The Winner's Curse

Do you really want to write that contract?

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The winner's curse is a phenomenon in which businesses tend to overpay when bidding for an uncertain return. It arises in insurance, banking, finance or any industry in which the product for sale involves some degree of competition and uncertainty.

So how does it work?

Have you ever won an auction and, immediately after winning the auction, felt that sinking feeling: why did I apparently value the item more than anyone else at the auction? Do you get that same feeling when your business sells an insurance policy, or a finance contract? Perhaps you should.

When an individual or business obtains quotes for their insurance, no doubt a variety of insurers will assess their risk slightly differently. So who is right? We won't know for some time. Which insurer gets to write the policy? Often it's the one who quoted it most cheaply.

So if you just won a contract (be it an insurance policy, finance contract, provision of services, etc.) then it's time to ask yourself:

- Why did the client choose us?
- Was it because we offered a superior product or service?
- Or did our competitors all underestimate the value of the contract?
- Or was **our** pricing model deficient?
- Will we come to regret our 'win'?

Such is the winner's curse.

How do I assess the effect for my business?

The winner's curse applies whenever a product of uncertain value (or cost) is being sold via auction. So two questions arise:

Q1) Is the value of our product uncertain?

If you're in the insurance game, absolutely. Uncertainty is the reason your business exists.

What about finance? How sure are you that you will recover your loan? Have you priced in this risk appropriately?

How about the energy industry? Do you know in advance what it will cost you to supply electricity and gas to a customer?

Does your business invest in long term customer retention? For how long will a customer remain loyal to your business? How much should you spend trying to acquire that customer, and should the amount you spend vary for different types of customers?

Q2) Are our products sold via auction?

If your customers have the ability to compare your prices with your competitors, then, in some sense, yes.

Selling your products through brokers can be like a silent auction, with you and your competitors acting as bidders and the broker as auctioneer. Of course, any good broker will compare more than just price, but we'll look at that later.

In the age of internet savvy customers it's getting easier than ever to compare prices between competitors. So called aggregator websites have emerged overseas where a customer enters the details of their insurance requirements, cell phone preferences, energy usage or travel aspirations. Within seconds they are provided with list of quotes, invariably with the cheapest quote at the top of the list. Take a look at moneysupermarket.com

The presence of similar websites in NZ is growing: pricespy.co.nz has been around for a while and provides a comparison for consumer goods, while whatsmynumber.org.nz provides a solution for the energy industry.

What can we do to address this effect?

Defensive solutions

Firstly we can stop selling products at a loss (unless we have good reason to – in which case we at least need to be clear on which products are our loss leaders, and why).

The first thing to do is to get your pricing right (or at least better than your competitors). This involves:

- Making the best use of your existing data.
- Capturing more and better data, for example, on potential customers who obtain quotes but don't proceed with the sale.
- Building a pricing model which utilises this data as best you can.
- Monitoring the prices (and actions) of your competitors.

But getting your pricing right involves more than just understanding your product. You need to understand the extent to which you and your competitors will misprice your product, simply because it is uncertain.

Defensive solutions might prevent a business from being driven into the ground. But defence alone won't drive a business forward.

Offensive solutions

So how do we counteract the tendency of people to simply choose the cheapest option? The idea is to convince the customer to purchase our (appropriately priced) product.

A few options are:

- Developing (and marketing) a product or service which is unique and superior to that of your competitors.
- Targeting customers who understand more than just price.
- Targeting a market which isn't already saturated with competition.

Of course, each of these options raises its own questions:

- How do we price a unique and superior product?
- Which customer segments do we target, and how much should we spend trying to acquire these customers?
- Why are there so few players in this market to date? Are the barriers to entry worth the eventual return to our business?

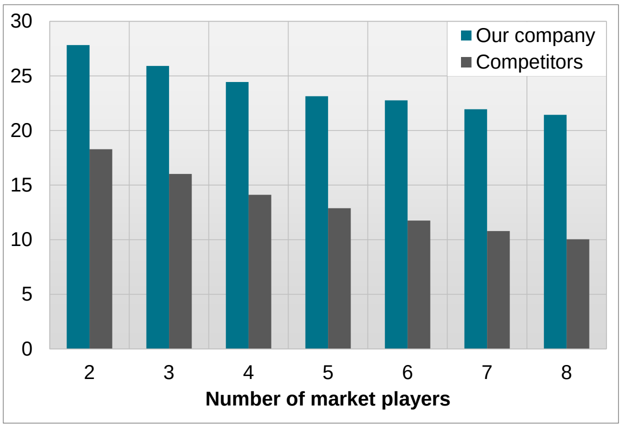
Let's draw a picture

Actuaries can't help but build models. So let's put together an oversimplified illustration of how a superior pricing model might help our company return a higher profit margin.

Let's assume:

- We (and our competitors) are selling a product that will ultimately cost us $100 (not that we can know this in advance).
- Our competitors can only guess the true cost of the product, so tend to estimate it as anywhere between $80 and $120.
- Our pricing model is a bit better than our competitors, so we estimate its cost as anywhere between $90 and $110.
- We each build in a 30% profit margin on top of what we think the product will cost us.
- Customers will always choose the lower priced product.

The chart below shows the average profit per product achieved by us and our competitors.



The existence of the winner's curse means that, unfortunately, we don't achieve the 30% profit margin we were targeting. We do, however, achieve a higher margin than our competitors.

Of course, the more players there are in the market, the more the winner's curse effect reduces our profit margin.

The key is to anticipate the impact of the winner's curse and to build in a sufficient margin so that our eventual profit is more in line with what we targeted.

Conclusion

Whatever business you're in, it's likely that, to some extent, the winner's curse phenomenon will impact your results. The more uncertainty involved in your products or services, and the greater tendency the market has to operate like an auction, the greater the effect.

Fortunately, there are a range of options to tackle the winner's curse. The business which understands and exploits these options sits at a distinct advantage to their less informed peers.

ABOUT MELVILLE JESSUP WEAVER

Melville Jessup Weaver is a New Zealand firm of consulting actuaries. The firm was established in 1992 and has offices in Auckland and Wellington. The firm is affiliated to Towers Watson, a global professional services firm that helps organisations around the world optimise performance through effective people, risk and financial management. Towers Watson has offices in 25 countries and the business covers human resources services, reinsurance and Tillinghast.

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