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ABSTRACT AND KEYWORDS	
Abstract	Marketing data appear in a variety of forms. An often-seen form is time-series data, like sales per month, prices over the last few years, market shares per week. Time-series data can be summarized in time-series models. In this chapter we review a few of these, focusing in particular on domains that have received considerable attention in the marketing literature. These are (1) the use of persistence modelling and (2) the use of state space models.
Free Keywords	Time Series, Marketing, Persistence, State Space
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Time-Series Models in Marketing

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1. INTRODUCTION

Marketing data appear in a variety of forms. Examples are choice data (think of brand choice), ordered choice data (think of answers to a survey on a scale of 1 to 5), duration data (e.g. the time between two purchases), and count data (e.g. the number of stores opened in a given country). An often-seen form is time-series data, where these concern, for example, sales per week, market shares per month, the price evolution over the last few years, or historically-observed advertising-spending patterns. The main feature of time-series data is that the observations are ordered over time, and hence that it is likely that earlier observations have predictive content for future observations. Indeed, if relative prices are, say, 1.50 today, they most likely will be around 1.50 tomorrow too, or in any case, not something like 150.

Time series can concern a single variable, like sales or advertising, but can also cover a vector of variables, like sales, prices and advertising, jointly. In some instances, marketing modelers may want to build a univariate model for a time series, and analyze the series strictly as a function of its own past. This is, for example, the case when one has to forecast (or extrapolate) exogenous variables, or when the number of variables to be analyzed (e.g. the number of items in a broad assortment) is so large that building multivariate models for each of them is too unwieldy (Hanssens, Parsons and Schultz 2001). However, univariate time-series models do not handle cause-and-effect situations, that are central to marketing planning. To specify the lag structure in response models, one extends the techniques of univariate extrapolation to the case of multiple time series.

Time-series data can be summarized in time-series models. However, not all models built on time-series data are referred to as time-series models. Unlike most econometric approaches to dynamic model specification, time-series modelers take a more data-driven approach. Specifically, one looks at historically-observed patterns in the data to help in model specification, rather than imposing a priori a certain structure derived from marketing or economic theory on the data. As put by Nobel Laureate Sir Clive Granger (1981, p. 121):

> "*It is well known that time-series analysts have a rather different approach to the analysis of economic data than does the remainder of the econometric profession. One aspect of this difference is that we admit more readily to looking at the data*

before finally specifying the model; in fact, we greatly encourage looking at the data. Although econometricians trained in a more traditional manner are still very much inhibited in the use of summary statistics derived from the data to help model selection, or identification, it could be to their advantage to change some of these attitudes."

This feature of looking at the data to help in model specification can be illustrated as follows. Given a hypothesized model for a time series, one can derive, assuming its validity, what the properties of empirical data would be in case that model would truly describe the data. For example, a simple model that says that y_t only depends on y_{t-1} using the scheme $y_t = \rho\, y_{t-1} + e_t$ would imply that y_t data show a correlation with y_{t-1} of size ρ, with y_{t-2} of size ρ^2, and so on. If such a correlation structure were to be found in empirical data, one would have a first guess at what the best descriptive model could look like. Similarly, a competing model with structure $y_t = e_t - \theta\, y_{t-1}$ would show a non-zero correlation between y_t and y_{t-1}, and a zero correlation between y_t and, respectively, y_{t-2}, y_{t-3}, … By comparing the empirically-observed correlation patterns (referred to as the empirical autocorrelation function) with the one associated theoretically with a given model structure, a model is selected that is likely to have generated the data. Other summary statistics that are useful in this respect are the partial autocorrelation function and (in case of multiple variables) the cross-correlation function (see e.g. Hanssens et al. 2001 for a review). While time-series modelers highly stimulate this "looking at the data", critics refer to this practice as data-mining, arguing that time-series models "lack foundations in marketing theory" (Leeflang et al. 2000, p. 458).

This criticism is one of the reasons why, historically, time-series models were not used that often in the marketing literature. Other reasons, described in detail in Dekimpe and Hanssens (2000), were (i) marketing scientists' traditional lack of training in time-series methods, (ii) the lack of access to user-friendly software, (iii) the absence of good-quality time-series data, and (iv) the absence of a substantive marketing area where time-series modeling was adopted as primary research tool. However, over the last few years, these inhibiting factors have begun to disappear. Several marketing-modeling textbooks now contain chapters outlining the use of time-series models (see e.g Hanssens et al.

2001; Leeflang et al. 2000), while others include an overview chapter on time-series applications in marketing (see e.g. the current volume, or Moorman and Lehmann 2004). In terms of software, several user-friendly PC-based packages have become available (see e.g. Eviews), while new data sources (e.g. long series of scanner data) have considerably alleviated the data concern. In terms of the substantive marketing area, several time-series techniques have been specifically designed to disentangle short- from long-run relationships. This fits well with one of marketing's main fields of interest: to quantify the long-run impact of marketing's tactical and strategic decisions. In terms of the critique on the a-theoretic character of time-series modeling, we observe two recent developments. First, some time-series techniques have a more confirmatory potential (e.g. cointegration testing for theoretically-expected equilibria, or structural VARX models to combine sample-based information with marketing theory). Second, following a 1995 special issue of Marketing Science, there is growing recognition of the value of Empirical Generalizations obtained through the repeated application of data-driven techniques on multiple data sets. We refer to Dekimpe and Hanssens (2000) for an in-depth discussion on these issues. Because of these developments, time-series models have become increasingly accepted in the marketing literature.

Time-series modelers make use of a wide array of techniques, which are discussed in great detail in textbooks as Hamilton (1994) or Franses (1998), among others. In this chapter, we will not attempt to review all of these techniques. Instead, we will focus on two domains which have recently received considerable attention in the marketing literature: (i) the use of persistence modeling to make long-run inferences (Section 2), and (ii) the use of state-space models, focusing on their integration with normative decision making (Section 3). Finally, we will discuss a number of opportunities and challenges for time-series modelers in marketing (Section 4).

2. PERSISTENCE MODELING

Long-run market response is a central concern of any marketing strategy that tries to create a sustainable competitive advantage. However, this is easier said than done, as only short-run results of marketing actions are readily available. Persistence modeling addresses the problem of long-run market-response identification by combining into one metric the net long-run impact of a chain reaction of consumer response, firm feedback, and competitor response that emerges following an initial marketing action. This marketing action could be an unexpected increase in advertising support (e.g. Dekimpe and Hanssens 1995a), a price promotion (e.g. Pauwels, Hanssens, and Siddarth 2002), or a competitive activity (e.g. Steenkamp et al. 2005), and the performance metric could be primary (Nijs et al. 2001) or secondary (Dekimpe and Hanssens 1995a) demand, profitability (Dekimpe and Hanssens 1999), or stock prices (Pauwels, Silva-Risso, Srinivasan and Hanssens 2004), among others.

Persistence modeling is a multi-step process, as depicted in Figure 1 (taken from Dekimpe and Hanssens 2004). In a first step, one applies unit-root tests to the different performance and marketing-support variables of interest to determine whether they are stable (mean or trend-stationary) or evolving. In the latter case, the series have a stochastic trend, and one has to test whether a long-run equilibrium exists between them. This is done through cointegration testing. Depending on the outcome of these preliminary (unit-root and cointegration) tests, one specifies a Vector AutoRegressive Model, probably augmented with some eXogenous variables (i.e. a VARX model), in the levels, in the differences, or in error-correction format. A technical discussion on these different steps is given in a recent review paper (Dekimpe and Hanssens 2004), and will not be repeated here. From these VARX models, one can derive impulse-response functions (IRFs), which trace the incremental effect of a one-unit (or one-standard-deviation) shock in one of the variables on the future values of the other endogenous variables.

---Figure 1 about here ---

Without going into mathematical details, we can graphically illustrate the key concepts of the approach in Figure 2 (taken from Nijs et al. 2001):

---Figure 2 about here ---

In this Figure, we depict the *incremental* primary demand that can be attributed to an initial price promotion. In the stable detergent market of Panel A, one observes an immediate sales increase, followed by a post-promotional dip. After some fluctuations, which can be attributed to factors such as purchase reinforcement, feedback rules, and competitive reactions, we observe that the incremental sales converge to zero. This does not imply that no more detergents are sold in this market, but rather that in the long run no additional sales can be attributed to the initial promotion. In contrast, in the evolving dairy-creamer market depicted in the bottom panel of Figure 2, we see that this incremental effect stabilizes at a non-zero, or persistent, level. In that case, a long-run effect has been identified, as the initial promotion keeps on generating extra sales. This could be due to new customers who have been attracted to the category by the initial promotion and now make repeat purchases. Alternatively, existing customers may have increased their product-usage rates. From these impulse-response functions, one can derive various summary statistics, such as:

(i) the immediate performance impact of the price promotion;

(ii) the long-run or permanent (persistent) impact, i.e., the value to which the impulse-response function converges; and

(iii) the combined cumulative effect over the dust-settling period. This period is defined as the time it takes before the convergence level is obtained. For the Figure in panel A, for example, the total effect over the dust-settling period (also referred to as the short-run effect) amounts to the area under the curve (specifically, the sum of the IRF estimates that have not yet converged to zero).

Persistence modeling offers two distinct advantages. First, it offers a clear and quantifiable distinction between short- and long-run promotional effectiveness, based on the difference between temporary and permanent movements in the data. Second, it uses a system's approach to market response, in that it combines the forces of customer response, competitive reaction, and firm decision rules. Indeed, the chain reaction of all these forces is reflected in the impulse-response functions, which are themselves derived from the multi-equation vector-autoregressive model.

Persistence modeling has been used extensively in the recent marketing literature, and has resulted in several strategic insights. We summarize these insights in Table 1, which updates Dekimpe and Hanssens (2004).

Many of these insights have been derived in a two-step modeling approach. In a first step, the procedure described in Figure 1 is applied to multiple brands and/or product categories (see e.g. Nijs et al. 2001; Srinivasan et al. 2004; Steenkamp et al. 2005). In a second step, one explains the observed variability across brands or product categories in the aforementioned summary statistics (i.e. the immediate effect, the long-run effect and the dust-settling effect) through a variety of marketing-theory-based covariates.[1] These could include, for example, the advertising intensity or concentration rate in the category, or the strength and nature (private label or national brand) of the brand. However, this approach was recently criticized in Fok et al. (2006) for not appropriately accounting for the uncertainty in the first-stage parameter estimates when estimating the second-stage model. They therefore proposed a single-step Hierarchical Bayes Error Correction Model. As an added benefit, their approach offers direct estimates of a marketing instrument's short- and long-run effects. This is more parsimonious than through the aforementioned summary statistics, which are a function of many VARX parameters. A similar Error Correction Model was used in van Heerde, Helsen, and Dekimpe (2006), who investigated how short- and long-run price and advertising elasticities changed following a product-harm crisis.

As indicated before, persistence and error-correction models have resulted in several empirical generalizations on the presence/absence of long-run marketing effects. However, these insights have remained largely descriptive. While some studies (see e.g. Pauwels 2004; van Heerde et al. 2006) have used these models for policy simulations,[2] their use for normative decision-making has remained the exception rather than the rule, and remains an important challenge for time-series modelers. The linkage with normative decision making has been made explicitly in recent applications of state-space modeling, which we review in Section 3. We offer somewhat more technical detail on these methods, as their usefulness for marketing has, to the best of our knowledge, not yet been covered in a review chapter.

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[1] This again helps to alleviate the criticism of being a-theoretical.

[2] We refer to Franses (2005) or van Heerde, Dekimpe, and Putsis (2005) for an in-depth discussion on the use of time-series modeling for policy simulation.

3. STATE-SPACE MODELS, THE KALMAN FILTER, AND NORMATIVE DECISION MAKING

3.1. State Space Models

Linear state-space models are expressed by two sets of equations:

$$Y_t = Z_t \alpha_t + c_t + \varepsilon_t, \quad \text{and} \tag{1}$$

$$\alpha_t = T_t \alpha_{t-1} + d_t + \nu_t, \tag{2}$$

where $\varepsilon_t \sim N(0, H_t)$, $\nu_t \sim N(0, Q_t)$, Y is a random vector (m x 1) and α is random vector (n x 1), where m could be greater than, less than or equal to n. The vector $Y_t = (y_{1t,} y_{2t}, \ldots y_{mt})'$ contains multiple time-series such as sales of brand A, sales of brand B, and so on observed over several time periods t = 1, …, T. Similarly, $\alpha_t = (\alpha_{1t,} \alpha_{2t}, \ldots \alpha_{nt})'$ includes multiple variables such as market shares for various brands (Naik, Raman and Winer 2005) or time-varying coefficients (Naik, Mantrala and Sawyer 1998) due to copy or repetition wear out. The dimensions of other matrices and vectors in the dynamic system conform to those of (Y, α). Specifically, the link matrix Z is an m x n matrix; T is an n x n transition matrix; the drift vectors (c, d) are m x 1 and n x 1, respectively; the covariance matrices H and Q have dimensions m x m and n x n, respectively.

Equation (2) is called the transition (or plant) equation, which captures the dynamics of the physical system explicitly. It is linked to the observed (i.e., measured) variables via equation (1), which is therefore called the measurement or observation equation. The vector Y is the observation vector; α is the state vector. The drift vectors (c, d) represent the effects of exogenous variables (e.g., $c_t = X_t'\beta$, $d_t = W_t'\gamma$, where X and W contain multiple variables, and (β, γ) are conformable parameter vectors). The subscript t denotes that the given quantity can change over time, indicating that it is potentially time-varying and therefore implicitly dynamic (besides the state vector that is explicitly dynamic). Table 2 summarizes the names and dimensions of vector-matrices in the state-space form.

--- Table 2 about here ---

The state-space form, given by (1) and (2), is extremely general. For example, standard time-series models like VAR, VMA, ARIMAX are special cases (see, e.g., Durbin and Koopman 2001, Harvey 1994). In addition, structural models that capture dynamic marketing phenomena such as Brandaid, the Nerlove-Arrow model, the Vidale-Wolfe model, Tracker, Litmus, the Bass diffusion model and the IMC model have a state space representation (see Tables 3 and 4 for details).

--- Tables 3 and 4 about here ---

Last but not least, there are many practical advantages for casting ARIMAX or any other structural dynamic models in the above state-space form:

i. the *exact* likelihood function can be computed to obtain parameter estimates, infer statistical significance, and select among model specifications;
ii. a *common* algorithm, based on Kalman filter recursions, can be used to analyze and estimate diverse model specifications;
iii. *multivariate* outcomes are handled as easily as univariate time-series;
iv. inter-equation *coupling* and correlations across equations can be estimated
v. *missing values* do not require special algorithms to impute or delete data;
vi. *unequally spaced* time-series observations pose no additional challenges;
vii. *unobserved* variables such as goodwill or brand equity, can be incorporated;
viii. *time varying coefficients* and *non-stationarity* can be specified;
ix. *heterogeneity* via random coefficients can be introduced seamlessly;
x. *normative decision-making* can be integrated with econometric analyses.

Below, we briefly describe the maximum-likelihood estimation of state-space models.

3.2. Parameter Estimation, Inference, Selection

Suppose we observe the sequence of multivariate time series Y = {Y_t} and X = {X_t} for t = 1, …, T. Then, given the model equations (1) and (2), the probability of observing the entire trajectory (Y_1, Y_2,…, Y_T) is given by the likelihood function,

$$\begin{aligned} L(\Theta; X; Y) &= p(Y_1, Y_2, \cdots, Y_T) \\ &= p(Y_1)p(Y_2 \mid Y_1)p(Y_3 \mid (Y_1, Y_2)) \cdots p(Y_T \mid (Y_1, \cdots, Y_{T-1})) \\ &= p(Y_1 \mid \Im_0)p(Y_2 \mid \Im_1)p(Y_3 \mid \Im_2) \cdots p(Y_T \mid \Im_{T-1}) \qquad (3) \\ &= \prod_{t=1}^{T} p(Y_t \mid \Im_{t-1}). \end{aligned}$$

In equation (3), $p(Y_1, Y_2, \ldots, Y_T)$ denotes the joint density function, and $p(Y_t | (Y_1, \ldots, Y_{t-1})) = p(Y_t | \Im_{t-1})$ represents the conditional density. Appendix A provides the moments of the random variable $Y_t | \Im_{t-1}$ via Kalman filter recursions. In addition, the information set $\Im_{t-1} = \{Y_1, Y_2, \ldots, Y_{t-1}\}$ contains the history generated by market activity up to time t-1.

Next, we obtain the parameter estimates by maximizing the log-likelihood function with respect to Θ:

$$\hat{\Theta} = \underset{\Theta}{\mathrm{ArgMax}}\, \mathrm{Ln}(\mathrm{L}(\Theta)), \tag{4}$$

which is asymptotically unbiased and possesses minimum variance.

To conduct statistical inference, we obtain the standard errors by taking the square-root of the diagonal elements of the covariance matrix:

$$\mathrm{Var}(\hat{\Theta}) = \left[-\frac{\partial^2 \mathrm{Ln}(\mathrm{L}(\Theta))}{\partial\Theta\partial\Theta'} \right]^{-1}_{\Theta=\hat{\Theta}}, \tag{5}$$

where the right-hand side of (5) is the negative inverse of the Hessian matrix evaluated at the maximum-likelihood estimates (resulting from (4)).

Finally, for model selection, we compute the expected Kullback-Leibler (K-L) information metric and select the model that attains the smallest value on this K-L metric (see Burnham and Anderson 2002 for details). An approximation of the K-L metric is given by Akaike's information criterion, $\mathrm{AIC} = -2\mathrm{L}^* + 2\mathrm{p}$, where $\mathrm{L}^* = \max \mathrm{Ln}(\mathrm{L}(\Theta))$ and p is the number of variables in X_t. As model complexity increases, both L^* and p increase; thus, AIC balances the tradeoff between goodness-of-fit and parsimony. However, the AIC ignores both the sample size and the number of variables in Y_t. Hurvich and Tsai (1993) provide the bias-corrected information criterion for finite samples:

$$\mathrm{AIC_C} = -2\mathrm{L}^* + \frac{\mathrm{T}(\mathrm{Tm} + \mathrm{pm}^2)}{\mathrm{T} - \mathrm{pm} - \mathrm{m} - 1}, \tag{6}$$

where T is the sample size, p and m are the number of variables in X and Y variables, respectively. To select a specific model, we compute (6) for different model specifications and retain the one that yields the smallest value.

3.3. Marketing Applications

In marketing, Xie et al. (1997) and Naik et al. (1998) pioneered the Kalman filter estimation of dynamic models. Specifically, Xie et al (1997) studied the nonlinear but univariate dynamics of the Bass model, while Naik et al. (1998) estimated the multivariate but linear dynamics of the modified Nerlove-Arrow model. To determine the half-life of an advertising campaign, Naik (1999) formulates an advertising model with time-varying, non-stationary effects of advertising effectiveness and then applies the Kalman filter to estimate copy and repetition wear out. By incorporating non-normality via a Poisson distribution, Neelamegham and Chintagunta (1999) forecast box-office sales for movies. To control for the biasing effects of measurement errors in dynamic models, Naik and Tsai (2000) propose a modified Kalman filter and show its satisfactory performance on both statistical measures (e.g., means square error) and managerial metrics (e.g., budget, profit). In the context of multimedia communications, Naik and Raman (2003) design a Kalman filter to establish the existence of synergy between multiple media advertising. Biyalogorsky and Naik (2003) develop an unbalanced filter with m = 3 dependent variables and n = 2 unobserved state variables to investigate the effects of customers' online behavior on retailers' offline sales and find negligible cannibalization effects (contrary to managers' fears). They also show how to impute missing values by fitting a cubic spline smoothing via a state-space representation. To investigate the effects of product innovation, Van Heerde, Mela and Manchanda (2004) deploy state space models to incorporate non-stationarity, changes in parameters over time, missing data, and cross-sectional heterogeneity.

To understand how to integrate normative decision-making with empirical state-space models, see Naik and Raman (2003) for multimedia allocation in the presence of synergy and Naik et al. (2005) for marketing-mix allocation in the presence of competition. In the context of multiple themes of advertising, Bass et al. (2006) generalize an ad wearout model for a single ad copy (Naik et al. 1998). They apply Bayesian estimation to a rich dataset from a company in the telecommunication sector, and illustrate the normative budget allocation across a portfolio of advertising themes.

3.4. Normative Decision-Making

One of the advantages of state space modeling, as noted earlier, is that we can integrate econometric analyses with normative decision-making problems faced by managers. Below we set up such a marketing problem and illustrate how to solve it.

Managerial Decision Problem

Consider a company spending resources on two marketing activities, say television and print advertising. A brand manager faces the decision problem of determining the total budget and its allocation to these activities over time. Suppose she decides to spend dollars over time as follows: $\{u_1, u_2, \ldots, u_t, \ldots\}$ and $\{v_1, v_2, \ldots, v_t, \ldots\}$. Given this specific media plan $\{(u_t, v_t): t \in (1, 2, \ldots)\}$, she generates the sales sequence $\{S_1, S_2, \ldots, S_t, \ldots\}$ and earns an associated stream of profits $\{\pi_1, \pi_2, \ldots, \pi_t, \ldots\}$. Discounting the future profits at the rate ρ, she computes the net present value J $= \sum_{t=1}^{\infty} e^{-\rho t} \pi_t(S_t, u_t, v_t)$. In other words, a media plan $(u, v) = \{(u_t, v_t): t = 1, 2, \ldots\}$ induces a sequence of sales that yields a stream of profits whose net present value is J(u, v).

Formally, the budgeting problem is to find the *optimal* plan (u^*, v^*) — one that attains the maximum value J^*. To this end, the brand manager needs to determine $u^*(t)$ and $v^*(t)$ by maximizing

$$J(u,v) = \int_0^{\infty} e^{-\rho t} \Pi(S(t), u(t), v(t))dt, \tag{7}$$

where ρ denotes the discount rate, $\Pi(S, u, v) = mS - c(u, v)$ is the profit function with margin m and cost function c(·), and J(u, v) is the performance index for any *arbitrary* multimedia policies (u(t), v(t)). We further assume a quadratic cost function $c(u, v) = u^2 + v^2$ to capture diminishing return to advertising. Below we illustrate how to derive the optimal plan using the IMC model proposed by Naik and Raman (2003).

Solution via Optimal Control Theory

In their IMC model, the sales dynamics is $S_t = \beta_1 u_t + \beta_2 v_t + \kappa u_t v_t + \lambda S_{t-1}$, where S_t is brand sales at time t, (β_1, β_2) are the effectiveness of marketing activities 1 and 2, (u_1, u_2) are dollars spent on those two activities, κ captures the synergy between them, and λ is the carryover effect. For other marketing problems, the essential dynamics would arise from the transition equation (2). If we have multiple transition equations in (2), the following approach generalizes (as we explain below). We re-express this dynamics in continuous-time as follows:

$$\frac{dS}{dt} = \beta_1 u(t) + \beta_2 v(t) + \kappa u(t)v(t) - (1-\lambda)S(t), \tag{8}$$

where dS/dt means instantaneous sales growth.

Then, to maximize our objective function in (7) subject to the dynamics specified in (8), we define the Hamiltonian function:

$$H(u, v, \mu) = \Pi(S, u, v) + \mu(\beta_1 u + \beta_2 v + \kappa uv - (1-\lambda)S), \tag{9}$$

where $\Pi(S, u, v) = mS - u^2 - v^2$ and μ is the co-state variable. We note two points; first, it is convenient to maximize H(.) in (9) rather than J(.) in (7), although the resulting solutions satisfy both these functions. Second, if we have an n x 1 vector transition equation in the state space model (2), we would extend H(.) in (9) by adding additional co-state variables because each state equation has an associated co-state variable μ_j, j = 1,…, n.

At optimality, the necessary conditions are as follows:

$$\frac{\partial H}{\partial u} = 0, \quad \frac{\partial H}{\partial v} = 0, \quad \frac{d\mu}{dt} = \rho\mu - \frac{\partial H}{\partial S}. \tag{10}$$

Furthermore, these conditions are also sufficient because H(·) is concave in u and v. Applying the optimality conditions, we differentiate (9) with respect to u and v to get

$$\frac{\partial H}{\partial u} = 0 \quad \Rightarrow -2u + \beta_1\mu + \kappa\mu v = 0$$
$$\frac{\partial H}{\partial v} = 0 \quad \Rightarrow -2v + \beta_2\mu + \kappa\mu u = 0$$

Solving these algebraic equations simultaneously, we express the solutions in terms of the co-state variable:

$$u^* = \frac{\mu(2\beta_1 + \mu\beta_2\kappa)}{4 - \mu^2\kappa^2} \text{ and } v^* = \frac{\mu(2\beta_2 + \mu\beta_1\kappa)}{4 - \mu^2\kappa^2}. \tag{11}$$

The remaining step is to eliminate the co-state variable $\mu(t)$ by expressing it in terms of model parameters. To this end, we use the third optimality condition in (10):

$$\frac{d\mu}{dt} = \rho\mu - \frac{\partial H}{\partial S} \quad \Rightarrow \frac{d\mu}{dt} = -m + \mu(1-\lambda) + \rho\mu.$$

To solve this differential equation, we note that transversality conditions for an autonomous system with infinite horizon are obtained from the steady-state for state and co-state variables (Kamien and Schwartz 1991, p. 160), which are given by $\partial S/\partial t = 0$ and $\partial\mu/\partial t = 0$, respectively. Consequently, $\mu(t) = \dfrac{m}{(1-\lambda+\rho)}$, which we substitute in (11) to obtain the optimal spending plans:

$$u^* = \frac{m(\beta_2\kappa m + 2\beta_1(1+\rho-\lambda))}{4(1+\rho-\lambda)^2 - \kappa^2 m^2} \text{ and } v^* = \frac{m(\beta_1\kappa m + 2\beta_2(1+\rho-\lambda))}{4(1+\rho-\lambda)^2 - \kappa^2 m^2}. \tag{12}$$

From (12), we finally obtain the total budget $B = u^* + v^*$ as

$$B = \frac{(\beta_1 + \beta_2)m}{2(1+\rho-\lambda) - \kappa m}, \tag{13}$$

and the optimal media mix $\Lambda = u^*/v^*$ as

$$\Lambda = \frac{2\beta_1(1+\rho-\lambda) + m\beta_2\kappa}{2\beta_2(1+\rho-\lambda) + m\beta_1\kappa}. \tag{14}$$

Normative Insights

Although we can generate several propositions by analyzing comparative statics via (13) and (14), we present three main insights and implications (see Naik and Raman 2003 for their proofs and intuition).

PROPOSITION 1. *As synergy (κ) increases, the firm should increase the media budget.*

This result sheds light on the issue of overspending in advertising. The marketing literature (see Hanssens et al. 2001, p. 260) suggests that advertisers *overspend*, i.e., the actual expenditure exceeds the optimal budget implied by normative models. However, the claim that "advertisers overspend" is likely to be overstated in an IMC context. This is because the optimal budget itself is *understated* when models ignore the impact of synergy. To see this clearly, we first compute the optimal budget from (13) with synergy ($\kappa \neq 0$) and without it ($\kappa = 0$). Then, we find that the optimal budget required for managing multimedia activities in the presence of synergy is always larger than that required in its absence. Hence, in practice, if advertisers' budgets reflect their plans for integrating multimedia communications, then overspending is likely to be smaller.

PROPOSITION 2. *As synergy increases, the firm should decrease (increase) the proportion of media budget allocated to the* <u>*more*</u> *(less) effective communications activity. If the various activities are equally effective (i.e., $\beta_1 = \beta_2$), then the firm should allocate the media budget equally amongst them, regardless of the magnitude of synergy.*

This finding has implications for emerging media, for example, Internet advertising. Companies should not think of Internet advertising and offline advertising (TV, Print) as *competing* alternatives. Rather, these activities possess different effectiveness levels and may benefit from integrative efforts to generate cross-media synergies. If so, the total media budget as well as its allocation to Internet advertising would grow.

PROPOSITION 3. *In the presence of synergy, the firm should allocate a non-zero budget to an activity* <u>*even if*</u> *its direct effectiveness is zero.*

This result clearly demonstrates that companies must *act differently* in the context of IMC. According to extant models of advertising that ignore synergy, an advertiser should allocate a zero budget to an ineffective activity (i.e., $v^* = 0$ if $\beta_2 = 0$). In contrast, in the presence of synergy, the company benefits not only from the direct effect of an activity but also from its joint effects with *other* activities. Hence, they should *not* eliminate spending on an ineffective activity because it can enhance the effectiveness of other activities by its synergistic presence. We call this phenomenon the *catalytic influence* of an activity.

In marketing, many activities exert a catalytic influence on one another. For example, business-to-business advertising may not directly influence purchase managers to buy a company's products, but it may enhance sales call effectiveness. Another example comes from the pharmaceutical industry; product samples or collateral materials may not directly increase sales of prescription medicines, but it may enhance the effectiveness of detailing efforts (Parsons and Vanden Abeele 1981). Indeed, marketing communications using billboards, publicity, corporate advertising, event marketing, in-transit ads, merchandising, and product placement in movies arguably may not have measurable impacts on sales. Yet, advertisers spend millions of dollars on these activities. Why? The IMC framework implies that these activities, by their mere presence in the communications mix, act like catalysts, and enhance the effectiveness of other activities such as broadcast advertising or salesforce effort.

The above discussion clearly illustrated how time-series models can be linked to normative decision making. More research is needed along these lines, however, especially on how models that distinguish between short- and long-run marketing effectiveness (as described in Section 2) can be used to derive optimal pricing and spending policies, reflecting management's short- and long-run objectives.

4. CONCLUSION

In this paper, we reviewed two time-series approaches that have received considerable attention in the recent marketing literature: (i) persistence modeling, and (ii) state-space modeling. However, this by no means offered an exhaustive discussion of all time-series applications in marketing. Because of space limitations, we did not review the use of "more traditional" time-series techniques in marketing, such as univariate ARIMA modeling, multivariate transfer-function modeling, or Granger-causality testing. A review of these applications is given in Table 1 of Dekimpe and Hanssens (2000). Similarly, we did not discuss the frequency-domain approach to time-series modeling (see e.g. Bronnenberg, Mela and Boulding 2006 for a recent application on the periodicity of pricing), nor did we review recent applications of band-pass filters to isolate business-cycle fluctuations in marketing time series (see e.g. Deleersnyder et al. 2004 or Lamey et al. 2006), or the use of smooth-transition regression models to capture different elasticity regimes (see e.g. Pauwels, Srinivasan and Franses 2006). Indeed, the use of time-series techniques in marketing is expanding rapidly, covering too many techniques and applications to be fully covered in detail in a single chapter.

Referring to the expanding size of marketing data sets, the accelerating rate of change in the market environment, the opportunity to study the marketing-finance relationship, and the emergence of internet data sources, Dekimpe and Hanssens argued in 2000 that "for time-series modelers in marketing, the best is yet to come." (p. 192). In a recent Marketing Letters article, Pauwels et al. (2004) identified a number of remaining challenges, including ways to (i) capture asymmetries in market response, (ii) allow for different levels of temporal aggregation between the different variables in a model, (iii) cope with the Lucas Critique, (iv) handle the short time series often encountered when working at the SKU level, and (v) incorporate Bayesian inference procedures in time-series modeling. In each of these areas, we have already seen important developments. For example, Lamey et al. (2006) developed an asymmetric growth model to capture the differential impact of economic expansions and recessions on private-label growth, and Ghysels, Pauwels and Wolfson 2006) introduced Mixed Data Sampling (MIDAS) regression models in marketing to dynamically relate hourly advertising to daily sales, see also Tellis and Franses (2006) who derive for some basic models what could be the optimal level of aggregation. Tests for the Lucas critique are becoming more widely accepted in marketing (see e.g. Franses 2005, van Heerde et al. 2005, 2006). Krider et al. (2005) developed graphical procedures to test for Granger causality between short time series, and Bayesian procedures are increasingly used to estimate error-correction specifications (see e.g Fok et al. 2006, van Heerde et al. 2006).

In sum, the diffusion of time-series applications in marketing has started. We hope the current chapter will contribute to this process.

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Table 1: Strategic insights from persistence modeling

Study	***Contribution***
Baghestani (1991)	Advertising has a long run impact on sales if both variables are (a) evolving and (b) in long-run equilibrium (cointegrated).
Bronnenberg, Mahajan, and Vanhonacker (2000)	Distribution coverage drives long-run market shares, especially the coverage evolution early in the life cycle.
Cavaliere and Tassinari (2001)	Advertising is not a long-run driver of aggregate whisky consumption in Italy.
Chowdhury (1994)	No long run equilibrium (cointegration) relationship is found between UK aggregate advertising spending and a variety of macro-economic variables.
Dekimpe and Hanssens (1995a)	Persistence measures quantify marketing's long-run effectiveness. Image-oriented and price-oriented advertising messages have a differential short- and long-run effect.
Dekimpe and Hanssens (1995b)	Sales series are mostly evolving, while a majority of market-share series is stationary.
Dekimpe and Hanssens (1999)	Different strategic scenarios (business as usual, escalation, hysteresis and evolving business practice) have different long-run profitability implications.
Dekimpe, Hanssens, and Silva-Risso (1999)	Little evidence of long-run promotional effects is found in FPCG markets.
Dekimpe et al. (1997)	New product introductions may cause structural breaks in otherwise stationary loyalty patterns
Franses (1994)	Gompertz growth models with non-constant market potential can be written in error-correction format.
Franses, Kloek, and Lucas (1999)	Outlier-robust unit-root and cointegration tests are called for in promotion-intensive scanner environments.
Franses, Srinivasan, and Boswijk (2001)	Unit root and cointegration tests which account for the logical consistency of market shares.
Hanssens (1998)	Factory orders and sales are in a long-run equilibrium, but shocks to either have different long-run consequences
Hanssens and Ouyang (2001)	Derivation of advertising allocation rules (in terms of triggering versus maintenance spending) under hysteresis conditions

Horváth et al. (2005)	The inclusion/exclusion of competitive reaction and feedback effects affects the net unit sales effects of price reductions, as do intrafirm effects.
Horváth, Leeflang, and Otter (2002)	Structural relationships between (lagged) consumer response and (lagged) marketing instruments can be inferred through canonical correlation analysis and Wiener-Granger causality testing.
Johnson et al. (1992)	The long-run consumption of alcoholic beverages is not price sensitive.
Joshi and Hanssens (2006)	Advertising has a long-run positive effect on firm valuation.
Jung and Seldon (1995)	Aggregate US advertising spending is in long-run equilibrium with aggregate personal consumption expenditures.
Lim, Currim, and Andrews (2005)	Consumer segmentation matters in persistence modeling for price-promotion effectiveness.
McCullough and Waldon (1998)	Network and national spot advertising are substitutes.
Nijs et al. (2001)	Limited long-run category expansion effects of price promotions. The impact differs in terms of the marketing intensity, competitive structure, and competitive conduct in the industry.
Nijs, Srinivasan, and Pauwels (2006)	Retail prices are driven by pricing history, competitive retailer prices, brand demand, wholesale prices, and retailer category management considerations.
Pauwels (2004)	Restricted policy simulations allow to distinguish four dynamic forces that drive long-term marketing effectiveness: consumer response, competitor response, company inertia and company support.
Pauwels and Srinivasan (2004)	Permanent performance effects are observed from store brand entry, but these effects differ between manufacturers and retailers, and between premium-price and second-tier national brands.
Pauwels and Hanssens (2006)	Brands in mature markets go through different performance regimes, which are influenced by their marketing policies
Pauwels et al. (2002)	The decomposition of the promotional sales spike in category-incidence, brand-switching and purchase-quantity effects differs depending on the time frame considered (short versus long run).
Pauwels et al. (2004)	Investor markets reward product innovation but punish promotional initiatives by automobile manufacturers.
Srinivasan and Bass (2000)	Stable market shares are consistent with evolving sales if brand and category sales are cointegrated
Srinivasan, Popkowski Leszczyc, and Bass (2000)	Temporary, gradual and structural price changes have a different impact on market shares.
Srinivasan et al. (2004)	Price promotions have a differential performance impact for retailers versus manufacturers.

Steenkamp et al.(2005)	Competitive reactions to promotion and advertising attacks are often passive. This rarely involves a missed sales opportunity. If reaction occurs, if often involves spoiled arms.
Villanueva, Yoo, and Hanssens (2006)	Customers acquired through different channels have different lifetime values.
Zanias (1994)	Feedback effects occur between sales and advertising. The importance of cointegration analysis is demonstrated with respect to Granger causality testing and multi-step forecasting.

Table 2: Names and Notation for Vectors and Matrices in State Space Models

Notation	Vector or Matrix	Name	Dimension
Y	Vector	Observation Vector	m x 1
α	Vector	State Vector	n x 1
T	Matrix	Transition Matrix	n x n
c	Vector	Drift vector (in observation)	n x 1
d	Vector	Drift vector (in transition)	m x 1
Z	Matrix	Link Matrix (from state to observation)	m x n
ε	Vector	Observation errors	m x 1
ν	Vector	Transition errors	n x 1
H	Matrix	Observation noise matrix	m x m
Q	Matrix	Transition noise matrix	n x n

Table 3. Description of Dynamic Marketing Models

Model	*The Mathematical Model*	*Model Description*
Vidale and Wolfe (1957)	$\frac{dA}{dt} = \beta(1-A)u - \delta A$ Discrete Version $A_t = (1-\beta u_t - \delta)A_{t-1} + \beta u_t$	Over a small period of time, increase in brand awareness (A) is due to the brand's advertising effort (u), which influences the unaware segment of the market, while attrition of the aware segment occurs due to forgetting of the advertised brand.
Nerlove and Arrow (1962)	$\frac{dA}{dt} = \beta u - \delta A$ Discrete Version $A_t = (1-\delta) A_{t-1} + \beta u_t$	The growth in awareness depends linearly on the advertising effort, while awareness decays due to forgetting of the advertised brand.
Brandaid (Little 1975)	$A_t = \lambda A_{t-1} + (1-\lambda)g(u_t)$ $g(u) = \frac{u^\beta}{\phi + u^\beta}$	Brand awareness in the current period depends partly on the last period brand awareness and partly on the response to advertising effort; the response to advertising effort can be linear, concave, or S-shaped.
Tracker (Blattberg and Golanty 1978)	$A_t - A_{t-1} = (1-e^{\alpha-\beta u_t})(1-A_{t-1})$	The incremental awareness depends on the advertising effort, which influences the unaware segment of the market.
Litmus (Blackburn and Clancy 1982)	$A_t = (1-e^{-\beta u_t})A^* + e^{-\beta u_t} A_{t-1}$	The current period awareness is a weighted average of the steady-state ("maximum") awareness and the last period awareness. The weights are determined by the advertising effort in period t.
IMC Model (Naik and Raman 2003)	$S_t = \alpha + \beta_1 u_{1t} + \beta_2 u_{2t} + \kappa u_{1t} u_{2t} + \lambda S_{t-1}$	Sales grow due to not only direct effects of advertising (β_i), but also indirect effects of synergy (κ) between advertising.

Table 4. System Matrices for Comparison of Models

System Matrices	***Vidale-Wolfe***	***Nerlove - Arrow***	***Brandaid***	***Tracker***	***Litmus***	***IMC model***
State Vector, α_t	$[A_t]$	$[A_t]$	$[A_t]$	$[A_t]$	$[A_t]$	$[S_t]$
Observation Vector, z	[1]	[1]	[1]	[1]	[1]	[1]
Transition Matrix, T_t	$[1-g(u_t) - \delta]$	$[1-\delta]$	$[\lambda]$	$[1-g(u_t)]$	$[1-g(u_t)]$	$[\lambda]$
Drift Vector, d_t	$[g(u_t)]$	$[g(u_t)]$	$[(1-\lambda)g(u_t)]$	$[g(u_t)]$	$[A^* g(u_t)]$	$g(u)$
Observation Noise, H	σ_ε^2	σ_ε^2	σ_ε^2	σ_ε^2	σ_ε^2	σ_ε^2
Transition Noise, Q	σ_v^2	σ_v^2	σ_v^2	σ_v^2	σ_v^2	σ_v^2
Response Function, g(x)	βx	βx	$x^\gamma/(\phi+x^\gamma)$	$1-e^{\alpha-\beta x}$	$1-e^{-\beta x}$	$\alpha+\sum\beta_i x_i$ $+\kappa x_1 x_2$

FIGURE 1: OVERVIEW OF PERSISTENCE MODELING PROCEDURE

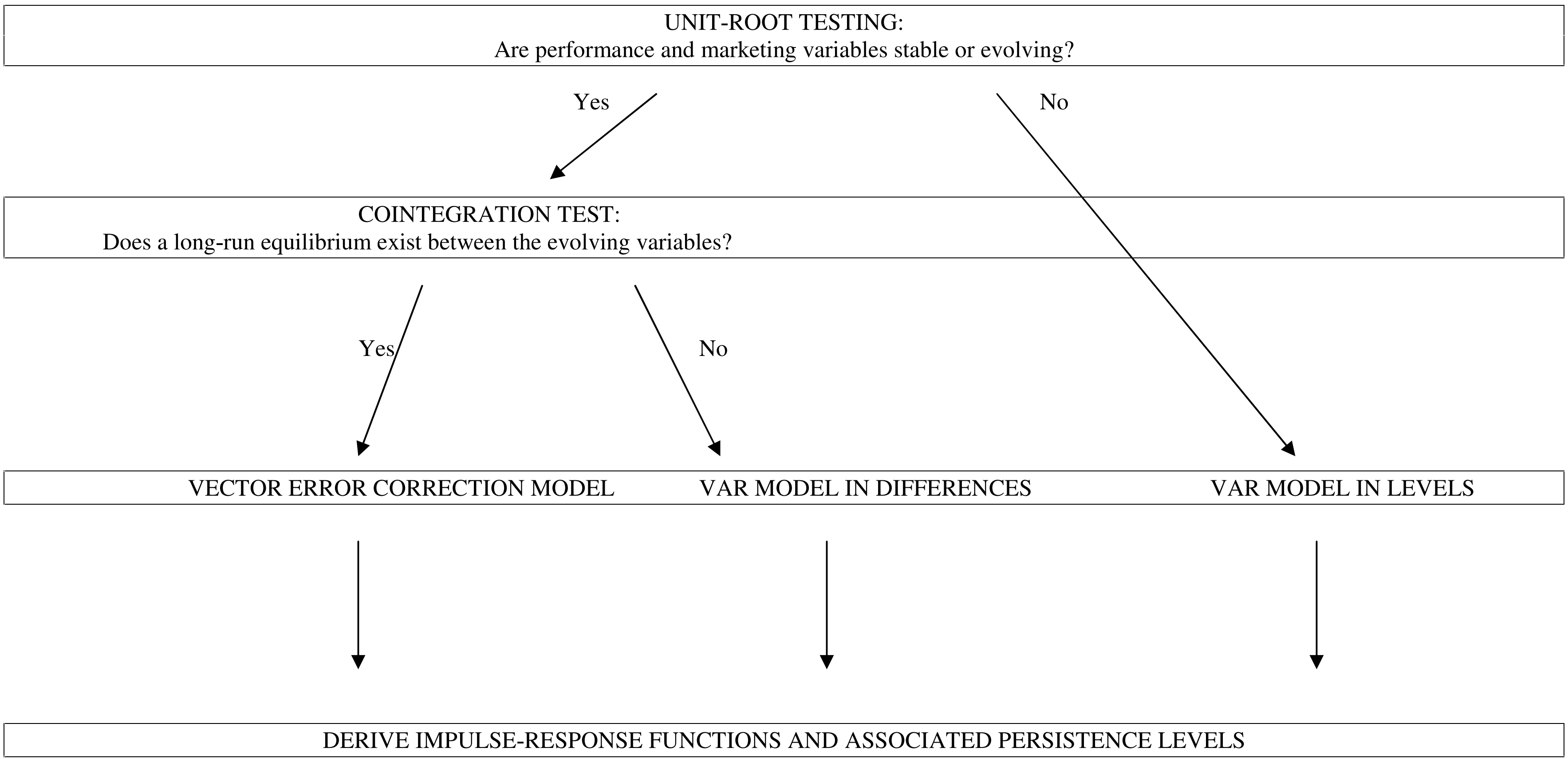
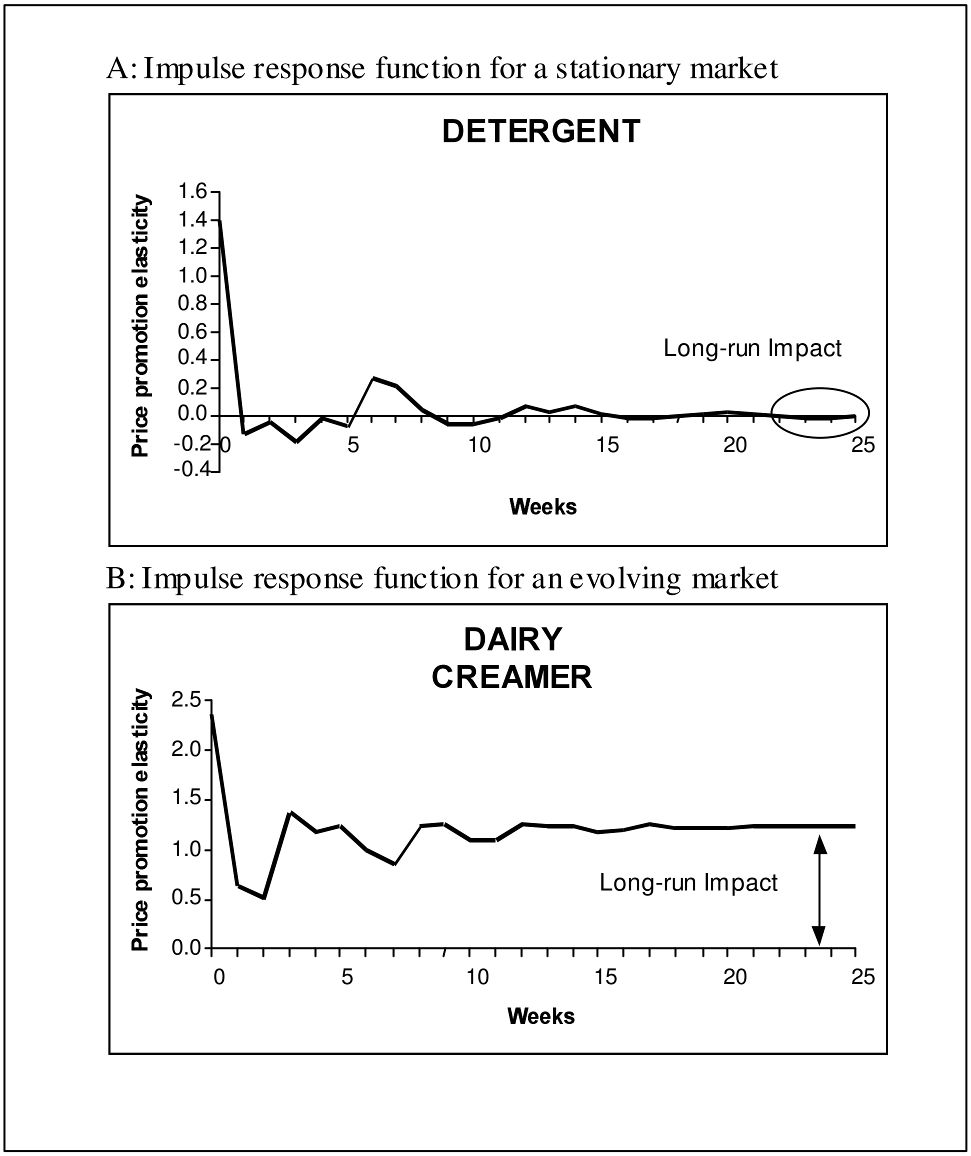


FIGURE 2: IMPULSE RESPONSE FUNCTIONS



Appendix A

Moments of the Conditional Density $p(Y_t|\vartheta_{t-1})$

This appendix provides the moments of the conditional density $p(Y_t|\vartheta_{t-1})$. We recall that the observation equation is $Y_t = Z_t\alpha_t + c_t + \varepsilon_t$, the transition equation is $\alpha_t = T_t \alpha_{t-1} + d_t + \nu_t$, and error terms are distributed as $\varepsilon_t \sim N(0, H_t)$ and $\nu_t \sim N(0,Q_t)$. Since the error terms are distributed normally and both the transition and observation equations are linear in the state variables α_t, the random variable $Y_t|\vartheta_{t-1}$ is normally distributed (because the sum of normal random variables is a normal.)

Let $\hat{Y}_t$ denote the mean and f_t be the variance of the normal random variable $Y_t|\vartheta_{t-1}$. By taking the expectation of observation equation, we obtain

$$\begin{aligned} \hat{Y}_t &= E[Y_t \mid \Im_{t-1}] \\ &= E[Z_t\alpha_t + c_t + \varepsilon_t \mid \Im_{t-1}] \\ &= Z_t E[\alpha_t \mid \Im_{t-1}] + c_t + 0 \\ &= Z_t a_{t|t-1} + c_t, \end{aligned} \tag{A1}$$

where $a_{t|t-1}$ is the mean of the state variable $\alpha_t|\vartheta_{t-1}$. Similarly, the variance of $Y_t|\vartheta_{t-1}$ is

$$\begin{aligned} f_t &= Var[Y_t \mid \Im_{t-1}] \\ &= Var[Z_t\alpha_t + \varepsilon_t \mid \Im_{t-1}] \\ &= Z_t Var[\alpha_t \mid \Im_{t-1}] Z_t' + Var[\varepsilon_t \mid \Im_{t-1}] \\ &= Z_t P_{t|t-1} Z_t' + H_t, \end{aligned} \tag{A2}$$

where $P_{t|t-1}$ is the covariance matrix of state variable $\alpha_t|\vartheta_{t-1}$.

Next, we obtain the evolution of mean vector and covariance matrix of α_t via the celebrated Kalman recursions (see, e.g., Harvey 1994 for details):

$$\begin{array}{ll} \text{Prior mean:} & a_{t|t-1} = T_t a_{t-1} + d_t \\ \text{Prior covariance:} & P_{t|t-1} = T_t P_{t-1} T_{t-1}' + Q_t \\ \text{Kalman Gain Factor:} & K_t = P_{t|t-1} Z_t' f_t^{-1} \\ \text{Posterior mean:} & a_{t|t} = a_{t|t-1} + K_t (Y_t - \hat{Y}_t) \\ \text{Posterior covariance:} & P_{t|t} = P_{t|t-1} - K_t Z_t P_{t|t-1} \end{array} \tag{A3}$$

Finally, we apply recursions in (A3) for each t, t = 1, …,T to obtain $a_{t|t-1}$ and $P_{t|t-1,}$ starting with a diffused initial prior on $\alpha_0 \sim N(a_0, P_0)$. For example, given (a_0, P_0), we get $(a_{1|0}, P_{1|0})$ and thus $(a_{1|1}, P_{1|1})$; now given $(a_{1|1}, P_{1|1})$, we get $(a_{2|1}, P_{2|1})$ and thus $(a_{2|2}, P_{2|2})$; and so on. Knowing $a_{t|t-1}$ and $P_{t|t-1}$ for each t, we determine the moments of $Y_t|\vartheta_{t-1}$ via equations (A1) and (A2). The initial mean vector, a_0, is estimated by treating it as hyper-parameters in the likelihood function.

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