roi of marketing and research: part 2

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subjective models of marketing research roi

In the first article of this series, we used the standard accounting definition of ROI: marketing research ROI is the profit generated by research as a percentage of the cost of research. More formally,

$$\frac{(\text{Revenue generated by research} - \text{The cost of research}) \times 100}{\text{The cost of research}}$$

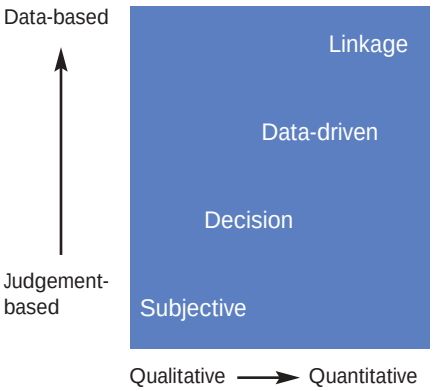
However this definition is not adequate in calculating marketing research ROI.

Consider a widget manufacturing company. It may invest $1 million in new machinery and produce 20% more widgets as a result. This generates $2 million in additional profits. For every dollar invested, the company has generated $2 in profits. Therefore, the standard accounting definition of ROI works well here. If the company had projected the results (and we can safely assume that they would have), it would have concluded that an investment of $1 million in new machinery is a sound one, unless a higher return could have been achieved investing the money elsewhere.

At a superficial level the same logic could be applied to marketing research ROI. However, a closer look at the problem shows that this is not always

appropriate. Let us assume that we have somehow found a way to calculate marketing research ROI as per the definition above. What then? Suppose we demonstrate that the return on marketing research investment is 20%. How should the company interpret it? Is it good or should it aim for a 25% return? If residential real estate offered a return of 27% then should the company invest in residential real estate rather than in marketing research? If the return on marketing research is 8%, should the company not bother about research because the return is too small? These are obviously meaningless questions because the company is in the business of making widgets and not in the business of buying research as an investment. No matter what the answers to our questions are, there is no intelligent way to use the ROI so calculated.

So, when companies want to know the ROI of marketing research, they are not really viewing research as an investment on par with their main business. Rather they are asking indirectly how this expenditure helps them to further their business objectives. Can we demonstrate that research will help them sell more widgets? It is important to remember this in discussing marketing research ROI. We may find the literal definition of ROI limiting when trying to understand marketing research ROI.



APPROACHES TO ESTIMATING MARKETING RESEARCH ROI

Formal measurement of marketing research ROI (MR ROI) can be complicated and expensive. So, formal measurements are not always warranted. It would be fairly inefficient, for example, to formally estimate the ROI on a taste test carried out on 100 consumers to assess whether the taste of a new soup would be acceptable to them. However, in many instances, it is possible to estimate MR ROI informally or semi-formally. Informal and semi-formal MR ROIs are estimated for two reasons: to justify the contemplated expense on research and to be accountable for expenses incurred on an ongoing basis. Here we will explore some approaches to estimating MR ROI.

In broad terms, MR ROI is the link between marketing research activities and the return that is assumed to follow from them. The models that purport to measure MR ROI can range from very informal subjective models to a much more elaborate and complicated linkage models. In broad terms, MR ROI can be estimated through:

1. Subjective models
2. Decision models
3. Data models
4. Linkage models

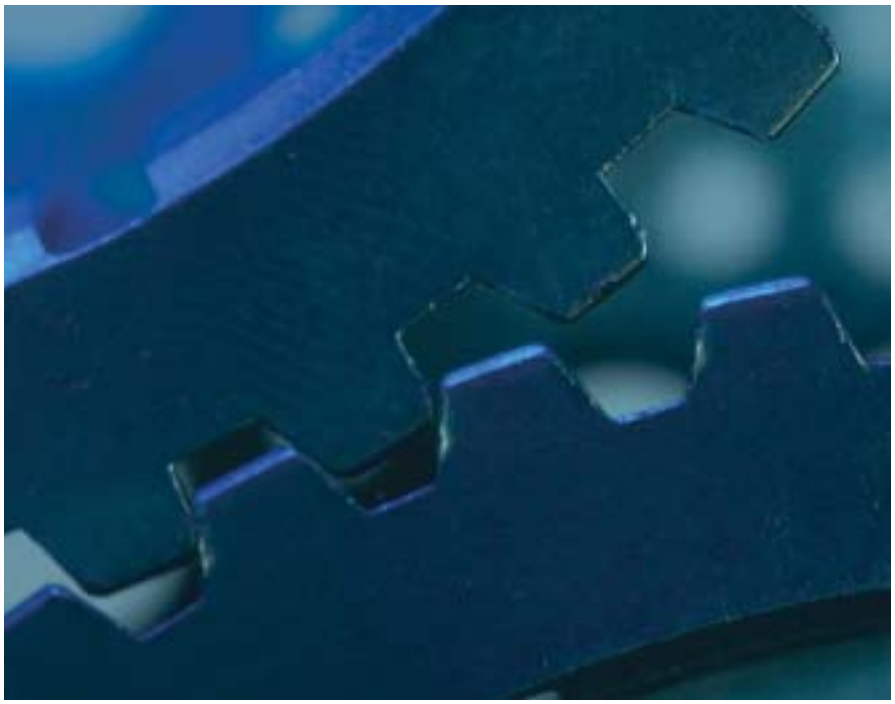
In marketing research literature, the term *linkage analysis* is used generally to describe models that measure the relationship between some marketing research metric, such as customer satisfaction, and some financial measure, such as profitability. Linkage models are considered to be the most sophisticated of all ROI models and we will discuss linkage models in some detail in subsequent articles. First, let's review some simpler models.

SUBJECTIVE MODELS

Subjective models are the simplest and the least formal of the four types of models. They are used in instances where a formal calculation of marketing research ROI is not possible, is wasteful or both. In such cases we use subjective models to estimate the ROI. A subjective model or subjective linkage is simply the agreed-upon value of research. Consider the following marketing questions: Which of the many possible line extensions is best liked by customers? Who are our competitors in major metropolitan areas? Are we considered an expensive brand? Research can be designed to answer any such marketing questions. But calculating the ROI on isolated research projects that are designed to answer specific marketing questions is neither easy nor particularly worthwhile.

Here is another marketing question: "Is our brand considered expensive?" We design a research project at a cost of $30,000 and find out that it is not. This may be an input to marketing strategy, but there might be other inputs as well. It would be difficult to isolate the effect of the research information from the other inputs that went in to create the marketing strategy. Besides, we may not even know the impact of our strategy on our revenue for years to come. We cannot clearly pinpoint the effect of research information in arriving at the strategy and subsequent revenue generation. In many organizations, many such projects are commissioned during any given year.

Although there is a specific need for the information when research projects like these are commissioned, at the year-end when research expenditures are reviewed as a whole, it is difficult to know why these research projects were commissioned in the first place. More importantly, the value of research is questioned since no one can immediately connect research to value received. As a result, researchers scramble to measure the ROI of research, when clearly it is not very meaningful. It is like asking the ROI on hinges that hold a door. Without hinges the door is of little practical use in safeguarding property. Yet, it is not easy to calculate the return on hinges since, without doors, hinges are of no value.



In most cases, the problem is the time gap between when the research is commissioned (whenever the need arises) and the time its value is assessed in isolation (usually at budget time). To overcome this problem, we could use the subjective linkage model. This is similar to subjective probability estimates used by Bayesian statisticians. The researcher could ask the purpose for which the results are to be used and what dollar value the marketer would place on the information.

If the marketer is unable to estimate the value of information, the researcher could use methods that are used to arrive at subjective probability estimates. For instance, the researcher could say "This project would cost $50,000." If the marketer agrees, then the researcher could ask "Suppose the project cost is $60,000 and the money is available to do it, would you still commission it?" If the marketer would still commission the project, the researcher could increase the cost of the project and repeat the question. At some point, the marketer is likely to respond "No, not at that price. I can do without the information." For example if the marketer would like that information at $100,000 but not at $110,000, then the perceived value of information is $100,000. Using the standard formula, the ROI using the subjective linkage method is:

$$\frac{(100{,}000 - 50{,}000) \times 100}{50{,}000} = 100\%$$

The $50,000 return pays for the research project. When the cost is $60,000, the return on investment is 80% ($40,000 in dollar terms), which is lower than the cost of research. As far as the decision maker is concerned, an 80% return on this project is not large enough to justify investment in research.

Another way of keeping track of the value of research is to explore the risk associated with not doing the research. Suppose we introduced a product without any research, the marketer could assess what the risk would be. The risk is, of course, the product could fail resulting in a loss of say $10 million. Research results cannot guarantee that a product that is tested well will necessarily succeed in the market place. However, research can be shown to decrease the risk of failure. If research could reduce the risk of failure by x%, the resulting saving can be calculated to assess the ROI of research.

Acknowledging the fact that there is no single way of calculating subjective ROI, Schmalensee and Lesh ("Measuring Returns on Research," *Marketing Research*, Fall 2004) suggest the following:

1. For research on new products, markets and market segments, the estimate can be based on the expected values of each promising new idea.
2. For product or line extension research, the estimate can be based on the incremental revenue expected.
3. For advertising research, the estimate can be based on the advertising budget at risk.

While these are not "scientific" methods of estimating ROI, they help those who commission research to think about the need for research. It provides researchers a basis for establishing that research funds are not just an expense for the organization but investments as judged by decision makers, along with estimated ROI on projects commissioned. Although subjective models do arrive at a quantitative ROI estimate, the main value of these models is that they force the buyer to think about the purpose of the research project and its potential value to the organization.

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