Customer analysis

ENHANCING YOUR ASSETS

Magnus Spence explains how a better understanding of customers through needs-based segmentation generates many benefits and leads to greater profits.

Segmentation is not easy, which is perhaps why it has not been applied properly and effectively in European asset management. Implementation is costly and involves more than just a few marketing geeks – the active involvement of the chief executive is crucial, for example.

But the rewards are huge. The first firms to truly crack segmentation will generate real competitive advantage and will increase their profitability.

Huge benefits

Proper customer[1] segmentation generates several benefits, including: more sales; more profit; greater organizational effectiveness; and a more robust strategy.

Know your customer, intones the UK regulator, and no doubt others elsewhere in Europe will follow. Good advice. Understanding customer needs allows companies to cluster them into distinct and meaningful segments, and distinct tailored propositions can then be developed for those segments that the provider chooses to target.

The narrower and clearer focus allows companies to understand better the sources of revenues and costs, and thus profit. Segments that are already profitable can be harvested, and unprofitable segments with potential can sometimes be turned around.

The better focus also improves the bottom line by cutting out waste and unnecessary effort throughout the marketing chain: fewer wasted communications to the wrong customers, lower product design costs, and less misdirected effort in the sales teams.

Effective segmentation makes a more effective organization – more sensitive to changes in customer behaviour and attitude, and thus less likely to be "caught out" – and more likely to be able to respond to such changes quicker than competitors.

Management decisions will tend to be more structured and decisive. For example, companies will be faster and more confident in introducing or withdrawing products, altering pricing and in deciding when to quit a falling segment or enter or develop a rising one.

Not segmentation as you know it

Forget the minor marketing department classification exercises of the past: an all-singing all-dancing segmentation needs the full and unqualified support of the chief executive and the whole organization. Back-office systems must be geared to *needs* of segments; human resources planning must be driven by the *nature* of the segments; and management information systems must be geared to measuring performance and profit *by segment*.

A company's segmentation is, in effect, a statement of what it is and what it wants to become. It is a vital foundation and a precondition of its strategy, and any plan that lacks a coherent and appropriate segmentation will be flawed from the outset.

Despite these benefits, segmentation is not being implemented in European asset management. This doesn't mean that companies don't think they are "doing segmentation", but they are not doing it right. For example, we have yet to find (and we, and others, have looked hard) a European asset management firm that is able to provide an analysis of its profits by customer segment.

That is a tough test that most firms in many other industries would also fail. But we don't have to be tough to make our point. Even the simplest and most diluted form of segmentation is seldom implemented. Companies may have impressive-looking customer clusters in their marketing plans, but in most cases

HOW MANY CUSTOMERS …?

Asset managers
Banks
Commercial banks
Direct high-net-worth
Direct intermediary
Discretionary private clients
Distribution partners
Financial institutions
Funds-of-funds
Hedge funds
IFAs
Institutional liquidity
Insurance companies
Intermediary
Mutual funds
Offshore – Jersey
Package providers
Pension funds
Private banks
Proprietary
Quasi-institutional
Retail
Sales direct to end-clients
Sub-advisory
Tied agents

[Based on responses to an FRC survey in 2004 of eleven well-known well known European firms, who were asked to describe in summary the customer/distributors through which they sell their funds.]

these classifications just don't work where they need to work – on the street.

The *How many customers … ?* box shows the *short-list* that we distilled from the responses to a survey that we conducted amongst European providers. Few of these terms seem to indicate robust classifications. They appear to us to be classic examples of *Segmentations that don't work*. The list of segmentations that *do* work is much shorter – ones based on grouping together *customers and distributors* with similar needs.

Why don't those segmentations work? Consider the commonest grouping in our survey – customer "type". More than half of our respondents treated IFAs, banks, asset managers and insurance companies as "different". Yet any sales team could take you to three "banks" in the same street in, say, Frankfurt with completely different needs in respect of funds. In the next street, there might be insurance company that thinks exactly like one of the banks, and another insurer that thinks exactly like another bank. Or an asset manager, or an intermediary. Underlying needs are more important than the nameplate.

Segmentations should therefore be developed by grouping together customers or distributors with similar needs. A segment should reveal something about what customers need, and how they buy, because the whole point of *having* a segment is to help monitor and meet those needs. A segment containing customers with different needs is useless, because it will not allow funds to be directed where they are needed. At best this is a waste of energy; at worst it will damage customer relationships and eventually destroy the business.

> Segmentations that work are based on grouping together customers and distributors with similar needs.

Excuses, excuses

There are four reasons (excuses, we call them) why segmentation has not been implemented properly in European asset management. Neatly, they all begin with C – complexity, change, corporate inertia, and convenience.

The most challenging reason is that customer needs are sometimes **complex**, which makes it very difficult to identify them accurately and cluster them into meaningful groups. For example, fund distributors often source funds for a variety of reasons – for their bank customers, their private bank customers, their

SEGMENTATIONS THAT DON'T WORK

Classifications of customer (bank/insurer/IFA etc) – these overlook important differences in needs within each type.

Classifications using sales force parameters such as territory or type of product.

Classifications reflecting a company's internal structure (retail/institutional splits, for example) are unlikely to be effective unless those structures have been built around customer needs rather than company convenience or tradition.

Classifications that confuse channels with segments. These may overlap, but customer needs vary within channels.

Classifications that use size as the sole basis of a segmentation – needs may still vary widely amongst, say, "small" distributors.

Classifications that are based around the products a company sells – as close to an actual crime as it is possible to get in this area!

FIGURE 1: THE FRC SEGMENTATION MODEL

Customer/distributor segment identification	Really really retail	Really retail	Re-tutional	Really institutional	Really really institutional	Really good friends	Really rich people
Illustrative industry language	Direct sales (retail)	Third party (retail)			Institutional	In-house (retail and institutional)	Very-high net worth (retail)
Examples People	IFA	Retail bank	Fund of network	Pension funds	Other plans	Family offices companies in same group	
Estimated proportion of the European fund industry	Very low	Low	Low	Low	In the middle	High	Low
Numbers of customers available	Vast	Medium	Not many	Few	Few	Very few	Few
Illustrative numbers of customers for one third-party supplier	25,000 people	3,000 people	500 people	100 people	200 pension plans	10 key contact points	Hundreds

fund supermarket, and so on. Decision making can be driven internally from one powerful centre, which would tend to reduce complexity, but the reality is that their needs can vary widely from division to division within the same organization. Similarly, customer needs on identical products may be quite different in different regions.

Rapid **change** is a dominant feature of European fund distribution. For example, larger distributors increasingly demand that their third-party fund suppliers engage in costly pre-sales rituals such as lengthy form-filling – in the same way that pension funds (the so-called classic institutional clients) have been requiring for decades. As a result, these retail fund products are said to be bought in an increasingly-institutional manner. Thus the two worlds of retail and institutional, which were once quite distinct, are now colliding.[2]

> Marketers are only human, so tend to group their customers in the easiest ways possible.

In some companies, the scale of **corporate inertia** is so great that it might be better described as the fossilization of company processes. Segments definitions and terminology were often developed in the early days of European expansion, based on the whim of the sales team – there were not too many marketing professionals around in those days. With no process leadership, segment definitions and terminology sometimes vary from country to country within the same firm.

The *status quo* is always hard to change. There are serious "turf issues" in giving control of segmentation to marketing professionals, and a serious investment in time and money is required to rebuild databases and management information systems in a format fit for current and future market needs and opportunities – quite apart from the question of up-dating the historical data series.

Convenience is an arch enemy of segmentation. Marketers are only human, so will tend to group their customers in the easiest ways possible. Perhaps this is just another way of saying that most marketers do not truly recognize the full value of segmentation, and so are not willing to put in the extra effort and resources to do it properly. And because they don't do it properly, it doesn't work – which convinces them that they were right not to put too much effort into it in the first place!

Try this solution

Accurate, relevant and usable segmentation is a painstaking and lengthy business. There are no short-cuts, but a proper framework can help to focus the effort more effectively. In that context, we offer our own FRC model as a guide.

We argue that the distributor/customer segments sit along a spectrum, and we use the terms "retail" and "institutional" to describe its two extremes. Our model (Figure 1) features five segments within the spectrum, and a further two segments that lie beyond the spectrum.

At the retail extreme of the spectrum is the "Really really retail" segment. Retail customers tend to be numerous and demanding but individually small; to be needy, rather ignorant, and to be dispersed in inconvenient places. People sold to direct are "Really really retail". Many (but by no means all) IFAs and other financial advisers are "Really retail".

FIGURE 2: DESCRIBING SEGMENT NEEDS

Customer/distributor segment needs	Really really retail	Really retail	Re-tutional	Really institutional	Really really institutional	Really good friends	Really rich people
End customer base to service	People	People	People	People	People	People	Very rich people
Product/service typically required							
Segregated mandate					Yes	Yes	
Fund sub-advisory			Yes				
Normal funds	Yes	Yes	Yes	Yes		Yes	Yes
Hedge funds	Yes (rich)	Yes (rich)		Yes	Yes	Yes	Yes
Size of need	Very small	Small	Medium	Large	Very large	Super-large	Large
Illustrative assets sourced each year per third party supplier (€ m)							
Flow per year per supplier	0.01	2	10	30		>100	
Assets under management					50		10
Buying behaviour							
When buying, places importance on (illustrative):							
Performance	Yes	Yes	Yes	Yes	Yes		Yes
Price/revenue share		Yes	Yes	Yes	Yes		
Branding	Yes	Yes	Yes				Yes
Relationship/people			Yes	Yes	Yes		Yes
Investment process				Yes	Yes		
Group loyalty/compulsion						Yes	

The "Really really institutional" segment sits at the other end of the spectrum. Institutionalness suggests a tendency in customers to be big but rare, complex and sophisticated. They are demanding in many ways, with complex and constantly changing needs – and requiring sensitive and sophisticated (and therefore costly) handling. This segment is generally reserved for those with old-fashioned institutional needs: for example, pension plans requiring a segregated mandate. The "Really institutional" segment, in contrast, includes many of the multi-national and multi-activity banks and funds of funds.

In the middle, these two tendencies meet. We call this segment "Re-tutional" at the moment, but if anyone has a better suggestion … It includes organizations, sometimes quite big, that need to offer funds to an underlying client base, but lack a detailed understanding of the sector.

Beyond the spectrum lie "Really good friends" and "Really rich people". "Really good friends" is a very large part of the market, comprising those customers that source their product from their associate or fellow group companies, their "friends". Their needs are just as real as those sourcing through third parties, but they are quite distinct: for example, they share a parent with their supplier.

The "Really rich people" segment consists of people who are so super-rich that their own family offices act in many senses as mini-institutions in their own right.

Segment needs

Figure 2 indicates the way in which the needs of each segment can be identified and described in a way that makes clear their quite distinct and different needs – which, incidentally, is another rule of segmentation.

Note what the segmentation is *not*. Size is not a basis for segmentation in this model, nor is the sector of the business. These are now inadequate, since they are frameworks that disguise a multitude of behavioural and need patterns. A large bank could be "Really retail", whilst a small bank could be "Really institutional". And a large multi-activity bank could have several arms, each of which might be in different segments. In other words, you can only segment a customer or distributor once you know how it behaves. And the segmentation process demands the painstaking placement of each customer into the appropriate segment, one by one.

FIGURE 3: ANALYSING SEGMENT COSTS

Sales and marketing cost implications for product suppliers by segment	Really really retail	Really retail	Re-tutional	Really institutional	Really really institutional	Really good friends	Really rich people
Favourable							
Not too many of them				Yes	Yes	Yes	Yes
Not demanding	Yes						
Not too inquisitive	Yes	Yes					
Conveniently located						Yes	
Understand industry language	.			Yes	Yes	Yes	
No need to meet them	Yes						
Adverse							
Infrastructure							
Multi-country locations		Yes	Yes	Yes			
Large customer numbers, so complex sales and marketing processes	Yes	Yes					
Team							
Large teams of salespeople		Yes	Yes				
Large teams of marketing people	Yes	Yes	Yes				
Sophisticated (costly) salespeople required				Yes	Yes	Yes	Yes
Up-front investment requirement							
Need to win many customers to build scale	Yes	Yes	Yes				
Need to invest in sales and marketing technology/processes	Yes	Yes					
Need to invest in branding	Yes	Yes	Yes				Yes
Complex communications system (website)	Yes	Yes					
On-going sales costs							
Customers are dispersed in inconvenient locations		Yes	Yes				Yes
Many clients need advice/hand-holding		Yes	Yes				
Each client is demanding		Yes	Yes	Yes	Yes	Yes	Yes
Require sophisticated sales approach/materials				Yes	Yes	Yes	
Need to be visited during selling		Yes	Yes	Yes	Yes	Yes	Yes
After-sales services required							
Mechanized (call centres/mailings)	Yes	Yes					
Semi-mechanized (reports/websites/roadshows)		Yes	Yes				
Tailored (personal visits)			Yes	Yes	Yes	Yes	Yes

And where different needs are revealed within the same organization, it is necessary to deconstruct the organization into distinct "buying units" – each determined, of course, by the behaviour of its customers – each of which then allocate *their* customers to dedicated segments as appropriate.

We don't claim our model is the end article, nor that it will work for everyone. It is just a start. But the key is to base the segmentation on a deep understanding of customers, which necessarily involves much more detail than can be indicated here.

Segment costs

This is not the end of segmentation, but just the start. Its value is derived from using it as a tool for action. For example, Figure 3 shows a rough analysis of the costs for product suppliers of doing business in each of the segments. Provided that each segment is properly specified and is made up of customers with similar needs, it is likely that there will be similar costs per organization in supplying these needs. It is therefore possible, indeed highly desirable, to predict these costs by segment, and subsequently to monitor them in the same way.

Costs can be influenced downwards by favourable factors – if, for example, there are just a few organizations in a segment – or upwards by unfavourable factors, such as a requirement for a large salesforce to service some segments.

FIGURE 4: ANALYSING SEGMENT PROFITS

Illustrative income, costs and profitability by segment	Really really retail	Really retail	Re-tutional	Really institutional	Really really institutional	Really good friends	Really rich people
Relative size of buying	Very low	Low	Low	Low	In the middle	High	Low
Estimated proportion of the European fund industry	----------	----------	21%	----------	----------	79%	----------
Illustrative business economics							
Illustrative gross fee income earned	Very high	High	High	Low	Very low	Low	Low
Equity long-only fund (basis points)	200	150	150	75		150	85
Equity segregated account (basis points)					30		
Illustrative revenue-sharing cost rebated to distributor	Nil	Medium	Medium	Nil	Nil	Very high	Nil
Equity long-only (basis points)	Nil	55	55	Nil	Nil	110	Nil
Illustrative net income kept by asset manager	Very high	High	High	Medium	Very low	Low	Medium
Equity long-only (basis points)	200	95	95	75	30	40	85
Illustrative sales and marketing costs	Very high	High	Medium	Low	Very low	Very low	Medium
Typical sales and marketing cost (basis points)	30	25	20	15	5	5	20
Net income less sales costs (basis points)	170	70	75	60	25	35	65
Illustrative all other on-going costs	Very high	High	Medium	Low	Very low	Very Low	Low
Core costs spread equally across all segments	15	15	15	15	15	15	15
Incremental costs specific to this segment (basis points)	50	20	20	10	0	0	5
Illustrative profit (basis points)	Very high 105	In the middle 35	In the middle 40	In the middle 35	Very low 10	Low 20	In the middle 45

Segment profits

The next natural step is obviously to impose pricing that varies by segment in relation to the costs they incur, which leads to a key output of a full segmentation – as Figure 4 indicates, each (properly analysed) segment can be seen as a distinct business that requires its own profit and loss account.

These figures are purely indicative, but show the power of the process. It is also important to keep the numbers in context – hence the relative weightings for each segment, as the value of any segment is the product of its (unit) profitability and its size. So, for example, "Really really retail" may be very profitable, but it is also very small.

From the perspective of marketing theory, it is disappointing that, as far as we are aware, no European asset management business yet has the capability to produce tables like these for their businesses. But, looking forwards, the power of the tool represents a huge opportunity for companies to focus their strategies properly, and to gain a huge competitive advantage over rivals that continue to eschew the technique. Surely no chief executive can now afford to ignore segmentation. ◻

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[1] This article focuses on asset management from the perspective of the big providers, so "customers" are generally distributors and other institutions – but the same segmentation arguments and opportunities apply to them and *their* customers, who are the final link in the retail chain. For brevity, the term "customer" is used to cover all these aspects throughout.

[2] As an aside, these two terms must now be used very carefully to avoid confusion.