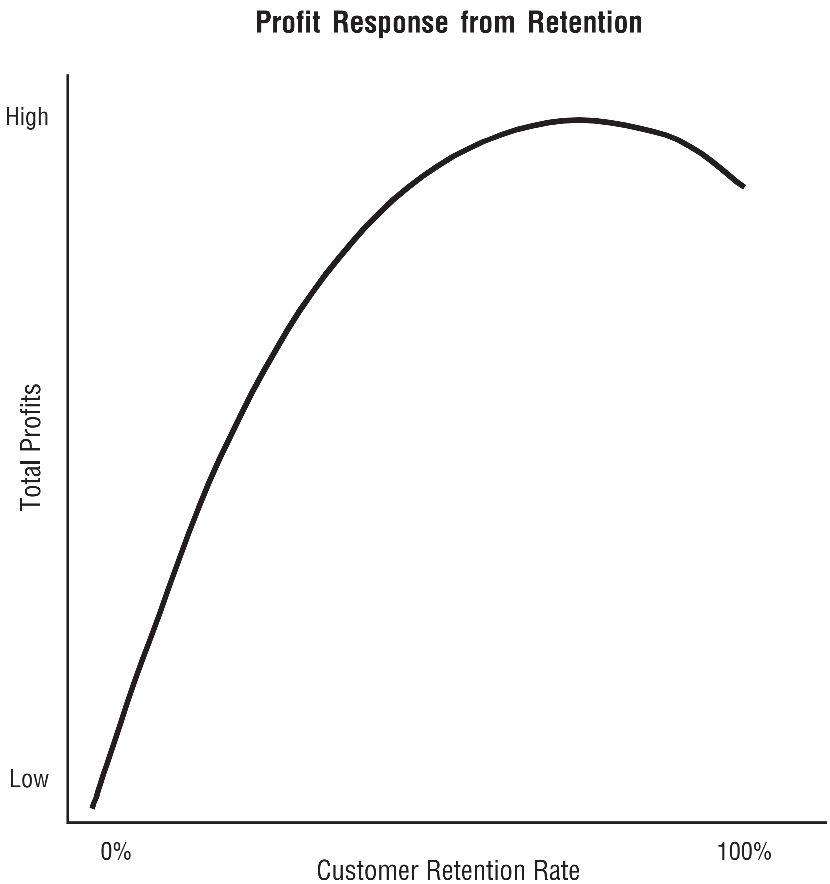
FIGURE 1.5 Increase from Retention



with regard to its retention-profit function, the return on investment of improving customer retention by 5 percent can be either positive or negative. (See Figure 1.6.)

3. For most firms, the most profitable 20 percent of customers generate between 150 and 300 percent of total profits; the middle 60 to 70 percent of customers about break even; and the least profitable 10 to 20 percent of customers lose 50 to 200 percent of total profits. Myth 7's greatest failing is its disregard for how customer profitability is distributed throughout firms' customerbases. For most firms, 20 percent of the customer base (the desired customers) generates the lion's share of the profits, and 10 to 20 percent are significant money losers (costly customers). The size of losses generated by Costly Customers typically determines whether a firm operates in the black or in the red. It doesn't take a rocket scientist to realize that retaining 5 percent more customers won't make money unless they are the *right* customers—those in the top 20 percent.

FIGURE 1.6 Diminishing Returns from Retention



LOYALTY MYTH 8: It Costs Five Times More to Acquire a New Customer than to Retain a Current Customer

Although it is difficult to determine the exact origins of this platitude, the earliest sources that we can find attribute it to research conducted by the Technical Assistance Research Project (TARP) in Washington, D.C., in the late 1980s.[39] Around the same time, other loyalty pundits claimed exactly the same findings as their own (for example, the Customer Service Institute,[40] Consumer Connections Corp.,[41] and ITEM Group[42]). Soon the myth found its way into the pages of prestigious journals and books. In 1990, Total Quality Management Group president Christopher Hart and Harvard professors James Heskett and W. Earl Sasser, Jr. lent the statement further credibility in their *Harvard Business Review* article "The Profitable Art of Service Recovery."[43] And popular business strategist Tom Peters likewise repeated the myth in his best-selling book *Thriving on Chaos*.[44]

This myth is so pervasive and so seemingly intuitive that it has stood unchallenged for 20 or more years! We, too, have published prior works repeating this fallacy. There is currently enough contrary information to bury or significantly qualify this truism, based on three major flaws.

1. The fundamental financial underpinnings of the argument are either misallocated in terms of acquisition and retention, or the financial effects attributed to retention are false. The basic argument that the cost to acquire new customers is substantially greater than that to retain existing customers hinges on a stream of interrelated factors. With regard to existing customers, there is the assumption that they will (1) increase their level of spending at an increasing rate; (2) purchase at full-margin rather than discount prices; and (3) create operating efficiencies for firms. Unfortunately, none of these things are true, as will be summarily disproved in other parts of this book.

With regard to new customers, operating costs are presumed to rise as the customer has to learn the procedures of the firm, and the firm has to learn the needs of its new customer. Even if that were universally true, most firms don't go through new account setups, credit searches, and so on. when a new customer walks through the door. The fallacy becomes obvious when we think about our own experiences as a new customer. What exactly was the additional cost to the companies of our purchasing from a new retailer, dining at a new restaurant, or flying with a new airline? For those industries in which there is a legitimate cost associated with sign-up, these costs are often incurred regardless of whether the consumer remains loyal to the firm. Exactly how much easier is it to purchase a new car, television, or washing machine simply by staying with the same brand?

The x-factor that makes this myth seem plausible is the costs associated with advertising and promotional expenses. While it is believable that they represent enormous expenses that would far exceed the costs of retaining existing customers, there is one fatal flaw with this assumption: advertising and promotion are not simply about inducing first-time purchases. Much advertising is about reinforcing brand imagery and maintaining awareness among current customers of the brand. And while some firms promotionally "price to lose" to attract new customers in the short term, typically such promotions are enjoyed by both prospective and current customers. Therefore the breakdown of acquisition- versus retention-related expenses associated with advertising and promotion is likely incorrectly weighted to the acquisition side of the equation to arrive at this fallacy.

2. The assertion ignores the life cycle of products, services, and institutions. When firms are in their introductory and growth phases, allocations to acquire customers will be substantial. The customer acquisition-retention cost ratio will typically be heavily weighted to acquisition. Conversely, when products or firms are in the decline phase, allocations required to retain customers will be substantial, making the typical acquisition-retention cost ratio weighted heavily to retention. It is in the maturity phase of a product's life cycle that the ratio of acquisition costs to retention costs can fall to either side.

3. It ignores the fact that a company's customer base is made up of a broad mix of customers who vary in cost to acquire and retain. Managerially, the problem with this myth is that it ignores the heterogeneity of customer bases. The fact is that customers vary dramatically in the costs both to acquire and to retain. As noted earlier, for most firms, customer profitability is not evenly distributed. Any costs associated with retaining customers in the bottom tier, when including their losses to the firm, are likely to far outweigh the costs to the firm of acquiring another customer. Additionally, paying to retain a customer in the large break-even segment is likely to result in the same problem.

Often the most expensive customers to retain are those who generate the most profits for the firm (Desired Customers). For obvious reasons, they are most desirable to competitors, and thus are more likely to receive attractive offers from the competition. Desired Customers also often know that their relationship is significant to the firm and, consequently, expect a higher level of service. The costs to retain these customers can be very high, but economically worthwhile to the firm.

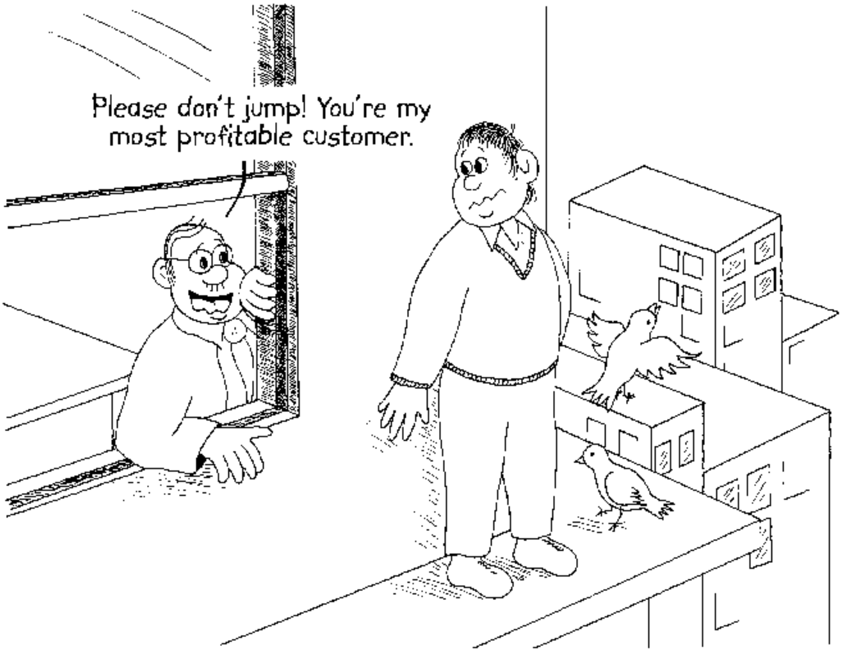
As a result, while it seems plausible that acquisition costs are significantly higher than retention costs, as with all myths, the reality is far more complex. And while it may serve as a provocative wake-up statement to ensure that management is aware of the importance of retaining customers, supporting any retention strategy based in whole upon this myth is a recipe for financial disappointment.

LOYALTY MYTH 9: Companies Should Focus on Their High Share-of-Wallet Customers

The most obvious manifestation of loyalty is customers' consolidation of their related purchases with a single vendor (maximizing their share of requirements with the vendor). In fact, for many product categories, share-of-wallet—not retention—is the most relevant behavioral loyalty metric. For example, Kraft Foods, the largest food and beverage firm in North America, defines a loyal customer as someone who purchases 70 percent or more of the same brand within a category over a three-year-period.[45] Because loyalty and share-of-wallet are inextricably linked, improving wallet share has become an overarching goal of many firms. Unfortunately, like many loyalty myths, its seductiveness belies a complex truth.

As noted earlier, the majority of a firm's customers do not produce an acceptable rate of return, with large percentages actually costing the firm money. In many situations, they are not unprofitable because they have a low share-of-spending with the firm; they are unprofitable because the level of service that they demand exceeds their willingness or ability to pay for goods and services in the category. Efforts to get higher wallet shares across the entire customer base are likely to be an exercise in futility.

Second, customers can have high wallet shares but be totally price driven. For example, a large financial services client found that in one of its product categories, increases in share-of-wallet resulted in correspondingly negative returns.[46] The problem was the price sensitivity of



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the customer base. Whenever the company offered a lower-priced option, customers quickly snapped up large quantities of the product. Share for these customers was entirely driven by their propensity to seek deals. This, of course, is far from a unique circumstance. Consumer packaged goods firms face this routinely, as they find enormous spikes in their sales related to sales promotions. And while these consumers may be stocking up on their favorite brands, they do so at the manufacturer's expense.

LOYALTY MYTH 10: In Planning for the Future, It's Always Best to Focus on Customers Who Have Contributed the Most to Company Profits

Without question, companies should ensure that their profitable customers are cherished. These customers have demonstrated a commitment by providing the firm with the profits it needs to remain viable.

Therefore, many loyalty-focused organizations choose to focus loyalty efforts on those customers who have generated the most profits to the firm in the past. In terms of a firm's efforts to profit from customer loyalty, however, this practice does not represent the best economic decision.

To pursue this approach, firms typically use a technique called "recency, frequency, and monetary value" (RFM) to detect their best customers. The RFM technique identifies customers who have spent a lot recently and targets them for future marketing activities. The effect is one that we have all experienced. What is the first thing that happens when we give money to most charities or nonprofit organizations? We get flooded with mail asking for more money the next week. This is RFM in action! But it also identifies one of the problems with this approach: Focusing on the volume of past purchasing activity does not necessarily help us understand the underlying purchase patterns. Many purchasing events are one-time or infrequent, but this technique ensures that you will be in the system for quite a while if you have generated significant revenue for the firm. Examining the purchases of a mail order company showed that a large segment of customers made concentrated purchases for a brief period of time, and then never again. Because of the way the RFM scores were calculated, the company kept this group on their active list for 36 months, well after it was profitable to do so. These misguided investments cost this particular company approximately $1 million annually.[47]

Another major problem is that focusing on past profitability ignores life-changing factors that are likely to influence future purchases. Customers get married, are promoted to better-paying jobs, buy homes, have children, and so on, all of which affect their future potential profitability to a company. One large European home products retailer found that by assessing nine key life factors of its customers, it was able to improve the return on investment of its retention expenditures from 2-to-1 to 10-to-1.

LOYALTY MYTH 11: Service Providers Differ Distinctly from Product Manufacturers in How Loyalty Tools Can Be Effectively Applied

Traditionally, people have dichotomized businesses into products and services. If the firm offered a physical product, it fell into the product sector; otherwise, it was classified as a service. This classification schema has had a profound impact on the way managers believe that they can apply tools designed to enhance customer loyalty. With the rise of the quality movement of the 1980s, U.S. and European manufacturers adopted the principles of such noted quality gurus as W. Edwards Deming and J.M. Juran—principles that had already been adopted over a decade earlier by Japanese manufacturers and were touted as the reasons for the success of the Japanese automotive, machine tool, and electronics industries.

The quality tools of Deming and Juran centered on eliminating variation in the manufacturing of products. The problem for service businesses was that the tools that applied to the manufacture of physical products did not work well in service settings (particularly in human interactions). People do not like the feeling that they are being treated like a number. Instead, they want to feel that their issues are being addressed in a manner fitting to their unique circumstances. It is no accident that Reichheld's and Sasser's seminal *Harvard Business Review* paper that propelled the customer loyalty movement was entitled "Zero Defections: Quality Comes to Services." Playing on the common manufacturing quality goal metric of zero defects, Reichheld and Sasser proposed a loyalty metric for services: zero defections (100 percent customer retention). In essence, the customer loyalty movement was established as a parallel quality movement for the service sector.

Because the initial thrust of the loyalty movement was the service sector, it was assumed that manufacturers must have a set of loyalty tools unique from the services sector. Customer loyalty for product companies was believed to focus on the elimination of variation (most frequently noted through what are referred to as Six Sigma programs). Service companies, on the other hand, sought to build customer loyalty through almost the opposite goal—customization of services, maximizing variation. In this way the service delivered to each customer conformed more to his needs than to a general blueprint.

There's just one major flaw with this strict dichotomization. Essentially all goods have a service component, and all services have some form of tangible representation; *there is no such thing as a pure product company.* In essence, everything is a service, though it may or may not have a physical product. While this viewpoint has not yet caught on with the general business community, it is now the accepted viewpoint of the leading service researchers. Christopher Lovelock, the author of the leading textbook on services for the past two decades, and Evert Gummesson observed, "The claim that services are uniquely different from goods [on the characteristics used to define the distinction between product and service companies] is not supported by the evidence."[48]

This may seem like academic minutia, but it is not. In companies traditionally viewed as service-based, efforts to build customer loyalty can be unnecessarily constrained if customization (variation from a standard) is discouraged. The delivery of services must be evaluated slightly differently than conformance of products to a standard. As Robert Eversole, president and CEO of Fifth Third Bank, based in Columbus, Ohio, observed, "In 2003, we had 8.4 billion transactions. We have to be extremely accurate. With that number, even if you are 98 or 99 percent accurate, that leaves a lot of room for error. . . . We printed millions of checking account statements, but if you didn't get yours, you don't care about the millions that did print."[49]

Similarly, companies traditionally viewed as product manufacturers can lose customer loyalty by failing to be customer-focused in the ways they relate to their customers. The U.S. division of Roche Diagnostics, a maker of diagnostic testing equipment, was forced to reengineer its entire phone support structure because it was significantly eroding customer loyalty. As Carlo Medici, former U.S. president of Roche Diagnostics, noted, "[We] ought to 'repair' the customer more than the machine."[50] The tools traditionally associated with enhancing loyalty for manufacturers actually apply to all companies where the determination of delivery quality (the degree to which a firm's offering is reliable, standardized, and free from errors) is driven by customers' expectations. The tools traditionally associated with services apply where customization dictates what customers expect. And because everything is a service, both sets of tools are necessary for all firms.

SETTING THE RECORD STRAIGHT: LOYALTY AND CORPORATE GOALS

In this chapter we've reviewed eleven myths dealing with customer loyalty subverting organizational goals. Orienting an organization to customer loyalty is a worthy undertaking, and it can be a good long-term strategy for differentiation and survival. But in this chapter we've shown that up to now, it hasn't always been good business. That's because the conventional (mis)understanding of customer loyalty has placed business executives at a distinct disadvantage.

We strongly support customer loyalty as a central mission for organizations so long as there is an adequate understanding of its potential return.

> **Loyalty Truth 1:** Don't manage for customer retention before you manage for customer selection. You probably don't want to keep all of your customers; create and apply loyalty strategies and tactics selectively. Make sure your loyalty efforts are directed primarily to those you wish to keep, and make offers that are relevant to these desired customers.

Companies survive only through profitable operations. Customer loyalty may be a meaningful corporate goal, but only under the proper circumstances and only when directed at a group of customers known to be profitable and therefore desirable to be retained. Blind reliance on loyalty as a universal goal will put you out of business. Any loyalty initiative, therefore, needs to begin with an understanding of the profitability of individual customers. Without such information, retention efforts may be oriented toward and offered to high-cost, low-value customers—an invitation to financial disaster.

Companies who dedicate their operations primarily to customer loyalty (retention marketing) should only do so if their product mix and industry are in the declining phases of the product life cycle. Finally, aiming to convert all customers to loyal customers is a false hope. Customers are who they are. It's far better to accept them as they are and then maintain those with whom a firm can build mutually productive relationships.

U.S. science fiction writer Philip K. Dick understood, "Reality is that which, when you stop believing in it, doesn't go away."[51] As this book has already demonstrated, much of the conventional wisdom about customer loyalty is just plain wrong. Like the most pervasive myths, the logic behind the loyalty myths is seductive, easy to grasp, and appealing to our human desire for fairness. By the end of this book, however, almost everything you've ever heard, read, or seen about customer loyalty will be debunked. The truth about customer loyalty is far more complex than we've been led to believe—but it is no less fair.