# LOYALTY MYTHS

## Hyped Strategies That Will Put You Out of Business—and Proven Tactics That Really Work

**Timothy L. Keiningham**

**Terry G. Vavra**

**Lerzan Aksoy**

**Henri Wallard**

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## Praise for *Loyalty Myths*

"*Loyalty Myths* is mandatory reading for anyone involved with customer relationship management initiatives and customer loyalty programs. Melding insights from the scholarly literature and real-life case studies, the authors cogently challenge conventional wisdom and offer valuable suggestions for understanding, building, and nurturing customer loyalty. A truly thought-provoking and fun-to-read book."

—A. "Parsu" Parasuraman, James W. McLamore Chair, University of Miami, and editor of the *Journal of Service Research*

"Keiningham et al. have fired a full broadside at the "managerially correct" and seemingly unassailable notion that customer loyalty is all that matters. In examples including First Chicago, Tansaş, and Ryanair and through broadly researched data and analysis they show that knowing what customers want and will pay for is the issue. This is a great place to start when doing a full review of the effectiveness of your marketing spend to find advantage in your competitors' inabilities to differentiate themselves."

—George Stalk, Senior Vice President of The Boston Consulting Group, and co-author of *Hardball: Are You Playing to Play or Playing to Win?*

"*Loyalty Myths* digs deep beneath the surface of conventional wisdom. It will make readers think twice about their longheld beliefs regarding customer loyalty management."

—Ruth N. Bolton, W. P. Carey Chair in Marketing, Arizona State University, and former editor of the *Journal of Marketing*

"When something becomes a truism, it requires daring people to challenge it. In *Loyalty Myths*, Keiningham, Vavra, Aksoy, and Wallard undress 53 truisms of customer loyalty. By combining new research with real-life business practice, they document how accepted wisdom has misled managers in their pursuit of customer loyalty and profitability—strategies that in the worst case might put you out of business. Having made the reader painfully aware of the flaws in existing knowledge, the authors generously offer proven tactics that really work—strategies that will make your business succeed. It is my prediction that *Loyalty Myths* will become the next must read for successful business managers."

—Tor W. Andreassen, Professor of Marketing, Norwegian School of Management

"It's no joy to have your beliefs challenged, even rubbished, but it's very healthy! Anyone interested in customer loyalty will enjoy trying to prove the authors are wrong."

—Senator Feargal Quinn, CEO, Superquinn Stores, Ireland, and author of *Crowning the Customer: How to Become Customer-Driven*

"*Loyalty Myths* provides great insights as to why simple answers never work in customer loyalty. The authors show with many real-life examples how businesses can go wrong in adopting an unquestioned mantra of "customer loyalty is all that counts" and illustrate how it will most likely not help, but hurt your profitability. Finally, the book gives managers a guide to get started on a more comprehensive approach to customer loyalty that already whets one's appetite for the sequel to this must-read book."

—Peter Jueptner, Executive Vice President, The Great Atlantic and Pacific Tea Company

"*Loyalty Myths* is a must read for anyone who manages customer loyalty. Keiningham and his colleagues mix their own considerable experience with the latest academic knowledge, and package it in an entertaining way."

—Roland T. Rust, David Bruce Smith Chair in Marketing, University of Maryland, and editor of the *Journal of Marketing*

"This book is a must read for every executive who is interested in reshaping their loyalty programs. The authors have presented the 53 myths with excellent supporting materials, which make everyone rethink their firm's loyalty strategy. I have no doubt that this book will revolutionize the thinking behind the loyalty concept."

—V. Kumar, ING Chair Professor, University of Connecticut, and author of *Customer Relationship Management: A Databased Approach*

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To those who seek to make the world a better place
and are crazy enough to believe that they actually can.

*"Never doubt that a small group of thoughtful, committed citizens can change the world. Indeed, it's the only thing that ever has."*

—Margaret Mead, anthropologist
(1901–1978)

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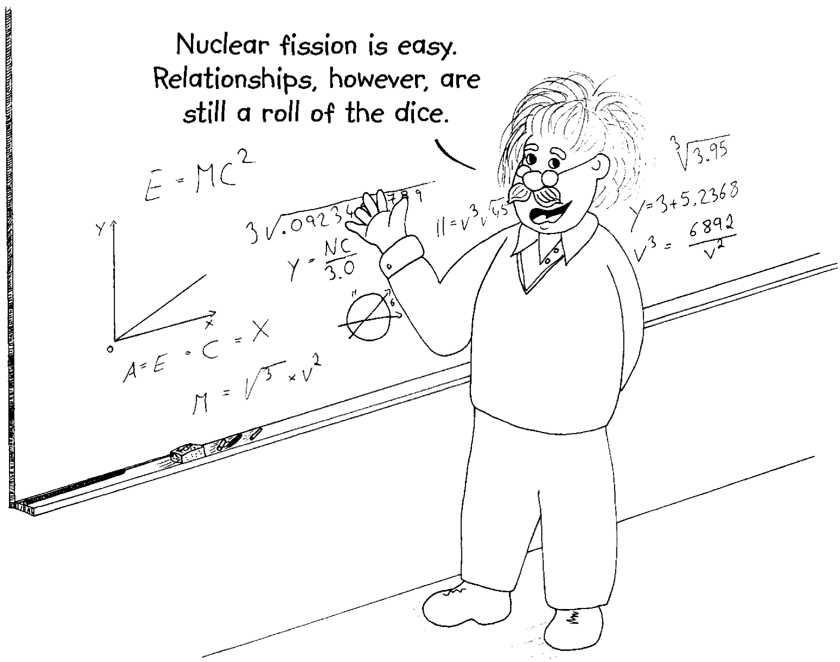
# PREFACE

*We are committed to the belief that strategically directed and effectively nurtured customer loyalty can truly differentiate firms from their competitors and will generate sustained profits. Following the myths of loyalty, however, will almost surely cause firms and customers to suffer. By exposing the myths for what they are we all can win, business and customer alike—by simply being good to one another.*

—Timothy L. Keiningham, Terry G. Vavra, Lerzan Aksoy, and Henri Wallard

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Loyalty! Without question, it is one of the greatest virtues humankind can possess. As renowned film producer Samuel Goldwyn once remarked, "I'll take fifty percent efficiency to get one hundred percent loyalty."[1] Like Goldwyn, most of us are willing to sacrifice much to achieve loyalty from those we depend upon.

So it is with management's current passion toward customer loyalty. CEOs worldwide consistently cite customer loyalty as one of if not *the* most important strategic objective of their firms. Billions of dollars are spent every year by firms pursuing increased loyalty from their customers. Over 40,000 books have been written espousing the virtues of customer loyalty and offering methods with which to accomplish it. Hundreds of thousands, perhaps millions of articles have been written worldwide describing the profit-healing benefits flowing from improved customer loyalty.

And why not? Doesn't every firm want loyal customers? The simple answer is, "Yes, but . . ." It is the "but" that is the problem. Because most of what we've been told about customer loyalty is just plain wrong. It isn't that there was a vast conspiracy designed to mislead the managers regarding the role of customer loyalty in business performance. The simple truth is that the science studying the subject was incomplete. "Incomplete" frequently tends to mean "wrong."

Scientific discovery—the basis of all true sciences—is based on incremental learning. Hypotheses and theories are forwarded, then tested, subjected to constructive scrutiny, and finally accepted or rejected. Casualties of reputation and pride often get caught up in this cycle. Professionals engaged in the development of a science have to accustom themselves to the inevitability that not all of their hypotheses or ideas will be right. The brightest thinkers of our times have been caught in such fallacious propositions. Theoretical physicist Stephen Hawking once proclaimed that cosmic black holes destroy the information of anything they ingest. Hawking's idea was later proved inaccurate and he admitted it.[2] Albert Einstein never accepted quantum theory, proclaiming, "I shall never believe that God plays dice with the world."[3] It seems, however, that God does indeed roll dice.

What many miss is that a scientific field progresses as much by negative proof as by positive proof. But the sophomore always hopes for positive outcomes—failure to find associations is somehow less proudly proclaimed than confirmed associations. Unfortunately, the most revered voices in a field are sometimes the most reluctant to point out their mistakes. (Big trees fall the hardest and are most resistant to challenge.) Such individuals often simply dig themselves deeper, ultimately dishonoring themselves and temporarily stymieing the evolution of their field.

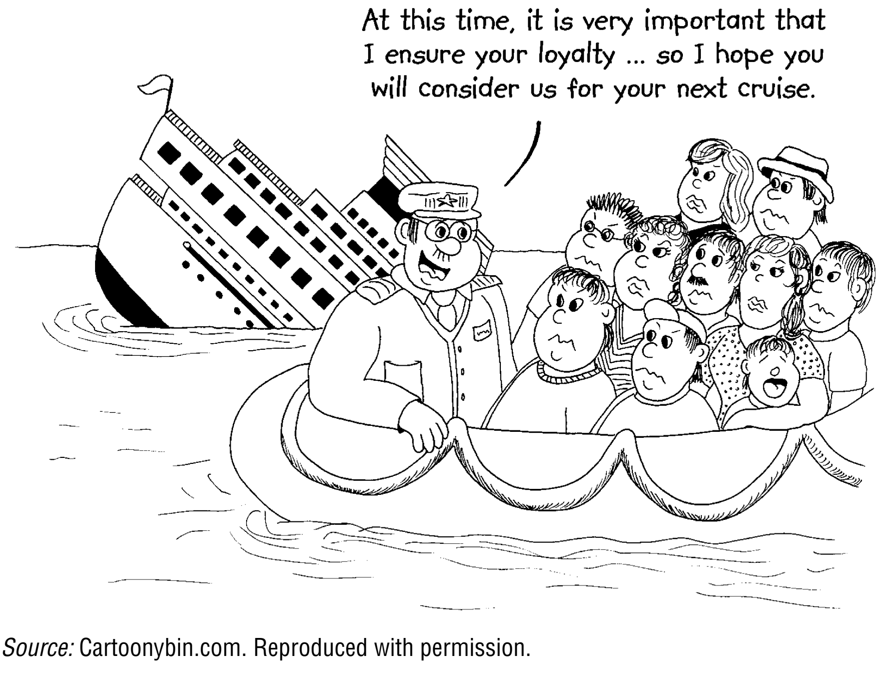
So it is, we believe, in the current science of marketing with regard to the correct understanding of customer loyalty. Some thought leaders in this area seem reluctant to admit that their early ideas, while helpful in guiding further inquiry, were not completely accurate. We ourselves, the authors of this book, have committed similar sins. But we are not beyond admitting our misperceptions and moving forward. In a book about customer loyalty, it is probably best to remember the words of author Mark Twain, "Loyalty to petrified opinions never yet broke a chain or freed a human soul in this world—and never will."[4]

The subject of this book is the evolution of thinking about customer loyalty. The serious reader will have to set aside many of the platitudes she has previously learned—they simply don't work in today's marketplace! Our intention here is to offer, to the best of our current ability, a truer picture of how businesses can leverage customer loyalty to help them survive and succeed.

More important to each of the authors, our goal in writing this book is to quite literally change the world, or at least a piece of it. We have been fortunate to make our living by demonstrating that it is indeed *good business to be good to one another*. In a world where life's pressures make it easy for each of us to lose a piece of our humanity—our requisite civility to one another—it is sometimes easy for us to forget that fact.

The pursuit of customer loyalty can be a highly profitable strategy, but not by clinging to the myths that have developed surrounding the idea. Following the conventional wisdom that has been propagated about customer loyalty will almost surely cause firms large and small to suffer . . . which ultimately means that customers will suffer as well. If loyalty doesn't pay, then firms will have to pursue another strategy or they won't remain competitive. This book seeks to expose the myths for what they are so that in the end all of us win—by being good to one another.

# The Myths of Loyalty: Did the Gods Mislead Us?

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*Loyalty rules at every level. Loyal employees in any company create loyal customers, who in turn create happy shareholders.*

—Sir Richard Branson, Chairman, Virgin Group

*[Loyalty] is a philosophy we live by at L.L. Bean, and one with which I couldn't agree more.*

—Leon A. Gorman, Chairman, L.L. Bean.

*Loyalty "is the hidden force behind growth, profits, and lasting value"—the intangible that binds an organization together and manifests the strength and quality of its culture.*[1]

—Robert T. Herres, Chairman, USAA

These are strong words likely spoken with conviction and sincerity. But these leaders have been misled in their overwhelming reliance on loyalty as a panacea. They have been misled by a torrent of literature that monotonously reiterates false findings and wrongly advocates simple solutions. The marketing community has deified the early pioneers of loyalty, and these individuals have misled leaders (like those above) and followers alike who have honestly sought out good business strategy. Our goal is to set the record straight!

## CHAOS IN PLEASANTVILLE

In what seems like only yesterday the consumer markets of the world operated with predictability and regularity. Customers could be depended upon to repeat-buy if they were at least minimally satisfied. Competitors were present, but they succeeded in luring only the occasional customer away; only infrequently did they become so aggressive as to openly solicit another's customers. Customers rarely drifted from their preferred brands.

Today, in the early twenty-first century, all of this has changed. Companies and brands today compete with a vengeance and do so in the most chaotic and hostile market ever faced by success-driven businesspeople. Maintaining market share has become extraordinarily difficult, and gaining more almost unthinkable. The old saying "You've got to run fast just to stay in place" has never been more true than in the resulting overcrowded product and service categories. Consumers have become beleaguered with a mind-boggling mass of offerings not just from competitors, but also from marketers as they extend their own brands or services. Take the venerable Oreo cookie: Once a single product on store shelves, today it's flanked by over 27 additional products bearing the Oreo brand! Each of these vies for customers' limited attention.

In this cacophonous market, products compete for recognition and purchase by a customer population that has become aggravatingly more fickle. But despite the increased indifference from customers, corporate boards and shareholders are no less demanding in their expectations for increased profits. These countervailing forces set up formidable odds for even the most creative businessperson. Pleasantville is no more.

## FALSE IDOLS

It is within this contemporary battlefield that customer loyalty has become a favored competitive tool. This is, no doubt, a result of the countless promises made by the loyalty community concerning the benefits of loyalty as a business tactic. But so many of the mandates are fallacious. Take the rule that admonishes us to retain as many customers as possible, because the value of customers increases over time.

Let's examine this more closely. Businesspeople have come to acknowledge the impact of the "Pareto Principle" on the survival of their enterprises. Pareto, a late nineteenth century Italian economist and sociologist, recognized that a majority of his nation's wealth was held by a minority of the population. The Pareto Principle is also referred to as the 80–20 Rule, suggesting that 80 percent of the wealth was held by 20 percent of the population. This principle is widely substantiated in marketing data. Figure I.1 depicts a fictional product in which just 20 percent of the users generate 50 percent of the profits.

But as dire as Pareto's prescription is, the everyday reality is probably even more severe. It's likely (especially in services) that 60 percent of a business's customers could actually be generating negative profits—costing the business money! Given this fact, one can easily see how the mandate of keeping all the customers possible can actually be a recipe for disaster.

But why have loyalty advocates been so adamant in recommending that we keep all our customers? They've made a faulty presumption: that all customers get more valuable with age. This observation is a naïve one, based on a simplistic interpretation of customer cohort groupings.

To better understand the true state of affairs, consider the customers of a fictional business, Tim's Torpedo Tricycles, depicted in Figure I.2. Not all of Tim's customers are equally valuable. Some are good customers, generating substantial profits for the business. We'll call these customers *Desired Customers*. A second group contains customers who aren't technically unprofitable, but contribute near the

**FIGURE I.1** Pareto Principle

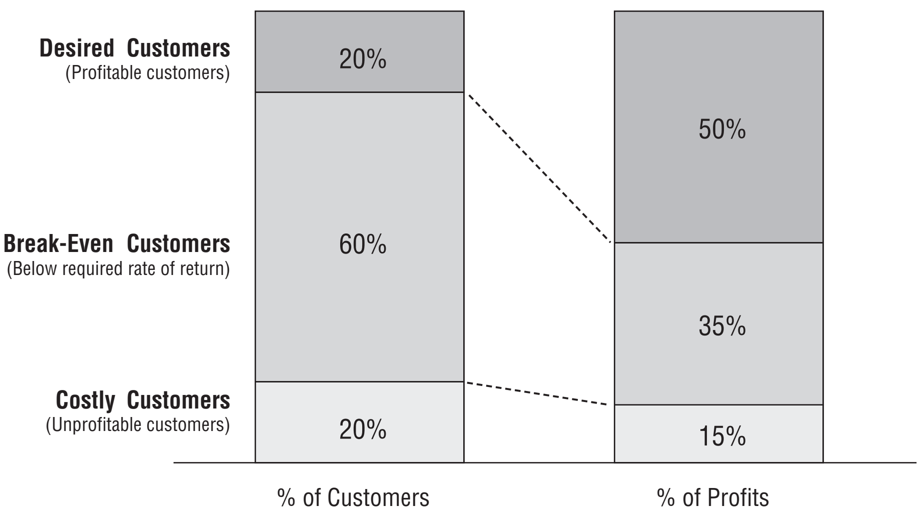
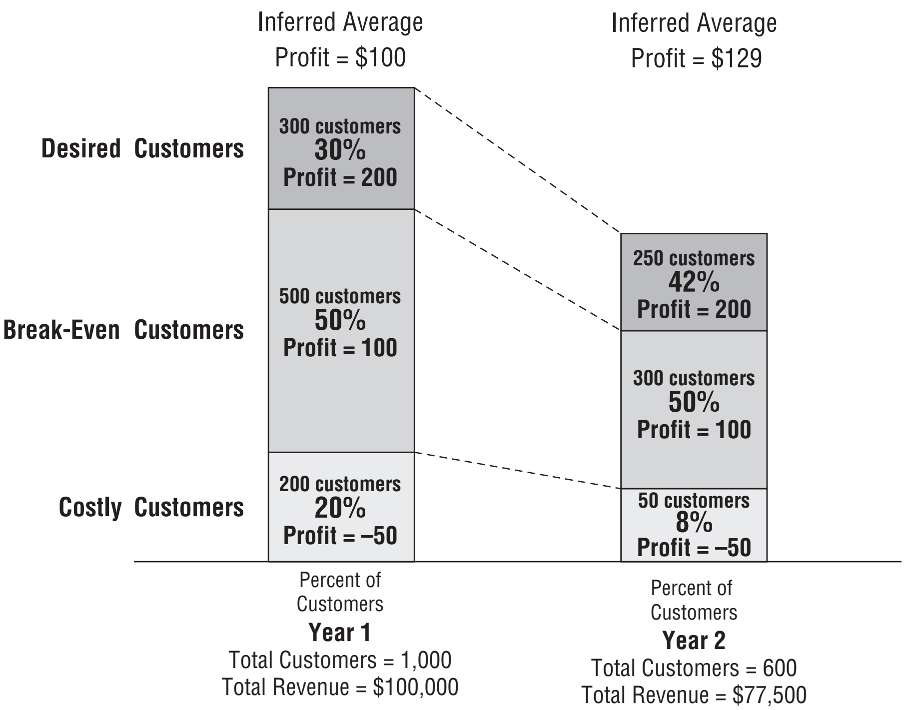


**FIGURE I.2** Tim's Torpedo Tricycles




minimally accepted rate of return for the company. We'll call these customers, *Break-even Customers*. The third and final group contains customers who require substantial servicing that more than offsets their contribution. We'll call these customers *Costly Customers*.

If Tim's Torpedo Tricycles starts in year 1 with 1,000 customers, we'll arbitrarily assume as many as 300 could be desired customers—those from whom Tim can expect to make a decent profit. About 500 customers might be break-even customers, and as many as 200 might be costly customers.

Roll the clock forward one year. If only 600 of Tim's initial 1,000 total customers are left, the average profit per customer will *appear* to be higher. Have individual customers improved in their profit generation? It's highly unlikely.

What has probably happened is that Tim's *mix* of customers within the remaining 600 has significantly changed in the direction of the profitable customers. Costly Customers are more transient in nature, and many may have departed, looking for better deals. Of these unprofitable customers, only 50 Costly Customers remain. A smaller proportion of Break-even Customers have defected. Of the 500 original Break-even Customers, 300 remain. A majority of Tim's Desired Customers have remained; 250 of the original 300 are still active. Thus, in the remaining mix of 600 customers, Tim has a stronger concentration of valuable customers, yielding much richer average profits per customer ($129 to a previous $100). However, the increased yield of profit is not the result of individual customers becoming more valuable with tenure, but rather a change in the composition of Tim's customer population. This simple fact seems to have eluded most loyalty experts, even though numerous writers in various journals have sought to set the record straight.

As can be seen from this hypothetical example, retaining *all* customers wouldn't be a good idea for Tim's Torpedo Tricycles, nor for any business. But this has been the simplistic prescription. In contrast,


*Source:* Cartoonybin.com. Reproduced with permission.

allowing the profitable customers to leave would be an even worse idea. Consequently the real solution rests in knowing the value of each customer and then focusing loyalty efforts on those customers who are the most valuable.

This example underscores our proposition: Most current loyalty maxims are predicated on faulty data or on a superficial reading of longitudinal data. Yet businesspeople still believe loyalty to be the most effective strategy for competition in today's market.

Understanding that loyalty is a necessary marketing tool is, unfortunately, only a small step in the right direction. Executives face formidable odds in creating an effective loyalty program. Five marketplace megatrends exist that both sanction and yet challenge the employment of customer loyalty as an effective business tool.

## The Epidemic of Customer Churn

The cable television and early cellular telephone industries were the first to notice the impact of customers enrolling for a service and then suddenly leaving, taking their business to another vendor. As this practice rose to epidemic levels, businesspeople in numerous other categories soon became aware of *customer churn*, started monitoring it, and began worrying about how to curtail it. Churn rates for some products and services have reached astoundingly high levels; they range from a trickle—3 to 5 percent per year in categories like insurance—to a flood, with an attrition rate of 70 to 80 percent (such as consumers who switch from one mortgage provider to another at their next purchase occasion).

While customers are partially responsible, ironically businesses also engendered this fickle behavior. Industry practices to entice customers from a competitor by offering monetary incentives or promises of upgraded equipment have caused customers to understand the value of their patronage. This recognition has transformed customers into mercenary agents who are determined not to simply acquire a product or service, but to demand as much as possible for their patronage in the transaction.

As churn was acknowledged for the epidemic it was, loyalty became recognized as a logical cure. However, attempts to head off customer attrition have not always been well planned nor well executed.