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## Management Review

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# Managing Through Rose-Colored Glasses

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During a recent meeting with executives of a large U.S.-based retailing company, the president and chief operating officer made an assertion that resonated closely with statements we have heard time and again from other senior managers. “We’ve

found that there’s a direct correlation between [X], [Y] and our bottom-line profitability,” the executive said with pride. Almost every day, senior managers, using their own Xs and Ys, make similar claims — as if to say that, at last, they have finally uncovered the levers that drive performance.

Many of today’s senior managers have an impressive understanding of operations. For example, they know how faster cycle times and lower costs can lead to improved profits. However, they often run into problems when they overreach — when they seize upon causal relationships that are tenuous at best and perhaps don’t even exist. It’s hard to believe that corporate managers who are entrusted with the financial health of their organizations would consciously embrace distorted views of reality. But if one considers some of the more popular management fads of recent years — for example, reengineering, total quality management or diversification — one has to wonder about senior management’s overall level of due diligence. Indeed, select any area of management, and a sober examination is likely to reveal that the best-known shibboleths are deeply flawed.

As consultants in the field of customer retention, we recently conducted an investigation into commonly held beliefs about customer loyalty. We initiated our study after hearing numerous complaints from managers that their loyalty initiatives

were not living up to expectations and their investments just weren’t paying off. We decided to examine as many beliefs about customer loyalty as we could find and match them up against the tactics that companies were employing to spur customer loyalty. We used data from practitioners and academics and our own experience with hundreds of companies worldwide to test maxims like, “It costs more to acquire a customer than to retain a customer” and “Loyal customers are more profitable to serve.”

In the course of our research, we found to our surprise that many of the most popular assertions about loyalty were little more than myths. For example, in digging into the oft-repeated claim about the benefits of retaining current customers over the costs of attracting new ones, we found several flaws. The claim first assumes that existing customers will spend more money than new customers, which may or may not be the case. Second, it assumes that current customers buy at full margin and don’t demand discounts, which isn’t a given either. And third, it assumes that it’s easier and cheaper to serve existing customers, which also requires a leap in logic. Data in fact shows that the added costs of serving new customers are often negligible, while the savings in serving long-term customers may not ever materialize. We found similar flaws in the assertion that loyal customers are more profitable. Documented studies across many industries show that all companies serve three types of customers. Generally, less than 20% of customers generate the lion’s share of the profits; another 60% to 70% of customers are break-even to marginal in their contribution to profit; and the remaining 20% or so eat up profits based on the high costs of serving them. However, there are loyal customers in each category. Profitability therefore has more to do with customer behavior than with the longevity of the relationship.

These discoveries raised some fundamental questions: Why are patently false promises widely

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accepted as true? Why do professional managers treat certain claims as “scripture” when experience and data show otherwise? And why do seemingly intelligent managers suspend disbelief about cause-and-effect relationships? In our view, the answer has to do with both how managers relate to problems and where they seek advice.

Much has been written about the “guru effect,” or the way consultants and business school professors create and package new ideas and practices for corporate consumption. But the gurus are not the only guilty ones. Managers themselves have been more than willing to hear what they want to hear and believe what conforms to their perception of a problem. In a sense, their bias toward a specific business outcome shapes their interpretation of causes and effects. In other words, they see relationships predicated upon a desired outcome. We refer to this phenomenon as *management teleology*. In our view, most managers are not twisting reality to protect their interests. Rather, they subconsciously latch onto beneficial outcomes to validate a new process, practice or idea.

### The Need to Know “Why”

Humans have always sought explanations for natural phenomena. As a species, we seek to understand the things that impact our lives. For most of human history, mythology and tradition offered explanations to the important “whys.” Science has since challenged many of the myths and brought new insights into the workings of our world. Occasionally, a new approach represents such a dramatic departure from conventional thinking that it triggers a public backlash. Quantum physics is a good example; it contradicts so many of the “laws” of conventional physics that its acceptance requires unlearning many basic principles. Even Einstein rebelled against the notion of chance occurrences in physics.

As methods and relationships become more abstract and complex, the challenge for managers is becoming increasingly difficult. In their efforts to provide a clear direction for their organizations, managers, under the guise of the scientific method, often fall back on preconceived notions and even biological biases to explain relationships. The result is the advancement of a new kind of mythology: the *analytically supported myth*. In many ways, analytically supported myths are more insidious than traditional myths. Their purported objectivity

gives them a level of authority that often rivals established facts.

### Searching Where the Light Is Brightest

There’s an old joke about an inebriated man crawling under a street lamp, searching for his car keys.

*“Where did you lose them?” a passerby asks.  
“Over near my car,” the man answers.  
“So why are you looking for them here?” the passerby inquires, with puzzlement.  
“Because the light is so much better here!”*

In many ways, the search for new and improved business practices is often guided by “where the light is brightest.” Below, we have identified a few of the more common syndromes affecting today’s managers.

**The Extraneous Correlation Syndrome** We tend to assume that the ability to predict outcomes affirms an accurate understanding of the cause-and-effect dynamics of relationships. But history shows that this isn’t necessarily the case. For example, pre-Copernican models of the solar system used highly complex mathematics to predict the location of the planets in relation to the Earth and did so with great accuracy. However, contrary to their assumption, the Earth wasn’t the center of the universe.

Even in modern economics, the ability to predict future events does not guarantee accurate assumptions about the underlying structure of an economic system. This view is typified by Nobel Prize-winning economist Milton Friedman’s assertion in a 1953 essay, “The Methodology of Positive Economics,” that the only value of a theory is its predictive ability and that an explanatory component is irrelevant.

Friedman’s dismissal of the role or importance of explanation in theory has been the subject of considerable debate in economics for many years. Other fields, including management science, however, have overlooked this nuance, accepting correlating relationships as *prima facie* proof. Consider the relationship between market share and profitability. In the 1950s and 1960s, researchers found that market share and firm profitability were highly correlated. Because of this connection, managers focused on improving market share in order to achieve greater profitability. Some of the greatest management thinkers of the time were seduced by

the link, even though it wasn't clear how they were related. Bruce Henderson, founder of the Boston Consulting Group, has been quoted as saying, "It doesn't matter why market share and profitability are linked, only that they are."

Unfortunately, most companies that pursued market share did not see higher profits. In retrospect, the reasons are obvious. Many of the activities that can improve market share — acquisitions in the same industry, price reductions or expanding manufacturing capacity — also have cost implications that hurt profitability. Furthermore, if most competitors in an industry pursued market share growth, they would add capacity, putting downward pressure on prices (and ultimately profits).

In light of these problems, one has to wonder why leading management thinkers didn't sound an alarm. We can only conclude that increasing market share was a message that business leaders wanted to hear; many saw it as a mark of accomplishment. Profitability, moreover, was the ultimate measure of success. It was only natural that managers would embrace the relationship between the two.

**The Gut-Instinct Syndrome** Despite management's proclivity toward objective quantification, belief and wishful thinking still drive much of corporate decision making. A common claim of senior managers is, "We know our customers, what they want and what we need to do to improve." However, this assertion rarely stands up to careful scrutiny; when we try to confirm management's portrayal through interviews with customers, we almost never hear the same view.

For example, a well-known U.S.-based financial services company had long structured its operations to support the functions of its client organizations. The internal organization (operations, account management, etc.) and staffing levels were configured to match those of its clients. The stated purpose was to keep clients happy and to maintain stability. In fact, it was generally assumed that client companies polled their employees about whether to renew relationships with vendors. However, in the course of interviewing the company's clients, we found that some of the main underpinnings for the company's operating strategy were based on either faulty information or information that was woefully out of date. For example, customers revealed that decision-making power was

not distributed widely among employees but tended to be controlled by a relatively small group. Ironically, the company was directing very few resources toward satisfying the *real* decision makers.

**The Desired Outcome Syndrome** Managers often have specific, high-level goals — for example, increasing market share or share price, or reducing costs. However, the mechanisms for attaining those goals are often fairly intricate, requiring managers to adopt a view about how different forces interact. More often than not, managers assume that they have more control over the business environment than they actually have.

Take, for example, the recent case of a U.S. automaker's plans for a new engine that would meet forthcoming fuel-economy and emissions standards. Management set a net present value target for the engine; to improve the likelihood that the target could be met, they created financial models that incorporated cost information on several critical engine components. The inclusion of this information revealed how difficult meeting the target would be. To compensate, managers revised some of the basic assumptions about the components and continued to make adjustments until the model hit the desired net present value. As the company's engine-pricing manager lamented: "The model was designed to achieve the target NPV, but we already knew what it had to be."

The urge to fulfill expectations cuts across disciplines such as finance, marketing and human resources. In our research into customer loyalty, for example, we saw that people found virtuous chains of effects (such as happy employees lead to happy customers lead to loyal customers lead to higher market share and profits) inherently appealing. Managers seem drawn to the notion of linkages at a fundamental level. Paradoxically, however, when such chains are tested, researchers usually find evidence that both supports and counters the essential theory.

**The New-Is-Better Syndrome** Scientific discovery is built on incremental learning. New hypotheses and theories are developed, tested, subjected to constructive scrutiny and then either rejected or accepted. Although different disciplines tend to have their own approaches, even ideas that have been thoroughly examined should be periodically revisited. The physical sciences historically have

been the most receptive to open review and re-examination of existing theories, although here, too, there appears to be a bias toward discovery research.

However, there is value in both types of pursuits. An attempt to replicate prior findings or reconfirm an already accepted relationship arguably can contribute as much to science as an attempt at discovering a new relationship or phenomenon: Science advances both by negative and positive proof. Sir Karl Popper argued that science demands “falsifiability.” In other words, a theory cannot be considered scientific if it does not accept or embrace the notion that it could be wrong and therefore must be repetitively tested.

Falsifiability is the standard for scientific testing. The ability to replicate findings is widely accepted as the most important criterion of genuine scientific knowledge. Still, confirmatory explorations continue to be accorded less prestige than those that challenge or overturn knowledge.

Some disciplines are actually biased against confirmatory research. Unfortunately, management science seems to be one of them. The most highly valued papers in the field are the ones that reflect major advances. This bias, which has been created and maintained both by the academic community and the numerous scientific journals in the field, fosters an environment in which myths and shaky assertions go unchallenged.

In addition to the bias against confirmatory research, a “Catch 22” undermines management science. If research confirms current theory, the work offers no contribution; if results refute current theory, the model coefficients likely will be analyzed in a host of different ways in order to explain the seeming failure to replicate. Worse still, with a failure to replicate, there will be no established theory to explain the new outcome. The absence of a contrary explanation makes it difficult to get the findings published in leading journals. Compounding this difficulty is the reality that journals often pick reviewers who participated in the original research that is being critiqued.

The result is that the lion’s share of discovery research addresses models that have been developed in whole or in part based on unconfirmed and possibly questionable conclusions from prior “guru-inspired” research. Given that hypotheses must be proposed and that there is a bias toward positive results, man-

agement scientists, like others, have at times succumbed to creating their own data-supported myths, which find their way into the pages of the most prestigious journals of management science.

We recently had a conversation with the editor of a leading management journal, which over the years has published articles on some of the most trendy management topics. Upon hearing our comments on the analytic deficiencies of many widely circulated articles, he conceded: “There are so many ideas and models published in the very best journals that simplify business phenomena too much, or have a too narrow focus. We need more critical views, reviews and research.”

### Our Brains Are Wired to Believe

Researchers in psychology have found that the human brain holds on to the most rewarding view of events and that our minds prefer to believe “facts” that conform to our views, even in the face of conflicting information or outright contradiction. This is a basic human tendency — one that is by no means unique to business managers. Nevertheless, when managers substitute beliefs for knowledge and don’t acknowledge the leap, they put their businesses at risk. It is inevitable that new management ideas will challenge current practice. But before managers embrace new ways of approaching problems, they should require a higher level of analytic rigor.

Managers need to cultivate the habit of questioning the underlying assumptions of their own views, and they need to apply the same degree of skepticism to ideas that come from the outside. It is only by challenging preconceived notions and questioning assumptions that managers will be able to create more successful and more adaptable organizations.

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