THE ROLE OF DIFFERENTIATION IN MARKETS DRIVEN BY ADVERTISING

by

D. SOBERMAN*

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* Assistant Professor of Marketing, INSEAD, Boulevard de Constance, 77305 Fontainebleau Cedex, France.

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David A. Soberman*
INSEAD

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* David Soberman is an Assistant Professor at INSEAD, Boulevard de Constance, Fontainbleau Cedex, France. Tel: 33-1-6072-4412. E-mail david.soberman@insead.edu
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Summary
Creating differentiation is an accepted mantra of strategic management and marketing. In fact, differentiation is defined as one of three or four generic strategies that an organization must pursue in order to sustain long-term competitive advantage and profits (Porter 1991, 1996). Assuming that differentiation makes a product better for some consumers and worse or less suitable for others, our analysis suggests a strong caveat to the wisdom of blindly pursuing differentiation.

Demand in many markets is strongly related to product awareness. The primary tool that is used to create awareness is advertising in mass media such as television, radio and print. This is true of most packaged goods markets and for much of the consumer-oriented service sector (e.g. fast-food restaurants).

An obvious but ignored effect of advertising is that it endogenously creates groups of consumers based on the combination of brands that they are aware of. Of course within any of these groups, there are a range of preferences for the different attribute levels that might be found in the market. A consumer who is aware of several brands in a market will compare the options that she is aware of and choose the product that suits her best. In contrast, a consumer who has seen but one brand’s advertising becomes a captive consumer of that brand. As noted above, within this group, there are significant differences in the amount that consumers are willing to pay. When firms take action to increase the differentiation between their products, these differences will be higher. The greater are these differences, the lower the price a firm must charge in order to maximise profit from the consumers who have only seen one firm’s advertising. As a result, as long as advertising levels are not too high, firms may actually suffer when they increase the level of differentiation between products.

Having highly differentiated products reduces the ability of competitive firms to capitalize on the segments over which they have monopoly-like power. When awareness is the primary generator of demand and the average awareness of all brands is not too high, the path to higher profits might be to market a product that is as widely acceptable as possible.
The Role of Differentiation in Markets Driven by Advertising

Creating differentiation is an accepted mantra of strategic management and marketing. As noted by Michael Porter, a critical ingredient of leadership is not only deciding which customers to serve but also deciding which customers not to serve\(^1\). In fact, the strategic management community defines differentiation as one of three or four generic strategies that an organization must pursue in order to sustain long-term competitive advantage and profits\(^2\). It is argued that firms should pursue a strategy of being the low-cost producer in an industry, being the technology leader, or that of creating a highly differentiated good or service for which a significant fraction of the market is willing to pay more. A firm that is unable to implement one of these strategies will ultimately find itself in dire straights due to its inability to manage competition. In fact, economists would predict that undifferentiated firms will ultimately find themselves reduced to conditions of marginal cost competition\(^3\).

The purpose of this article is to question this idea and suggest that in many markets, differentiation may be less advantageous than argued by academics, marketers and business strategy gurus\(^4\).

It is difficult to deny that the value of creating differentiation has become more than simple Business School hype. Firms in markets ranging from soft drinks to fast food restaurants make significant effort to create distinct positions for themselves. This is not simply a case of a firm arguing that its product is better than the competition. There are firms that do make this argument. For example, with slogans like “Heinz, there are no other kinds”, Heinz clearly positions its ketchup as superior to competitive products in all
respects. However, to employ such a positioning, the product must have either clearly superior performance or a commanding market position (if not both). As a result, this type of positioning is not feasible for the vast majority of firms and products.

It is much more common for firms to choose differentiated positionings. These are typified by products like 7-Up or by companies like Red Lobster restaurants (in the service sector). 7-Up has traditionally positioned itself as the Uncola. This positioning is distinctive yet it clearly implies that 7-Up is unsuitable for cola drinkers (cola drinkers make up more than 70% of the soft drink market in North America). Similarly, Red Lobster positions itself as the family seafood restaurant. This suggests that Red Lobster is the ideal restaurant for families who want to eat seafood. However, it also suggests that Red Lobster is not the restaurant for people who do not like (or are allergic) to seafood. In both of these cases, the positioning of the product is saying to a significant percent of the relevant market “this IS NOT the product for you” (cola drinkers in the case of 7-Up and more than 70% of the fast food patrons that prefer hamburger restaurants). The purpose of this discussion is to underline the reality or cost of differentiation. Firms are effectively telling a significant percent of potential customers “we do not want you as customers”.

But why do firms spend money to tell some consumers “we do not want you as customers”? The reason lies in the constraints that firms face due to their being part of a competitive environment. Many economic models demonstrate the effects of having undifferentiated products. Using spatial models economists have shown that competitors who are located near to each other (i.e. they are undifferentiated in a spatial sense) will find themselves reduced to cut-throat competition. We also have the reality of markets
where consumers can easily compare the products of competing firms and the products themselves are extremely similar. Most notorious is the US airline industry where the major competitors (United, American, Delta, Northwest, TWA and Continental) offer products that are difficult to distinguish from each other. The ease by which consumers can compare the prices of alternative airlines (either through the travel agents or on internet reservation services such as Travelocity or Expedia) has led to an industry where the average return is less than what could be earned by investing in treasury notes. Interestingly, a firm like Southwest has managed to differentiate itself from other carriers and is able to report impressive performance year after year.

The rationale for the value of differentiation is that it allows a firm to obtain a significant advantage with a distinct group or customers. This advantage allows the differentiated firm to charge higher prices to this distinct group of customers without having to worry that those customers will defect to a competitor (even if that competitor offers an attractive lower price). The idea is that it is better to have a smaller group of consumers to which a firm can charge high prices than to have a large group of consumers that swings back and forth between firms based on whichever firm offers the lowest price. Effectively, differentiation allows a firm to create a local monopoly over a set of customers who have a distinct preference for its product.

It is important to note that all the ideas described above are based on markets where it is easy for the customers in question to compare the key products or offerings in the market. Said differently, the customers are assumed to be fully aware of all the options and prices available in a market. Interestingly, we know that much of modern economic theory has focused on situations where consumers or firms (or both) lack
complete information about the products that they are buying. From markets ranging from used cars to insurance, a clear explanation of market behaviour requires the observer to recognize the lack of information that customers or insurance companies have (about the quality of the car or the health or character of a potential policy holder respectively)\(^6\). However, the problems created by a lack of information generally extend beyond those of hidden quality and/or hidden action. The average consumer makes decisions in more than 100 categories in a given month and is exposed (on average) to more than 1600 commercial messages in a day\(^7\). It is hardly surprising that consumers frequently lack fundamental information in a given category about the leading products, their physical characteristics and their prices. To the consternation of marketers in the developed world, consumers are highly skilled at ignoring advertising, forgetting advertising and also gathering information when they need it for a purchase decision. Accordingly, in many categories, a key determinant of what consumers do is based on the information they have at hand when they need to make a decision. This can mean that many leading products may not receive consideration in a consumer’s purchase decision if the consumer has not been exposed recently to advertising or information about the brand in question.

Interestingly, the theories and reasoning that support the value of creating differentiated products and services do not recognize this fundamental characteristic of markets. They are all based on the idea that consumers have automatic access to the relevant information for the best alternatives in any category. The objective of our discussion is precisely to argue that the value of creating differentiated products is
ambiguous when the awareness of products or offerings is an important determinant of consumer behaviour.

**Typical Buying Situations driven by Awareness**

Advertisers will tell you that advertising does much more than create awareness for products. They will tell you that advertising provides important information that helps consumers to see if the product or offering matches their needs. But they will also tell you that advertising helps a marketer to create a personality for the product or offering and this personality ultimately provides a form of reassurance to consumers. They will explain how advertising can create an image for the brand. An attractive image can increase the amount consumers are willing to pay for a brand that is physically identical to a brand with an unattractive image. Over the years, this effect of advertising has attracted the wrath of famous economists such as John Kenneth Galbraith\(^8\).

Amongst economists, activists, marketers and politicians, there is tremendous diversity of opinion about the value or damage created by advertising. Nevertheless, one aspect of advertising over which there is little controversy is the role that advertising plays a) in terms of generating awareness for products and b) making consumers aware of their key attributes. For example, Duracell advertising makes consumers aware of Duracell (as a brand of batteries) and it conveys a message to consumers about the key strength of Duracell batteries (their durability and expected life compared to other batteries). In fact, in many categories, this type of information is sufficient to create significant demand for the product. Think of the market share Duracell would enjoy if it
were perceived to be the only battery that lasted a long time! This would in fact be the case were there no competitive alkaline batteries.

We contend that in many categories, this type of information is the primary driver of demand. Moreover, we further argue that competition and market outcomes can be understood by assuming that the only thing that advertising does is to provide this type of information. However, there are many categories where this assumption may be erroneous. When consumers are highly involved in the purchase decision, factors such as reassurance and image may take on dominant roles. But many decisions are low involvement and here, the primary driver of demand is awareness of the product or offering (and its primary attributes).

For example, many of the purchases that we make every day are impulse purchases. The decision to buy a chocolate bar or a candy from a stand in the morning is a typical impulse purchase. Even on regular shopping trips, certain items are impulse purchases. For instance, batteries such as Duracell are typically impulse purchases and this explains why they are invariably merchandised near the checkout at most supermarkets. Research shows that the primary driver of purchase in these situations is awareness9.

Second, certain items that are consumed or purchased on a regular basis are chosen as a result of memory-based decision-making10. These refer to situations where a decision to consume or purchase is based on a consumer making a choice from options that she has in her memory. A typical example would be a mother making a decision about where she would like to take her family to dinner. The children express a desire for seafood and the mother generates a set of alternatives based on the seafood restaurants
that she remembers. Perhaps she remembers that both Red Lobster and Long John Silver are acceptable family seafood restaurants. She then makes a decision based on specific attributes that she knows about. She is unlikely to visit both restaurants to obtain information to make a decision; in all likelihood, she will have made her decision before she loads her family into the car. Note the importance of awareness in this example. If the mother knows only of Red Lobster as the family restaurant for seafood, then it is straightforward to predict which restaurant she will go to.

Finally, many purchases we make as part of regular shopping trips may be planned but they are also low involvement. For example, a consumer who knows that he needs to buy cereal for his family will pass down the cereal aisle at the supermarket. Here, awareness is likely to play a critical role in determining which box he will choose. Perhaps he is aware that his kids only like certain brands. Perhaps he is buying cereal for the first time. Perhaps he has been told that his children have been eating too much sweet cereal and he is looking for something healthier. In any of these situations, awareness will be strongly correlated to the decision the consumer ultimately makes. This is just one example of the scores of decisions that an average consumer makes on a given shopping trip. It is apparent that many shopping trip decisions can be appropriately described as low involvement.

The objective in outlining a series of situations where awareness plays such a key role in the consumer’s purchase decision is, first, to provide justification for the simplifying assumption we propose i.e. the only thing advertising does is to generate awareness for products (and make consumers aware of the key attributes). Second, it is to demonstrate breadth of marketing situations in which the assumption is justified. This is
not a narrow obscure phenomenon. In fact, the majority of small-ticket purchases made by consumers can be appropriately represented using this assumption. In addition, many forms of advertising including outdoor advertising, stadium signage, and neon signs have limited ability to build a brand personality or image and are primarily utilized to create awareness for products.

**Why Differentiation might Reduce Profits**

Based on the assumption that advertising’s primary role is to create awareness of products and their primary characteristics, we now move to the firm’s problem of using advertising to create awareness. One of a marketer’s biggest challenges is to select a media strategy that maximises the likelihood that “category users” are exposed to commercials. For a firm that advertises, the unfortunate reality is that a significant fraction of its media expenditures are wasted on viewers or individuals who are not really interested in the category. Think of how much more efficient local advertising such as brochures, catalogues and flyers would be if firms could restrict delivery of these materials to people who read them. The reality of mass advertising is inescapable and has been with us since the 19th century when John Wanamaker (a department store owner) remarked, “Half the money I spend on advertising is wasted and the trouble is I don’t know which half”.

For all intents and purposes, mass media advertising can be described as a series of messages directed towards a target audience defined by a series of demographic guidelines. In fact, the media guidelines for firms in the same category are similar and the challenge for advertising agencies (with an allocated budget) is to achieve a desired
number of exposures (frequency) with as large a fraction of the target audience as possible (reach). However, in spite of the similarity in the guidelines given to the agencies by competing firms, the groups of consumers that see the advertising are different. This is because there are only a limited number of advertising slots available in any media (television broadcasts, radio broadcasts, outdoor sign locations, or the back pages of popular publications) and each slot is sold exclusively to only one firm or another. Even if two competing firms have identical guidelines, they will have to share the relevant slots not only with each other, but also with other firms who have similar demographic guidelines (in other categories). Thus, the very nature of advertising means that two competitive firms, while targeting the same demographic segment, will run their advertising at different times and in different places. As a result, a significant proportion of the people that are exposed to the advertising of the two firms will be different.

For example, on any given Sunday, there will be a percentage of young males that watch football in the afternoon and baseball at night on television. But there will also be some males who were busy in the afternoon and only saw the baseball and others who were busy at night and only saw the football. If Miller sponsored the football and Budweiser sponsored the baseball game, it is apparent that the media activity of the breweries naturally creates three groups of informed males: those who saw both Miller and Budweiser advertising and those who only saw one brewery’s advertising and not the other’s. The lower the advertising levels of the respective firms, the less likely a consumer will have seen advertising from both firms (he may well have seen advertising from one firm alone). On the other hand, when both firms advertise heavily, the likelihood is high that a given consumer has seen advertising from both firms.
The above example considers a market with two firms but the same logic applies to an industry with three or more key competitors. The higher the base level of advertising from all firms, the higher the likelihood that any given consumer will be aware of all brands. In contrast, the lower the base level of advertising, the greater the likelihood that a consumer has only seen advertising from one firm.

This simple characteristic of advertising is what creates an unusual relationship between the level of differentiation between brands and the profits they are able to generate. To explain this relationship, let us consider a hypothetical example from the soft drink market and we will assume there are only two competitors in the market worth discussing: Coke and Pepsi. As noted above, three distinct groups of consumers are created by the advertising and following the assumption we made earlier, a consumer will only consider a product if he is aware of the advertising. Thus, from the perspective of Coke, there are two groups of consumers to consider: those who have seen only Coke advertising and those who have seen advertising from both firms. Of course, Pepsi faces a situation that mirrors the situation faced by Coke. The pricing that firms choose contingent on the awareness that has been created by advertising depends on balancing the profitability generated by each of the two groups of consumers. Note that each firm has monopoly-like power over the consumers who have seen only its advertising. (Following our assumption, a consumer will not even consider the alternative product if he is unaware of it.) In contrast, the firms will compete for those consumers who have seen advertising from both firms, since these consumers will make a comparison of the two products of which they are aware.
Here is where differentiation comes in. Within the group of consumers who have seen advertising for both brands, there will be a range of tastes. Some of the consumers will have a natural preference for the Coke products (perhaps they are from Atlanta) and others will have a natural preference for the Pepsi products. In fact, a whole range of tastes might exist including some consumers who are almost completely indifferent given equivalent prices. The key point here is that wider the range of preferences for the two products, the less fierce the competition will be for the consumers who are aware of both brands. In fact, the breadth of preferences that exists between the two brands is the direct analogue of the degree of differentiation between the brands. Note that when the breadth of preferences is narrow (and most consumers are indifferent between the two brands given equivalent prices), the competition for the group of consumers aware of both brands is entirely based on price. In fact, were the market comprised entirely of fully informed consumers who had a narrow breadth of preferences, the competitors would become engaged in cutthroat competition and find the profitability of their business significantly reduced. In this context, we recover the so-called Principle of Differentiation where the more the firms are differentiated, the better is their profitability.

Of course, this is only part of the story because the market is not comprised entirely of consumers who are aware of all products in the market. Even when both brands in our example have awareness of 66%, the fraction of informed consumers aware of both brands is only half of all informed consumers\(^{11}\). The firms are choosing prices to take advantage of the consumers who have only seen their respective advertising as well as those consumers who have seen advertising from both brands. As noted earlier, each firm has monopoly-like power over the consumers who have only seen its advertising.
How does differentiation affect the market dynamics for this group of consumers? When the breadth of preferences is narrow, the firm can charge a high price and almost all consumers in the group will buy. However, when the breadth of preferences is wide, the firm will have to subsidise the consumers who have a natural tendency to prefer the firm’s brand i.e. charge them less than they are willing to pay. The reason for this is that a lower price is necessary in order to get business from the consumers who have a natural preference for a product with different attribute levels. For example, suppose that Coke had a mild less-sweet taste than Pepsi and that some cola drinkers prefer a strong sweet taste. If those cola drinkers were only informed about Coke (and hence only considered Coke), but also knew its taste was quite mild, the product would have to be more attractively priced for them (to get them to buy) than it would be for the consumers who naturally like a milder taste. When the breadth of preferences (or differentiation) is high, there will be large differences in the amount that each consumer within the captive consumer group is willing to pay for either brand in our example. To fully capitalize on consumers that are captive, a firm will need to charge a lower price, the greater is the level of differentiation between brands.

Thus, we have a situation where differentiation is positively related to profitability in the group of consumers that are informed of both Coke and Pepsi and negatively related to profitability in the group of consumer that are only informed of one brand. Ultimately, it is these two countervailing effects, that make the relationship between differentiation and profitability more ambiguous than is typically believed. As noted earlier, the positive effects of differentiation highlighted in the literature are based on consumers being fully informed about the options that are available. In a sense, these
effects are based on *all* consumers belonging to the group of consumers who have seen advertising from both (or all) firms in the market i.e. that all firms in the market have 100% awareness!

We now consider the actual relationship between differentiation and profits. A naïve inference might be that the valence of the relationship (positive or negative) depends on the relative size of the two groups of consumers considered in a two brand example i.e. when the group of consumers that has only seen advertising from one brand is bigger than the group of consumers that has seen advertising from both brands then differentiation should be negatively related to profits and the inverse should be true when the group of consumer that has seen advertising from both brands is bigger. This is part of the story but it is incomplete. The relationship is also strongly related to the natural level of differentiation that exists within the category.

Firms in markets from detergents to automobiles have differentiated products and marketing managers make strong efforts to distinguish their products from competitors and establish unique clienteles. However, the ability to differentiate is not absolute and depends to a large extent on the nature of the category. For example, it is easier to differentiate a complex product like an automobile than a simple product like laundry detergent. So in a sense, our discussion relates to marginal effect of increasing differentiation given the differentiation that is more or less natural to the category.

Let us consider two canonical cases. First let us consider a category like laundry detergent where the products are difficult to differentiate. We could say that breadth of preferences in laundry detergent is lower than the breadth of preference in cars. In the detergent category, there are two sources of profit: profit from consumers who are captive
consumers and profit from consumers who have seen advertising from both firms. In this situation, the profits from the consumers who are captive are much greater because the low level of differentiation in the fully informed group means that competition is more cutthroat and this dissipates much of the profit from this segment. Of course, we assume that all the consumers shop at the same stores (moreover the firms cannot identify who has seen what advertising) and in general, the same price is offered to everybody. Firms of course, would be delighted if they could charge different prices to the two groups of consumers created by advertising.

So how do firms capture the added profit from captive consumers but still compete for fully informed consumers? They do it by switching back and forth between high prices and low prices. That is one reason why there is lot of discounting, daily specials, and special offers on products like laundry detergent. This type of pricing allows firms to balance the needs of the two groups. However, because almost all the profits in this type of market are due to the prices that captive consumers pay, except when awareness levels approach 100% for both brands, differentiation is negatively related to profit.

We now consider a category where the breadth of preferences (or natural level of differentiation) between products is higher. Here the optimal prices for the two groups of consumers in a two firm example (from which a firm generates demand) are much closer and firms choose stable prices that are a compromise between the optimal pricing for the two groups of consumers. The difference here is that the profit earned from the fully informed group of consumers is much more important. As a result, the relationship of differentiation to profitability in these conditions is more closely related to the relative
size of the groups. In fact, depending on the precise natural level of differentiation in the market, when awareness levels are higher than 65-70%, differentiation is positively related to profitability. Of course, this also implies that for awareness levels less than 65-70%, the relationship is negative. In our two firm example, these results always hold as long as the two firms are competing with each other (i.e. when the breadth of preference in a two firm market exceeds a certain limit, the firms effectively become little monopolies over the section of the market where they are preferred).

To conclude, the basic insight provided by this discussion is that when one considers the heterogeneity that mass advertising creates naturally in markets, the relationship of differentiation to profits is quite ambiguous. In fact, for a significant fraction of the cases that might occur in a two firm market, we find that differentiation is negatively related to profitability. This should certainly raise some red flags about the unquestioning belief that many practitioners and academics have in the value of differentiation.

**Conclusion**

Our analysis suggests a strong caveat to the wisdom of blindly pursuing differentiation as a managerial strategy. (As noted earlier, we assume that differentiation makes a product or service better for some consumers and worse or less suitable for others.) In fact, our discussion suggests that in markets where advertising is important for activating consumers, not only is differentiation ineffective for increasing profit, it may actually lead to reduced profits. Frequently managers know a) that a significant fraction of consumers will not see their advertising (or that of their competitors) and b) that
awareness levels in the category are significantly less than 100% (many reasons prevent firms from achieving total awareness notably the cost of advertising and limited media options)\textsuperscript{14}. These points imply that when consumer awareness of products is a key determinant of demand, it is highly probable that competing firms do not benefit by increasing the degree of differentiation between them. This finding stands in contrast to conventional wisdom and the well-known Principle of Differentiation.

It is precisely mass advertising's ability to create heterogeneity that leads to an inverse relationship between differentiation and profitability. Our discussion shows how advertising naturally creates distinct groups of consumers. When a consumer has only seen one brand’s advertising, that brand has monopoly-like power over her. This stands in contrast to the group of consumers who have seen advertising from both brands. Mass-media advertising creates different groups of consumers whenever consumer awareness is an important predictor of demand.

There are of course, markets where consumer awareness is not a key driver of demand. For example, at bazaars and trade shows, demand is driven primarily by pricing. In such situations, the typical “positive” relationship between differentiation and profits is recovered. In our discussion, we also find situations where differentiation is positively related to downstream profits e.g, in a two-brand market, when awareness levels are above 65-70% and the natural level of differentiation in the category is significant. Here, a majority of consumers are informed about both brands and the relative profitability of this fully informed group of consumers dominates those consumers who have only seen one brand’s advertising. In a market with 2 or more brands, when firms inform (almost)
everybody about their brands, advertising creates demand but it does not generate customer heterogeneity.

Nevertheless, there are few categories where 2 or 3 major brands enjoy close to 100% awareness. Most brand managers operate in categories where awareness levels (even for major brands) are less than 50%. As a result, the insight in our discussion is useful to understand the relationship between decisions that brand managers need to make.

First, managers need to consider whether policies designed to increase differentiation in their category are advisable. In markets driven by consumer awareness (and hence advertising), the analysis shows that there are many situations where differentiation is negatively related to profit. In these conditions, the path to increased profits might be to market a product that is as widely acceptable as possible. Perhaps, it is no accident that the leading products in many categories are extremely similar. Consider for example, the similarity of the leading beer brands in the U.S.

Second, managers need to understand the strategic costs of creating significant increases in brand awareness. Not only is there the added cost of advertising but there may also be costs in terms of reducing the number of captive consumers that each brand has. The model shows that these consumers are the most important source of profit in markets with low natural levels of differentiation. High levels of advertising on the part of all competing firms can drive these segments to insignificance.

Third, managers need to understand that the natural mechanics of mass-media advertising do marketers a great service by selling advertising spots exclusively. It is the independence of the groups of consumers that see each brand’s advertising that creates a
second level of customer heterogeneity beyond fundamental preferences (such as a preferences for a sweeter product). The discussion above demonstrates how important this heterogeneity is for explaining how firms can make positive profits in markets where the products or services are relatively undifferentiated. The discussion further suggests that competing firms gain a lot by sponsoring events exclusively. If competing firms shared the sponsorship of major events, there would be much less heterogeneity created by advertising activity. Conventional wisdom would suggest that the primary motivation to obtain exclusive sponsorship of an event is to lock the competitor out. Our analysis suggests another reason for exclusivity. When exclusivity by category is the standard approach for selling sponsorships to media events, it means that the groups of consumers that are being informed of competing brands are independent and have less overlap. Given the prevalence of exclusive sponsorships for sporting events (and even for many television shows), this is perhaps an area where the practitioners are leading and not following current managerial thinking.
Notes

3 This idea is based on markets where firms primarily compete on a basis of price (i.e. Bertrand competition). In markets where firms have limited capacity or compete based on quality, the results would be somewhat different.
9 Kotler, op. cit.
11 This is based on distribution of informed consumers for each brand being independent. Note that 70% is a very high awareness level; many brand managers would be delighted with such high awareness levels.
12 Kotler, op. cit.
13 Technically, firms will employ mixed pricing strategies when the natural level of differentiation in the category is low.
14 As mentioned earlier, a significant barrier to achieving awareness levels of close to 100% is the amount of media that is wasted to reach the last few consumers in a target group.