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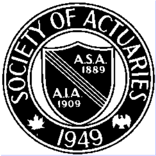

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Chairperson's Corner

by David A. Seidel

It is that odd time of the year when actuaries everywhere are putting the very final touches on 1997, and marketers are looking to our 1999 plans, leaving one to ask, "Who is working on 1998?"

I work in the direct-response area, marketing through financial institutions, and the still-too-long gestation period for new products and offers has us already looking for 1999 opportunities. I wanted to highlight some trends I see from my perspective and the challenges and opportunities provided to actuaries serving this market:

- In the quest for ever-increasing fee income, financial institutions are going beyond insurance to satisfy their needs. Club programs, noninsurance health discount programs, and service contract/ warranties all compete for the marketing opportunities that had once been reserved for insurance. Implications—there is a huge need for new products and delivery solutions in insurance and, I believe, a huge opportunity for actuaries to assist the noninsurance product arena. And, perhaps, the biggest opportunity of all will go to those who can integrate these well, from marketing and financial standpoints.
- There has been continued rapid change in players and competitors in each and every market. New acquisitions (for example, Cendant buying American Bankers) create great potential synergies but, in my humble opinion, have rarely evolved past consolidation of operations. Implications—huge opportunities for the organizations that capitalize, via acquisition or strategic alliance, to truly add marketing value (for example, more products integrated in a more comprehensive and well-thought-out delivery strategy) instead of merely subtracting

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Analyzing Direct Marketing Business Alternatives Using a "Value" Approach

by David S. Lee and Jay M. Jaffe

Direct-response professionals often address questions such as, "Did we get enough of a response-rate increase from the more expensive, creative package to justify the extra expense?" or "Did we get enough 'bang for the buck' from our free-gift offer?" This article describes an approach to these decisions based on "maximizing value to the company."

There are a number of old profitability "rules of thumb" for insurance direct or data-based marketing that are useful but not sufficient in today's environment. These rules were developed under much simpler market conditions.

Today's insurance direct marketers and actuaries are producing more complicated programs and products in an environment where making a reasonable profit is becoming more and more difficult. It can be dangerous for an insurance direct-marketing company to base "go or no-go" decisions solely on old rules of thumb.

In some cases, profitability decisions should be based on full-cost pricing, but there are situations in which marginal cost pricing is not only appropriate but possibly the preferred approach. The decision whether a program is good or bad should be based on whether the program increases the value of the company and not necessarily, for example, on a simple ratio of annualized premium to marketing costs (the old TARP/MC measure). Deciding on the acceptability of a single campaign or choosing between alternative campaigns requires a decision process based on maximizing the value of the company.

This article describes some of the traditional profit measurement standards and then presents a more comprehensive and up-to-date foundation for insurance direct marketers and actuaries to use when reviewing either individual campaigns or total marketing programs.

Traditional Rules of Thumb

Two of the most frequently used measures of direct marketing success have
been:

$$\frac{TARP}{MC}$$

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where *TARP* is a measure of the annualized premium and *MC* equals the marketing costs associated with the program; and

n = number of months before (Premiums − Marketing Costs − Expenses − Claims > 0)

Some people view n as the number of months it takes for a program to "break even."

Back in the days when it was easier to make money from direct-marketing campaigns, an accepted "rule of thumb" was to break even by the twelfth month, using the above definition. Today, as competition and marketing costs have increased and response rates have generally declined, it usually requires longer than 12 months to break even. The unresolved question—does a company make money just because a product "breaks even" within n months?

Example 1: The "Sick" Hospital Indemnity (HIP) Program

Suppose a company is considering a 100,000-piece direct-mail HIP program. The marketing costs are estimated at $60,000. Based on the expected response rates, TARP is anticipated to equal $54,000. Premium income is expected to begin at $4,500 per month, and decline by $100 each ensuing month.

Applying the rules of thumb discussed above, *TARP/MC* = 90% and n = 20 months (approximately). Generally, these results would define a "successful" mailing. The *TARP/MC* ratio is high, and the "break-even month" is reasonable. However, let us consider some of the financial data in greater detail.

Suppose the actuary projects the various costs of the program as a percentage of the present value of premium over the expected lifetime of the policies, as shown in Table 1.

Clearly, in spite of the favorable rules of thumb, the actuary reviewing the information in Table 1 would have concerns about mailing a significant quantity of offers.

The problem with the old rules of thumb is that they focus on premiums rather than profitability. The HIP program discussed above does a great job of generating premiums. Unfortunately, the underlying business is not profitable. The approach discussed below addresses this shortcoming.

Maximizing Value to the Corporation as a Measurement Tool

A program is said to "add value to the corporation" if the present value of future profits generated by the program is greater than zero. Discounting of future profits is at the corporate hurdle rate.

Consider the appropriate expenses used in the financial projection. In many cases, the most useful measurements are based on "expenses that are marginal to the program being considered." Some actuaries dislike the idea of using marginal expenses in profit testing. However, for many day-to-day tactical profitability decisions, a marginal expense analysis may be the best approach.

Suppose, for example, we are evaluating the effectiveness of a telemarketing follow-up program to a direct-mail campaign. Corporate overhead is unlikely to change based on this particular "go or no-go" decision. Therefore, if the actuary forces the telemarketing program to "cover its share of overhead," the results may be misleading. The only company expenses that will change are those that are marginal with respect to the telemarketing follow-up, and the analysis should reflect this fact.

Example 2: Using the Value Maximization Approach

Suppose a company is preparing for a 100,000-piece roll-out mailing after pretesting the offer with and without telemarketing follow-up. Assume the expected response rate is 0.2% (mail only) and 0.3% (mail plus telemarketing). The cost of follow-up telemarketing to the entire file would be $120,000. How does the company use "value maximization" to make the business decision on whether to include the telemarketing?

In these situations, the actuary should calculate the expected present value of future profit for the additional 100 policies (100,000 × 0.1%) that result from the telemarketing follow-up by using expenses (including the $120,000 telemarketing expense) that are marginal to the additional 100

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TABLE 1
Projection of Costs as a Percentage of the Present Value of Premium

Component	Present Value of Premium
Marketing Costs	35%
Acquisition Expenses	5
Maintenance Expenses	10
Premium Tax	2
Claims	55
Total	107%

TABLE 2
Expected Incremental Results from Telemarketing Follow-Up

(1)	Number of Policies Issued	100
(2)	Annual New-Business Premium	$50,000
(3)	Telemarketing Costs	$120,000
(4)	Present Value of Premium Income	$250,000 (100%)
(5)	Present Value of Investment Income	$12,500 (5%)
(6)	Present-Value Death Benefits	$75,000 (30%)
(7)	Present Value of Surrender Benefits	$25,000 (10%)
(8)	Present Value of Marginal Expenses (excluding telemarketing)	$7,500 (3%)
(9)	Present Value of Reserve Increases	$20,000 (8%)
(10)	Present Value of Book Profits = (4)+(5)−[(6)+(7)+(8)+(9)]	$135,000 (54%)

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policies. If the present value of future profit, discounted at the corporate hurdle rate, is positive, then the telemarketing follow-up adds value to the corporation. Basically, this means the expected future profit on the additional 100 policies must equal or exceed the $120,000 telemarketing cost. Sample results are presented in Table 2 on page 4. The percentages are ratios to the present value of premium income.

The expenses in (8) include the marginal costs of issuing and maintaining the additional 100 policies directly resulting from the telemarketing program. In this example, book profits are "before tax." An after-tax approach can be used if the telemarketing expense is adjusted to an after-tax basis.

The present value of book profit exceeds the telemarketing expense by $15,000. Therefore, telemarketing follow-up is expected to add $15,000 of value to the company, meaning telemarketing follow-up is probably a sound business decision for this situation. "Conventional" analysis might have led to a different conclusion. (The $120,000 telemarketing expense is generating only $50,000 of new business premium. The *TARP/MC* ratio is only 42%. The number of months until "break-even" is probably in the 30–40 range, well in excess of the old 12-month rule-of-thumb. The reason for the difference in conclusions is that the "value" approach recognizes that the product being marketed in this example is very profitable. Therefore, the program can afford more marketing costs for each dollar of TARP and still add value to the corporation.

Conclusion

The approach to decision making presented in this article has numerous applications in marketing situations. To the extent companies are using the traditional "rule-of-thumb" methods, an actuary should consider other profit perspectives, including the use of marginal costs as described above, as a tool to help make more effective business decisions.

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"Emerging Markets for the New Senior Citizen" Seminar Rescheduled

The Product Development and Nontraditional Marketing Section will co-sponsor a seminar entitled "Emerging Markets for the New Senior Citizen" designed to help actuaries and other professionals learn more about the needs, desires, demographics, and influences baby boomers and their parents have in today's world. Attendees will find out how insurance companies and service providers might want to position themselves in the coming millennium to take advantage of changes in the health care system, tax reform, technological advances, and underwriting protocols. Topics to be addressed include:

- An overview of market demographics
- Implications of recent tax law changes
- Mortality trends and underwriting issues
- Potential changes being discussed relative to valuation and nonforfeiture regulations
- Distribution issues using state-of-the-art technologies
- Overview of current products and services
  - Life insurance
  - Reverse mortgages
  - CCRCs
  - Long-term care
- Insights into senior marketing

This seminar, originally scheduled for March 1–3 in Charleston, South Carolina, has been rescheduled to November 15–17 at the same Charleston location. The day-and-a-half meeting will begin on November 16, with a reception that night.

For further details, please contact Sheri Abel at 847–706–3536.