

# *The Loyalty Effect*

essays

on the  
relationship  
between  
loyalty and  
profits

the  
**metaphysics**  
of measurement

essay # 2

**BAIN & COMPANY**

# the metaphysics of measurement

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## You Are What You Measure

It is only through measures that managers can capture the creative spirit of vision and harness it to the earthly realities of daily business practices.

What a business measures shapes employee thinking, communicates company values and channels organizational learning. Measures, by establishing the feedback loops that are the foundation of learning, define what an organization is and what it will become. Deciding what to measure and how measures are linked to incentives are among the most important decisions a senior manager must make.

However, most executives today are making do with inherited and outdated measurement systems that warp and distort their business strategies. Current measurement systems are vestiges of past accounting traditions and regulatory requirements having little to do with actualizing the corporate vision.

As a result, today's CEO functions like a pilot flying an airplane with nothing but an air speed indicator to tell him how he is doing. Without an altimeter or compass, most planes would crash; and without the right measurements, most organizations face a similar fate. With almost total reliance on measures of current period profits, today's managers are flying blind. Because CEOs generally relish the all-absorbing job of the pilot, few have the time and energy to address their true strategic job – the design of

the plane and its instrumentation. They fool themselves into believing that if they simply create and communicate a vision, the organization can keep the craft on course.

For example, the CEO of a leading international company became convinced that his organization had to improve service quality and increase customer focus. He saw that the competitive battlefield was shifting from technology to service. In every speech, he emphasized these themes. In every interview with journalists, he focused on this vision and its compelling logic. At shareholder meetings, he articulated the importance of service quality and customer focus. As part of every strategic plan review, he insisted that each division specify the initiatives they were taking to increase service quality and customer focus.

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After three years, to be certain that his vision was having impact, he polled his senior managers. On a confidential basis, they were asked to weight their top priorities. The result: Their number one priority, by far, was hitting the annual profit plan. Service quality and customer focus did not even make it into the top three. In explanation, one of his managers said, “Everybody knows what drives annual bonuses and how our careers are measured—it’s the annual profit budget.”

The problem, as we at Bain saw it: Measures for service quality and customer focus had not been tied into the annual plan numbers. As a result, there was a disconnect between the vision and the reality. The auto industry has tried to bridge this gap by measuring customer satisfaction and linking it to management bonuses and dealer incentives. However, the link between satisfaction scores and profits is unclear. Satisfaction scores for the industry have ballooned up to 90% or more as managers have learned how to game the system; meanwhile, repurchase rates have remained mired below 50%.

The irony of this situation is that most managers in the automobile industry clearly understand the economic value of customer repurchase loyalty. However, most of them measure customer satisfaction (perhaps because it is easier?) rather than repurchase rates. Their historic measurement systems track cars by their government—required vehicle identification number—not by customers. Have regulators had more impact on measures than managers?

The simple truth is that satisfaction surveys alone don’t yield the information companies need to have about delivering value to customers. Would anyone who is serious about measuring shareholder value question stockholders about “satisfaction” and consider the job to be complete? I don’t think so. Yet one of the largest auto companies has declared that its mission is to be the best value to customers, while it continues to base management decisions on satisfaction measures. It doesn’t even track how customer repurchase rates vary by dealer to learn about best and worst practices.

The dominant measures in the auto business, as in most companies, are keyed only to shareholders' short term needs. They are especially dangerous because they entice managers to make decisions that will improve the numbers for the short term, rather than provide value to the long term stakeholders in the system.

Under these conditions, managers become manipulators who react to symptoms rather than deal with root causes. All too often, a negative symptom is merely suppressed by palliatives, only to come roaring back with greater destructive strength later on. For example, short term cost reductions and price increases often boost this year's earnings but can destroy long term value.

Some companies have recognized that they need to extend the range of gauges used to keep their business flying on course. However, without a clear understanding of the kind of data that is useful, they generate information overload, which only exacerbates the problem. All measures must be linked together through their relationship to current and future cash flows or trade-offs can't be evaluated. Short term earnings will always win out unless other drivers of value can be quantified and solidly linked to cash flows.

## Building Meta-Measures

One company that has built an effective measurement system is USAA, the San Antonio-based insurance and financial services firm. In an industry that is not known for its superior service quality, but is well known for costs which are spiraling out of control, USAA has pursued a vision of delivering the very best service and value to its customers. In fact, its cost per policy has declined in real dollars for the past ten years. At the same time, quality levels have risen to set new industry standards. What is it about USAA's measurement system that has unleashed organizational learning?

First, unlike other insurers who measure policy lapse rates, USAA tracks customer lapse rates. Where other insurers can't easily distinguish a customer defection versus a loyal customer who cancels one policy and replaces it with another from the same company, USAA can make this distinction. As a result, its employees have learned from true defectors how the company has failed to deliver value. Customer retention rates stand very high in USAA's measurement hierarchy and currently exceed 98% (compared to the industry average of 85%).

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Second, at USAA, every department must establish measures which address the three drivers of customer retention: 1) quality to the customer, 2) costs and productivity and 3) employee capability and motivation. In other companies, cost reduction efforts are based on simplistic productivity measures such as policies per employee, usually leading to cost reductions which also reduce customer quality. By tying all three dimensions together through its knowledge of retention economics, USAA has focused learning on actions which, on net, increase value and retention. This system has enabled each department to learn how to turn the corporate vision into a reality.

Several other leading insurers have also committed to visions of delivering superior value to their customers. However, they have not built measurement systems designed to measure customer retention or to quantify retention economics. As a result, historic accounting measures (short term costs and revenues) remain the focus of organizational efforts and learning. The corporate vision is not firmly connected to the daily realities of running the business.

## The CEO As Systems Designer

As businesses become increasingly complex, it will be impossible for CEOs to act as pilots for their corporations. Their job must evolve to enable them to concentrate on the design of a fleet of planes with sufficient instrumentation so that average managers can fly them successfully. By linking each of the instrument families to customer retention, the final connection can be made to cash flow impact. Appropriate trade-offs among measures can then be made and corporate visions can be achieved.

Creating lofty visions for the corporation is entirely appropriate — a necessity for superior performance. But these castles in the air must have foundations put under them. It is absurd to claim to be customer-focused and then have dominant measures focus on short term profits. It is not reasonable to claim your company's mission is to deliver the best value to customers and then have no reliable measure for delivering value.

Measures will never achieve their metaphysical potential when they are considered only as “controls” — which is how the subject is taught in most business schools. Their real power lies in their ability to inspire and focus learning. It is only through measures that organizations can learn, only through learning that they can create value in an ever-changing world, and only through creating value that they can survive and prosper.

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