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SEGMENTATION AND MARKET SPECIALIZATION

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1. Adoption of a segmentation and market specialization strategy
2. Construction and implementation of a strategy
3. Examples of strategy by lines of business
   a. Individual
   b. Group

MR. JOSEPH M. FITZGERALD: By way of introduction of this panel discussion, I would like to make two observations. First, I would note that the marketing field, be it research, planning or implementation, has become an increasingly important part of our industry. This certainly has been the experience at my company, CIGNA Corporation. Ten years ago, few of our major product line divisions had formal marketing departments within their organizations, and those that did focused their efforts primarily on such things as sales aids and sales support. Today, each division within CIGNA Corporation has its own marketing organization and each is charged with providing the full range of marketing services to the product line division. It's hard to say exactly why this transformation has occurred, but certainly the increased competition within our industry as well as the entry of non-insurance company competitors into the financial services field has created the need to sharpen our marketing skills.

My second observation is that in today's competitive environment, it's clear we can't all go after the same market and hope to continue to write business at acceptable profit levels. One effective technique for meeting the challenges of today's marketplace is to adopt a strategy of segmentation and market specialization. We are very fortunate to have with us on the panel today individuals who have experience in implementing this type of marketing strategy.

Our first speaker, Marki Ware, will outline the theory of market segmentation and specialization. She will be followed by Wil Thornthwaite, Fred Brown, and Harry Ploss, who will provide specific examples of how they've implemented this type of strategy in their respective companies.

MS. MARGARET J. WARE: We've all heard it a thousand times - if we were all the same, life would be boring. But fortunately people come in a lot of varieties, and that makes life interesting. It also provides for marketing opportunities. Today we will talk about these opportunities which result from the differences and similarities among potential customers.

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Of course, what I'm referring to is segmenting the market. There are three major topics to cover: why anyone should want to segment, how to identify useful segments, and what to do with them once they have been defined.

First, I will build a frame of reference for assessing the benefits of segmenting. In any marketing discussion, one can be pretty sure that the "four P's" will be at least referred to, and this is no exception. The four P's are the primary variables that companies control and manipulate to satisfy customer needs. They have to be creatively worded to all start with "P" but that device works to help people remember them.

These four variables, price, product, promotion (communication) and physical distribution, comprise the Marketing Mix. A marketing strategy determines how resources will be allocated and spent on each of these four variables. Once the marketing mix is established, total sales demand is generated based on the market's elasticity to each variable. Demand is a function of the marketing mix.

Exhibit 1

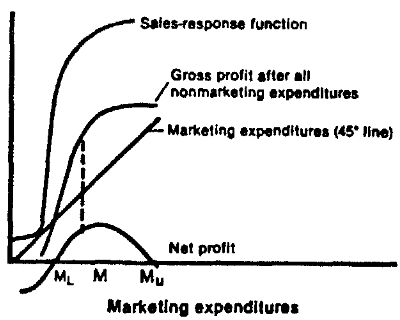

Exhibit 1 demonstrates the relationship between the demand function, marketing expenses, and bottom line profit. The top line represents the sales response function for a given mix. Gross profit is the result after all non-marketing expenditures are subtracted. The straight line at an arbitrary 45 degrees (which sets the scale for the other curves here) represents the marketing expenditures in total. Once these are subtracted from the gross profit, we are left with the net profit. At some point M, where profit is maximized, marketing expenditures should be capped.

This set of curves represents the market in total. The basic idea underlying segmentation is that any market is heterogeneous; it is likely to consist of submarkets, or segments, which respond in a specific way to the marketing mix elements. Segments which are homogeneous can be satisfied more exactly with a mix geared specifically to them.

Exhibit 2

$$Sales = f(m) = am_1 + bm_2 + cm_3 + dm_4 + r$$

becomes

$$Sales = f(m) = \sum_i a_i m_{1i} + b_i m_{2i} + c_i m_{3i} + d_i m_{4i} + r_i$$

Our simple sales function which is represented by the first equation in Exhibit 2, becomes a sum of all the sales functions of the segments, generated by the market's responses to the various marketing mixes being applied. In this exhibit, the "m"s correspond to the four marketing mix elements, and r is the random factor. The function is summed over i for as many segments as have separate mixes.

The benefit of identifying the segments and allocating resources in the marketing mixes that more exactly meet segment needs is twofold: the sales function can be maximized for any given marketing expenditure; or, for any given target sales level, marketing expenditures can be minimized by optimally allocating them in order to get the biggest bang for the buck. In either case, or with a combination of the two, all other things being equal, the net profit is maximized.

Now that we see the benefit of segmenting, i.e., maximizing profit, how are segments defined? While this can be somewhat of an art form, there are some structured steps one can follow to define segments.

To be worthwhile, segments should meet four criteria:

- Homogeneous within - by definition
- Heterogeneous between - different from the rest, distinguishable
- Substantial - large enough to be worth pursuing with a tailored marketing mix
- Operational - relevant to marketing decisions, identifiable characteristics

The first three criteria are clear. The last point, operational, requires additional comment. Some criteria that are useful indicators of buying behavior, and therefore useful criteria for segmenting, are not operational and cannot be applied. Personality is a good example. Suppose we know that "aggressive" people buy IRAs. There is no good way to develop a marketing mix to attract aggressive people, and therefore it is not operational.

Segmenting is done in three stages: 1) identifying different bases for segmenting using indicators of buying behavior, 2) profiling the resulting segments, and 3) measuring attractiveness.

To identify segments, there are two critical activities: customer analysis, and finding meaningful distinguishing criteria for segmenting. Customer analysis is the most important part of segmentation. This must be based on information from the market...real market research, not vague conventional wisdom. That does not necessarily mean sophisticated surveys. Conclusions need to be based on an informed evaluation of customer needs, attitudes and circumstances. The fundamental element is remembering to base conclusions on customers' wants, regardless of one's personal preferences. If you have a firm understanding from personal field exposure, trade publication reports of research, or polling of sales personnel (who are an excellent source of market research data), then you don't need to do "fancy" research. If you don't really know who the customer is, and what his needs are, then it is very difficult to compete to satisfy him. What you ideally would like to know is buyer behavior -- who purchases what, why and how they purchase. Usually the best you can get is a proxy for behavior, some characteristic which relates to behavior, e.g., income level relates to likelihood of purchasing tax shelters. Another example is that people with enough money to participate in certain large investments tend to rely heavily on the advice of their lawyer and/or accountant. You usually do need some sort of research, however, to tell you which characteristics are good predictors of buyer behavior. This research can be fairly simple, or can require very involved computer programming. While I have seen no statistics on this, my hunch is that most effective marketing companies do more than simple analysis, but few can utilize state-of-the-art computer modeling techniques. As a rule of thumb, the more competitive the market, the greater the need for sophistication. In general, not only does good customer data lead to effective segmentation, but good segmentation is impossible without a sound information base about potential customers.

Once the customer analysis is completed, segmentation criteria must be found. What follows is a fairly complete list of option categories, and my assessment of which ones tend to be commonly applied.

<u>Segmentation Criteria</u>

.Geographic
.Demographic
.Psychographic
.Consumption/Usage patterns
.Brand familiarity
.Buying situation
.Benefits sought

Geographic segmentation may be done by state, or region, or city vs. country, etc. We are all familiar with demographic characteristics of people such as their age, sex, marital status, location, concentration, migration, etc. Geographic and demographic criteria are the most frequently used criteria. There is a wealth of readily available data related to both. Psychographics are personal traits, preferences and life-style characteristics. These are frequently useful in marketing consumer goods. An analysis done at Connecticut General (CG) indicates that in the future, psychographics will be invaluable in segmenting the market for financial services. Consumption and use patterns can be especially helpful for products with frequent repurchase, unlike life insurance. Brand familiarity, or segmenting buyers based on their current brand purchasing behavior, can be important when quality or trust is a critical purchase consideration. Buying situation refers to the circumstances affecting a buyer's perspective or priorities. For example, a person might feel a much stronger need to procure a paddle if he is up the creek in a canoe without one, than if he is planning to fish on "Golden Pond" in a motorboat six months from now. Lastly, the market can be segmented according to the benefit being sought. For example, with financial products, the benefit might be preservation of capital, asset growth, high cash flow, or liquidity, and a separate marketing mix can be tailored for people who have each of those desired benefits in mind.

While demographic and geographic data, and consumption data for some consumer goods are the most readily available, the other indicators are often better predicators of behavior and therefore justify the additional cost and effort necessary to obtain customer data related to them.

These categories are guides to help in the search for distinguishing characteristics or descriptors. They are clues, not answers. Segments are often defined using multiple characteristics. The criteria do overlap. That is, a target customer could have 2 children, be 40, live in California and be risk averse; or you could define a segment such that members have greater than $100,000 annual income, need a will and a tax shelter along with life insurance, and rely on an attorney for advice; or a segment could be comprised by people who are retired, live in Florida, like to talk to a broker every day, and are primarily concerned with preservation of principal.

While in practice it may be difficult to get the data needed, segmenting is most effective when the distinguishing characteristics used to define the segments are indicators of purchase behavior, rather than factors that have little or nothing to do with what is being sold. Use analytical tools, insight, creativity, and intuition to model and predict customer behavior. If all else fails, you can also use a process of elimination. You can list customer characteristics from the customer analysis. Determine which ones are related to customer needs and actions. Try possible segment definitions. There is no magic here. Good segmentation depends on judgment, intuition, and creativity to weigh the importance of various dimensions. This will be difficult without any market related experience and/or good market research. For the data you have on customer needs, see if responses to preferences or decision criteria show a change at some point - that point might define a segment break.

When we segmented the commercial market at CG recently, we gathered information on businesses' priorities, product usage, decision criteria, "demographics" - i.e., sales volume, number of employees, etc., and took several cuts at breaking the market into pieces. Some of our divisions had already conducted research to determine what criteria were the best indicators of purchase behavior. We used all the data, research analysis, and product manager input to select criteria and determine segment breakpoints.

As a specific example, some research at CG indicates that for group medical coverage, commercial respondents of greater than 150 employees show a shift in the importance they place on low premiums and prompt claim services compared to employers with less than 150 employees. This suggests a segment break at 150 employees. What then is required in terms of premiums and claim service levels for each segment can be established based on customer feedback, and the marketing mix can be set to best satisfy each segment separately.

With the customer analyzed and the segments identified, Stage I is completed. Stage II is to profile the segment(s) so you have a clear picture of it (them). This profile or listing of segment intelligence will support the development of the marketing mix. Be sure that the segment definitions are based on hard data whenever possible to assure that the "operational" criterion is met.

Once the segment is profiled, Stage III is determining its market attractiveness. It is important to remember the earlier point that markets do not have potential all by themselves. A segment's attractiveness depends on the customers' responses to the marketing mix. Evaluating attractiveness can be the most difficult part of segmenting if good cost information is not available. The four factors which essentially determine attractiveness are economics, competitive advantage, sustainability, and risk.

Economics refers to size (i.e., the sales response function), potential profit margin, growth, etc. Competitive advantage is a concept often used by McKinsey & Company, which looks at your company's strengths and weaknesses and your product attributes compared to the competition. Analyze competitive offerings, position your own product, and compare. Look for gaps in competitor product offerings, and look for competitive weaknesses. You want to position your product as far from harm's way as you can while satisfying the customer. Sustainability - if you can profitably sustain a competitive advantage in a market, the market is attractive; if you cannot, its attractiveness is questionable. Risk too often is not consciously assessed, but is nonetheless taken implicity into account when the market evaluation is being done. Risk does not make a market unattractive, it just drives up the required return a market should generate.

Once attractiveness is evaluated, select attractive segments to support your strategy. There are three fundamental strategies:

- Undifferentiated strategy: going after the whole market, focusing on what is common in the needs of people rather than on what is different.
- Differentiated strategy (or target marketing): selecting target segments and developing a positioning and marketing mix strategy for each.
- Concentrated strategy: going after one or only a few segments.

You can specialize in any of the three basic strategies. No one is automatically the best. Select one of the three strategies based on:

- Company resources
- Product variation
- Product Life Cycle
- Market homogeneity
- Competitor strategies

Limited company resources demand that you use a concentrated strategy. Choose an undifferentiated strategy for undifferentiated products such as grapefruit; if product variation is high as in cameras, then differentiate. An undifferentiated strategy is generally appropriate for products early in the life cycle so as to develop primary demand. Mature products tend to be differentiated and require a corresponding differentiated strategy. An undifferentiated strategy is needed if the market has no segments or if everyone responds in the same way to marketing mix - i.e., the whole market is homogeneous, as is the case with most commodities. You can use a differentiated strategy if competitors are undifferentiated as in the example of Purdue chickens, but you cannot be undifferentiated if competition is differentiated.

Life and Health insurance is mature, and becoming differentiated even though it is a commodity product. Basically, this means that an undifferentiated strategy is likely to be ineffective. You must either target market or concentrate, and you decide between these two alternatives by evaluating how many segments you can pursue based on your company resources and your market position. In either case, you must segment the market and pick your shots to be successful.

Segmenting is worthwhile because it can optimize profit. The key points in the prior remarks are capsulized below:

- First find different bases for segmenting. The most critical activity is creative and effective customer analysis.

- Once segments are identified, they must be profiled, paying particular attention to the segments' elasticity to the marketing mix variables of price, product, promotion, and distribution.

- After profiling, the attractiveness of the segments should be gauged. Along with the fundamental measures of attractiveness, the key concept to remember is that demand is a function of the marketing mix.

- Since life and health insurance cannot effectively be marketed using an undifferentiated strategy, life and health insurance marketers - and most if not all financial product providers - must decide whether to target market or concentrate. This is a decision based on a company's capacity to pursue more than a very limited number of segments.

- Once segments are selected, a marketing mix for each can then be set to maximize profit.

In closing, I have this thought, that if you do not segment when all around you are, then your success will depend on the incompetence of your competition, or luck -- neither is a sound foundation for a strategy.

MR. WILFRED L. THORNTHWAITE: My remarks will focus on our topic as applied to the group insurance market and, in particular, the small group or MET marketplace. In the past, "market segmentation" may not have seemed as applicable to this marketplace because of the perceived lack of sophistication in both product offering and markets served. In fact, at National Life and Accident, the mass marketing lines (payroll deduction and group), have traditionally directed their efforts toward the small employer (ones with 15 or less employees). However, events of the past five years in markets such as group health insurance have created an environment in which market segmentation assumes an increasing level of importance. It is now clear that the increase in competitive pressures in this market, combined with erosion of profitability for the product line, necessitates more than a passing attention to this important concept.

In examining the importance of market segmentation as applied to the small group market, there are at least four influences that should be recognized:

1. Competitive Environment

   Unless a critical examination is made of what our competitors are doing in the group marketplace, we will often be left "holding the bag". As an example, it has been common practice among group carriers to offer guaranteed issue medical coverage to employers with five or more employees and specified levels of participation.

   As long as this was a general industry practice, it was assumed that a reasonable pooled premium could be charged for a cross section of risk. In recent years, a number of companies have moved to a "preferred risk" coverage in which a selection of industries with better experience is combined with some level of simplified underwriting to produce a lower rate basis. As the healthier groups move to these "preferred risk" pools, the guaranteed issue pools show deteriorating experience. In time, this form of competitive segmentation will probably force a restructuring of guaranteed issue group health coverages in the small employer market.

2. Changing Group Insurance Needs of Employers/Employees

   In a similar way, changes in the consumers' needs will force group carriers to re-examine their market segmentation philosophy. We are seeing a pronounced movement toward benefits designed specifically for white collar, service type industries rather than the more traditional blue collar, manufacturing industries. Depending on the life cycle of the industry, there may also be differences in the perception of the employer concerning the level and cost of benefits desired. For those businesses with limited growth potential, there may be a desire for limited benefit packages with a lower cost in contrast to the desire in a growth oriented company for broader benefits at a corresponding higher cost. The age and dependency characteristics of the employees may also dramatically affect the corporate marketing effort. We are seeing, even in the small case market, a trend away from dependent coverage due to the larger proportion of two income households.

3. Economic Environment

   Clearly, the three most important economic influences today on the small group market are unemployment, high rate of business failures and the escalation of medical costs. Even the threat of unemployment has an adverse effect on group claims in that the employee may accelerate the use of available benefits in anticipation of the loss of coverage upon termination of employment. At the case level, economic hardship and business failures have increased the number of case terminations and uncollected premiums. These factors will affect rate levels and/or ultimate profit developed from the group line. Finally, the escalating cost of medical care has resulted in the movement of the trend rate used in pricing from the 15-18% annual rate that was prevalent just a couple of years ago, to the more common 24-28% annual rate today. While other factors such as product design and cost shifting influence these trend rates, the largest proportion of the rate is directly attributable to medical cost inflation.

   As the realities of the economic environment come to bear on marketing planning, many companies are identifying those market segments containing more stable employer groups. Counteracting medical cost inflation, there has been a trend towards benefit design, including more cost containment features such as second opinion, higher cost sharing, and outpatient surgery.

4. Regulatory Environment

   Even though mandatory coverage changes tend to become the rule in time, the insurer must be sensitive to regulatory aberrations that may require unreasonable group benefits. The short-term solution may include redefining market segments to exclude those geographic areas subject to onerous group regulations.

While each of these four items is important in itself, there are obvious interrelationships that must be recognized. The relative value that an insurer places on each will ultimately influence the corporate marketing strategies and the market segments to be served.

Once market segmentation is recognized as part of the overall strategic planning process, the selection of market segments becomes an important issue. In this selection process, there are several points to be considered.

1. An obvious point, and probably the most important, is the proper identification of segments. The clear definition of a market segment is a precondition to both the allocation of corporate resources to a particular marketing strategy and the

successful execution of such a strategy. The definition of a particular segment may encompass demographic, geographic, socioeconomic and psychographic considerations. A clear definition of the market segments selected can be a more difficult task than one might imagine.

2. Once market segments are identified, the consistency with overall corporate strategic planning must be reviewed. As an extreme example, the identification of a market segment involving group dental coverage sold to an association of shepherds on the West Coast might be meaningless if present corporate strategy precludes any marketing efforts on the West Coast (group dental coverage and shepherds aside). Without this review process, it becomes easier to fall into the "all things to all people" marketing trap.

3. After the identification of segments and corporate strategy review takes place, a final screen against established corporate selection criteria should be done. Without suggesting a specific list of selection criteria, there are at least three important criteria that should be part of this screen:

   (a) Potential Contribution to Corporate Operating Results

   It is interesting how often this important criterion is overlooked in targeting a particular market segment. Often the patron of a special marketing effort will have some vague impression of its potential contribution to corporate operating results. While it is recognized that precise quantification of expected results and corresponding investment of resources may be often difficult, a realistic attempt should be made to do so. As marketing research tools have become more sophisticated, this has become more of a science than an art.

   (b) Availability of Corporate Resources

   In the small group market, there is a no shortage of marketeers with proposals to bring large amounts of premium to the company that is willing to quickly divert resources to the "deal at hand". Smaller companies are often more vulnerable to these approaches because of pressures to quickly increase premium income to enable the attainment of other corporate objectives. In the current group insurance environment, it becomes imperative for an insurer to do a rigorous strength/weakness analysis before selecting those market segments to be penetrated, hopefully, on a profitable basis.

   (c) Consistency with Other Marketing Programs

   A point often overlooked is the consistency of a particular group marketing strategy with other corporate marketing programs. This is often more of a problem in a company with product line organization where marketing coordination may be difficult. An example is development of a marketing program centered on the sale of a supplemental group life plan to small employers while at the same time the individual area is aggressively marketing an individual salary savings whole life plan to the same market segment.

Once the identification of profitable market segments consistent with overall corporate strategy has been made, a target marketing strategy for group products and services may be implemented. Such a strategy contains at least four important elements:

1. Segment Identification

   We have already discussed this subject and the importance of proper and clearly delineated identification of the market segments to be targeted.

2. Marketing Mix

   For each market segment, the insurer should identify the optimal mix of marketing variables--product, price, distribution and promotion--that will give it the best advantage over competitors while meeting corporate performance expectations. Such a mix might include new products not previously offered or use of alternative distribution channels other than the company's traditional base. In my company, our small group products were initially developed to support our combination agency force; however, over the past five years we have been more successful in marketing through group brokerage outlets.

3. Positioning

   Closely identified with marketing mix is the concept of positioning, i.e., the relative position of our product/services to those of our competitors. Company A might position itself as a flexible, innovative group marketeer emphasizing low price and distributing through brokers. On the other hand, Company B might position itself as a more conservative, service oriented marketeer with less flexible products sold through more stable distribution channels. One point to consider is the avoidance of an "identity crisis" where inconsistent shifts in marketing strategy come in conflict with the perceived position of the company in the marketplace.

4. Monitoring of Results

   Proper feedback is extremely important in the small group market. The company must continually monitor the operating results of identified segments to assure that pricing levels are adequate for the segment served. In the brokerage market especially, if there are inconsistencies in the group marketing program, i.e., pricing and/or underwriting for a particular geographic area, this may be quickly exploited with a resulting surge in possibly nonprofitable premium. Because of the many variables involved in group insurance, it is extremely important to have a reliable management information system to monitor results on both a short-term and long-term basis. Through this monitoring program, the group marketing strategy can be continually evaluated and appropriate changes made where needed to create consistency with overall corporate strategy.

In conclusion, it might be stated that it is not enough to be merely a follower in the small group market in today's competitive environment. To lack a full understanding of markets being served and why a particular target market strategy is being used may doom an insurer to failure in marketing group insurance. During the past several years, a number of companies have dropped the group line entirely (and in some cases the company has gone with it), so these decisions have an important impact on overall corporate strategy.

The proper application of the principles we have discussed today can significantly increase the probability that an insurer can survive by covering the group insurance risk in the small employer marketplace. While there are many who would state that it is almost impossible to currently sell group health insurance on a profitable risk basis, I believe there are identifiable market segments that can indeed be sold at a profit.

MR. FRED BROWN: Marki has given you an excellent overview of the market segmentation process. I will discuss some of the techniques Unionmutual has used in implementing market segmentation for Group Products. Unionmutual sells a broad range of Group Life and Health products to the non-jumbo sized client, concentrating on the under 250 life groups.

Every company will approach market segmentation differently. I will discuss some of the factors that have shaped our approach and our specific techniques. Firstly, our profit center structure has supported the kind of teamwork between financial and pricing people, underwriting, product development and market analysis people that market segmentation requires.

Secondly, the changing nature of our product portfolio has driven a changing emphasis on market segmentation techniques in recent years. Five years ago, we basically had a successful portfolio of products we were working to enhance and maintain. In recent years, there has been a greater emphasis on expanding current products to new markets and broadening the product portfolio. This "expand and broaden" strategy requires different techniques than a "maintain and enhance" strategy.

For Unionmutual, and for most companies, the competitive environment is much more intense than it was five years ago. This requires more sophisticated techniques to monitor competitive challenges in current product/market segments so we can react swiftly and effectively based on objective criteria.

However, the most significant factor shaping the specific techniques employed has been the information tools and systems capabilities available. These tools and capabilities evolved over many years, predating the emphasis on current marketing techniques. In a way, the tools came first and we're still learning how best to use them.

Certainly, the information tools available will shape how one can look at and monitor one's marketplace. At Unionmutual, our information systems can be grouped into several generic categories. The first category of systems estimates the size of possible market segments. The appeal of any market segment is a function of its size or potential. If the market has been segmented based on demographic criteria (location, size, industry, etc.), then government data, census data, Chamber of Commerce data and 5500 filings may be used to estimate potential size and degree of saturation. As segmentation criteria get more sophisticated or nontraditional (e.g. psychographics) the useful data tends to dry up. We find ourselves estimating segment potential by correlating these criteria to demographic data based on past observations or survey results of sampled clients.

The second category of information systems monitors sales volumes and trends. Once a segment has been picked and an action plan formulated, we monitor our sales volumes by that segment to see how the market is responding to our plan. Currently, trends are monitored in sales and lapse figures, putting changes in historical perspective. The way to successfully manage a marketing plan, however, is to establish clear guideposts or expected results at specified dates by which success or failure will be determined. To that end we are working to monitor how aggressively sales people are approaching defined segments and what the sales closing ratio is in those segments, rather than just monitoring sales volumes.

The third category of systems monitors the financial performance of defined segments against assumptions. Product line financial projections embody assumptions about performance in defined segments. On a quarterly basis, actuaries analyze variances between actual experience and the projections. Variances are analyzed for significance, and the impact on future financial results both with and without corrective action is modelled. This process highlights broad segmentation groups that are not performing as expected.

Finally, we subset our book of business on a regular basis, looking for trends in profitability as well as growth. Interesting trends are pursued by taking finer or different cuts of the segment to isolate a problem or an opportunity. We compare usage patterns against key pricing assumptions for the segment and compare performance with industry data or data from other segments. Again, the goal is to highlight segments not performing as expected.

All of these systems allow the essential feedback of information to the marketing manager. For this feedback loop to be successful, however, these different information systems _must_ be integrated. Clearly, market potential and expected/demonstrated profitability need to be presented together if managers are to embrace this information as a tool for making decisions. An integrated system will minimize inconsistencies in data which require extraordinary amounts of non-productive time to resolve, and will foster ownership in the information.

I think of our segmentation techniques as ranging from defensive to offensive, depending on the specific application. While there are no clear, distinct categories, one can group segmentation techniques into three categories. The first category, "reactive" techniques, are used to scan one's existing portfolios of business in a search for relative problem areas or opportunities. The objective is to identify and manage pricing umbrellas that currently exist. Segments are monitored for signs of increasing competitive pressure (e.g., increased lapses or reduced sales). This kind of work forms the basis for segment level price or product adjustments designed to stimulate sales in high-margin segments and reduce sales in low margin segments.

"Active" techniques are used to aggresively manage product mix in order to increase the efficiency or productivity of the product portfolio. This requires a more sophisticated approach to identifying and capitalizing on market segments with appeal, as defined by pre-determined criteria. The search will expose interesting segments that show low growth or below-average profitability and thus have not been obvious candidates for emphasis. This is where the marketing manager should refine the product to better meet the needs of that segment. To give an example, in one situation a product was "over-engineered" for a particular market's needs, leading to anti-selection. When the product underwriting was tightened and the price lowered, margins and sales volume both improved, and a new target segment was born.

"Proactive" techniques are those basically described by Marki. I'll say no more at this point other than that we've employed this kind of in-depth market analysis only when introducing new products.

Reactive techniques are used both to defend and enhance current products in current segments. Active techniques are used to expand to new segments with existing products, building on current strengths and market position. Proactive techniques are used to identify and meet client needs for new products. While the proactive techniques sound romantic, remember that the reactive techniques are central to maintaining a base of operation. The more you expand, the more you will ultimately need to defend.

I have talked about types of information systems and types of segmentation techniques. Let me tie the two together and be more specific by discussing how Unionmutual implements segmentation techniques. Our reactive segmentation is characterized by continuing analysis of successive layers of product/market subsets. We monitor sales and lapse rates on a monthly basis for key, broad market segments. On a quarterly basis, we look at the mix and financial performance of our products by segment, and compare against assumptions based generally on momentum performance. Annually, we do an in-depth scan of our existing product/market portfolio to re-catalog our problem segments and high performers and prioritize remedial action steps. Follow-up reports take even more detailed cuts at the data to isolate subsets with unique performance characteristics. All of these studies are part of a continuous feedback loop for the product development people. Without this information, there would be no way to prioritize remedial action steps aimed at conserving the current book of business and capitalizing on new opportunities.

A general characterization of our reactive segmentation process would be that costs are driving price. That is, current profit margins by segment are used as the basis for determining maximum appropriate price adjustments. This is a sure-fire recipe for mediocrity over the long haul. Generally, its much easier to lower the rates on profitable segments until above-average margins no longer exist than it is to raise the rates on low-profit segments.

Active segmentation is based on the assumption that missed opportunities abound, and one is limited only by available resources. The objective is to spot the diamonds packed in chunks of coal. To do this we look at growth and market share data for each defined segment and integrate that with an analysis of claims experience relative to industry norms. Segments that would otherwise be very appealing but demonstrate low penetration and poor margins are prime candidates. Addressing the problem often requires that the product development people estimate the segment's reaction to product changes based on their knowledge of the current market. Clearly, not every attempt will be successful. Risk taking must be supported, and feedback loop must be set up for each new segment attacked.

The field sales force needs a lot of support, as we try to re-direct their efforts to market segments previously considered "dog business." Systems monitor quote activity in these segments, and this information is fed to field managers. A home office sales person designs programs to help the field sales force effectively access new segments. The active segmentation process recognizes that volume drives costs, which in turn affects profit margins.

Our experience with proactive segmentation techniques has centered around several new product initiatives taken since 1980. The approach followed was basically the process that Marki outlined. The information systems used were totally independent of other systems used for current products. We completed in-depth customer analyses using group discussions and professionally designed surveys. Based on our analysis of that data, segmentation criteria were chosen which are different from industry norms. We then isolated desirable segments based on a number of factors (including the competition's ability to meet the segments' needs). Our product was designed to maximize the uniqueness of our offering in this segment. In retrospect, the most difficult part of this proactive process is that of maintining objectivity. Well-defined criteria for desirable segments established before-hand can help keep product development people focused.

Marki said that not to segment when all around you are doing so courts peril. While I agree, I would like to make the point that you can get good results without employing sophisticated marketing techniques. The key is that you don't need to be perfect at it; just do a better job than your competition.

MR. HARRY PLOSS: Segmentation is the divide and conquer of marketing. By segmenting the market into homogeneous bite size pieces, you can more accurately meet customer needs than if you use an overall average approach. Even if segments are not individually managed, you will find some to be more profitable than others, and the reduction or elimination of unprofitable segments will increase profits while decreasing revenue slightly.

Margaret mentioned the "4 P's": Product, Price, Producer Distribution, and Packaging. As actuaries we hear so much about product and price that we frequently lose sight of packaging and distribution system alternatives. My discussion will focus on packaging and distribution methods in the direct mail selling.

Direct mail has been with us for many years, but in the last 10 years the competition has become ferocious. No longer can a company starting in direct mail expect to be profitable if it is not 70% state of the art in copywriting, mailing piece design and production, list management, customer service and insurance processing systems. Let me give you an example of how each of these items are affected by segmentation.

Direct mail copywriting has to be personal and address the needs of the targeted customer. A dramatic example of conceptual packaging is the Veteran's Trust which appeals to a large segment of the population in direct mail. A few companies are using this selling tool. By describing a different life style or need, and the ways in which the insurance product meets that need, the appeal can be changed. In the old age market where graded death whole life and medicare supplement are sold, greater appeal can be generated via an endorsement of a celebrity or a nonprofit organization founded for this purpose. This type of conceptual packaging requires the establishment of legal entities and legal changes in the policy filings. However, there are conceptual packing options that do not require any legal changes. A three-day elimination period on a $50 a day benefit can be described as a $150 deductible. A benefit period can be described as a dollar policy maximum. A death benefit can be converted to monthly income. These features that seem so insignificant to us actuaries may be a dominant sales point to our customers.

Artistic packaging is also important. The mailing piece has to catch the customers' eye so that they will open it. Spanish speaking people prefer different colors than English speaking people. Such color appeal needs to be tested separately for each major segment. Involvement items such as plastic credit size cards, tokens to be put into slots, "if you're not interested" notes, and personalized ink jet letters are tools that can be designed for specific segments. Copywriting and mailing piece design are the packaging/promotion/communication portion of direct mail. These items are very visible and easy to copy, but very difficult to understand what works and why without valid statistical testing.

List management is increasingly important in direct mail and is the greatest opportunity of statistical segmentation. Mailing lists frequently have buying history, age, sex, address, family size, annual income, et cetera. One can measure response rate by these variables. Formulas that predict response rate for specific segments are developed.

A simple formula is to add the percentage deviation in response rate that each characteristic on the mailing file has from the whole list. For example, if the age group 20-29 has a response rate of 80% of the whole file, subtract 20 points for that characteristic; if list members buying a widget in the last six months have a 25% higher response rate, add 25 points for this characteristic. The list members with the most points will probably have the highest response. More sophisticated formulas use multivariate, non-linear regression with correlation, but appear not to produce significant improvement over the simple technique. An important refinement is to replace segment response rates with dollars of projected gross profits based on segment average premium, loss ratio, persistency, et cetera. This process is called "targeting for backend profitability". The ability to predict profit/loss potential of each customer on a new list is vital to increasing profit margins. All segments that meet the insurer's return on investment requirements are solicited. Direct mail has always been a gold mine, but as the quality of the ore becomes poorer, better technology is required if one is to profitably conduct mining operations. The days when one could profitability pan for gold are over.

Statistical segmentation and recombination is a facet of list management and direct mail marketing that is exciting to talented actuaries. The computer revolution has made it possible to enhance the information on a mailing list by matching with census tract demographic data, motor vehicle registration, past company experience and other data lists. Increased knowledge of each prospect allows us to better separate the good from the poor sales prospects. Segmentation and selection of sales prospects by computer is much less expensive than printing and postage costs lost in a too broadly directed mail campaign. Mailing lists that are bad in the aggregate may have very fertile segments, while even excellent lists can have their results significantly improved through segmentation.

In direct mail, large volumes of homogeneous business is generated. The processing and servicing needs are different from agency business. As there is no agent, servicing is done via "800" toll-free telephones with operators trained in the product features and aided by convenient CRT terminals giving appropriate customer policy information. Many types of traditional individual life processing are no longer needed and can make the software processing slower and harder to maintain. The need for efficiency forces specialization in all phases of the organization, not just in marketing.

In direct marketing, segmentation is becoming increasing more automated. Computers can segment and recombine customer lists in optimal ways that are too complex to be intuitively predicted. These electronic information methods are becoming cheaper than normal economical distribution costs such as printing and postage. These methods will also be applied to telephone and media marketing. We are entering an "information revolution" and segmentation is one strategy that our new technology facilitates.