The Future of Retail

A Harvard Business Review Insight Center Report
The HBR Insight Center is an interactive resource that highlights the emerging thinking around today’s most important issues. The Future of Retail Insight Center explores the ways in which new technologies, innovations, and ways of doing business are changing the retail industry — and the way we all shop.

Poll

HBR.org readers were polled on retail issues.

Which innovation is having the biggest impact on the shopping experience?

- Price comparison applications
- Crowd-sourced product reviews and ratings
- Crowd-sourced promotions and discounts
- Location-based targeted offers
- Concierge/virtual customer service support
- All of the above
- Other
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Retailers Should Invest More in Employees

by Zynep Ton

Doug Rauch, the former president of Trader Joe’s, visited my Service Operations class at MIT last week. When he mentioned that Trader Joe’s invests in its employees a lot more than its competitors do, he was challenged by one of my students: “Isn’t it a bad idea to invest in employees in settings like yours where shopping is transactional and can easily be done online?”

Doug had a strong reaction: “Nowadays you can go through an entire day without a single person acknowledging your existence. But don’t forget that we are people who generally like connecting with other people.” He went on to explain how profitable it is to invest in employees, even for a supermarket that competes on the basis of low prices, and how most online grocers have not found a way to make money.

My class had already discussed QuikTrip, a convenience store chain with over 500 stores, and Mercadona, Spain’s largest supermarket chain. We also talked briefly about Costco, a large and publicly traded wholesale club. All of these retailers, along with Trader Joe’s, invest significantly more in their employees than is typical for their retail peers. They also have high profits, low prices for their industry, excellent operational metrics, and a reputation for great customer service. These retailers deliver great value to their customers, employees, and investors—all at the same time. (My article in the January-February 2012 issue of Harvard Business Review, “Why ‘Good Jobs’ Are Good for Retailers,” analyzes how they manage to do this.)

Even so, I was not surprised that my student was questioning Doug on his company’s choice to invest in its employees. Many in the business community still see employees in low-cost retail as interchangeable parts. They can see with their own eyes that most large retailers, such as Walmart, do not invest much in their employees. And it makes sense to them, as it made sense to my student, that low-cost retailers really have only one thing to offer their customers: the quick, cheap sale. That’s what the customers are there for, and there’s no point in offering more.

These people miss two things.
1. **Even in low-cost retail, it takes a lot of human effort and judgment to get the right product to the right location at the right time and to make an efficient transaction.**

It’s the low-paid employee, not the inventory-management software, who notices that a shelf looks messy or that some of the products are in the wrong place. It’s the low-paid employee who notices that some of the lettuce has gone bad or that there are still signs up for last week’s promotion. It’s the low-paid cashier who can tell the difference between serrano peppers and jalapeño peppers during checkout. It’s the low-paid employee who notices that there are too many customers waiting in the checkout and offers to open an additional cash register. When retailers don’t invest in human capital, operational execution suffers and the company pays with lower sales and lower profits than it could have had.

2. **Even in low-cost retail, there is still interaction between customers and employees.**

It’s the employee who notices a customer standing in the aisle looking lost and offers help. It’s the employee who can read from a familiar customer’s face that he’s had a bad day and could use a friendly smile. It’s also the employee who can turn a customer off—maybe permanently—by being rude or even just not very helpful. It’s the people who make you want to shop here even though you can easily buy the same stuff there. Yet most low-cost retailers forget about that.

Those are what we could call the business reasons for more investment in employees. But business on the scale of these retail chains is never just business. It’s people’s lives—the employees’ and the customers’.

I care that millions of retail employees are not given decent wages, benefits, work schedules, and an opportunity for growth, even though doing so is free for retailers. I care that a lot of human talent is wasted. When I’m shopping with my children, I care what view they are forming of the society they live in. I try to go to places where they will see what people are like at their best, not at their most disengaged. I want them to live in a society in which people acknowledge each other’s presence and are kind and respectful to each other, and I think that begins with being brought up to see kindness and respect as normal. What Doug Rauch and others have shown is that what I want for my children is not at all incompatible with what they want for their companies.

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**FEATURED COMMENT**

“This is an outstanding article, and I heartily agree with all of your assertions. One point I would add is about the enormous importance of retail employees—they can make or break how a customer perceives and defines the brand of the retailer. Every time I walk into a Starbucks or a QuikTrip, I am reminded of the power of brand realization—the potential of an employee to create a lasting impact in a single touchpoint, to either add great value or create dissonance to the company’s brand with their smile or scowl, words and actions, even in the way they take my dollar bill for a 32-oz. soda.” – Dr. John Miller
In order to assess the future of retail, we need to understand the sector's current impact on our entire economy and the direction that Washington is taking the retail industry with policies that are being shaped today.

Three months after we launched the National Retail Federation’s (NRF’s) “Retail Means Jobs” campaign, the importance of the retail industry to the nation’s economy could not be clearer. Retail is a barometer of the nation’s economy—the point where the efforts of many other industries get turned into cash. Increases in retail translate into the creation of new jobs all along the huge supply chain that brings products to store shelves. In fact, a PricewaterhouseCoopers study commissioned by NRF found that the retail industry supports 42 million American jobs—individuals employed directly in retail, plus the suppliers and vendors who keep retail running. That’s one in four jobs, making retail the largest private-sector employer, dwarfing the numbers seen in major fields such as manufacturing and health care. Retail contributes $2.5 trillion to the GDP, or about one-fifth of the nation’s total gross domestic product.

The future of retail is going to impact our future economic well-being, and much of it depends on what’s happening in Washington today.

We launched our Retail Means Jobs campaign to ensure that members of Congress realize how many of their constituents owe their livelihood to the retail industry and to encourage them to support a pro-retail, pro-jobs agenda that will put the people who elected them back to work. To that end, we have developed a detailed Jobs, Innovation, and Consumer Value Agenda, which covers issues such as corporate tax reform, sales tax fairness, transportation infrastructure, international trade, consumer privacy, health care reform, improving the visa process for foreign travelers who want to come here to shop, and many other issues. It’s critical that the policy agendas being shaped today—which will in large part shape the future of retail, at least in the near term—be viewed through the lens of whether they support or hinder job creation in the retail sector. Our agenda focuses on:
The Future of Retail Depends on Today’s Policy Decisions

1. Spurring Job Creation

The policies being enacted today need to:

- Encourage global trade: Smart trade policy that eliminates trade barriers at home and abroad and facilitates international commerce will help American companies grow and be more competitive.
- Reform the corporate tax system: Simplifying the tax code by eliminating special tax deductions and credits in return for lower rates will allow retailers to grow and create jobs.
- Promote sales tax fairness: Congress needs to establish a level playing field where all retailers collect sales tax regardless of whether they sell their products in stores, online, or through the mail.
- Eliminate visa delays, making it easier for more overseas travelers to visit the United States: Overseas travelers spend an average of $4,000 each time they visit the United States. By removing visa barriers without weakening security, we can generate billions in new economic output and create more than a million U.S. jobs.
- Modernize our nation’s aging infrastructure: It is crucial that the U.S. transportation infrastructure—including our ports, airports, rail lines, and roads—can meet future demands. We need a national freight policy that will support U.S. competitiveness, economic growth, and job creation.
- Implement smart health care reforms: The retail industry is highly sensitive to rising labor costs, and federal health coverage mandates will force many retailers to downsize their workforce. NRF is working to fix or repeal the provisions in the 2010 health care reform law that are hostile to the future of the retail industry.
- Support labor and workplace flexibility: Efforts to implement “card check” union-organizing legislation or other onerous policies intrude on business operations, restrict an employer’s workplace flexibility, undermine employees’ privacy rights, and often lead to unnecessary costs for retailers.

2. Advancing Innovation

Today’s policies need to:

- Protect consumer privacy while promoting innovation: NRF supports industry-led self-regulation. Overly broad privacy legislation and regulation will stifle innovation and hamper the growth of online retail. Public policy must protect consumer privacy without hindering technological innovation.
- Promote advances in mobile payments: Before lawmakers and regulators intervene in the development of this nascent technology, they must first consider its tremendous benefits and fully weigh the potential costs of any proposed regulation.
- Drive Consumer Value: Retailers must be able to give consumers ever more convenient and cost-effective ways to make informed buying decisions. To do that, we need policies that will:
  - Maximize supply chain efficiency: We support efforts to streamline the transportation of goods from manufacturer to retailer to customer, and we oppose regulatory proposals that lengthen the supply chain, raise transportation costs, or undermine the rapid delivery of affordable products.
  - Combat organized retail crime: We need comprehensive federal organized retail crime legislation that stiffens the penalties for criminals and gives law enforcement the tools they need to go after organized retail crime.
  - Reduce swipe fees: Reforming credit card swipe fees could save retailers and consumers billions.

As an industry that supports one in four American jobs, retail is essential to our nation’s economic recovery. With their direct daily contact with U.S. consumers in every city, state, and congressional district, retailers have an untapped grassroots potential larger than any other industry and an opportunity to send a strong message on what needs to be done to put our nation on the right track for the future. That’s why our Retail Means Jobs message is critical to the future of retail and critical to the future growth and competitiveness of the American economy.
In Retailing, Assortment Is Job One

by Dieter Brandes and Nils Brandes

The biggest problem with retailing today is that, in too many companies, senior management neglects its most important job: to manage the assortment of goods and services they sell.

We see evidence of it everywhere. A Walmart bodega store in Mexico City, with a total selling area of 70,000 square feet, stocks 50 different SKUs of toilet paper. A highly sophisticated supermarket in Hamburg, which sells some 30 varieties of yogurt, neglects to stock the 10% cream variety that many of its most discerning customers prefer. (For that, they must cross the street to the Turkish store.) A shopper walking into either one of these retail environments might well ask, “Is this the right place for me?”

As a retailer, you must be confident that the answer will be “yes”—and that means asking your own managers first: why should our customers prefer to shop at our store? You must be clear on your business’s mission and strategy, and how they will translate to your aisles. Decide on the kind of store you will be and the kind you will not be. Don’t make the mistake of “sitting between the chairs” so that in an attempt to capture the average you create a setting that is comfortable for no one. Find a convincing concept and stick to it.

Then remember the basic truth of the business: that retail is detail. Ask the next layer of questions about how the assortment will reflect that concept, and the next and the next. Include all your employees and their brains in improving the details. Remind them every day of how important it is. (It’s the assortment, Stupid!)

Don’t leave it to computers. If there is one clear culprit behind today’s lack of competence in assortment management, it is the computer. Too many retailers in the world think that their computers, by analyzing point-of-sale data, can generate all the answers. But with 10,000 or more items to manage, it is impossible even to get reliable answers to specific queries, the huge amounts of data notwithstanding. To comprehend the bigger picture, we need to use our brains first and talk to our colleagues. Then we can put the computers to work.
Likewise, don’t leave assortment decisions to trial and error. Constantly experimenting with your assortment, and learning from the results, is extremely valuable—but don’t expect a trial-and-error approach at the SKU level to roll up to an assortment that works as a whole.

Be aware, too, that market research can only tell you so much. But the beauty of the retail business is that managers are consumers too. Ask them to use their own instincts about the different signals that would be sent by different assortments.

Finally, don’t leave the management of your assortment to suppliers. They may be smart and very capable at data analysis, but at the end of the day, their strategy is not yours.

Succeeding in the retail business means being good on a number of dimensions; they include service, pricing, marketing, and location selection. But assortment is number one. Too many retailers are sitting between the chairs, and their customers are left asking the question: why shop in this store? The biggest sign that a business is in serious trouble is when even its own managers cannot answer that question.

**FEATURED COMMENT**

“Great post! I think the recent misstep by Walmart in the way of SKU reduction was a wake-up call on this very point—assortment is king.” —C. Anderson
In all my years of studying and interacting with retailers, I have yet to meet one who doesn’t worry about the optimal level of aggregate inventory that their firm should carry. Since there’s evidence that inventory levels are predictive of sales and earnings surprises, and sophisticated investors are increasingly looking at firms’ inventory levels, it’s something that retailers should worry about.

**Benchmarking Inventory Levels**

There are a number of metrics that can be used to benchmark a retailer’s inventory levels. A common one is inventory turns (cost of sales divided by inventory) or its inverse, days of inventory. But I think it’s inadequate. Inventory turns vary substantially across similar firms in a given year and for a firm over time. For example, during 1987–2000, the annual inventory turnover at Best Buy stores, a consumer electronics retailer, ranged from 2.85 to 8.53. It varied similarly at three peer retailers during the same period: at Circuit City from 3.97 to 5.60, at RadioShack from 1.45 to 3.05, and at CompUSA from 6.20 to 8.65.

Comparing inventory turns over time for a single retailer can also be difficult. During 1985–2000, inventory turns at the Gap fluctuated between 3.6 and 6.3, while Walmart’s fluctuated between 4.9 and 7.2. Any attempt to use inventory turns to benchmark inventory levels—across retailers or over time for a specific retailer—would have to be done with caution and judgment.

With a little bit of effort, though, inventory turns can be modified to derive a better benchmark: adjusted inventory turns. It is derived by adjusting for changes in gross margin, capital intensity (fixed assets as a proportion of total assets), and positively for sales surprise (the degree to which actual sales exceed or fall short of forecast).

Consider the following example that Vishal Gaur of Cornell, my frequent coauthor, shared with me. Between 1995 and 2005, Walmart’s inventory level surged from less than 5 to over 7, while Target’s inventory turns stayed reasonably flat around 6. Using inventory turns alone would sug-
Retailers Beware: Markets Punish Stores with Too Much Inventory

Suggest that Walmart’s inventory productivity improved dramatically and would also suggest that by 2005 Walmart was substantially better than Target at managing its inventory. On the other hand, adjusted inventory turns during the same period provided a statistical dead heat between the two. In fact, the growth in Walmart’s inventory turns was complemented by a reduction in its gross margin.

Practitioners have long recognized the limitation of using inventory turns to evaluate inventory productivity. In industry parlance, retailers are often classified as “earns retailers” (those with high gross margins as a percentage of sales) or “turns retailers” (those with high inventory turns). Retailers typically acknowledge that earns retailers tend to have low inventory turns and turns retailers tend to have low gross margins.

Impact of Excess Inventory on Future Sales and Earnings
Excess inventory is the difference between the inventory carried by the retailer and the amount it should carry. In a paper that Saravanan Kesavan, Vishal Gaur, and I wrote, we offer a sophisticated methodology that relies on past sales, margin, and inventory data to determine the amount of inventory a retailer should carry in a particular year.

We have discussed this relationship with many retailers and investors who agreed that the relationship is quite reasonable. Excess inventory in a particular year leads to the inventory becoming stale in the subsequent year—a fashion retailer might have stock of the previous year’s fashion, for example.

We have used data from many years and many firms to examine if over-inventoried retailers on average fall short of analysts’ sales and earnings expectations. The answer: yes! A year prior, equity analysts overestimated sales for over-inventoried retailers by roughly 3% on average.

Even more surprising, we found that under-inventoried retailers exceeded analysts’ sales and earnings expectations. A year prior, equity analysts underestimated sales for under-inventoried retailers by roughly 2% on average. Similarly, Saravanan Kesavan and Vidya Mani of the University of North Carolina found that analysts overestimated earnings by far more for over-inventoried retailers. In other words, being over- or under-inventoried can help predict the bias in analysts’ earnings forecasts.

Inventory as the Basis of a Trading Strategy
If inventory levels are predictive of sales and earnings surprises, could one invest based on inventory turns and beat the returns one gets in the market? This question has been rigorously studied by Yasin Alan, George Gao, and Vishal Gaur of Cornell. They examined more than 20 years of data from a large number of retailers, looked at their performances each year, and ranked them on a number of inventory-related metrics. Their finding: retailers with the highest inventory turnover (or least inventory) statistically outperformed those with low inventory turnover (or high inventory). Based on these results, the three designed an investment strategy that handily outperforms the market, even after controlling for factors like risk and size of firm.

So what?
Retailers beware! Investors whom we’ve studied, like hedge-fund manager David Berman, are watching inventory closely and will increasingly penalize retailers for carrying too much inventory on their balance sheets. Retailers need to prepare for these investors by planning their aggregate inventory more carefully. This blog—and the papers referenced in it—attempts to give them some tools to do so.

FEATURED COMMENT
“Inventory can be a retailer’s best friend or worst enemy. Hence it has to be managed using a dashboard with multiple indicators.”
—Umesh Dhand
Retailing is at a tipping point, with category killers—highly focused stores like Barnes & Noble, Best Buy, and Staples—being the first significant casualties of the revolution under way. Retail store asset productivity has been in decline since the recession of 2007, and we believe that this trend will accelerate over the coming years. Online retailers, meanwhile, are exploiting their distinct advantages over physical stores. For mass-market retailers who understand this and react quickly, this upheaval is survivable. But those slow to see the tsunami on the horizon stand to be swept away.

The Internet has created a daunting situation for category killers in particular. The focus that made them so powerful in the 1980s and 90s is creating the conditions for their current struggles. That’s because Amazon and other e-commerce players have done a tremendous job focusing on items and categories that consumers are willing to buy via the Internet, such as books, music, and consumer electronics. For many retailers, the economics of a store can suddenly become negative when 5% to 10% of their total floor space (in high-margin categories) becomes unproductive as customers curtail spending and migrate to e-tailers. During the current recession, overall consumer spending has declined or held flat, sales per square foot have not improved significantly, and retailers’ return on invested capital (ROIC) has suffered dramatically.

The most obvious victims of this shift so far are music, video, and book sellers. But these are not the only categories that have suffered from consumers’ embrace of e-commerce. Best Buy, arguably a bricks-and-clicks monopolist in the electronics segment, is a prime example of this impact. With the demise of Circuit City in 2009, one would have reckoned that Best Buy’s best days were ahead. Instead, Best Buy is working fiercely to reinvent itself because comparable store sales have barely kept up with inflation since 2008 and space devoted to its vast collection of music, computers, and televisions is becoming increasingly unproductive. Best Buy’s ROIC has declined from 23.68% to 15.01% since 2007, while domestic sales per square foot (including online sales) declined from $909 to $853 during this same period.

Bricks-and-mortar store productivity declines will likely accelerate over the coming decade.
With technology making both pricing and assortment choices transparent for the consumer, there is less and less incentive to buy from a physical store when a better price can be found online. And aggressive tactics by e-tailers to lure shoppers from physical stores will only accelerate the trend. Amazon’s recent move to pay shoppers to use its price-check app at stores and then defect for a better deal is a case in point. Bricks-and-mortar stores will find it increasingly hard to compete against the compelling economics of the Web-only retail business model. Amazon leverages its higher inventory turns, lower investments in physical assets, and faster cash conversion cycle to deliver up to 20% cost savings to the consumer. At a 5% price advantage, consumers might not see much advantage in shifting their purchases online, but at a 20% discount, it is not a matter of if but when the category economics will shift.

While many physical retailers may think the solution lies simply in forecasting accurately when certain product categories will shift to the Web, we believe this is the wrong question to pose. Retailers need to ask the more strategic question of how to best deploy the assets of a store to generate a compelling return on capital. To compete with online competitors, they will need to be agile in eliminating or downsizing categories that do not benefit from their stores’ assets and introduce new categories that decisively do. There are three areas in which physical stores can differentiate themselves from online retailers:

**Convenience:** Physical stores can provide instant gratification in a way that even free two-day shipping can’t.

**Sensory experience:** Consumers will always want to touch fabrics, smell cologne, sample food, and otherwise engage physically with products.

**Assistance:** When a category is complex and the consumer needs to be educated or otherwise requires personalized selling (for example, with cosmetics), physical stores have a distinct advantage.

An ever-evolving store that understands how key store-level assets can be deployed in a category to create a compelling shopping experience—one that’s difficult or impossible to replicate online—will separate the winners from the bankrupt over the next decade.

**FEATURED COMMENT**

“Marketing’s goal is to get customers into stores. Companies carefully study their targeted demographic audiences, learning everything possible to polish their marketing efforts. However, they know little about what happens once a potential buyer enters a store. The weakness of modern retail strategy is that its marketing efforts ignore what the shopper does while shopping. For instance, most people spend around 80% of their time in a store simply moving from one spot to another. Moreover, retailers set up their stores for the convenience of the “stock-up” shopper, the one who is coming in to buy a lot of goods.” —Richard Meyer
On a recent visit to a boutique bath shop, one of us became so overwhelmed by the intensity of the scent circulating through the store that he was forced to flee within seconds. It’s a reminder of how managers are often encouraged to help consumers connect with brands by amplifying the sensory qualities of products and retail spaces. Think of Singapore Airlines’ signature scent or the Intel jingle, which is one of the most recognizable sounds in the world. Such marketing efforts leverage the ability of sensation to create brand attachment and drive retail sales.

In addition to the more common sensory marketing approaches that focus on sight, sound, or smell, research has now begun to highlight the forgotten sense of touch. We tend to think about consumers using touch primarily because they have to—in order to examine packages and to fill shopping carts. However, touch can also create symbolic connections between people and products, and between buyers and sellers. Physically holding products can create a sense of psychological ownership, driving must-have purchase decisions. This idea may underlie the push to move inventory from display cases into customers’ hands, a trend seen in many electronics outlets such as the Apple Store and Best Buy. Additionally, interpersonal touch, such as a handshake or light pat on the shoulder, can lead people to feel safer and subsequently spend and consume more. (This is especially true when the person doing the touching is a woman). Along these lines, research has found that waitresses who touch restaurant patrons earn more in tips and customers innocently touched by female bartenders drink more alcohol.

Different tactile sensations can even lead customers to interpret and interact with their surroundings in unique ways. Understanding the precise manner in which touch shapes these mind-sets can help managers hit the right note when designing retail spaces.

Consider several recent studies and their implications. In one experiment, people were asked to hold either a warm or cold therapeutic pad. They believed that the researchers were interested in their evaluations of the products. Unbeknownst to them, the researchers were actually interested in whether warmth sensations would alter people’s behavior in subsequent, unrelated investment decisions. In fact, people invested 43% more money after briefly holding the warm
Please Touch the Merchandise

pad, suggesting that the physical sensation of warmth led people to feel psychologically warmer, safer, and more trusting. In other words, tactile warmth made people see metaphorical warmth in others and act in warmer ways. Utilizing physical warmth to engender trust should be especially effective in retail settings involving high-risk decisions and a high degree of interpersonal contact between salespeople and customers, such as car dealerships and clothing stores. In these settings, a simple gesture such as a warm cup of coffee or a warm handshake can convey trustworthiness, going a long way towards easing consumers into transactions.

In another experiment, people were asked to evaluate a potential job candidate while holding either a lightweight or a heavyweight clipboard. When people held the heavy clipboard, they viewed the candidate as expressing a more serious interest in the job, suggesting that the sensation of holding a heavy object brings gravitas to people and issues, making them seem “weightier.” Some auto manufacturers apply a similar principle when they add dampeners to car doors specifically to make them sound heavier when they close. Other researchers have shown that related effects can be achieved by modifying not products themselves but their packaging. In one study, people given mineral water to drink rated the same water as being of better quality when served in a firm rather than a flimsy cup. Given such findings, firms may benefit by emphasizing product and package weight when customers are shopping for important needs. For example, cell phones are arguably the most important tool in the modern consumer’s life. Phones designed using metal rather than plastic casings and heavy, solid packaging rather than light plastic clamshell packaging may increase the value people perceive in the product itself.

In a final study, researchers investigated the tactile sensation of hardness. People in the study haggled over the price of a new car while sitting in either hard wooden chairs or softer cushioned chairs. Those people sitting in the harder cushion-free chairs didn’t feel more negative, yet they changed their offer prices less over the course of the negotiation, offering 28% less than people in soft chairs. That is, hard chairs made people harder negotiators. This suggests that when people touch soft products, they may be more susceptible to outside persuasive influences.

Interestingly, in the studies above, the people taking part were not aware at all that the tactile sensations were having any influence on them. Findings like these suggest that many touch experiences within retail spaces can shape how customers shop. Certain firms are using such ideas to good effect. For example, Bed Bath & Beyond organizes the shopping experience around touch, allowing consumers to feel their way through curtains, linens, and other home furnishings, thereby experiencing the warmth and comfort these products offer. Whole Foods is another retailer highlighting the sensory experience of consumers. Whole Foods stores strive to have an organic feel, an atmosphere aided by the use of taste stations throughout the stores. These stations provide consumers with opportunities to touch and taste, warming them up to Whole Foods’ products and helping them to trust the brand.

These firms clearly appreciate the importance of touch in shaping consumer behavior: consumers use their hands to connect with brands. However, a large opportunity remains for firms to adopt the more precise insights of recent research, including the specific ways that physical warmth, weight, and hardness can influence consumer decisions. Arming managers with knowledge regarding the precise effects of specific touch sensations can further improve retail strategy.

**FEATURED COMMENT**

“This is an excellent article on a topic close to my heart. On Robert’s point, there will always be a proportion of companies and individuals who use insights such as these to persuade rather than inform . . . . I agree that to think otherwise is naïve. The advertising industry itself has been built since the 1950s by leveraging such new insight into consumer behaviour and then, in a neat trick, using the same understanding to persuade its own clientèle of the (actually often dubious) efficacy of its approach.” —David Foster
We cofounded Warby Parker with two friends while we were all MBA students at Wharton. The idea for the business was simple: we’d each grown tired of walking into an optical shop, getting excited about a particular frame, and walking out feeling ripped off after paying $500+. I (Neil) had worked for an eyewear nonprofit before business school and knew that beautiful glasses were not that expensive to manufacture. Through Warby Parker, we aimed to cut out the middleman by designing our own frames and selling them with Rx lenses for $95 via a Web site. The four of us weren’t completely comfortable buying glasses online, so to get over the hurdle, we offered a virtual try-on using facial recognition software and an innovative home try-on program: we send out five pairs that you choose, you keep them for five days, and return them when you’re done—for free, with no obligation to buy. We launched in February of 2010, and within three weeks we’d beaten our first-year sales goals.

Although we created Warby Parker as a brand to be predominately sold online, we quickly learned that customers wanted physical contact. In the first month, we sold out of our top 15 frames and needed to temporarily suspend our home try-on program. While we were still full-time students, customers would call us at our apartment in Philadelphia and ask if they could come over to try on frames at our “office.” At first we thought this would be a suboptimal experience. We’d lay out our collection on the dining room table, and customers would walk into an apartment with no idea what to expect. But something magical happened. We built close personal relationships with our customers. How often do customers get to meet the people behind the brand? Hundreds of people came to our Philly apartment. When we graduated and moved to New York, we set up our office on the sixth floor of a building near Union Square. It wasn’t a shop per se, but on our Web site we said people could book appointments to come by to try on frames. From the beginning, there was a four-week wait for an appointment, and pretty soon we were selling close to one thousand pairs of glasses per month from our office.

Many companies think about being online or bricks and mortar, like it’s black or white. Too many people silo themselves, and they forget what they’re trying to do is serve customers. So even
though we originally thought of ourselves as a technology-enabled fashion brand, we’ve gradually been finding ways to let our customers physically interact with our products. We still take appointments at our Manhattan location, and we’ve opened a ground-level temporary holiday store. We’ve also partnered with boutiques in a number of cities—including Boston, L.A., San Francisco, Philadelphia, Portland (Ore), and Columbus (Ohio). These partnerships are an unusual arrangement: we pay rent for showroom space to display our frames, which customers can buy online, and we pay a commission to the boutique on each sale. Even when customers come to our headquarters, they still have to buy “online” through an in-store iMac or iPad, and they receive their glasses by mail a few days later.

Having a retail presence makes sense to us for four reasons. First, our customers wanted it. Second, it allows us to build close personal relationships with customers by meeting them, which you don’t get from an online transaction. Third, the showrooms act as learning laboratories and help us to create ways to make shopping for glasses online easier based on how we see people behaving physically in person. Fourth, the stores are a great training opportunity for our staff. When they’ve served people in our showrooms, they do a better job helping customers who need assistance by phone or over e-mail.

Right now, we still sell far more glasses online than we do in our small network of stores, and we don’t expect that to change over time. However, physical selling will probably always be an important part of our branding and will help us to innovate and create the best customer experience possible. Creating a new brand is hard, particularly when you’re trying to build a fashion brand online and a brand that stands for doing good in the world. We rely heavily on press and word of mouth and have done very little paid customer acquisition or advertising. Our stores have been one way to raise awareness and create an emotional connection with our customers.

FEATURING COMMENT
"It’s interesting that the box here seems to be online vs. on-street, but Warby Parker violated the model by integrating both pieces of the dichotomy into one. The fact that they had no existing on-street distribution enabled them to sell online without a fear of self-competition. Perhaps that information, that self-competition did not become an issue, can inform other start-ups."—Bart Schuster
If you’re browsing through online reader reviews looking for a book to buy, you might notice something odd: If a book got positive reviews at first, chances are its later reviews were more negative. If it got negative reviews at first, its later reviews were likely to be more positive.

What’s going on? Books don’t change over time, so why do reviewers seem to blow hot then cold, or cold then hot? And what’s a reader—or publisher—to make of the shift in sentiment?

To investigate, we studied 51,854 reviews contributed to Amazon, covering 858 books from 2000 to early 2004. We found that the order in which reviews are written matters a great deal: some newly posted reviews tend to disagree with existing reviews instead of only focusing on the book.

There are two main reasons for this: expectations and self-selection.

A disconnect between expectations and experience is something we’re all familiar with. Your friend’s assertion that The Tree of Life is the greatest movie you’ll ever see is pretty much a guarantee that you’ll be scratching your head afterward. High expectations often lead to disappointment; low expectations often lead to pleasant surprises. An expectation disconnect is one of the factors that prompt readers to post reviews.

Self-selection refers to readers’ motives for taking the time to write. Some contribute reviews in order to correct what they see as misperceptions; others do so just because they like to be contrary in order to stand out. Either way, the result tends to be disagreement with the initial wave of reviews.

The effect tends to be more pronounced if books are relatively unpopular, probably because, for these books, there are few alternative information sources. For the big best sellers, the effect is much weaker. The phenomenon is also more pronounced if early reviews are numerous and consistent.

We speculate that the effect is less likely to show up in reviews for utilitarian products like digital cameras and more likely for products that generate strong subjective feelings. So consumers
Online Reviewers React to Early Postings by Saying the Opposite

who are shopping online for products such as books and movies should be aware that a long string of recent books might be mainly due to an initial spate of cheers. Adding to the potential confusion is our finding that negative reviews are more likely to be long and detailed, factors that may amplify their impact.

For publishers, the stakes are high. A 2007 Nielsen survey of 26,486 Internet users showed that 78% consider recommendations from consumers to be the most credible form of advertising. Another survey shows that 62% of consumers read product reviews posted by other consumers, and of these, 82% say the reviews directly influence their purchase decisions.

Publishers might want to consider inviting independent reviewers to balance later reviewers’ tendency to contradict existing favorable reviews. It also might be worthwhile for publishers to try to avoid a rush of sugary reviews all at once—that’s a veritable invitation to negative reviews such as this one: “OK, I liked this book, but I was hoping for more ... I read the previous reviews and couldn’t wait to get the book. I was disappointed .... If you like her stuff, read this but don’t have high expectations. Maybe that’s what ruined it for me.”

FEATURED COMMENT

“For products, as opposed to articles, I never look at reviews based on when they were posted. Sometimes I’ll look at them in order of the how helpful they were rated to be if a lot of people have voted, but if not, I generally go right to the negative reviews. My thinking is that if the product description sounds good to me, I want to know what I might be overlooking, not why a product I already think sounds good is in fact good.” —Kit
Between 1994 and 2011, the number of farmers’ markets across the United States grew from 1,755 to 7,175. While much of this growth is likely due to a broader understanding of the importance of eating local, fresher, and seasonal, I also suspect that it is driven by a desire of many people to shop differently—in pleasant family-friendly contexts that enable low-key, face-to-face interactions with merchants. A parallel trend is the rise of the food truck movement. In research we conducted earlier this year on the future of commerce, we found that people gravitate towards these kinds of “pop-up” vendor experiences because of the more personal qualities they provide—getting to know the vendor, suggestions for making the most of a purchase, or even just a certain quirkiness. In other words, these are fundamentally more human retail experiences.

It’s not just with pop-up vendors, though. As the Apple Store demonstrates, and Ron Johnson explains, retail needs to get more human at all levels. One place we’re seeing this is in the experience of paying for an item. The road from tills to cash registers to large and complex point-of-sale machines has led to an increasingly literal divide between the buyer and the seller. Store employees spend more time looking at their displays than at the customer—and the customer is left looking at the back of the display, which is rarely an attractive sight. But at the Apple Store, you don’t need to wait in line to purchase your items from someone behind a counter. Purchases take place anywhere in the store, and the customer and sales associate typically stand side by side during the transaction, which is executed on a modified iPod Touch.

Such technology can find its way to any merchant, thanks to services like Square, which enables any iPhone or iPad to accept credit card payments (and brings us back around to farmers’ markets and food trucks, some of the greatest users of Square). Square, in turn, points the way to new transaction opportunities. Square can enable a nearly frictionless transaction, where the customer walks up to a counter, asks for and is given some item, and walks away without ever taking out cash, presenting a card, or even pulling out a phone. How does this happen? Square uses geolocation to inform merchants of when their customers are nearby, popping up the customer’s photo on the merchant’s iPad and approving any purchase the customer makes.
For the longest time, retail used technology as a way to automate or make more efficient the interactions between buyer and seller, typically at the cost of any connection or relationship between the two. When I first started writing this post, I thought I'd need to find a way to explain the success of self-checkout stations at supermarkets, because it runs contrary to the thesis that shoppers seek more human experiences. Well, it turns out that self-checkout is on the wane, and some supermarkets are removing it altogether.

The technologies that are succeeding don’t supplant people or make them more efficient, but instead ease transactions and encourage something that can never be replaced by machines—the conversational interaction between people. In our increasingly connected world, people crave authentic human interaction, and the future of retail is going to look a lot more like it did in the more distant past (or still does in markets and bazaars) and a lot less like the bureaucratically driven mass consumerism we grew to expect in the twentieth century.

**FEATURED COMMENT**

"Completely agree that choice is where it’s at. Apple Store’s success shows that people want choice, not that every retailer should adopt the Apple model. That would just eliminate choice too." —Adnan
Shopping Carts Will Track Consumers’ Every Move

by Martin Lindstrom

A couple of months ago I found myself in, of all places, the research lab of one of the largest shopping cart manufacturers. I had been invited to preview a prototype for the future. It was a whole new area of study for my ongoing investigation into the psychology of brands. Until this visit, I’d never so much as given a thought to the shopping cart’s design. To me, they have looked much the same since forever.

The head of the research lab—I’ll call him Anders—opened his presentation with an interesting fact: the bigger the cart, the more we buy. In fact, if the cart is double the size of our regular one, we buy an astounding 40% more than we usually do. It’s not as if we need the extra items, but larger carts tap in to our primordial need to hoard food. We’re still operating with our primitive brain, and, ultimately, we’re primed to guard against starvation. Evolutionarily speaking, we’re hardwired to store food in times of plenty. So, if our shopping cart looks half empty, we’ll fill it.

The humble shopping cart made its first appearance in 1937 at the Piggly Wiggly supermarket chain in Oklahoma City. Two baskets, one above the other, were wheeled around on a simple metal frame. Ever-more-sophisticated checkout systems allowed retailers to tally each purchase, maintain stock control, and see what was being purchased when.

The new shopping cart that Anders wheeled out looked much the same, except for one small significant detail: each comes with a small computer that can be programmed to understand the shopper’s buying patterns. It reveals the speed of the shopper, how long it takes to make a selection, the preferred route, and the order in which items are placed in the cart.

The mini device, equipped with a GPS, plugs into the supermarket’s mainframe computer, making it possible to pinpoint, within inches, exactly where the shopper is, all the while building up a personal shopping profile. In return for this behavioral data, the shoppers are promised specially customized discounts, available only to them. All that’s required is a quick swipe of a loyalty card on a display positioned beside the shopping cart’s handle. This is bound to change the nature of the regular supermarket shop because, for the first time ever, each customer can be tracked in real
Shopping Carts Will Track Consumers’ Every Move

time. The consumer profile can be matched with the consumer’s actual behavior and thus can be matched with the advertising messages most likely to attract the shopper.

So, armed with all this new data, the question is—where should a supermarket shopper’s journey begin? What category will best pre-dispose her hoarding instincts to be sparked? Retailers are looking for their own version of the domino theory. The first product should lead to another, to another, and by the time the shopper’s reached the checkout, she’s bought more than she intended.

For three years, Anders and his team had worked on this project. They studied millions of data points along the shoppers’ path, from barbecue sauces to cat food and back to toilet paper. They’d analyzed walking speeds and times taken from first pause to actual selection. They’d discovered that if the first product the consumer bought seems cheaper than he or she expected, there was a tendency for the shopper to be more trusting and, thus, purchase more, regardless of the subsequent prices.

One can only assume that mobile technology will be Anders’s next assignment. It’s entirely probable that as smartphones become increasingly integrated into our daily lives, wireless advertising will link directly to the shopping data.

The digitized shopping cart will undoubtedly give rise to a more flexible retail store—one that constantly adapts to the ever-changing moods and trends of the shoppers. That aside, it will also open up entirely new revenue channels: retailers will be able to sell their customer insights to manufacturers, and when online, wireless, and in-store shopping carts are linked, it’s entirely likely that each platform will present new advertising opportunities.

As I left the factory, I saw hundreds of shopping carts all lined up to have their mini-computer installed. I couldn’t help but think of the consequences these devices will have on our lives, our privacy, and the future of retailing. After years of retailers trying to second-guess the behavior of consumers, now this little black box on the side of the handle will transform the supermarket. It will invade our privacy, or what’s left of it. It will make use of contextual marketing, targeting our already strained hip pocket. Contextual marketing will increase the sell, store revenues will rise, and it is likely to become the most accurate source of consumer insight for manufacturers looking for more effective packaging design, line extensions, and pricing. All this because of a device attached to the simple shopping cart, which somehow doesn’t seem quite as simple anymore.

FEATURED COMMENT

“This has already been tried and abandoned by The Nielsen Company—stores stopped the program cold after people took the carts and held them for ransom. All this and more will be done by what the consumers already have in their pockets/purses—smartphones.”

—Brian
The power of chain stores and chain restaurants lies in their familiarity. For the consumer visiting a new city, a Target or an Applebee’s looks like a safer bet than Mack & Dave’s Department Store or Lagniappe Cajun Creole Eatery. But Yelp seems poised to change that competitive landscape.

The consumer reviews posted on Yelp, the network of online city guides featuring user reviews, help independents and small, local chains overcome the unfamiliarity barrier. With a quick look at a smartphone, a traveler can easily find a great local store or restaurant option nearby. It makes sense that this technology would help independents gain business—and new data shows that for restaurants, at least, the intuition is correct.

To understand the impact of Yelp restaurant reviews, I studied records on all 3,582 restaurants that were in business in Seattle at any point from 2003 to 2009 and found that increases in independent or small chain restaurants’ Yelp ratings led to revenue increases, with ratings having more impact the more reviews a restaurant gets.

The early data suggests that if every independent restaurant in Seattle were covered on Yelp, the average chain’s revenue would drop 5% in comparison with that of the average independent restaurant. On a large scale, that kind of shift would be significant. Consumers spent some $125 billion on U.S. chain restaurants in 2007, more than half of all restaurant spending in the country.

Yelp has expanded rapidly since it was founded in 2004 in San Francisco. It now covers most large cities within the United States and is beginning to expand abroad. It gets some 60 million unique visitors per month. In Seattle, Yelp was carrying more than 60,000 reviews covering 70% of the city’s restaurants by the end of 2009. The Seattle Times, for comparison, reviews about 5% of restaurants, and Food & Wine covers roughly 1%.

Although my research focused on restaurants, it’s likely that Yelp and other consumer-review sites are helping (or have the potential to help) independent businesses in a variety of industries, from retailers to tax preparers to tutors to dental practices. I expect to see the most dramatic changes in
industries where consumers are most excited to write reviews and in industries where the existing advertising is most costly.

My research has focused on how reviews affect choice among companies (in this case, restaurants). Yet reviews can also help customers choose among products within a given retailer’s offerings. Some shoppers at Gap, for example, might be concerned about itchy sweaters, while others might be concerned about sweaters that aren’t warm enough. Properly implemented, review systems can be used by retailers not only to help customers identify the best products but also to help them identify products that would be the best match for their needs.

Review sites allow consumers to tap into a vast pool of formerly private knowledge, and that knowledge is beginning to undermine the traditional advantages of mass-market branding and advertising. As this trend gains momentum, businesses that rely on traditional marketing will be forced to adapt.

FEATURED COMMENT

“Rather than [Yelp] leaving chains behind, your preliminary data seems to suggest that Yelp is helping to level the playing field between mega-chains and small businesses.”
—Jeff Toister
Employees Who Identify with the Company Boost Financial Performance

by Donald R. Lichtenstein, James G. Maxham III, and Richard G. Netemeyer

Executives spend a lot of time worrying about their companies’ products and prices, but they don’t spend nearly enough time worrying about corporate character. Why would they? A lot of them don’t believe companies even have a character, and others don’t see what difference it could possibly make.

But your company’s character can earn you—or cost you—real money. Our research on thousands of managers, frontline employees, and customers of a U.S. retailer shows that there are connections between customer spending and what’s known as the organizational identification of the people who work at the company. The greater the OI, as researchers like to call it, the greater the spending. And organizational identification is, to a great extent, about company character.

Corporate character is like corporate reputation, but it’s a deeper and more nuanced concept. It has little to do with advertising or marketing. Like your own character, it’s judged by actions more than words. If your company sticks its neck out for a principle, it will be seen as having integrity, just as you’re seen as having integrity when you stand up for the employee who’s being scapegoated by some other manager. A long history of admirable moves builds an impression of a solid character. A history of missteps does the opposite. You can probably name companies with solid character as easily as we can: Zappos, Ritz-Carlton, and USAA, to name just a few.

Fine, you might say. So what?

The most desirable managers and employees—those who are smart, capable, and conscientious—have the ability to choose, to some extent, where they work, and they tend to self-select into companies that they identify with. Just to be clear on what we’re talking about, identification means that the individual’s view of himself or herself overlaps with his or her perception of the company. We test this psychologically by asking people their level of agreement with pairs of statements about themselves and their companies—for example, “A leader accurately describes me,” and “A leader accurately describes my company.” If there’s a lot of agreement in the responses to
these pairs, it means the person strongly identifies with the organization.

In a study of 306 store managers, 1,615 employees, and more than 57,000 customers of a women's clothing retailer, we found that organizational identification is directly related to employee performance and indirectly related to customer evaluations and store performance.

Not all employees, especially in retail, arrive with fully formed views of the company's character, of course. Many pick up their sense of organizational identification—or lack thereof—from their managers. We found that there's a chain reaction from managerial OI to employee OI and on to customer spending: raising managerial OI by a value of one on our seven-point scale increases employee OI by 0.29 of a point; raising employee OI by one point increases customer OI by 0.25 of a point; and raising customer OI by one point is associated with customers' spending $71 more per year per person at the retailer. So in retail, at least, managerial OI is a crucial part of how companies can differentiate themselves and improve their sales. And managerial OI tends to be high in companies with characters that people identify with.

Executives constantly have to decide what actions their companies should take, and in doing so, many of them carefully consider stakeholders' expected reactions. Our research suggests a further step: consider what a given move would reveal about the company's character. The stronger the character, the more likely the company is to attract managers who can say, “I am the company, and the company is me,” an attitude that can spill over to frontline employees and customers and improve the bottom line.

**FEATURED COMMENT**

“This is an excellent article that provides meaningful data points around a belief that many of us have had for years—that corporate character counts, that the direct manager has a profound impact on the living mind-sets of employees, and that customers pick up on those mind-sets in touchpoints with the company.” —J. Miller
Choice Helps High-End Products, Hurts Low-End Products

by Marco Bertini and Luc Wathieu

If you want your customers to care about product quality, give them a choice.

That’s the finding from our recent research, forthcoming in the Journal of Marketing Research, which reveals a surprising fact about retail assortments: consumers who are offered a richer array of relevant choices in a given product category grow engaged and interested in quality and are prepared to stretch their budgets accordingly. In one of our experiments, for instance, consumers paid 40% more for a high-end chocolate and 33% less for a low-end chocolate when they chose from 21 different pieces instead of only five.

What’s the explanation behind this phenomenon? We believe that consumers exposed to a sparse set of alternatives (think of the choice of sugar or eggs at your local supermarket) take the limited assortment as a signal that the average consumer is unenthusiastic about quality differences and therefore that there is no real reason to get excited about the purchase. But a consumer who is exposed to a dense set of alternatives (think now of the choice of coffee or yogurt at your local supermarket) concludes instead that like-minded consumers must care about even small differences in quality, so this consumer should follow suit.

This finding is great news for marketers who focus on value creation. It means that empowered consumers—those who are given access to and trusted to make a choice among many different offers—won’t necessarily “give up” and embark on a chase for the lowest-priced option. Especially in situations where consumers typically refine their preferences at the point of purchase, we can expect that choice engages interest in innovation and quality differences. And the effect is not limited to specific categories of products; a surprisingly large assortment invites people to contemplate and raise their personal interest in quality, regardless of whether we are talking about groceries or musical instruments, sports cars, or—as our research shows—collectors’ items sold at auction. We analyzed two-and-a-half years of auctions (81,245 lots) conducted by Christie’s at their London branches. These auctions included books, carpets, furniture, jewelry, photographs, watches, pictures, and wine, among other items. Across all sales, we replicated our lab results: while the hammer prices of items with high initial expert appraisals soared with the number of
Choice Helps High-End Products, Hurts Low-End Products

total lots in the sale catalogue, lower-quality pieces suffered from the availability of choice.

Of course the opposite rule also holds, and our findings have implications for firms that seek to compete on price with me-too products. Their goal is to persuade consumers that a low-quality, low-price alternative is practical and, frankly, good enough. Accordingly, these firms need to partner with like-minded retailers that actively limit the number of SKUs and price points per category—a sparse assortment diverts attention from quality and pushes the focus back on price. After all, consumers typically do not frequent Costco or ALDI to learn about and appreciate quality. Similarly, retailers that invest in private labels can benefit further if they flank their attractively priced products with fewer branded alternatives.

A final implication of our research is that the creation of a super-premium brand might be an appropriate response in a crowded marketplace, even when undercutting competitors with a low-end, efficiently produced product might be tempting and, for many managers, the intuitive reaction. This is one interpretation of Apple’s success in the fragmented personal computer industry. While companies like Dell assumed that the market was ripe for price competition, consumers had grown choosy and there was a thirst for a jump towards new innovative heights. We believe that the garment industry, after the recent successes of Zara, H&M, and Mango—where in each case variety coexists with low prices—will soon revert to a course where consumers are passionate about what they wear and turn their attention back to higher-quality items.

**FEATURED COMMENT**

“This totally works in CPA firms too. We have implemented what we call Value Pricing in our firm, and we do not bill by the hour. Instead, we spend large amounts of time up front determining what the value of our services is to the customer. We then offer three pricing options toward their value.” —Jason Blumer
Along with the growth in scale of leading retailers in the twentieth century came a growing attitude toward the people working in the stores: they were a cost to be minimized. Sam Walton, the founder of the biggest retailer in the world, summed it up in his book Made in America: “No matter how you slice it in the retail business, payroll is one of the most important parts of overhead, and overhead is one of the most crucial things you have to fight to maintain your profit margins. That was true then, and it is still true today.” But recent research by my colleagues and me suggests that retailers are thinking far too simplistically about the cost and potential value of their workforces.

Let’s start with stockouts, a problem most big retailers are highly attuned to; they know that when a customer arrives intending to make a purchase and finds the shelf picked clean of the desired item, the store not only loses a sale but also damages the likelihood of that customer’s returning. Fixated on that challenge, retail chains have invested heavily in sophisticated inventory management systems. Yet at one large retail chain we studied, those systems didn’t seem to be doing the trick. When we analyzed results of a customer survey, we found that nearly 20% of the products they wanted to buy were out of stock. This was despite the fact that, according to the inventory management system, only 2% to 3% of items ever ran out before being replenished. It wasn’t that the system’s numbers were wrong. The problem was that customers couldn’t find what they were looking for—and without a store associate to help, they left empty-handed.

Saving sales by pointing to merchandise locations is just one of the ways that store employees facilitate the sales process and perform a very important role. But in large retail enterprises, it’s easy for managers to ignore the details of sales floor interactions and opt for large-scale, broad-brush solutions to the challenge of staffing. Most simply set targets for store staffing levels they must maintain over time (mandating, for example, that the cost of labor cannot exceed 10% of sales) and then apply that level across the board. At best, they vary staffing levels based on sales forecasts. Almost invariably, such overall targets lead to a situation where some stores are over-staffed while others are understaffed.
Given today’s technology available for data acquisition as well as new developments in analytics, it is possible to do much better than this. Rather than simply predicting what volume of merchandise will sell in a certain period and scheduling more or fewer labor hours accordingly, it is possible to observe the actual flow of customers through stores and make adjustments—even in real time by moving additional employees to the sales floor or redeploying them to higher-traffic areas. Our studies have shown the wisdom of this: stores that manage labor levels in light of store traffic rather than sales forecasts achieve substantial sales increases without extra costs.

Even better results come when retailers recognize that their workforces are not just homogeneous pools of labor to draw on. The most innovative employee managers we know use business analytics to understand the differences in how individual store associates perform. When these retailers make dynamic adjustments, therefore, they are deciding not only how many but who in particular to move to a sales floor. Ann Taylor, the women’s clothing retailer, has been a pioneer in tying staff scheduling to the past performance of sales associates: its best salespeople get first choice of times to work and more schedule flexibility. It’s a capability that is also finding its way to other business sectors. Call center companies are increasingly capitalizing on their ability to track individual sales to match the most effective people with the right opportunities.

A Boston-based start-up, Objective Logistics, has just received a round of funding from Google Ventures, Atlas Ventures, and a few other investors to bring performance-based scheduling software to restaurants. (Full disclosure: I am an advisor to the company.) The system would offer up the best times to work, like Friday and Saturday dinner times when bigger orders generate higher tips, to the most productive waiters.

Scheduling, however, is an area where the tools exist to manage better today—and where the evidence is clear that managing simplistically can send a retailer into a dangerous downward spiral. In a recent study, colleagues and I used data from major retail chains and found a common trend of low forecasted sales for a weekend resulting in stores staffed too thinly to provide adequate service for the customers who actually showed up. The lost potential was evident in the long lines observed at checkouts and the poorly stocked shelves; undoubtedly many customers left the store without buying. But for any manager looking only at receipts and staffing, the end of the day brought vindication: sales, indeed, were low. Isn’t it remarkable how prophecies can fulfill themselves?

FEATURED COMMENT

“As we strive to achieve the ultimate tipping point between operational efficiency and delivery of every sales opportunity, we will need to drill down and understand the shopper experience as we define what availability truly is.” —D. Dowling
While Black Friday and Cyber Monday were successful days for the retail sector, these two days alone are not a panacea for the sector’s performance challenges. Some retailers will continue this momentum. Others will not. The difference between the two sets of retailers? Knowing when and how to act as the water around you gets hot.

In our world, there are two kinds of frogs—those that jump out of the pot when it’s boiling and those that boil. Smart retailers jump out of the pot before it boils. They are keenly aware of changing conditions on the ground. And they don’t allow personal opinions about the cause behind the changing conditions to stand in the way of decisions and actions.

The global push to meet today’s needs without compromising future generations’ ability to do the same is one such boiling pot for retailers. Some are ignoring customer interest in all things environmental and social. Smart retailers, on the other hand, have realized the water around them is getting hot, and they are proactively taking action. As a result, these retailers are cutting costs today, planting growth seeds for tomorrow, and setting the stage for accelerated strategic agility well into the future.

This is wisdom gained from studying hundreds of companies in support of my new competitive strategy and sustainability book, The Future of Value. Here are three of the most salient best practices of smart retailers from my research.

**Cut Costs**

Margins in the retailing sector have long been razor thin. Since consumers have many retailers at which to shop, premium prices are quickly competed away. So retailers manage their supply chains and overhead costs with a tight fist. Smart retailers have come to view reducing their environmental and social challenges as another way to improve financial performance.

Consider Asda. The large U.K. retailer, owned by Walmart, lowered its 2010 expenses by over £70 million ($110 million) through energy and waste reduction throughout its retail footprint of 500
stores. The secret to the company’s success at cost reduction? Its decision to view environmental and social actions not as altruism but as smart expense management.

Let’s extend our smart retailer analysis to include restaurants in order to show how the same thinking applies to smaller businesses. Sweet Basil is a family-owned Italian restaurant in Needham, Massachusetts. The restaurant is challenging the conventional wisdom that thinking about ways to dispose of waste is, well, a waste of time. Recently Sweet Basil eliminated 75% of its waste disposal costs by rethinking the packages and materials it consumes. By challenging conventional thinking, Sweet Basil was able to switch to recyclable dumpsters, instead of regular dumpsters, that cost small businesses, like Sweet Basil, less to use.

**Grow Revenue**

Regular people are looking to save cash too. And smart retailers are always searching for ways to meet their consumers’ needs. By helping consumers reduce the impact of their consumption decisions on the environment, smart retailers are finding ways to grow.

Take Patagonia. As I covered in my October HBR.org post “Patagonia’s ‘Buy Less’ Campaign May Lead to More Revenue,” Patagonia has launched a campaign to encourage its consumers to buy only the apparel they need. The maverick retailer has also launched a new Web site for owners of Patagonia apparel to sell their used clothes to other consumers. The company has made a powerful connection between its mission of environmental stewardship and its competitive strategy. Patagonia’s actions further support the retailer’s ability to increase prices, sell more apparel, and expand into new categories.

Other smart retailers are making similar connections between stewardship and strategy. Their distinctive insight? Offer products and services that can save consumers money by being conscious about the impact of their actions. The U.K. retailer Marks & Spencer, for example, has expanded into residential energy management by launching a new service called M&S Energy. Through the service, U.K. residents can buy solar energy products that also reduce their heating and electricity bills. Other U.K. retailers have since followed suit.

**Accelerate Strategic Agility**

There’s an axiom that says the only constant in business is change. Retailers certainly have experienced their fair share of change. Think Internet, for example. Smart retailers know society is playing an ever-increasing role in shaping this change. Armed with this insight, companies like eBay are engaging their consumers to get real-time feedback and a steady stream of ideas to better compete for years to come.

eBay created a Green Team program and Web site to tap into the wisdom of crowds. The program’s mission is to “inspire the world to buy, sell, and think green every day.” To date, over 300,000 sellers—individuals who sell goods on eBay’s platform—have signed up to share ideas and views aimed at making eBay a greener sales partner. The eBay Box, a corrugated cardboard box designed to be durable enough to be used by sellers over and over again, is among the ideas that came from this community and have been rolled out.

More and more often, smart retailers like eBay are using social media to hold dialogue with the public in order to know how and where to move next. While the future comes into focus, one thing about the present is clear: smart retailers succeed financially by challenging their conventional thinking about environmental and social challenges.

**FEATURED COMMENT**

“Fantastic article. Very interesting concept by Patagonia.” —T. Hunter
For decades the mystery shopper was the main way retailers assessed operations from a customer’s point of view. By sending in a fake shopper, typically once a month, an individual store essentially was buying a dozen performance snapshots per year. Then telephone surveys began to supplement mystery shopping. Today digital technologies are supplanting both, with online customer surveys providing an exponentially greater number of performance snapshots per day.

A well-managed loop that links customer-experience feedback with recommendations on social networks like Facebook, Twitter, and Yelp can boost service quality and operational performance, increase traffic, and create more happy customers—people who crow about a retailer online for free, turning their friends into new customers too.

A new mini-industry has emerged using these techniques, known as “customer experience management,” or CEM. Our company, Empathica—as well as a number of competitors—is providing customer feedback to operations while partnering with “Web scraping” companies to listen to random chatter online.

Now we’re turning attention to linking operations to marketing through “social CEM.” The aim is not to drive online advertising impressions but to explicitly and transparently drive the behavior of customers, frontline service staff, and retail managers. The aim is to create a true dialogue, not simply a listening post for customer kudos and complaints. And by doing so, this loop can drive meaningful operations and customer satisfaction gains.

An example: at Debenhams, a major international department store chain based in London, a customer complained through an online survey about a poor meal received at the store’s restaurant. “Ordered turkey dinner. Very dried out. Overcooked vegetables in greasy, cold gravy.” The store manager called the customer that night, apologized, and sent a coupon for two free meals. The customer was invited to post his or her happiness with the problem’s resolution on Facebook, and did. The store manager made sure the kitchen turned out better turkey dinners. The result: a satisfied customer, better kitchen operations, and free social network advertising.
Debenham’s effectively took what would have been a one-off customer experience problem and turned that customer into a Debenham’s advocate online and improved its operations to reduce the possibility of future disgruntled customers.

A social network feedback loop starts with information gleaned from customer surveys conducted online. Those survey takers are then linked directly to social networks like Facebook through a link on the survey.

So how many customers will actually bother to move from surveys to socializing their experience? We have some data that suggests a healthy amount. We conducted 25 million surveys last year; more than 80% of respondents said they’d recommend the brand they were being quizzed about. We’ve then seen 10% to 20% of customers follow through with social network postings after the survey.

Some recommendations for retailers considering tying together their feedback, social, and operations loops: customers need some nudging. Incentives like coupons do the job. At 100 Boston Market restaurants, customer advocates got $3 coupons for a recommendation. In a three-month period, Boston Market received 100,000 Facebook newsfeed recommendations; advocates redeemed more than 4,000 coupons.

Finding customer advocates isn’t the only goal. Unhappy customers need to be channeled through a “customer rescue” process to help solve problems, mend relationships, and provide feedback on problems for operations to solve.

At Citibank branches in New York City, for example, every customer who completes a survey receives a call back from their bank manager within one to two days. The manager uses survey feedback and software intelligence to determine whether complaints need resolution or whether the manager should provide a simple “thank you” to reinforce the local branch’s commitment to customer service—like old-fashioned retail and small local banks or credit unions still do.

The advocate process is proving far more powerful than regular social network advertising. The key is authenticity: we listen to our friends and colleagues for advice and recommendations. So while retailers and restaurant owners can buy social media advertising, the real place to drive growth is on the consumer newsfeeds. Not only are those kinds of click-throughs more numerous, they are also more powerful. Beyond simple word-of-mouth advertising, poor-performing outlets get suggestions for improvement, which they use to guide better operational performance.

FEATURED COMMENT

“Social media is really giving companies a lot of feedback. These are platforms that allow our customers to talk about all of our products and services in a good or bad way. The customer service problems are now very transparent and can be seen by the public. We are no longer able to keep these customers’ problems a secret.” —Zach Fretz
Retailers periodically update their product assortments, deleting slow sellers and adding new products in response to shifts in consumer demand or to accommodate new offerings from suppliers. Assortment-planning processes vary greatly across retailers and product segments but have one thing in common: they rely too much on human judgment and not enough on hard data that might allow a retailer to predict how customers will react to a change in the assortment.

This is the indisputable finding of research that Ramnath Vaidyanathan of McGill University and I have conducted. Moreover, techniques that we have developed with several retailers over the last few years show that analytics are providing retailers a tremendous opportunity to improve revenues and profits.

Retailers who rely heavily on human judgment to make assortment decisions are flying blind, which leads to tales of woe like these:

Walmart introduced Project Impact in 2008, an effort to “declutter” stores by removing 15% of the SKUs they carried. It saw an immediate decline in sales and eventually had to roll back most of the changes.

A grocery retailer deleted 20% of its dry-grocery SKUs to allow for expansion of its fresh product offering. Sales declined 40% and the retailer is in bankruptcy. While all of the deleted SKUs had low sales, when customers couldn’t find them, they elected to shop elsewhere.

A retailer of items for the home sought to localize its assortments by store. Out of the 35 categories it carried, it chose fashion bedding, designed localized assortments for five store clusters, and was thrilled to see an 18% increase in revenues. It next applied the same process to fashion bath, got no revenue lift, and abandoned its localization effort.

These examples illustrate the need to answer several questions when revising assortments:
Don’t Trust Your Gut with Assortment Planning

- How will sales change if we increase or decrease the number of products carried in an assortment?
- If customers don’t find their ideal product, what is the likelihood they will buy a substitute product?
- What’s the likely benefit of localizing a category? How many store clusters should we have? What are the right metrics to use in clustering stores?
- What are the likely sales of items we are considering adding to our assortment?

The technique that Ramnath Vaidyanathan and I developed answers these questions. We identify a few attributes for each SKU that are meaningful for customers, use sales of existing SKUs to estimate the demand for attribute levels, and then use the estimates to forecast the demand for any combination of attributes, including those that correspond to new products that might be added to the assortment. We have made this approach formulaic so you can sic a computer on your sales data.

This technique lets you discover new products that have a high chance of selling well. For example, if an auto-parts retailer sees that one of its stores sells many parts for Honda Accords and lots of brake pads but doesn’t carry pads for Accords, then it would seem like a good idea for the store to add Accord brake pads to its assortment.

For food products, the attributes could be flavor, brand, and package size. For flat-panel TVs, they could be screen size, screen types, resolutions, and vendor. And across many product segments, price/value is a relevant attribute.

Our approach also challenges common practices like this: a retailer thinks customers don’t want to buy product type X, so offers a limited amount of it and thus doesn’t sell much of it, thereby confirming its assumption that customers didn’t want X. But that may not be the case. In a study of tires that we conducted where the attributes were size, brand, and mileage warranty, the lowest-priced brand had only a 10% share of the retailer’s sales, but the retailer offered it only in a limited number of sizes (nine). We discovered that in those nine sizes, the brand outsold the next-highest-price brand 40 to 1 and had a 61% share.

This retailer offered a limited selection of the cheapest tire because it thought it could get customers to trade up to a higher-priced brand, and the data showed that 45% of the time it could. But the 55% of the time it couldn’t, times the 61% share of that category, showed it was losing a third of potential sales. We used our estimates to revise the tire retailer’s assortments. The result: a 5.8% revenue increase.

A study done for another auto-parts retailer focused on appearance chemicals, a category that includes products for washing and waxing cars, shining tires, and polishing and protecting glass. This retailer was eager to understand how demand patterns differed across stores but felt it would not be feasible to have more than five different assortments corresponding to five store clusters. We showed that most of the gain could be achieved with just two store clusters. The interesting pattern we observed was that appearance chemicals applied to tires sold many times better in stores that had an urban/bilingual demography.

As these examples illustrate, the era of analytics has arrived in retailing. While there will always be room for intuition, it should be tested by analyzing the data.

FEATURED COMMENT

“Well-written article and valid points. Especially the one on analyzing based on attributes. Questions that remain unanswered are related to criteria to be used for SKU rationalization/dropout and metrics to be used for store clustering, especially in a diverse market like India.” —Umesh Dhand
Is the entire marketing profession headed in the wrong direction? My article (coauthored with Leandro Dalle Mule and John Lucker) in HBR’s December issue spotlight on retailing deals with one tenet of marketing orthodoxy—that customers will respond well to targeted “next best offers” (NBOs). We describe how the best consumer marketers are finally starting to pull together information about the customer, the product or services they might want, and the purchase context—all to make NBOs so precisely targeted that customers pounce.

I don’t question this orthodoxy personally. I am so besieged by junk e-mail, for example, that I almost cried tears of joy the other day when I got a discount offer from one of my favorite restaurants (Selva Grill in Sarasota, which makes a skirt steak to die for). I knew it was just a random hit, but it made me think of the power of NBOs involving products and services I really want. I bought the restaurant discount offer, and I’m guessing that if more NBOs were well targeted, the wheels of commerce would spin much faster. I’d be willing to sacrifice some privacy for this; in fact, I’ve always subscribed to the Scott McNealy comment: “You have zero privacy anyway—get over it!”

However, some of the amazing NBO capabilities we describe in the article made me uneasy about the privacy implications. Microsoft, for example, has an incredible ability to tailor “offers” for its Bing search engine (the product is free, so Microsoft is just trying to get you to use it) based on a variety of factors—including your location, age, gender, and recent online activity—that it can determine from your cookies and other sources. If you have signed up for Microsoft Passport, the company has even more information about you that allows for targeting the offers even more effectively. I was dazzled by Microsoft’s ability (facilitated by the Infor Interaction Advisor software they use) to instantly compose a targeted e-mail the moment you click on an offer in your inbox; it all takes about 200 milliseconds. Microsoft says it works extremely well to lift conversion rates. And I don’t think that Microsoft abuses personal information. But on reflection, I wonder to what degree customers will tolerate this sort of thing once they know what’s going on.

A recent study of American adults, in fact, suggests that consumers are a lot less enthusiastic about targeted offers than marketers imagine. The title of the report says it all: “Americans Reject...
Are Targeted Ads Worth the Privacy Price?

Tailored Advertising.” Sixty-six percent of the respondents said they did not want Web sites to show them ads tailored to their interests. Forty-nine percent said they didn’t even want discount offers tailored to their interests. And young people were not much more interested in being targeted than were old folks like me. What’s more, when consumers are informed about common ways that marketers gather the data they use to tailor ads, between 73% and 86% say they would not want such advertising.

When I have discussed this study with analytics and marketing people, they’ve professed disbelief. But the survey is pretty well done. And if you’re from outside the United States, I’m guessing that your customers are even less desirous of becoming an online bull’s-eye than these Americans were. While respondents in other surveys have not been quite so negative about targeted ads and offers, it is clearly time for marketers and senior executives to take seriously the issue of customer privacy and preferences for targeted ads and offers. You could start, for example, by asking your customers if they really want them!

FEATURED COMMENT

“In my opinion this issue is best evaluated in the context of a value exchange that includes several major elements: the services delivered by the site, privacy, the relative effectiveness of the targeted advertising, the relevance of the advertising, and the customer readiness to pay a subscription fee.” —Arie Goldshlager
If you’re a retailer and you’re not generating a nonstop flow of customized, interactive content, the writing’s on the wall: publish or perish. Publishing has become an essential tool for keeping customers close as they pursue their decision journeys on the way to purchase. Just look around. Macy’s mBlog offers “news, reviews, magic, and more”; JCPenney posts teen-hosted haul videos on YouTube; Target’s got an online style monthly; and L.L.Bean promotes “Share Your Story,” where customers emote about its products. Merchandizing that was once limited to the store window, shelves, print ads, or catalogs can now be micropersonalized and published across every conceivable channel.

Here are four publishing approaches retailers are trying:

**The Mass Publisher:** Mass publisher retailers create content of broad interest to their customers. They ask, “If we were a cable TV channel or a mass-market magazine, what would our content, tone, and the experience we offered be? What would be the on-demand shows or feature articles that get viewed and shared virally? What topics could we own?” Sears is heading in this direction with cooking and fashion programming streamed from a live studio next to one of its stores onto YouTube, Facebook, and other social sites. Macy’s mBlog posts articles on fashion, cooking, homewares, and other topics that have copious links to product pages. Target’s “On the Dot” online magazine similarly teems with links to featured products.

**The Problem Solver:** Most marketing aims to make consumers aware of a solution or an aspiration they had not considered. But increasingly marketers are seeking to help consumers who are already in a market solve a problem. As these customers search for answers, retailers can intersect with them by publishing text or video content, interactive tools, or gateways to one-to-one help. Home Depot churns out a continuous stream of do-it-yourself help videos that it distributes through YouTube, Facebook, and its own Web site. Thomas Pink’s Pink TV runs fashion-show-type videos oriented to different “wardrobe occasions,” such as formal, corporate, and casual, with how-to advice on getting the tie knot or color coordination just right. Viewers can click to further explore and purchase the goods described. Pink TV’s gift section offers curated...
ensembles to help customers pick items for “the arty dresser” or “the media type.” Williams-Sonoma’s interactive tools walk viewers through the right wines to pair with each course of a Thanksgiving meal, based on recipes they choose. Lands’ End cues up opportunities to click to chat when it senses consumers lingering for a while on a page or clicking around quickly—suggesting that they can’t find what they want.

The Social Engager: Facebook and other social media are not merely vehicles for running promotions and gathering friends or followers. They are a place where people engage with your brand to get a stream of deals, participate in contests, see sneak previews, or receive other regular communications. Delivering on that promise requires creating a robust programming schedule to feed the channel, having people available (with appropriate protocols) to respond to customer posts, and designing experiences that encourage followers to get others involved. Through its social media presence, L.L.Bean posts not only daily markdowns but also a steady stream of stories from customers who share how they have used L.L.Bean products “to enjoy the outdoors.” The company encourages this sharing because it showcases customer loyalty, spreads new ideas about how to use Bean products, and provides customer insight.

The Personal Concierge: Sophisticated retailers create personalized content to help move each customer through a decision journey from considering a brand to evaluating, buying, experiencing, advocating, and ultimately bonding. For traditional direct marketers, the customer relationship management aspect of this may at first sound familiar, but the multi-channel digital world brings new twists to the game. The immediacy of interactive channels requires software-based rules that can rapidly evaluate an interaction, looking at where a customer has come from, what she’s looking at, what others like her have bought, and other data in order to assemble and present a customized response. Certainly Amazon.com is the master of this, following up on vacated shopping carts with targeted offers, asking you to rate an item you bought, and sending you offers for accessories to match a major purchase. As more retailers follow Amazon’s lead they are finding that the magic requires not only sharp information analytics but also the right language tone, timing, process management, and strategy to deliver each customer to the best next step.

Whether publishing on a mass, segmented, social, or personal basis, today’s retailers—and the banks, insurers, airlines, and other direct sellers like them—are rapidly recognizing the importance of content to their brands. They are building content supply chains that are guided by insights into customer behavior and replenished by customer-generated content. It’s a new publishing model, and one that retailers may be heading towards even faster than traditional media companies. So, the time seems right to ask: “What is your publishing strategy, and who is your brand’s Editor in Chief?”

FEATURED COMMENT

“Just because you publish does not mean people will read or engage. I’m intrigued to see some of the analytics behind these tools. I would suspect that for someone like Macy’s, a blog post on a particular product generates a relatively small amount of direct purchases by consumers. There is the additional problem that if everyone is creating content, how do consumers effectively wade through it and filter what is relevant for them?” —Anthony Silverman
How Technology Made Me Love to Shop

by Dan McGinn

Like many men, I’ve never been very enthusiastic about shopping.

That’s partly because I’m frugal and don’t enjoy spending money. It’s partly due to the hassles I associate with visiting retail stores—a series of inconveniences that begins in the parking lot (hunting for spaces), continues in the aisles (where I can never find what I need), and ends at the cash registers (where I have little patience for long lines).

Much of the problem, though, lies in psychology. While I can be confident of my decision-making skills in other areas of life, my shopping decisions are often plagued by second-guessing, paralysis, and buyer’s remorse. Even when I recognize the need for a product—I’ve been looking for a good pair of lace-up black shoes for three months—I often put it off, afraid of making a decision I’ll regret.

In the last year, however, I’ve noticed these problems are ebbing. I don’t dread shopping as much as I used to. At times, I’m even starting to enjoy it. Upon reflection, I attribute this attitude adjustment to a simple phenomenon: I’m becoming armed with better information.

In the December issue of HBR, consultant Darrell Rigby describes the need for retailers to create an omnichannel shopping experience—one that integrates the advantages of shopping in a traditional retail store with the convenience and information-rich experience of online retailing. It’s an unusually compelling article, partly because many readers will recognize their own behaviors among the ones Rigby describes as driving the need for retailers to reinvent their model. That’s true for me too.

I’m becoming a more confident shopper largely because digital retailing gives me access to a wider variety of choices, easy price comparisons, and previous buyers’ reviews. Thanks to free shipping and hassle-free returns, the costs associated with making a bad choice have gone down, so I’m more inclined to purchase things even if I’m not 100% sure it’s the right choice. Crucially, these factors are influencing the way I shop in physical stores too. A few years ago I mostly bought books
online, but today I’ll look online for just about anything, and that ability to quickly scan all available options—even from my iPhone—has made me more confident of purchases I make in physical stores too. In fact, I don’t really think about shopping “online” or “offline” anymore—it’s all blurring into one experience. For many purchases, I’ll start online to look at models, pricing, and reviews, then visit a retail store to do some hands-on research, and then decide which channel makes sense based on pricing and how quickly I need the purchase.

I’ve followed that path with the black shoes I need to buy too. Last month my wife bought me a pair as a birthday gift via Zappos. They were too shiny, so I utilized the site’s free return shipping policy. At a local mall, I looked at Allen Edmonds (too pricey) and Johnston & Murphy’s, where I found a pair I liked but balked at the price (more than my first car). I’m still looking around at options, stopping in stores when I have the time. The Johnston & Murphy’s pair is still in contention, as are some less expensive options from Zappos. In the past I’d have succumbed to the pressure to just get this over with by choosing something too quickly, even if I wasn’t sure of my choice. Today, awash in information and options, I feel more in control and able to proceed at my own pace.

Chances are the way you shop is changing too—and as that behavior changes, retailers are being forced to adapt. Over the next month, HBR.org will explore the ways in which new technologies, innovations, and ways of doing business are changing the retail industry via this Future of Retail Insight Center. We’ll look at how retailers are making better use of the information they gather about us to guide us toward better choices. We’ll examine how retailers are developing new pricing strategies to adapt to shoppers armed with smartphones. These online articles will be a nice complement to the Future of Retail articles in this month’s magazine, now available at newsstands—which, come to think of it, is a nice kind of two-channel experience unto itself.

**FEATURED COMMENT**

“I was reading your articles, and my attention goes here ‘I’m becoming a more confident shopper largely because digital retailing gives me access to a wider variety of choices, easy price comparisons, and previous buyers’ reviews.’” —Liz K.
Ever since people started shopping on the Internet, commentators and forecasters have been predicting the death of retail as we know it, much as the self-service format (Retail 2.0) largely killed off the full-service model (Retail 1.0) in the last half of the twentieth century.

The dot-com crash gave pause to that idea, and a less radical consensus has formed around the view that the Internet is “just another channel” and retail will become a stable world of integrated clicks and bricks. There’s an almost eerie parallel to Francis Fukuyama’s notion of two decades ago that history was dead.

It’s perhaps worth pushing the parallel even further: less than ten years after Fukuyama’s book was published, history came back with a vengeance. And if you take a look at the data on retail you’ll see that in category after category the Internet format—Retail 3.0—has accounted for essentially all of the growth over the last decade, if not longer.

The writing is already on the wall for some categories. For example, scarcely a single new bookstore has opened since about 1998. In computers and electronics—the Apple Store notwithstanding—the Internet has captured more than 40% of sales, and incumbent stores are so vulnerable to smartphone-based comparison shopping that they are rapidly becoming nothing more than showrooms for Internet-only retailers.

In many categories, online retailing is advancing much faster than the last format innovation—self-serve—did the last time around. That’s partly because having to build out stores is not a constraint to growth in the virtual world.

But it’s also because the Internet growth is starting to affect the economies of scale on which traditional retailing relies. Every time an item is sold online, another unit of volume is lost by a self-serve store somewhere. And as they lose that volume, their economics become more marginal, the pressure to protect profitability by raising prices increases, and the risk of a doom loop deepens.
No doubt some will argue that consumers will always want the in-store experience, and that may indeed be true in some categories. But ask yourself this: are you hearing a refrain of the mom-and-pop grocer’s pain in the 1950s? Or the dedicated appliance store owner in the 1970s? Or the self-deluding rationalization of a 1970s gas station attendant? All of these “traditional” formats have all but vanished—there was no defense for those who failed to adopt the new self-serve formats.

Take apparel: who would have thought ten years ago that Zappos could build an online business that prides itself on delivering not just low prices but an excellent customer experience, including service? Zappos’s online-only retail format is so efficient that it can offer very competitive prices, free shipping, and free returns of as many shoes as you like, at a stroke, removing the biggest problem with online apparel shopping: “Does it fit?”

In the future will our daughters meet at the mall to shop on a Saturday or instead at a friend’s house or a fashionable café to compare what they got in the post that morning? Perhaps they already do.

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**FEATURED COMMENT**

“Retail 3.0, as Ken and Nick put it, will offer opportunities for digitizing the retail experience through the power of technology and access devices. This is bound to throw up new challenges across categories and opportunities for smart manufacturers willing to see the definite trend.” —Umesh Dhand
There are troubling signs for the country’s retailers as Americans continue to slow down their spending and hunt for deep discounts. No one expects a blockbuster holiday season. Most retailers are just hoping to eke out a slight increase over the year before. Some retailers, however, are leveraging location-based mobile tools like Foursquare to outsmart the competition.

Foursquare recently passed one billion check-ins. For businesses of any type—but especially for retailers—Foursquare allows brands to attract, reward, and engage customers in ways that were never possible before. Innovative retailers are leveraging the growing popularity of check-ins to create fun, meaningful interactions that encourage long-term loyalty. Here are five ways to use Foursquare to build loyalty this holiday season and beyond:

1. **Offer creative, compelling specials.** Offering a customer $1 off a pizza isn’t going to inspire anyone. That’s just an example of pushing a tired, traditional newspaper coupon to people on their mobile devices. Walgreens could offer a discount on shampoo or any of the other products it offers, but the pharmacy decided to do something innovative. Walk into any Walgreens during the flu season of 2011/2012, check in on Foursquare, and Walgreens will donate a voucher for a free flu shot to someone in need. Walgreens expects to contribute $6 million worth of flu shots during the campaign. Walgreens is thinking creatively, connecting its Foursquare special with the brand’s unique voice.

2. **Recognize the “mayor.”** Foursquare has exploded in popularity partly because it adds a gaming layer to the location-based service. The person who checks in the most is designated the “mayor.” Many brands are rewarding their most loyal customer with extra special discounts or creative promotions. The restaurant Miss Shirley’s in downtown Baltimore is known for its one-hour waits for weekend brunch. The mayor of Miss Shirley’s gets to cut to the front of the line and take three friends along. Simon Malls offers its mayors reserved, prime-location parking spots, and the ice cream chain Tasti D-Lite posts photographs of each location’s mayor on an in-store digital display. Tasti D-Lite has found that nearly 20% of its customers check in on Foursquare and a large percentage of those users share their check-ins with friends on Twitter and Facebook. Showing
the mayor some love provides benefits that extend to the mayor and his or her social networks.

3. Encourage a flash mob. Foursquare offers up to seven different types of merchant specials. Most merchants stick with the simplest—check in and get something in return. Branch out. Offer a “flash” special from time to time. This is the equivalent of a Black Friday discount on any day of the week. A merchant might offer the following Foursquare special for an especially slow period: the first ten people who check in after the doors open at 8:00 a.m. will receive an additional 20% off their purchases.

4. Incentivize people to do good. Retailers recognize that giving people a large discount might attract a crowd, but encouraging long-term loyalty means that customers must feel good about doing business with your brand. On Black Friday, JCPenney is putting Foursquare to good use, literally. Every check-in on that day will trigger a $25 donation to the Salvation Army.

5. Have fun. Foursquare is, by definition, playful. Don't take your campaign too seriously. The Bryant Park Grill in New York City is built within an aviary. That means there are birds everywhere, an unusual sight in NYC. The Foursquare special: take a photo of a bird on your phone, show it to the bartender, and get a free drink or signature dessert. Remember, smartphones are tools for engagement. People have fun with their phones. Play along with them.

When the chairman of American Express, Edward Gilligan, announced a Foursquare partnership, he said, “We go to where our customers are, and they are on places like Foursquare.” Your customers are increasingly living their lives on their smartphones, but, despite growing by more than 30,000 users per day, Foursquare is still in its infancy, and there is much to learn. How are you using Foursquare creatively to attract, reward, and engage your customers?

FEATURED COMMENT

“Great article showing ways to leverage Foursquare to benefit your business, the customer, and society.” —Jim T.
How Retailers Can Appeal to Lower-Income Shoppers

by Dr. Venkatesh Bala, Shreya Shankar, and Eddie Yoon

Retailers face several challenges as they enter the 2011 holiday season. Unemployment remains high. Gas prices have risen 90% from 2008 to 2010, leaving consumers with $160 billion less spending money per year.

Many retailers are responding with across-the-board price promotion strategies. This is problematic because not all shoppers are equally price sensitive across all categories. The Cambridge Group conducted a Pricing Power Study across 124 everyday consumable categories using Nielsen data from 2008 to 2010. Our findings suggest that a more precise strategy that carefully raises and lowers prices for the right shoppers in the right categories can drive profitable growth for the retailer and the category overall.

In particular, we found lower-income shoppers to be surprisingly resilient to price increases in a number of categories. These lower-income shoppers think like savvy CFOs and are willing to pay more for categories that provide a usage benefit as well as a variety of economic benefits for their own “household P&L.”

For example, lower-income shoppers appear willing to pay more now to hedge future costs. One such category was over-the-counter family planning products, better known as birth control. Between 2008 and 2010, prices of these products grew 17%, while sales grew by 14%. Lower-income shoppers may see OTC family planning as a way to control family costs in an uncertain economic environment.

We see that many lower-income shoppers think holistically about pricing, focusing more on total cost versus the individual cost of inputs. In food, for instance, we see that lower-income shoppers think more about total cost per meal instead of cost per item.

We see that “sandwiches” as a meal category has grown, especially given the relatively low cost per meal ($1–$2 per meal per person) that sandwich items can provide. Low cost-per-meal sandwich categories like canned seafood and packaged deli meats meaningfully raised prices and
grew sales 5% and 3%, respectively. In contrast, higher cost-per-meal categories like prepared meals (which cost $4–$5 per person, on average) raised prices 8%, but declined in sales by 5%.

Similarly, categories that provide similar quality but are a meaningful discount to their quick-serve restaurant equivalents have grown significantly. Breakfast foods increased prices by 6% and grew sales by 9%, while coffee prices increased by 6% and sales grew by 3%.

Lower-income shoppers are also willing to pay more for categories that they see as an investment in their careers and future income. For example, the men’s shaving category successfully raised prices and sales. While many assume men’s personal care is primarily driven by romantic relationships, in fact one of the biggest drivers of demand for men’s personal care is career advancement. Spending more on shaving products in a tough economic environment makes sense in that context because it strengthens employment prospects.

Retailers must understand the role that a particular category plays not only in its shoppers’ lives but also in its shoppers’ financial context and their household P&L. Is the category a hedge, an investment with a greater benefit payoff, or a cost to be managed? If it is a cost to be managed, then retailers must assess if the shopper is managing cost at a total level (e.g., cost per meal) or at an individual unit level.

Once a retailer understands the economic benefit a category can provide, it can tailor its merchandising and marketing strategies. Retailers can use displays to highlight the economic benefits of a category holistically and over time, versus merely the promotion on hand. They should think about prioritizing and merchandising lower total-cost categories. Several retailers are capitalizing on this insight and offering “meal packages” that pull from several categories across the store, such as meat and fresh produce. SuperValu, for instance, has reported that even its slowest “meal deal” drove a 20% lift.

By more fully appreciating the shopping savvy and sophistication of lower-income shoppers, retailers can avoid blanket and knee-jerk price promotions/reductions strategies. These strategies not only leave money on the table but are not viable strategies for long-term profitable growth. Precision pricing helps avoid pie-splitting strategies that yield “rented” market share with low loyalty instead of a true pie-growing strategy that drives healthy category growth.

FEATURED COMMENT

“Well-written article. You make the point that lower-income shoppers make smart decisions, which means retailers have more latitude in raising prices for goods that provide the most value.” — Rohit
The Future of How We Consume Things

by Henry Chesbrough

We often look at innovation in terms of the new products and technologies that come to market. We don’t often think about how we consume these new offerings. But that’s what is far more important. Our lives are shaped by how we interact with the “things” or “stuff” we use every day, not the increased capability of some new gizmo.

Consider the lowly refrigerator. If you needed to buy one 20 years ago, you’d go to a retail store and look at the models it had in stock. You’d compare the features of the different models and select the least offensive. Later, if you had complaints or suggestions about the product, you were shunted off to a customer support line that was often busy or staffed by someone with little or no authority to act on your request. Once you bought it, you were basically stuck with it.

If you buy a refrigerator today, online reviews abound. Comparison shopping sites force retailers to compete on price, warranty, and rebates. Through their Web sites, companies inform customers about their products and also involve customers directly in developing new products by soliciting new ideas and reviews. Social media lets companies attract fans to their products and obtain feedback about problems with current products so they can take immediate corrective action. All of these mechanisms combine to make it much more likely that you will be satisfied by your fridge purchase than you would have been 20 years ago.

What’s more exciting is how you will consume refrigerators in the near future. Will you even need to buy one? Perhaps manufacturers will lease you a fridge and charge a low monthly rate for managing your refrigeration needs. They might bundle energy costs in as part of the package and then help you find ways to reduce energy usage. They’ll probably invite you to share clever ways to use refrigerators or to comment on their own ideas and innovate even better offerings next time. We will increasingly consume products like refrigeration as services rather than as products. As a result, our consumption will be more accessible, more convenient, more affordable, and more personalized.

If this seems fanciful, just look around at the other things you consume on a regular basis. Do you rent movies on DVD from Blockbuster or view them on Netflix? Do you buy gifts from a store or...
get gift reminders from Amazon to buy a book or a toy or a piece of jewelry, with recommendations based on your previous purchases? Do you purchase CDs at Best Buy, or do you buy online digital music tracks individually and create your own custom-made playlists? Do you shell out cash for a printer for your home office, or do you take advantage of Xerox or HP copier services by the page? Do you hire an accountant to prepare your taxes, or do you use an online service to prepare and file your return? If you live in a city, do you own a car, or do you turn to ZipCar whenever you happen to need one?

The continuing change in how we consume things is a good deal for us and for our suppliers. The suppliers will benefit from their ability to utilize their specialized knowledge to design better, faster, and more cost-effective ways to deliver these services to us. We will benefit from greater flexibility (no up-front payment, for example), plus the comfort of paying only for what we use.

**FEATURED COMMENT**

“Interesting how the process of product/service development has become so collaborative and seamless, with less and less separation between manufacturer and consumer. Good product development was always the result of listening to customers; however, now the rapidity and volume of consumer feedback has emphasized the importance of distilling and prioritizing user input, as well as translating it effectively into meaningful products and features.”
—Madelyn Sierra
For retailers, the future of shopping is here and many are scrambling just to keep up. Ushered in by the onslaught of mobility, social media, and online commerce, the rampant consumerization of IT is creating a power shift from associate to shopper. Increasingly, consumers on the floor know more than the sales staff about the store’s products and price points—and competing offers.

Some retailers are responding with clever innovations. Old Navy deployed a mobile payment checkout device over Christmas. Nordstrom and Home Depot announced large-scale mobile solutions for their associates to help digitally enabled shoppers. And we’ve all seen Apple apply IT to “out-retail” pretty much everyone else.

But many retailers seem a bit overwhelmed. How do they adopt an intelligent-store strategy that incorporates associates, shoppers, changing technology, new consumer behaviors, and the store itself? Our research suggests five key strategies.

Create a store without boundaries. Take the store to the shopper, regardless of the consumer’s location. Why should the shopper in aisle three be treated worse than a shopper in a checkout lane or sitting at home? Shouldn’t all shoppers receive customized shopping recommendations based on past behavior, integrated with their online accounts and delivered to their mobile devices? Shouldn’t every shopper have access to time-, loyalty-, or location-based offers, whether in the store or walking in the park?

Create an IT environment based on the “shopper architecture.” Leverage cloud-based services to augment basic mobile device services to provide a rich and contextual shopping experience. Our shopper in aisle three would need the store’s Wi-Fi network and IT ecosystem to support the technology on his or her mobile device.

Get away from fixed POS devices. Well, maybe some of them will have their place. But if we can get more associates out from behind the POS and into aisle three to provide an improved shopping experience, we know the positive impact of a shopper-assisted sell on basket size and conversion rate.
Automate and digitize everything. Why must coupon redemption (the third-highest source of shopper irritation, according to our research) be manual? Wouldn’t it be great if the shopper showed up at the checkout counter (which, by the way, should be a mobile one) and coupons from different manufacturers were applied automatically and processed all the way through settlement? And why must return processes be so manual? Make it easy. Sometimes your best customers are the ones who return the most! Have the shopper log into a returns e-commerce site, schedule a return, choose a credit or refund option, and ship the return from the nearest UPS or FedEx center.

Replicate the personal social media experience. Think of how a Generation Y associate consumes technology with friends via social media on Sunday evening at home and then how she consumes it as a POS associate Monday morning. Big difference. Research has linked high associate attrition with a poor technology environment.

Focusing on the online channel alone means changing your competitor set to Amazon. That is a battle most retailers will lose. Creating this new intelligent store requires, at the very least, the CIO, the chief marketing officer, the SVP of store operations, and the SVP of e-commerce to determine how to best engage with increasingly digital-savvy, data-driven shoppers. Doing this right will allow the CFO to keep the store as an asset on the balance sheet, not a liability—a move shareholders would surely reward.

**FEATURED COMMENT**

“Your point on bringing the store to the customer is highlighting the way in which retail has gone from the powerful advertiser to the powerful customer. In the digital signage industry, it is clear that the content displayed in areas of business, retail, entertainment, and other public-facing environments has to of course be attractive to the customer (current and potential), but with digital and interactive displays you can reach the need of multiple customers depending on their own interests and desires.” —Gareth Wilmer
A person with a smartphone can scan a bar code in Best Buy or Macy’s, check the price, and order from Amazon or Target on the spot. So Amazon could receive an order from a customer who was stimulated to buy while in Best Buy.

This may revolutionize retailing and cause considerable consternation and ultimately dislocation for several players.

Remember when the Internet arrived and the customer who was savvy gained the power to check prices of all the options? Especially for durables, that power led to sensitivity to prices and resulting price pressures.

The smartphone’s ability to scan SCAs and buy items from competitors on the spot adds a step function to this pressure. The driver is the availability and use of smartphones. Over 40% of all wireless phones now are now smartphones, and this number is growing fast. A new report from Experian Simmons estimates that nearly 20% of smartphone users scan barcodes, and the same percentage make purchases directly from their phones.

These numbers are enough to change the profitability of particular retailers significantly, either positively or negatively. And they are growing quickly. There will be a tipping point, which probably has already occurred in some contexts, at which time there will be a dramatic change in the nature of retailing. There will be winners, but the strategy of some retailers to provide value-added services will become problematic, and others will be forced out of business.

There are a host of implications. Consider a few: Amazon and other retailers with a strong brand and Internet commerce strengths and following will benefit. Retailers with a cost advantage may benefit as price becomes more important. Those with a strong private label line with distinctive attributes will be affected less because the items will not be found elsewhere. National brands will have a harder time maintaining price discipline in the marketplace. Those like Apple with distribution control will be well positioned.
The world has before exaggerated the impact of technology. The checkless society was a solid prediction a half century ago, and the electric razor was expected to kill off safety razors. However, smartphones may be the real thing.

FEATURED COMMENT

“Isn’t it fair to say that a large majority of retailers focus far too much on price chasers already? Sales and discounts occur with such regularity that shoppers simply wait until the products they want go on sale locally, or they buy online instead.” —Joseph Martins
Online Shopping and the Problem with Pictures

by Jacqueline Conard

What if the thing that gets online shoppers to buy a product is also the thing that makes them dissatisfied with the product when it arrives?

In a recent research project, I tested this hypothesis using the pictures of products that accompany the online shopping experience. Images are the crux of online shopping. Good pictures—even interactive ones that allow shoppers to see the product from every angle and in every color combination possible—help consumers feel confident in their purchase decisions. It’s what gets them to buy.

But with online shopping, after the purchase comes the wait—the time it takes the product to ship through the mail. According to my research, retailers should be more worried about this waiting period than they currently are. Here’s why: when consumers purchase items online, often they’ll print a receipt. They might pin the picture on their bulletin board or keep it on their desk. The retailer has no control over the quality of this image. It could be printed in black and white or on a lower-end inkjet printer, the colors of which are not nearly as sharp as what’s displayed on a screen.

It turns out that both of these types of pictures seem to affect expectations during the shipping time and can result in dissatisfied consumers.

To test this, I had research subjects buy a mug.

I then gave them pictures of their purchased product on their printed receipt. In the first experiment, the receipts had either a low-quality color picture, typical of a home inkjet printer, or no picture at all. In another, the receipts had either a black-and-white image or none at all.

After waiting a week for the delivery of the product, the consumers who had the low-quality color picture and the black-and-white picture reported that they were much more dissatisfied with their product at the time of delivery as compared to consumers who had no picture. Their word-of-mouth (would they recommend the product) ratings were more negative, and intentions to
make another purchase from the vendor were reported to be much lower.

After this, I experimented with giving consumers photo-quality pictures with their receipts, images that closely matched what the person saw while shopping. This worked. Customer satisfaction improved on all three measures (overall satisfaction, word-of-mouth recommendations, and repeat purchasing).

So what’s happening here? Though more work will be needed to confirm this, it appears that the low-quality images alter their memories of what they bought and shift their expectations while they wait for the purchase to show up. The high-quality, sometimes interactive images that excited the person enough to purchase are replaced by the different images in the printouts. When the product arrives, there’s some disconnect between what they’ve been imagining and what they’re looking at.

This presents something of a dilemma for online retailers. On the one hand, they need to offer extremely high-quality imagery and interaction that allows for seeing colors and other features in detail in order to motivate consumers to buy products. On the other hand, they can expect any printed-out image of that purchase not to match the quality of the image that got them to buy—thus creating disappointed shoppers.

One solution appears to be to give consumers extremely high-quality images to keep with them while the product ships. But this is unrealistic for online shopping. Retailers can’t control the kind of printers consumers use and can’t tell consumers, “Don’t print out this receipt; instead keep it in your e-mail and refer to our high-quality picture there.” (It may work for people who buy in the store and need a product shipped, since the company could control the quality of the printout.)

In one more experiment, I tested another possible solution: providing a Photoshop-generated line drawing of the purchase.

The idea here is to provide enough information to allow the people to feel good about the money they had just spent but not give enough detail to allow the memory of the purchase to be altered. This is not an attempt to recreate the thing that got them to buy, but rather to represent the purchase in a more abstract way.

And this worked too. Satisfaction, word-of-mouth, and repeat purchase scores were all higher than with the low-quality photos. For online retailers, this could be an easy, cost-effective way to improve customer satisfaction.

FEATURED COMMENT

“Very neat idea. I am a bit surprised by the findings, as I would have guessed it would have gone the other way—the low-res images would lower my expectations for the product, leading to an upward surprise when the product arrives. I guess that’s why we do the research.” —Mike
Create “Choosing” (Not “Shopping”) Experiences

by John Sviokla

On a recent gorgeous day in New York City, I walked from Bergdorf Goodman at Fifty-Ninth Street and Fifth Avenue past Cartier on Fifty-Second Street and continued down Fifth Avenue for over a mile. Because I was preparing for a speech I was scheduled to deliver to the Global Retail Marketing Association, I was paying particular attention to the stores and the shopping experiences they created—from the posh ambiance of Bergdorf’s with its $4,000 blue blazers to Diesel’s inexplicable ad line: “Smart has the brains, but stupid has the balls.”

My conclusion: the shopping experience at every store along this route was pretty much the same. The only difference was how much each merchant was willing to cut its prices—by 20%, 40%, or even 75%. None of them had created a choosing process—in which customers’ actions are guided by known principles of behavioral economics that help them make a purchase, not just look around. Instead, the retailers had simply stuffed the shelves, windows, and hallways with option after option after option, driving more shopping and less choosing.

There are many ways a merchant can create a choosing—not just a shopping—experience. For example, we know from extensive research in the online realm (and from common sense) that ratings and popularity drive increases in sales. Yet nowhere in the stores could customers find reviews or any information about which items were most popular.

Products tend to move more quickly when people talk about them. Oddly, information exchange seems to presage choice, and stores can facilitate this in simple ways (imagine a souvenir store that told customers what most “out of town” tourists buy) or in a more sophisticated fashion (e.g., displaying customers’ online reviews near products in stores—something Best Buy reportedly is considering).

In addition, retailers could employ any number of other behavioral economics techniques that make it easier for people to choose. One of my favorites, which I’ve written about before, is the decoy effect in which you make it easy for a customer to get a deal. In my previous post, I noted that when The Economist magazine had three offers ($59 for online only, $125 for print only,
Create “Choosing” (Not “Shopping”) Experiences

and $125 for both), 84% of purchasers chose the print-and-online option because they got the online for “free.” Nobody bought the $125 print-only option, and 16% went for the online-only offer. This meant that the “average basket” of the population of Economist shoppers was just over $114 (84% of $125 + 16% of $59).

When the print-only choice was removed, 68% of purchasers chose the $59 option, only 32% went for the print-and-online bundle, and the average basket was approximately $80 (32% of $125 + 68% of $59). So when the decoy was added, the average sale increased from $80 to $114 dollars.

Likewise, any merchant that might be considering a 20% off sale on a $500 suit could instead offer $500 for the suit, $100 for a shirt, and $500 for the shirt and the suit. More people would be likely to buy the combo for $500, and it’s also likely that most of those people would have gone only for the shirt if the bundled deal wasn’t offered. This technique could help merchants in their eternal quest to increase the average sale per customer.

The growing popularity of mobile devices like iPhones, Android phones, and iPads makes helping consumers choose, not just shop, even more important for retailers. That’s because these gizmos allow consumers shopping in a store to consider many other options outside the store. Since we know that increased choice tends to freeze decision making, the result will be consumers who shop more and more and choose less and less.

With all this in mind, ask yourself: is your sales process increasing choosing behavior or simply fomenting increased shopping? If your answer is the latter, you need to start designing a customer-choosing process.

FEATURED COMMENT

“Nice article, John. But just a thought of rare scenario: had the cost price been equal to selling price for whatsoever reason, wouldn’t option one (offering two articles in combination) increase the average price per customer and hence the loss?” —Neha
Ken Hicks, the CEO of Foot Locker, formerly the president and chief merchandising officer of JCPenney, graduated from the United States Military Academy and spent six years in the army just after the Vietnam War. HBR talked to Ken about how his time as a young officer prepared him for a career as a retail executive.

Tell me about a couple of things you learned from your military experience that have made you a more effective CEO.

When I took over my artillery battery, at age 25, I could shoot a cannon better than any of my section chiefs—and I had six guns. The only problem was, I could shoot only one gun at a time. I realized that what I had to do was train my section chiefs to be better cannoneers than I was because shooting 18% of the battery isn’t going to be effective. And my job really wasn’t to shoot a cannon; it was to develop an entire artillery battery.

So I learned that you’re very dependent on your people to be their best. You train and develop and motivate them. People think in the army that you tell somebody to do something and they do it, and that’s far from the truth. They actually have more options and pressures that can be very intense. Think about it—if somebody in Afghanistan screws up, they get sent back home. If they don’t, they stay in combat.

To be a successful leader, you have to understand what skills are required and be competent at them, and you also have to have confidence. Sometimes people mistake confidence for leadership or competence for leadership, but it takes both of them together.

Do you see any connections between how the military and the retail industry operate?

In retail and the military, you’re very dependent on the people at the front or the selling floor. You realize how important the sale associate is. It’s the same thing in the army; you’re very dependent on your privates and specialists, and so you talk with them and learn from them. Six or eight months after I’d left JCPenney, I was in a Penney’s store looking at some merchandise, and
an associate recognized me and came running across the floor to say hello. She remembered me because I’d treated her with respect and listened to her. That’s what you have to do to inspire people. The people on the selling floor, just like the cannoneers, the gunners, and the infantry, are the ones who make everything happen.

**How do you stay connected to frontline employees, besides going out and talking to them?**

Recognition. I send out a little note card every month to the employees who perform best, thanking them for doing a good job. If you think about the military, people are willing to give their life in defense of the country and their friends, and what do they get for it? They get a ribbon on their chest. Everybody thinks recognition needs to be a big bonus or a promotion. It really doesn’t. What you learn in the military is people do their work because they trust and respect you, and they want you to be able to recognize them for that. I send out these cards, and the next thing you know, they frame them and put them on the wall in their stores or their cubicles because it’s important to them.

**What else has made you successful as a senior leader?**

Learning and studying each situation. When I was in the army I had the opportunity to have lunch a couple of times with Omar Bradley. Here’s a guy from history who led troops across Europe and commanded the war in Korea, and people would always ask him, who is the greatest general you served with? And he would say the greatest field commander was Patton. That’s because Patton did his homework, he studied the map, and he knew where the enemy was going to be and where they needed to go. It’s the same in business. You have to study the numbers and constantly try to understand where the opportunities are and how you can go after them. I’ve got on my wall in my conference room the principles of war. And each of the principles of war applies in business. For example, mass: don’t spread your troops out, don’t spread your resources too thin. Unity of command: know who’s in charge, who has responsibility, and who doesn’t. Security: don’t be surprised, study the competition, know what’s happening. I worked with a retailer who said, “Retail is war without blood.” You study and spend a lot of time understanding the competition’s situation. You learn not to overreact.

**How do you communicate a clear mission?**

You have to constantly reinforce it so people always know why you’re doing what you’re doing: we’re going after this because of that. Then people know why they’re there and what they need to focus on and what they should do. You can empower them. One of the differences between our army and the Soviet army was that our tanks all had radios; every tank could communicate with every other tank. You could see the difference that made in mock battles. In the Russian army, the tank commander had a radio, and the platoon leaders and all the other tanks just followed the leader and did whatever the leader wanted. If something happened to the leader’s tank or they were lost, they didn’t know what to do.

I assign a lot of projects to people and say, “Here’s what we want to accomplish. You’re the lead; you have responsibility. You bring the resources to bear, and let’s accomplish it.”

**You’re in a pretty volatile industry. How have you adjusted the way that you go about planning to take into account the rapid nature of change?**

Constant communication and watchfulness. When I was in the army I was in a cavalry regiment, and one of the cavalry’s jobs is to go out and scout. I send people out to our competitors’ stores all the time. We look at the competition, the press, any venue we can think of where we will see new ideas and new things.

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**FEATURED COMMENT**

“Not only is your organization more effective when you train and trust your team, the team’s engagement level improves too. When your entire team is invested in the solution, you reap the benefits of more than just your smarts.” —Andy
Companies spend a great deal of time and money trying to improve customer loyalty by measuring and managing metrics like satisfaction and Net Promoter Scores. But traditional gauges of loyalty correlate poorly with what matters most: share of wallet. This is the percentage of a customer’s spending within a category that’s captured by a given brand or store or firm. Customers may be very satisfied with your brand and happily recommend it to others—but if they like your competitors just as much (or more), you’re losing sales. Making changes to increase satisfaction won’t necessarily help. This doesn’t mean traditional metrics aren’t valuable; it can be very useful to know whether your customers are satisfied and would recommend you to their friends and colleagues. But these measures in themselves can’t tell you how your customers will divide their spending among you and your competitors.

Walmart had a rude awakening in this regard. In 2008, guided by extensive customer feedback, it launched Project Impact, a remodeling initiative designed to improve customers’ experiences. It removed unsightly stacks of pallets from the aisles, trimmed distracting endcap displays, and thinned out overstuffed shelves. As expected, satisfaction scores rose. But same-store sales entered their longest decline in the company’s history. “The customers, for the most part, are still in the store shopping,” Charles Holley, Walmart’s chief financial officer, recently observed, “but they’ve started doing some more shopping elsewhere.” Even as satisfaction increased, share of wallet fell.

If traditional loyalty metrics don’t link to share of wallet, what does? To find out, we undertook a two-year longitudinal study of more than 17,000 consumers, looking at purchasing in more than a dozen industries and in nine countries. We asked a broad array of questions and collected ongoing purchase histories and satisfaction and loyalty ratings. Our analysis—to our knowledge the largest and most rigorous of its kind—revealed an elegant correlation: the rank that consumers assign to a brand relative to the other brands they use predicts share of wallet according to a simple, previously unknown formula, which we’ve named the Wallet Allocation Rule. From company
to company and industry to industry, the correlation between a brand’s Wallet Allocation Rule score and its share of wallet was remarkably consistent—the average was greater than 0.9 (a perfect correlation is 1.0). Even more important, the correlation between changes in the Wallet Allocation Rule score and in a customer’s share of wallet was a robust 0.8. The correlation between changes in satisfaction or intention to recommend and in share of wallet was very weak—only 0.1.

The essential distinction of the Wallet Allocation Rule is that it takes into account both rank—Is your brand a customer’s first choice? Second?—and the number of brands in the set the consumer uses. Knowing these two values allows you to confidently predict share of wallet. (For a step-by-step demonstration of the calculation, see the exhibit “Using the Wallet Allocation Rule.”) For example, if your brand is one of only two a customer uses for a given purpose, the rule shows that the difference between being her first choice and being her second can have a major financial impact. In such a situation, even being tied has grave consequences: half of each dollar you could be collecting from the customer is going to your competitor instead. The flip side is that the negative impact of being second diminishes as the consumer’s choice set increases.

Using the Wallet Allocation Rule

The Rule in Practice

The new rule has important implications for strategy. To understand what drives changes in share of wallet, managers need to shift their focus from drivers of satisfaction to drivers of rank.

First, you can’t assess brand performance as if it existed in a vacuum. That sounds obvious, but in reality it’s exactly what most managers do, measuring customer satisfaction or using other metrics that are based on customers’ perceptions of their brand alone. As a result, the loyalty objectives used to evaluate and compensate managers usually have to do with achieving a certain satisfaction rating (which rarely boosts share of wallet), not with improving a brand’s rank (which actually does).

Second, the rule makes it possible to craft strategies that directly affect brand performance and then measure the impact on share of wallet. Think about how a company typically tries to improve share of wallet. The effort often boils down to launching initiatives intended to make customers happier and then measuring satisfaction. As Walmart discovered, even initiatives that result in happier customers may have little or no positive impact on the top line. Instead, companies should understand exactly why their customers use each of the brands they do. If you’re not number one, you should ask your customers why they prefer your competitor and use the insights you gain to move up the ranking ladder. The Wallet Allocation Rule is clear on this point: if you can’t improve your rank, you can’t improve your share of wallet. (See “How to Improve Your Rank.”)

How to Improve Your Rank

Let’s look at a composite case, drawn from our research, that illustrates how a full-service grocery retailer might put the rule to use. The grocer surveys its customers and finds that they are generally very happy with their experience—53% give the store a nine or ten on a 0-to-10-point “would recommend” scale. However, despite these good scores, only 43% of customers rank the grocer as their first choice. The unpleasant implication is that 57% either prefer one or more of its competitors or consider the grocer to be tied with one of them. Using the Wallet Allocation Rule, the grocer calculates its average share of wallet and that of its three main competitors. Multiplying these estimates by its customers’ average monthly grocery spend and the number of its customers who also patronize the competing stores, the grocer determines that its top three competitors are extracting a total of $425 million from its customers’ wallets—some of which it could capture by moving up in the ranks.

Returning to the store’s customer surveys, managers learn that the top two reasons its satisfied customers recommend the grocer are the superior quality of its produce and the ambience. This is not surprising; management has worked hard to differentiate the grocer on these parameters. What attracts the store’s customers to the competition? The survey indicates that for Competitor One, the primary attraction is everyday low prices. Competitor Two also competes on price, but largely through rotating deep discounts. Competitor
Three’s main appeal is the convenience of its locations.

The managers immediately realize that if the grocer is to move up to first place in more of its customers’ minds, it can’t simply enhance what it already does well; stocking even better produce or improving the aesthetics might further delight customers who already rank it first but would be unlikely to change the minds of the rest, who are mainly interested in low prices and convenience.

The grocer can’t compete on price in every category, so its managers decide to drop prices on its most commonly purchased staples, reasoning that customers who are already attracted to the store for its produce and ambiance will then have less reason to shop at its strongest competitor, the everyday-low-price store. Surveys after the price change find that 49% of customers now peg the grocer as their first choice (a gain of 6%) and that the number of stores customers regularly shop in has dropped from 2.5 to 2, on average. These changes, when plugged into the Wallet Allocation Rule, translate to a seven-point increase in share of wallet. It’s the equivalent of shifting $62 million from competitors’ registers into the grocer’s own.

Many companies could see this kind of revenue jump if they decided not to pursue customer satisfaction for its own sake and focused instead on how satisfaction and other loyalty boosters could help them pull ahead of the competition. If growth is what you’re after, stop watching your scores and start paying attention to your rank. The path to winning has always been the same. It’s not just how many points you score that matters—you need to score more than your competitors do.

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**FEATURED COMMENT**

“This is a breakthrough article and approach, putting profitability to ‘loyalty’ in a way that so many other metrics only infer but then speak about as if they were irrefutable facts. The Wallet Allocation Rule is measurable fact and an enormous contribution to the field.”

—Ron Kaufman
Faced with an eroding core business, most companies seem to do ... nothing. In the media and entertainment industry, look at Blockbuster’s lackluster embrace of mail delivery and video streaming, newspapers’ mainly tepid moves into digital publishing, and television networks’ doubling down on a small number of hot shows. A company in a turbulent industry often seems like a dairy farmer whose herd has been reduced to just one cow; his only adaptation of his business plan is to milk that heifer extra hard. The story cannot end happily.

Barnes & Noble (B&N), America’s largest bookseller, is bucking these trends. While its biggest traditional competitor, Borders, has ended up in bankruptcy, B&N is creating a credible growth plan in the midst of upheaval. In the first quarter of 2011, industry-wide book sales were down 2.5% from the same period in 2010. Print books are in decline but e-books are rocketing ahead, growing nearly 150% year-on-year. B&N is moving boldly into this future in four ways that hold lessons for any company facing a troubled core.

Competing with its legacy business: Rather than swim against the e-book tide, B&N has embraced the inevitable with its Nook readers. Other bricks-and-mortar booksellers have offered e-books online, and Borders licensed a reader of its own from an outside company called Kobo. But B&N is the only legacy retailer to create its own devices—and rather than offer a single reader as a defensive move, it took the offense with a frequently updated family of products promoted prominently in-store. The company has moved so aggressively into the reader space that its e-book market share has grown to 26%, and Consumer Reports has rated the latest Nook as (by a hair-thin margin) the best reader in the industry.

Focusing on target customers: The Kindles try to be versatile, toting around PDF documents from a user’s PC and allowing for easy text annotation. B&N’s Nook Color has more modest aims as a device focused tightly on reading, but it is a standout in how it handles glossy magazines and children’s books. In its functionality, design, and marketing, the device aims squarely for women who love to read. The more basic black-and-white model has been praised for its size, weight, and ultra-intuitive operation. B&N CEO William Lynch says it’s made “for Grandma.” While Amazon is
rumored to be working on full-fledged tablet computers, B&N is carefully picking its shots. It has made a brave bet on customers who love reading yet have been under-addressed by its giant rival.

Experimenting relentlessly: B&N has long been in the vanguard of the bookselling industry. It was one of the first to discount best sellers, publish its own titles, offer authors self-publishing options, create superstores, and put coffee shops in its establishments. More recently, it has succeeded with selling toys and games. The company has also made its share of missteps, such as buying the mall-based bookstore chain B. Dalton, whose shops have now been closed. In an industry stretching back centuries, it readily tries out new formulas and adjusts its approaches based on careful listening to marketplace reactions.

Staying humble about what can be known: While B&N has chosen a sensible target market of frequent readers, it does not pretend to know exactly how their habits will evolve. Any big retailer makes long-term financial forecasts to assess the viability of store sites, yet B&N understands that its projections must be exceptionally uncertain these days. It has typically taken ten-year leases on stores, but with over 100 store leases now up for renewal annually, the company is negotiating short-term contracts that allow it to close stores quickly. Sometimes companies are lauded for making clear predictions about a hazy future, but the bravest and most honest forecast may be “We just don't know.” B&N is willing to incur higher lease costs in the near term to provide it with much-needed flexibility over the medium term.

An industry transitioning from physical products to virtual goods goes through about as jarring a change as can happen in business. Many companies don’t manage to make the leap. The jury is still out about whether B&N will succeed, but investors seem willing to believe; the company’s stock price has been retaining its value. If B&N can move so bravely, shouldn’t companies with the luxury of healthier core businesses chart their futures this capably too?

FEATURED COMMENT

“Looking at the NOOK growing multimedia books, I think they are on the right track once they get the cost under control. I always saw this as the true power of an e-book that will pull it away from the pack, especially for instructional and nonfiction titles.”

—Frank White
Know What Your Customers Want Before They Do

Webinar featuring Thomas H. Davenport and Michael Parduhn
Moderated by Angelia Herrin

OVERVIEW

Well-done next best offers (NBOs) are the future of retail. These offers are targeted to customers based on who they are, their purchase history, their preferences, and their behaviors. When done right, NBOs provide customers with relevant and compelling offers that can dramatically impact sales and profits. A framework for effective next best offers links NBOs to an organization’s strategy and can improve the likelihood of success. This framework includes knowing your customers, your products and offers, and the purchase context. It also includes using analytics technology to effectively execute NBOs and implementing a process of testing and learning.

CONTEXT

Professor Davenport described what next best offers are and why they matter to retailers. He offered a framework for thinking about and developing effective NBOs. After each step in this framework, Michael Parduhn elaborated on how CVS applies that step in its activities. Other examples also were shared of companies using different aspects of this framework for creating effective next best offers.
“Well-done NBOs are the future of retail.”
—Thomas H. Davenport

**KEY LEARNINGS**

**Effective NBOs produce great value for customers and marketers.**

Davenport explained what NBOs are and why they matter.

**What Next Best Offers Are**

A “next best offer” (NBO) is an offer for a product or service that is targeted at a customer based on an analysis of multiple factors about that customer, including their past purchase behavior, the specific purchasing context, product attributes, and more. The NBO is usually determined by technology (analytics and/or business rules), but may include a human filter. NBOs may be delivered through multiple channels, including email, mobile phone, or a sales or service person.

**Why Next Best Offers Are Important**

Customers today are inundated with numerous offers across multiple channels. Yet most offers are poorly targeted and delivered. As a result, most customers find it difficult to name a company that consistently wows them with relevant, compelling offers.

This is a missed opportunity because when offers are done well they can have a big impact. Effective NBOs can dramatically increase conversions, sales, and profits. Companies can see immediate and significant benefits.

With a proliferation in the number of communication channels and the growth of social, mobile, and location-based technologies (SoMoLo), the need to effectively manage offers is greater than ever. Analytics plays a key role in maximizing the effectiveness of NBOs, as NBOs are a tangible, practical application of customer and product analytics.

**There is a path to creating effective NBOs.**

To assist organizations in creating more effective offers, the presenters have developed the NBO process framework that is shown and described below.
THE STEPS IN THE NBO PROCESS FRAMEWORK ARE:

**Design Your Strategy**

This involves defining the direction, objectives, and scope of NBOs, and aligning offers to meet customers’ needs while fulfilling stakeholders’ expectations. Strategic decisions include determining which types of customers to go after, which products and services to make offers for, and which channels to use to deliver offers.

At CVS, the overall objective of NBOs is to maximize value for the company. The company’s NBO strategy has been to take a rigorous “test and learn” approach.

Examples: Redbox changed the strategic objective of its NBOs from offers that focused on getting people to try its service to offers that encouraged customers to rent more DVDs. Tesco’s strategy is to use NBOs to reward customer loyalty. Nordstrom’s customer-intimacy strategy relies on making offers through its salespeople.

**Know Your Customer**

Knowing customers includes knowledge of their demographics and psychographics, their purchase history, and how a customer has responded to previous offers. This includes information about who customers are, their product and communication preferences, their purchase context, and their behavior. Also important is understanding what customers are saying about a product, service, or company. This information can be gathered through a variety of sources, including a company’s own purchase history data, social media, and actively listening to customers.

CVS relies heavily on its own purchase history data to know customers and predict future customer behavior. It updates its data in real time and may use today’s purchase history to effect tomorrow’s offers.

Examples: Sears is building a full customer record that will include contact history and even friends. Target has implemented its REDcard program, which provides participants a discount, as a way to identify who its customers are and track their transactions. Ticketmaster is using social media to understand what events young people want to attend.

**Know Your Offers**

Retailers must know the specific attributes associated with each purchase and each offer so those attributes can be mapped to future offers. Because some products have so many attributes, this can be extremely difficult. When retailers don’t know the attributes associated with a purchase or offer, they may make offers that alienate customers. For example, one online retailer regularly sends offers to people based on purchases made years earlier and for purchases that were made as gifts. People who receive irrelevant offers are often annoyed by them, which can hurt a retailer’s relationship with its customers.

CVS focuses on identifying those attributes of its products and offers that are most relevant and critical to customers. Also, CVS recognizes that consumer behaviors and attitudes are constantly changing. Therefore, an offer that worked well at one point may not necessarily work well at another point in time, stressing the need for ongoing testing and learning.

Examples: Tesco has determined a segment of customers who like to purchase adventurous products. It looks at what products some adventurous customers buy (such as Thai green curry paste) and markets other “adventurous” products to these individuals.
Know What Your Customers Want Before They Do

“We build predictive models that let the data speak. We let data guide our offers.” —Michael Parduhn

Know the Purchase Context

This consists of knowing the contextual factors that affect a customer’s purchase decision, such as their physical proximity, their online behavior, and the behavior of their social network, that can influence a purchase decision. For example, do they come into a retail location or buy online? Are they alone or with friends?

CVS looks at the patterns surrounding a customer’s purchase history to determine what types of offers to make on which products. For example, a customer who consistently purchases a 30-day supply of Claritin doesn't require an offer, but a customer who purchases it inconsistently may be compelled by an offer, as might a customer purchasing the product just on a seasonal basis. The key is understanding customer behaviors.

Examples: Microsoft creates offers for customers based on how recently and how often a person used the company’s software. Bank of America looks at data indicating what channel a customer came in from.

Analytics and Execution

Executing an offer is an analytical process (involving technology such as SAS) that matches a customer’s behavior and product/channel preferences with a relevant offer. The most effective NBOs don’t flood one channel; they track results across multiple channels. They also time and sequence offers so that customers are most likely to respond to them.

CVS relies heavily on analytical tools and technologies to determine the most effective NBO. In using these tools, CVS lets its decisions be guided by the data.

Examples: Harrah's typically communicates with customers via email, but starts sending offers to a customer's mobile device 24 hours before a visit begins. Offers are delivered to a customer’s mobile device throughout their visit. T. Rowe Price has analytically targeted offers, but doesn't want such offers delivered on more than 50% of customer interactions with the company.

Feedback and Adaptation

Creating effective NBOs is an ongoing process of experimentation and learning. Every offer should be treated as a test and a learning opportunity, and companies probably shouldn't undertake NBOs unless they are committed to ongoing testing and learning.

CVS’s attitude is that “every offer is a test.” This overriding principle guides all aspects of the company’s NBO activities.

Examples: Sam's Club sees its NBO process as a learning engine, and Sears is focused on creating a closed-loop, test-and-control model.

Not all consumers are interested in targeted offers.

While conventional wisdom holds that all customers want tailored ads and discounts, this may not be correct. Research indicates that the majority of consumers do not want targeted ads and only younger consumers (those under 35) want tailored discounts. Consumers are concerned about the underlying technologies that track their behaviors to provide such offers. Retailers should be aware of the significant concerns among many consumers and should proceed with caution. For more information about this research see: http://www.ftc.gov/bcp/workshops/privacyroundtables/Turow.pdf
THE LAST WORD ON NBOs

Professor Davenport offered the following advice:

- Many elements may be relevant to offers, so decide which ones are important and start gathering them now.
- You can buy software for recommendations and offer assembly, but integration still is necessary.
- Your NBO strategy needs to change as your business changes.
- Poor NBOs will annoy customer and cost you business.
- Well-done NBOs are the future of retail!

OTHER IMPORTANT POINTS

Part of marketing. Organizationally, the analytical groups that work on NBOs often reside within the marketing function. However, there also are examples of groups in the IT and finance functions.

Common methods. Methods used in determining NBOs include predictive models that use regression, decision rules with “if/then” scenarios, and extensive use of test and learn.

Selective use. CVS’s experience has shown that if NBOs are run too often they lose their impact and risk alienating customers. People get disenchanted with overly frequent and irrelevant offers.

SPEAKER BIOGRAPHIES

Thomas H. Davenport, Professor, Babson College; Co-Author, Analytics at Work

Thomas H. Davenport holds the President’s Chair in Information Technology and Management at Babson College. He has published widely on the topics of analytics in business, process management, information and knowledge management, and enterprise systems. He pioneered the concept of “competing on analytics” with his best-selling 2006 Harvard Business Review article (and his 2007 book Competing on Analytics).

His most recent book is Analytics at Work: Smarter Decisions, Better Results, with Jeanne Harris and Bob Morison. He wrote or edited 12 other books, and has written over 100 articles for such publications as Harvard Business Review, Sloan Management Review, the Financial Times, and many other publications. Tom has also been a columnist for CIO, InformationWeek, and Darwin magazines. In 2003 he was named one of the world’s “Top 25 Consultants” by Consulting magazine. In 2005 Optimize magazine’s readers named him among the top three business and technology analysts in the world. In 2007 and 2008 he was named one of the most 100 influential people in the information technology industry by Ziff-Davis magazines.

Tom is also the cofounder and research director of the International Institute for Analytics, which brings together the world’s leading analytics practitioners and researchers to provide unique insights to both business and IT leaders on the most current research findings and industry best practices.
Michael Parduhn, Director, ExtraCare Analytics and Operations, CVS Caremark Corporation

Michael Parduhn is an information technology professional with a 15-year track record of delivering revenues and savings to businesses. He has been with CVS since 2009 and is currently the director for analytics and operations for the Caremark ExtraCare division. Previously, Michael served as VP of Information Management at UFood Restaurant Group, where he was responsible for all aspects of information management. He also spent three years at the Ford Motor Company managing the company’s strategic IT initiatives. Michael received his BS in Information Technology and Accounting from Illinois State University and his MBA from MIT Sloan School of Management.

Angelia Herrin, Editor for Research and Special Projects, Harvard Business Review

Angelia Herrin is editor for research and special projects at Harvard Business Review. At Harvard Business Review, Herrin oversaw the relaunch of the management newsletter line and established the conference and virtual seminar division. More recently, she created a new series to deliver customized programs and products to organizations and associations.

Prior to coming to Harvard Business Review, Herrin was the vice president for content at women-CONNECT, a website focused on women business owners and executives.

Herrin’s journalism experience spans 20 years, primarily with Knight-Ridder newspapers and USA Today. At Knight-Ridder, she covered Congress as well as the 1988 presidential election. At USA Today, she worked as Washington editor, heading the 1996 election coverage. She was awarded the John S. Knight Fellowship in Professional Journalism at Stanford University in 1989–1990.

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