

Will It Lead You to Rags or to Riches?



by **SHARAN JAGPAL**

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The Pursuit of ROI

It's no secret that the business world is slow to change, but now that the downturn has set in, this unwillingness to replace old strategies with new ones is leading some companies to hardship and many others to their deaths.

I ask CEOs and marketing executives to reconsider one popular business metric in particular: the Return on Investment (ROI) criterion. Too many businesses measure performance (including marketing productivity) using ROI: a simple metric, but one that takes no account of the risk taken, especially with regard to marketing strategy. And though the financial crisis has brought to the fore the colossal consequences of mispricing risk, few businesses realize the fundamental changes in business practices necessary to bring risk into their calculations of financial performance.

For most people the idea of adjusting ROI for risk is quite novel and the idea of comparing risk-adjusted ROI across different strategies is equally so. To get a clearer picture of what I mean, consider the following examples:

ROI: EXPORT VS. DOMESTIC FOCUS

Many Chinese manufacturers presently focus on the export market. Given the current global downturn, should they continue using this strategy? Suppose a Chinese manufacturer, say Haier (海尔), is presently considering whether to allocate more resources to the export or the domestic market. Let's say that by investing USD 100 million in the export market, Haier expects to obtain an average increase in annual net profits of USD 40 million. Correspondingly, by investing the same amount in the domestic market, Haier expects to obtain an average increase in annual net profits of USD 30 million. Clearly, by using the standard ROI criterion, Haier would conclude that the strategy of investing in the export market is superior. After all, an ROI of 40% is better than an ROI of 30%, right?

But when you take the level of risk into

consideration, you find that the standard measure of ROI isn't necessarily the way for Haier to go. In general, the export market is more risky than the domestic market. Indeed, after correcting for risk, it is quite possible that the domestic expansion strategy is superior even though, on average, it provides a lower ROI.

Marketing and finance must work together to measure risk and balance it against return. So, regarding the "export" versus "domestic" market strategy question, how should a Chinese company decide which is best? Two steps are necessary:

1. The marketing department must provide quantitative estimates of the risk and return of the cash flows from different strategies

2. The finance department (or senior management or the CEO) should determine which strategy provides a higher return after adjusting for risk. 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.

The implications for Chinese firms are profound. Decisionmakers must compute risk-adjusted ROI differently, depending on whether the firm is publicly held, owned by a state-owned enterprise, or is a joint venture between Chinese and foreign concerns. And marketers must eschew their fixation on creativity and on merely collating data; instead, they must increasingly focus on analytical methods and the use of objective metrics.

ROI AND MEDIA PLANNING: WHEN RISK ADJUSTMENT ISN'T ENOUGH

Suppose China Unicom (中国联通) is considering two media to advertise the new iPhone: national TV or Internet advertising. Let

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's say both media plans involve the same budgets. Should China Unicom choose the advertising medium with the higher ROI? As in the Haier example, simply considering ROI fails to consider the tradeoff between risk and return; hence, it may not lead to the optimal media plan for China Unicom.

However, there is an additional factor that China Unicom needs to consider: media overlap. Simply examining your risk-adjusted ROI will not always be enough. China Unicom should also consider whether audience duplication will boost or reduce its media productivity. Suppose China Unicom's only advertising goal is to create brand awareness. Then TV and Internet advertising are substitutes. However, consider the following more realistic scenario. Suppose China Unicom's goal is twofold. 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 China Unicom's media productivity. Hence China Unicom 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 Haier example) will lead to suboptimal results.

These scenarios illuminate an over-arching truth about business: The best marketing strategies, those that yield long-term value, must be based not on trends, anecdotal evidence or past "success stories" but on new scientific methods explicitly developed for analyzing data that are often imprecise. With that in mind, here are four lessons managers should glean from the above examples:

Lesson 1: When allocating marketing resources, it is necessary to adjust the Return on Investment (ROI) metric for risk.

Lesson 2: Since different marketing decisions involve different combinations of risk and return, financial and marketing decision-making must be coordinated. A top-down approach should not be used where the CEO, senior management, or Finance dictate the required rate of return of marketing activities.

Lesson 3: In general, firms must measure the joint effect of different marketing decisions on risk and return,

even after correcting ROI for risk.

Lesson 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 risk and return need to be balanced in assessing and choosing marketing policies.

Clearly, these lessons have far-reaching implications: A fundamental transformation is necessary in the mindsets of managers at all levels in the organization and across functional areas.

As companies work to integrate these changes into their "new school" of operations 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 in the organization be revised so that Marketing and Finance can work together to maximize organizational performance?

To answer these questions, firms must eliminate the intellectual and functional silos that separate different functions such as marketing and finance. Fusing marketing and finance may sound daunting; however, the hardest part is making the psychological leap. There is great opportunity out there, even in an economic downturn. When key players work together to apply new concepts and metrics to measure marketing productivity, your company can seize the hour. ■

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