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Pricing Wealth Products in Competitive Markets

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What is the right pricing decision?

COST-PLUS BUILD	
Actuary's price	**$10**
Direct costs	($3)
Unit overheads	($4)

Unit 'profit'	$3
Volume	0?
Product profit	$0?

PROFIT BUT NO SALES?

OR...

MARKET BUILD	
Marketing's price	**$5**
Direct costs	($3)
Unit overheads	($4)

Unit 'profit'	($2)
Volume	1000?
Product profit	($2000)?

SALES BUT NO PROFIT?

OR...

MARKET BUILD	
Marketing's price	**$5**
Direct costs	($3)

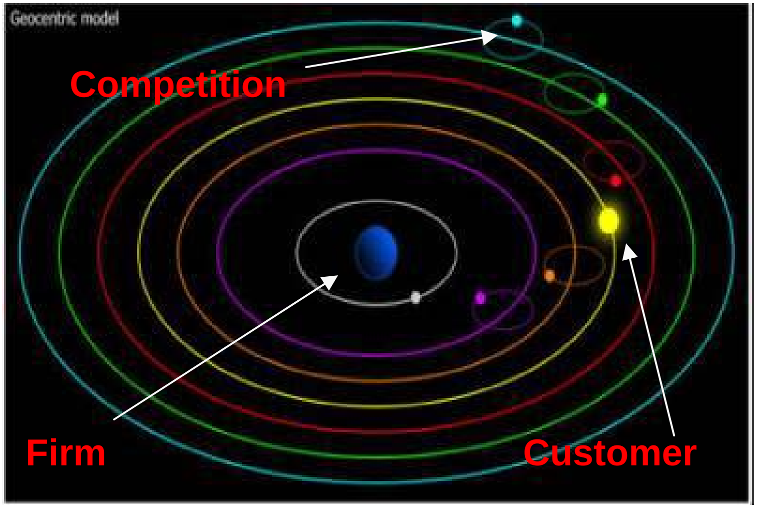
Unit contribution	$2
Volume	1000?
Product contribution to corporate overheads and profit	$2000?

TAKE WHAT YOU CAN!

Cost-plus pricing is a technique which has an aura of prudence

- It produces a ‘sound actuarial price’ which delivers a ‘fair’ product contribution
- It is a simple guide to profitability which apparently works
- A “blueprint for mediocre financial performance”?

- Centre of gravity for making pricing decisions = firm
- Customer has no special position of primacy
- Firm-centric = “Ptolemaic view”.



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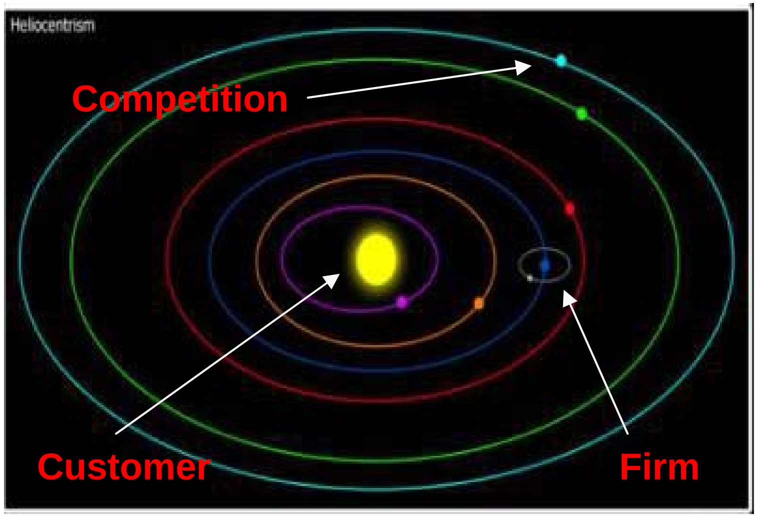
Cost-plus pricing is inwards-out focussed

- In practice the market is “acknowledged”
- Optimal pricing inhibited because it’s centred around the internal economics
- Manages business from within

Competitive pricing is not a technique but rather a coherent philosophy...

- What really matters when making optimal pricing and product design decisions?
- Foundation for marketing strategies that target optimality.
- Centre of gravity for making pricing decisions = customer
- Firms jostle for competitive position to get their attention
- Market-centric = “Copernican view”.



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Competitive pricing is outwards-in focussed

- Begins with the market
- Understands customer behavioural characteristics
- Understands competitor dynamics
- Maximises product throughput

Competitive pricing is better aligned to how markets and businesses operate

- Prices might be lower <u>or</u> higher than cost-plus.
- The combination of margin and volume should deliver higher contributions to overheads and profit.
- If not, it means:
  - we don’t understand the price-demand elasticity curve
  - we are sacrificing margin and/or sales unnecessarily
- Competitive pricing understands managing the business strategy and the infrastructure take place at a portfolio or firm level

With a shift in mindset comes a shift in focus, emphasis and effort

Product → Costs → Price → Value → Customers

Customers → Value → Price → Costs → Product

Accountability is made more transparent

- Product management and pricing actuaries should focus on optimising the throughput, ie “the shopfront”
  - volume x margin = throughput
- General management should focus on optimising the portfolio and the business, ie “the shop”
  - Ensure product range and mix is optimal
  - Ensure the overheads are covered and a suitable profit is earned.
  - Create and maximise competitive advantage - expenses, marketing, suppliers.
- (Ironically?) competitive pricing is more likely to foster the right management behaviours.

Pricing should be seen as a strategic exercise

- Framed around the market
- Extracts maximum throughput from each client
- Part of marketing mix
- Recognises that products make contributions to overheads and profit.
- Not driven by “product profitability”
- Not driven by notions of “covering overheads”

Endorsement of competitive pricing thinking is...

- NOT a necessary prerequisite for taking advantage of strategic pricing techniques
- BUT endorsement does provide the bedrock for vigorously embracing them and leveraging their full potential.

To be get the full benefit of competitive pricing thinking...

- Colleagues ➔ educate and advocate
- Management ➔ product decision making aligned
- Accountabilities ➔ transparent (pricing and expenses)
- Scorecards ➔ align personal results with degree of control
- MI framework ➔ align with pricing
- Statutory funds ➔ re-weight expenses to throughput?
- Footnote: IAAust education materials ➔ fill gap

Appendix

Marginal pricing is merely a cost-plus decision to ignore overheads.

- It is dressed up as competitive pricing but it is deeply flawed.
- Full-cost products probably do not pick up the overhead left on the ground.
- Full-cost products are exposed to cherrypicking by competitors who choose to aggressively price, with consequences for sales (and even more overhead left on the ground).
- Marginal-cost priced products are most likely giving away margin unnecessarily.
- Like price wars, it is a dangerous game unless:
  - part of an overarching business strategy <u>and</u> where all stakeholders interests are aligned, or
  - restricted to optional rider-type benefits

"Danger! Danger, Will Robinson!"

Overhead expenses

- An expense is considered overhead, if in the context of a particular decision with reference to a particular time frame it does not vary with the decision. All other expenses for the particular decision are considered incremental.
- Apply this test: If the product did not exist, which expenses would not be impacted? These are the overheads for this product.
- Typically such expenses would include finance, HR, IT, or legal but even they could be affected by a product initiative.
- Some expenses are directly related to product volume eg commissions as % of premium, or investment management fees as % of FUM are assumed to be taken directly to the product. They would never be overheads.
- There is grey area of expenses though which will require some form of expense attribution to product and overheads. Typical of these are service centres and systems.