



# RETHINKING ROI: WILL USING THIS TRADITIONAL METRIC LEAD YOU TO RAGS OR TO RICHES?

By Sharan Jagpal

It's no secret that the business world is slow to change. Sure, it has made the evolution from typewriters to computers for word processing, and from snail mail to e-mail for written communication. But in regard to the core of doing business — from the methods and measurements that are used to the way departments are siloed — many 21st century companies might as well be stuck in the Stone Age.

And now that the recession has reset the global playing field, this unwillingness to replace old business models, strategies, and metrics with new ones will lead many companies to their demise and cause others significant hardship. Given the new world many businesses find themselves in today, CEOs and marketing executives need to take a fresh look at standard financial metrics. A good example is Return on Investment, which is a popular resource allocation tool and measure of performance, including marketing productivity. The question is, is your reliance on the ROI approach leading you to riches—or keeping you in rags?

As you doubtless already know, the traditional formula goes like this:

$$\text{ROI} = \text{Profit}/\text{Investment}$$

So, if your profit = \$1 million and your investment = \$20 million, then your ROI is five percent. Fairly straightforward, right? Not so fast.

While the ROI concept may seem elementary, there are two glaring problems with it. First, it measures financial performance without taking into account the level of risk associated with the investment, particularly when assessing marketing strate-

gies. Second, except for simple strategies, ROI is likely to lead to poor decisions — for example, when the firm uses a multimedia advertising strategy, sells products to a common customer base, or sells products that share joint costs.

For many people the idea of adjusting ROI for risk is quite novel, and the idea of comparing risk-adjusted ROIs across different strategies is equally so. But at a time when most businesses could use a boost, it's time for such new school metrics to become standard. Consider the following scenarios:

**ROI Scenario 1: Customer retention vs. market growth.** Wal-mart is currently facing increasing competition in the United States from a major European retailer, Aldi. Let's say that Wal-mart is considering two strategies to hold off Aldi's rise: 1) increasing the retention rate of its own customers or 2) obtaining new customers. Let's say that the advertising expenditures for both strategies are equal (\$1 million).

Suppose Wal-mart's management expects the retention strategy to lead to an average increase in net profits of \$300,000 and the market growth strategy to lead to a higher average increase in net profits, \$400,000. By using the standard ROI criterion, Wal-mart would conclude that the market growth strategy is superior. After all, an ROI of 40 percent is better than an ROI of 30 percent, right?

But when you recognize that Wal-mart's choice of marketing strategies changes their risk level, you find that market growth isn't necessarily the way for them to go. In general, it is riskier to obtain new customers than it is to retain existing ones. In fact, after correcting for risk, it is quite possible that the customer retention strategy is supe-

rior for Wal-mart — even though, on average, it provides a lower ROI than the market growth strategy.

As the Wal-mart example shows, the standard ROI criterion is likely to lead to poor decision making, because it fails to consider the trade-off between risk and return. It is essential to compare strategies using the risk-adjusted ROI since different marketing policies involve different combinations of risk and return. Depending on the magnitude of the uncertainties involved, after comparing risk and return, many companies could well find that it may be better for them to focus on marketing strategies with lower, not higher, average profits.

Starbucks is a prime example of a company that made the mistake of focusing on average ROI without adjusting for risk. In October 2006, Starbucks dramatically raised its long-term store opening goal to 40,000 locations from its prior goal of 30,000. The stock market responded positively to this announcement and the company's shares closed higher by 7.6 percent that day. But subsequently, Starbucks paid the price for choosing the wrong strategy. It paid a high price (i.e., lower profits) for focusing on ROI without correcting for risk.

So regarding the market growth vs. customer retention question above, how should a company decide which is best? The answer requires two steps:

1. The marketing department must provide quantitative estimates of the risk and return of the cash flows from these two strategies, and
2. The finance department (or senior management or CEO) should use this infor-

mation to determine which strategy provides a higher risk-adjusted ROI.

In this analysis, the ownership structure of the firm is critical. A publicly-owned firm should focus on market risk — i.e., the risk to stockholders after they have diversified their holdings across firms. A privately held firm should choose the optimal strategy based on the owner's tolerance for risk and return.

As with most rules, there is always a caveat. The same is true of the risk-adjusted ROI. Just as calculating ROI isn't sufficient, there are times when a company will have to look deeper than just its risk-adjusted ROI to determine which marketing strategy is best for it.

Suppose Dell Computer is considering two different media to advertise a new laptop: national TV and Internet advertising. Let's say that both media plans involve the same budgets. Should Dell choose the advertising medium with the higher ROI?

As the Wal-mart example shows, simply considering ROI fails to consider the trade-off between risk and return, so it may not lead to the optimal decision for Dell's new media plan. However, there is an additional factor that Dell needs to consider: media overlap.

Dell should consider whether audience duplication will boost or reduce its media productivity. Let's say that Dell's only advertising goal is to create brand awareness. In this case, TV and Internet advertising are substitutes. However, consider the following more realistic scenario. Let's say Dell's goal is two-fold: first, to create brand awareness (via national TV) among the target segment; then, to encourage this subgroup to go to the Internet to obtain more detailed information about the new product.

For this scenario, audience duplication will boost Dell's media productivity. And it is for this reason that Dell needs to measure the joint productivity of its national TV and Internet advertising. Measuring productivity for each medium separately — even after adjusting for risk as in the Wal-mart example — and allocating resources accordingly will lead to suboptimal results.

In general, the firm needs to measure the joint productivity of its marketing mix. Separately analyzing the ROI of each marketing decision will lead to poor resource

allocations, even if one allows for the trade-off between risk and return.

Here are four key takeaways managers should glean from the above examples:

1. When allocating marketing resources and assessing performance, it is necessary to adjust the Return on Investment (ROI) metric for risk.
2. Since different marketing decisions involve different combinations of risk and return, financial and marketing decision making must be coordinated. In particular, a top-down approach should not be used where the CEO, senior management, or finance dictate the required rate of return of marketing activities.
3. In general, firms must measure the joint effect of different marketing decisions on risk and return and simultaneously correct ROI for risk.
4. Publicly and privately held firms need to assess risk differently when measuring marketing productivity. The owners of public firms can reduce risk by diversifying their holdings across different firms; in contrast, the owners of privately held firms cannot. Hence, ownership structure has a crucial effect on how the firm should determine its risk-adjusted ROI when choosing and assessing marketing policies.

Though such new school ideas might be hard to swallow, these examples highlight an overarching truth about business. The best marketing strategies, those that yield long-term value, are based not on trends, anecdotal evidence, or past success stories, but on new scientific methods and metrics explicitly developed for analyzing data that are often imprecise.

As companies work to implement this new school thinking, they'll have to find answers to the following questions:

- How should the risk and return from different marketing policies be measured?
- How should the standard ROI criterion be modified so that it leads to better decision making?



- How should performance metrics and reward structures in the organization be revised so that Marketing and Finance can work together to maximize organizational performance?

To answer these questions, it is necessary to develop a new paradigm by fusing marketing and finance. *Fusion for Profit* is the first book to undertake this task and to provide guidance in addressing these questions as well as many others.

Fusing marketing and finance may sound daunting; however, the hardest part is making the psychological leap. When key players go beyond conventional metrics and work together to apply new concepts and metrics to measure marketing productivity and to allocate resources, your company can seize the hour. ■

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