Why ROI Is Often Wrong For Measuring Marketing Impact

By Daniel Kehrer, Director of Content for MarketShare

It’s hard to have a marketing related conversation these days without hearing ROI-this and ROI-that. It is, after all, one of today’s most beloved business buzz terms. And of course top management wants the “bottom line” on marketing’s contribution to business goals.

But is “return on investment” an adequate way to measure marketing effectiveness? Sadly, the answer is no.

It’s not that ROI is a bad thing. Linking marketing to financial performance is critical. It’s just that most people who use ROI in a marketing context probably aren’t applying it correctly, or really mean something else, says Dominique Hanssens, professor of marketing at UCLA Anderson School of Management. ROI’s roots are in evaluating one-time capital projects. “But
is marketing a one-time capital project?” asks Hanssens. Clearly not. We might (and indeed do) talk about marketing “investments” all the time. But marketing expenditures are technically an expense, as opposed to an investment, and that’s an issue. Marketing costs are a P&L item, not a balance sheet item.

As a result, notes Hanssens, who is also co-founder of MarketShare, marketers rarely mean ROI when they say ROI. “Plain” ROI is certainly an important metric for managers. But it falls well short of helping us understand marketing’s contribution to business goals, or how those contributions can be improved. ROI is too limited. To gauge and improve marketing effectiveness, for example, we must factor in the strategic intent of all marketing investments a company makes.

The Rub over ROI

We’d all love to quantify marketing performance with a single number. But ROI is a ratio, and ratios are not what matter here. Net cash flows are what really matter, says Hanssens. Other performance measures — say, net profit for example — are derived by subtracting various costs from revenue. ROI is different. You get it by dividing net revenue by cost. Question is, how do you compare that to the ROI on different marketing investments, such as a television ad campaign versus a search campaign? As it turns out, you can only make this comparison if the spending amounts are the same.

And it’s also critical to know that maximum ROI does not necessarily produce maximum profit. Oops! Blame the Law of Diminishing Returns. Many marketers might think that the highest ROI is always the correct business goal. Unfortunately, that’s not so. For example, should you stop spending when ROI drops, even if you continue to produce bigger profits? Most likely not. The point at which you’d stop or make a change depends on the return of the last incremental amount spent, not the overall ROI.

This is also what’s known as return on marginal investment — or ROMI. And this “marginal” return vs. an average is what makes all the difference. So if you
must use a return measure to gauge marketing effectiveness, use ROMI, notes Hanssens.

ROI, you see, changes at different spending levels. It is not a function of the medium, but rather of the investment. The only thing you really need to know is whether it is positive or negative. Or, put another way, are you underspending in a given category...overspending...or getting it “just right” (where ROMI is zero)? And the determining lever is how much you spend.

What’s more, a good ROI around a specific activity means nothing if broader marketing goals aren’t being met. Focusing solely on dollars-in (“I”) compared to dollars-out (“R”) ignores a complex web of interactions that happen in between. Only by analyzing as many of those intermediate processes as possible can we gain insights into what’s working and what’s not, and alter allocations to achieve better results.

The basic message is this: If you settle for a seductively simple measure such as ROI, you may severely distort the true value that marketing it delivering for your organization.

**What’s your take? Leave a comment below. View our videos and follow MarketShare on Twitter, LinkedIn and Facebook.**

Daniel Kehrer, a long-time business & financial journalist, columnist and editor, is the author of seven books and earned his MBA from the UCLA Anderson School of Management.

© 2013 MarketShare LLC. All rights reserved.