

Customer Lifetime Value as the Basis of Customer Segmentation: Issues and Challenges

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SUMMARY. In this article, we examine current trends in customer lifetime value and customer segmentation models and identify key issues for future research. CLV-based segmentation is a segmentation approach that groups customers into meaningful segments based upon customer lifetime value and (potentially) other factors. In the article, we discuss the extent to which CLV-based segmentation meets the criteria

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55

for effective segmentation. We also identify six areas for future research: (1) models and management of “micro-segments,” (2) using CLV-based segmentation to improve the efficiency of marketing programs, (3) the need for more dynamic CLV-based segmentation models, (4) applying CLV-based customer segmentation to new products and new customers, (5) challenges associated with implementing CLV-based segmentation, and (6) the need for new models that enable firms to segment customers by response to marketing activities and CLV at different points in the customer decision process. doi:10.1300/J366v05n02_04 [Article copies available for a fee from The Haworth Document Delivery Service: 1-800-HAWORTH. E-mail address: <docdelivery@haworthpress.com> Website: <<http://www.HaworthPress.com>> © 2006 by The Haworth Press, Inc. All rights reserved.]

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INTRODUCTION

Why do firms employ customer segmentation and customer lifetime value (CLV) models? In a perfect world, using these models would allow firms to tailor their products to specific customers, and then select appropriate marketing actions that maximize customer response. In addition, in such a perfect world, we would be able to improve the efficiency and effectiveness of these marketing approaches and, when possible, reduce marketing expenditures so as to maximize firms' overall profitability. However, as such perfection is difficult to achieve, these objectives, collectively, represent an overwhelming challenge. In this article, we examine the contribution that emerging models of CLV-based customer segmentation models and approaches can make to these daunting goals and set forth an agenda for future research in this area.

Why is segmentation important and how is it changing?

Segmentation is a fundamental strategy to managing marketing efforts directed at customers. It was introduced in the 1950s to reflect a change from mass marketing to the new (at that time) marketing concept: targeting products and/or marketing campaigns to specific groups of customers. CLV is changing segmentation because of the increased pressure to

view each and every customer as an asset (Rust, Lemon, and Zeithaml, 2004). Further, incorporating customer profitability into segmentation strategies enables an organization to improve the effectiveness and efficiency of their marketing programs (Niraj, Gupta, and Narasimhan, 2001).

According to a recent article by Forrester Research (Kolko and Gazala, 2005), firms are experiencing increased pressure to offer customer-centric strategies because many of their competitors are offering one-to-one or customized marketing strategies. Customers' expectations are changing, and as a result, companies need to better understand customer needs, preferences, and profitability in order to better acquire new customers, and better serve and retain their current customers. With advances in technology and segmentation methods, segmentation strategies are evolving to reflect this shift in power toward the customer.

Today, managers have access to an abundance of data about their customers, including their purchasing history, attitudinal data collected from customer satisfaction surveys, and demographic and socioeconomic data collected from rewards/loyalty programs. Segmentation offers managers one approach to utilize these data to customize the firm's marketing efforts, but successful segmentation efforts require sophisticated models to use relevant information, and to most effectively target specific customers with appropriate offers to maximize response. In addition, recent research and cost/benefit analysis suggests that, in some industries, a CLV-segmentation strategy, i.e., clustering customers into meaningful segments based upon customer profitability and other variables, may be a more appropriate use of a firm's resources than individual-level customer profitability models (Libai, Narayandas, and Humby, 2002). There are several factors that may contribute to the difficulties and high costs of developing and implementing CLV-based segmentation strategies: software requirements, employee incentives, human resources needed to understand individual needs and preferences, customized firm-level modeling requirements, and the difficulties associated with transforming these demands into targeted marketing campaigns and new products and services.

CLV and customer profitability are fast becoming accepted as new bases to customer segmentation. Firms are building on (or in some cases replacing) traditional bases of segmentation such as geographic, demographic, socioeconomic, attitudinal, and behavioral to incorporate customer past and projected purchase data into customer segmentation models, customer portfolio models and resource allocation decision-making (Johnson and Selnes 2004, 2005). These models provide sales

and account managers another lens through which to understand and prioritize their customers, and to evaluate the efficiency and effectiveness of their marketing and sales programs and resource allocations.

What is CLV-based customer segmentation?

In this article, we define CLV-based segmentation as a segmentation approach used by a firm that groups customers into meaningful segments based upon customer lifetime value and potentially other factors. Typically, this process involves some variant of the following steps:

1. Gather data to analyze the current and potential profitability of current customers.
2. Develop a firm-specific model for calculating customer lifetime value, defined as the sum of accumulated cash flows of a customer (in terms of profit) over the customer's lifetime with the company, discounted to the present.
3. Categorize customers based upon their customer lifetime value, and utilize these groups, potentially along with other factors, as the segmentation structure.
4. Develop distinct marketing approaches for each segment, allocating additional resources to those segments with high CLV, and fewer resources to those segments with low or negative CLV.

How does CLV change the objective of segmentation models?

Segmentation is not a natural phenomenon—it is a managerially imposed market structure employed to improve the effectiveness and efficiency of marketing strategies (e.g., product development, positioning, advertising, pricing) and tactical decisions (customer acquisition and retention, resource allocation decisions, how much, to whom, and when). There is no one perfect approach to segmenting a market; the best segmentation model is the one that (a) provides insight to managers regarding current and potential customers, and (b) enables managers to effectively reach the market and gain appropriate customer response. Traditionally, objectives of segmentation strategies focused on identifying groups of potential customers, e.g., profiling prospects for product development, identifying appropriate prospects for marketing campaigns, and classifying groups in accordance with their potential response to specific pricing strategies. However, incorporating customer profitability measures such as CLV into segmentation approaches changes these objectives. CLV enables a firm to focus on im-

proving the effectiveness of marketing expenditures. For example, using CLV as a basis, a segmentation objective may focus on evaluating customer migration expenditures. Libai et al. (2002) define migration expenditures as all marketing activities aimed at improving the profitability level of customers and at reducing the number of customers that become less profitable over time. Similarly, the firm's objective may be to identify segments of potential customers with high CLV. Kumar, Venkatesan and Reinartz (2006) suggest such an application of CLV-based segmentation and show how it can improve market resource allocation (see also Venkatesan and Kumar 2004; Rust, Zeithaml, and Lemon, 2000).

HOW DOES CLV COMPLICATE SEGMENTATION STRATEGIES?

It is useful to examine how customer lifetime value may influence the effectiveness of segmentation strategies. Wedel and Kamakura (1998) identified several criteria for effective segmentation: identifiability, substantiality, accessibility, stability, actionability and responsiveness. Below, we identify potential complicating issues brought on by customer lifetime value-based segmentation utilizing these six criteria.

- *Identifiability*: Can homogenous segments be identified? It may be difficult for firms to capture, track, and merge the necessary data to calculate CLV. In addition, there are many measures and approaches to calculating CLV, and the decision of which approach to use may hinder attempts to identify distinct segments.
- *Substantiality*: Are segments large enough to justify marketing resource allocations? Typically, CLV is calculated at the individual customer level, for existing customers of a firm. However, individual-level CLV may not be appropriate for all industries, particularly some consumer markets. Thus it is important to consider the costs and benefits associated with individual versus some broader cluster or segment analysis of CLV, and to determine the situations in which individual or segment-level is more appropriate. Finally, market size and market structure may also influence the substantiality of a CLV-based segmentation approach.
- *Accessibility*: Will promotions targeted at segments reach the intended audience? Typically, CLV-based segmentation approaches seek to identify the current or potentially most valuable customers,

and to target them with marketing actions. However, we are just beginning to scratch the surface in terms of understanding how CLV can enhance our ability to target customers. For example, Reinartz, Thomas, and Kumar (2005) show that CLV models can identify which customers to target with what type of marketing communication at what point in time, and can enable firms to allocate limited resources to the most valuable (or most promising) customers. This area of research is promising and suggests that incorporating CLV into traditional segmentation strategies can improve the effectiveness (and perhaps efficiency) of marketing campaigns.

- *Stability*: Does the segment membership or segment profile change over time? It is necessary for a segment to remain stable for a long enough duration to build a profile of the segment, identify a strategic approach, implement the approach and evaluate the success of a campaign. This issue has not yet received rigorous attention in the literature (Wedel and Kamakura, 1998; Steenkamp and Ter Hofstede, 2002). Static segmentation models make the implicit assumption of stability; however, from a managerial perspective, the stability of a segment's characteristics and membership structure over time is important because it would otherwise make the model ineffective at meeting its objectives. Also, if a segment's size or characteristics change over time, then a small segment size may be insufficient justification to warrant a target marketing strategy for specific segments. Finally, because of the inherent assumptions and data requirements necessary to calculate CLV, the stability of segments may change over time. This suggests a need for dynamic CLV-based segmentation models as, although these models (by design) are not necessarily stable, they are likely to be more accurate than static models in terms of predicting customer profitability.
- *Actionability*: Does the segmentation approach result in effective targeted marketing efforts? It is important to consider how CLV as a basis may improve the effectiveness of a targeted marketing campaign. Recent research suggests that CLV enables managers to improve the allocation of marketing resources to the most valuable customers (Reinartz, Thomas, and Kumar, 2005). However, it is not clear that CLV, per se, improves the actual *effectiveness* of a given marketing campaign. Rather, it is a matter of determining which strategy may be more effective in changing customers' buying patterns based on their profitability levels (e.g., can a given

campaign reduce service costs for less profitable customers, or increase cross-buying of more profitable products or services for current customers?).

- *Responsiveness*: Do the segments respond uniquely to marketing efforts targeted toward them? The issue here is one of understanding how managers should allocate resources (which strategy is more effective/efficient) to each segment based on the segment's CLV or customer profitability. If a segment is not responsive to marketing efforts but highly profitable, then it may be in the best interest of the firm to allocate resources to determine why the segment is not responding. On the other hand, if the segment is not responsive and not profitable, then the firm may decide not to do anything, or to "terminate" the relationship with these customers.

Overall, the above discussion suggests that incorporating CLV into customer segmentation models may be challenging, but may also be significantly financially rewarding. CLV-based segmentation, if done well, appears to meet the criteria of identifiability, accessibility and (potentially) substantiality, and actionability. However, the resulting segments may not be stable, and may not differ uniquely in terms of responsiveness.

ISSUES FOR FUTURE RESEARCH: IMPLICATIONS OF CLV AND SEGMENTATION STRATEGY

As firms continue to improve in their abilities to track and calculate customer lifetime value, there are several issues that need to be better understood. Below, we discuss six areas that are ripe for future research. First, CLV-based segmentation suggests that it may be efficient to develop and manage smaller "micro-segments." Second, incorporating CLV into segmentation approaches suggests that we should be able to improve efficiency of marketing programs. Third, we see a need for more dynamic CLV-based segmentation models, highlighting the importance of understanding how marketing resource allocations affect the profitability of customers over time. Fourth, most current CLV models focus on existing customers of the firm for existing products marketed by the firm. New research is needed to apply CLV-based customer segmentation to new products and new customers. Fifth, there are significant challenges associated with implementing CLV-based seg-

mentation. Finally, we believe there is a need for new models that enable firms to segment customers by customer response to marketing activities and CLV at different points in the customer decision process.

Smaller Micro-Segments

Customers may have similar profiles, but different profitability levels. For example, two customers may have similar satisfaction levels, similar age profiles, similar buying history with the firm, yet different profitability levels (perhaps due to channel choices or costs-to-serve). This pattern can occur, for example, when a firm has multiple customers who seek the same features in a product or service, but who differ in terms of service expectations. Therefore, some customers may cost more to serve over the lifetime of the relationship. By incorporating profitability into the segmentation model, the existing profile can be further divided into profitable and less profitable segments, and managers can decide how to allocate resources accordingly.

It is not clear, however, how thinly these segments should be “sliced” in terms of CLV. Libai et al. (2002) suggest that, in frequently packaged consumer goods markets, the benefit of individual level customer profitability models relative to the costs may not be substantial to warrant individual-level analysis but that broader CLV-based segments may do better. However, in business-to-business and direct marketing settings, individual analysis may be more appropriate. This suggests that future research should examine the extent to which micro-segments or “segments of one” can meet the criteria for successful segmentation set out by Wedel and Kamakura (1998), and the specific contexts in which individual models versus cluster or segment-based models are more appropriate.

Improve Efficiency of Marketing Programs

Much research in the area of customer lifetime value has focused on the extent to which customer lifetime value modeling can improve the efficiency of marketing programs (Venkatesan and Kumar, 2004; Reinartz, Thomas, and Kumar, 2005; Rust, Lemon, and Zeithaml, 2004; Zeithaml, Rust, and Lemon, 2001). Broadly, this approach is straightforward: allocate more resources to those current and future customers who are more valuable. Much of this research has implied an underlying segmentation structure based upon customer lifetime value. For exam-

ple, Zeithaml, Rust, and Lemon (2001) suggest dividing customers into tiers, using CLV as a metric, from “gold” to “lead” and designing service and marketing programs for each tier. However, additional research is needed to link the significant amount of research and knowledge built up in the area of segmentation (e.g., our understanding of the role of heterogeneity and the value of latent-class models) and CLV approaches.

Dynamic Segmentation Models

A critical area for future research is the development of dynamic CLV-based customer segmentation models. It is important to understand how marketing resource allocations affect the profitability of customers over time. Recent research has begun to examine this issue, seeking to understand what to market, to whom, at what point in time (e.g., Venkatesan and Kumar, 2004; Reinartz, Thomas, and Kumar, 2005; Thomas and Sullivan, 2005). However, given that customers develop and change their response behavior over time, segment membership may not be stable over time. Therefore, dynamic models are required that specifically model the migration of customers from less profitable to more profitable segments (or vice versa). Specific challenges that can be addressed as these dynamic models are developed are: (a) understanding and modeling the factors that may influence customer migration from one CLV-segment to another, (b) modeling the process by which customers change and update their response behavior, and (c) determining how to forecast customer changes in tastes, trends and behavior (Zeithaml et al. 2006).

Models for New Products and New Customers

As we consider the link between customer lifetime value and customer segmentation, it is also useful to consider how CLV approaches can improve segmentation decisions for introducing new products and attracting new customers. For example, Hogan, Lemon, and Libai (2002) show that customers who stop using a service (customers who “disadopt”) early in the diffusion process are more costly to the firm in terms of future profits than customers (with the same CLV) who disadopt later in the diffusion process. Additional research is needed to determine whether CLV models can also inform our understanding of overall market potential, which customers or segments to target with

new products or services, or even the entire new product development process.

As most CLV models to date have focused on current or existing customers (see Rust, Lemon, and Zeithaml, 2004, for a model that also incorporates customer switching from competitors), additional research is also needed to understand how CLV approaches can inform firms' decisions of what *potential* customers to target. Harrah's Entertainment is moving toward this approach with its opportunistic customer segmentation strategies (Lal and Carrolo, 2002). Utilizing only information gained on a customer's first visit to the casino, Harrah's has developed proprietary models to forecast the customer's future potential, thereby determining in advance what offers are most appropriate for that customer.

Facing Implementation Challenges

As firms seek to implement CLV-based segmentation approaches, there are four key areas that present challenges: data and analysis, strategy development, program implementation, and evaluation. As the field of customer management begins to mature, we need to enhance our understanding of what is necessary to successfully develop and implement these approaches.

First, collecting the right data and developing analytic tools is critical. This is, perhaps, the area in which the field of customer management is furthest along. It is understood, for example, that firms need sufficient data and analysis to determine: (a) who the current and potential customers (or customer segments) are, (b) the CLVs of each current and potential customer (or segments), and (c), the drivers of behavior for current and potential customers. In addition, these analyses need to be available throughout the organization, at appropriate levels (e.g., across customer groups, or across geographic regions). Additional research is needed to enhance our understanding of the following:

- What information needs to be collected and by whom?
- What role in the organization should analyze the data?
- What is the role of IT in data collection and analytics?
- What is flow of data in the organization and does it support customer growth?
- What are the appropriate analyses?

Second, developing strategies that utilize the key insights from the analyses is also challenging. The organization needs to be structured to enable a 360° view of customers for each customer group. Successful strategy depends upon (a) having a culture that supports investment in customer initiatives, (b) a CLV-based process for customer segmentation and selection, and (c) a focus on customers—not products, i.e., an understanding of key drivers of customer behavior and how they link to firm capabilities. Future research in this area could examine the ways in which an organization's structure, culture and goals may support or impede strategic customer opportunities.

Third, the actual implementation of specific marketing programs utilizing CLV-based customer segmentation poses its own additional challenges. Sufficient budget and staffing must be allocated for each initiative, and it must often be implemented across geographic regions (often with distinct language, cultural or other barriers). In addition, successful implementation requires an integrated marketing approach to customers (including integrated marketing communications, and pricing consistent with customer expectations), and must often be implemented through and in cooperation with the distribution channel. Future research should examine best practices in the implementation of these strategies, and identify key bottlenecks in the process.

Drilling Down: Drivers of CLV Throughout the Decision Process

Considering the recent advances in our understanding of CLV-based segmentation, we propose that a critical area for future research is the development of dynamic models that incorporate customer segmentation and CLV into the overall consumer decision process. We believe that the next step in the development of CLV-based segmentation approaches will be models that will enable firms to segment customers by customer response to marketing activities and customer CLV at *different points* in the customer decision process. What is now needed is a set of models that enable firms to segment customers throughout the decision process, understanding (a) how customers respond to distinct marketing activities at each point in the decision process, (b) how these customer responses then influence the customer's lifetime value, and (c) which customers (or customer segments, newly defined in this way) the firm should focus on to maximize long-term profitability.

Consider that customers go through a decision process in order to purchase or to repurchase a product or service. Firms traditionally have seg-

mented customers prior to purchase, to determine which customers (or segments) to target with their offerings. However, the advent of customer metrics such as CLV has enabled firms also to segment their customers after initial purchase, based upon potential customer value. Thus, currently we have developed models that enable firms to understand the key drivers of CLV and customer equity. In addition, we have developed sophisticated segmentation models that enable firms to understand how different customers respond differently to marketing actions (consider latent class models such as Kamakura, Kim, and Lee, 1996). Third, we have developed models that examine the relationships among various aspects of the customer consideration and purchase process (e.g., Mittal and Kamakura, 2001; Rust and Verhoef, 2005). However, what is now needed is to bring these elements together in a CLV-based segmentation approach that also takes into account the fact that customers may respond differently at various points in the purchase process.

Such an approach would recognize that firms engage in marketing actions, throughout the consumer decision process, to move consumers to the next stage of the process. CLV and customer segmentation models could be used to determine who, based upon the nature of responses in moving consumers from one stage in the process (say awareness) to a more advanced stage (say consideration), is most likely to become a high CLV customer or customer segment. These “high-potential” consumers become the top-tier candidates for marketing actions designed to move customers from consideration to purchase and beyond. The key distinction here is that consumers may follow *different paths* through the decision process that lead to high CLV. Some highly valuable customers, for example, may move directly from awareness to purchase, and may require little marketing intervention or actions. Other valuable customers may require much more hand-holding throughout the purchase process, but may be much more profitable in the long run.

It is important to identify the most important drivers for each customer segment at *each decision stage*—to maximize customer lifetime value. Such a model would incorporate customer response-based measurement models at each step of the consumer/customer decision process. In addition, it would link marketing actions to CLV throughout the customer decision process, from initial awareness to purchase, repurchase and cross-buying (Bolton, Lemon, and Verhoef, 2004). Finally, it would be able to segment customers by customer response to marketing actions and CLV throughout the customer decision-making process.

Why would this be valuable? This type of model, or set of models, would have many distinct advantages over our current models. First, customer knowledge is captured at all steps of the decision process, and is linked to customer lifetime value. Second, marketing actions become targeted, customized, measurable, and accountable, at every step in the decision process. Third, marketing expenditures can become even more efficient as customers who are unlikely to migrate to purchase (or repurchase) are no longer targeted, or are targeted with less expensive marketing activities. Fourth, such models may enable marketing and sales teams to work more closely together to focus on long-term growth. Finally, the result should be higher CLV per customer and lower marketing costs overall.

Clearly, we are calling for a complex, dynamic decision calculus that combines current approaches to CLV-based customer segmentation with current models of consumer behavior and decision-making. We recognize that this will be a challenge to develop and will require researchers from diverse fields to work together. However, we hope that future research will move in this direction, eventually leading to models that can enable firms to realize the full benefits of CLV-based customer segmentation.

CONCLUSIONS

This article was motivated by our discussions with companies about the challenges of implementing customer lifetime value and customer equity models. Over the past few years, it has become clear to us that there is a reawakening of interest in customer segmentation. Consider, for example, Kumar, Venkatesan and Reinartz's (2006) article, "Knowing What to Sell, When, and to Whom." This article highlights the critical advances that have been made in the last several years linking customer lifetime value, customer segmentation and marketing actions. In addition, there have been some significant advances in our ability to model customer segmentation and heterogeneity over the past decade. Thus, in this article, we have tried to outline a new agenda for customer segmentation—linking it more directly to customer behaviors and customer lifetime value. We believe that there is a significant opportunity for future research on this topic, and we look forward to seeing continued (and accelerated) advances to the field of CLV-based customer segmentation in the next few years.

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