

TAME THE ROLLERCOASTER RIDE



When it comes to managing prices, take the following approach to risk-management tools.

BY MEGAN PIERCE

Milk and feed prices have become a volatile rollercoaster ride over the past few years. A rollercoaster aficionado might consider our market similar to a sidewinder. A sidewinder starts like the first half of a traditional vertical loop. When the train is near the loop's apex, it will be inverted and head back in the direction it entered. Rather than completing the loop in the traditional way, the train rolls on its axis, becoming right-side-up, while simultaneously turning away from the loop. The train exits the maneuver nearly 90 degrees to the right or left of the direction it entered.

A sidewinder is similar to what we've seen with feed prices over the last 12 months. For example, corn prices peaked last June at \$7.88 per bushel and returned to \$3.97 this June.

Yet, risk-management tools are available in the marketplace to help you avoid this extreme rollercoaster ride.

Here is a look at nine things you need to do before you start using risk-management tools.

1. Educate yourself

Education is critical because there are many different types of strategies available in the market. Understand all of the options available to you and how they work before you start using risk-management tools.

Tools offered at the Chicago Mercantile Exchange are just

one option, says Dave Kurzawski, broker and market analyst at Downes-O'Neill in Chicago, Ill. Futures and options offer different strategies. Futures lock up a fixed price for both milk and corn. Options can be used to set a minimum milk price and a maximum corn price. Both remove volatility.

Familiarize yourself with risk-management jargon. (See glossary of terms on page 15.)

2. Decide on a strategy

Before you start using risk-management tools, decide which strategy is right for your situation.

Deciding on a strategy can be challenging because every dairy is different and every dairy producer has a different price risk-tolerance level.

"As a dairyman, you have to decide how much price volatility you can live with," says Henry te Velde, owner of JVJ Dairies and Merced River Farms in Delhi, Calif. Te Velde has been using risk-management tools for more than five years.

Te Velde uses different risk-management strategies for different situations. He develops strategies by working with a market analyst. Having these strategies in place allows him to make smarter purchasing decisions instead of trading out of fear. Buying or selling anything out of fear is not a good strategy.

Remember, no two strategies to manage price risk will be alike. And, no one method is best in all times or situations, says Mike Hogan, senior market adviser for Stewart-Peterson in West Bend, Wis.

GLOSSARY OF TERMS

Hedging: Any technique designed to reduce or eliminate financial risk.

Forward contract: A forward contract is an agreement between two parties to buy or sell an asset at a specified point of time in the future.

Futures: A futures contract is a standardized contract, traded on a futures exchange, to buy or sell a commodity at a certain date in the future, at a specified price. The future date is called the delivery date or final settlement date.

Option: An option is a legally binding contract that contains a right, but not an obligation to either buy (call option) or sell (put option) an underlying futures contract.

Put option: An option that allows the option buyer the right, but not the obligation, to sell the underlying futures contract at a specified price on or before the expiration of the option.

Call option: An option that allows the buyer the right, but not the obligation, to purchase the underlying futures contract at a specified price on or before the expiration date of the option.

Strike price: The price at which the buyer of a call or put may exercise the right to purchase or sell the underlying futures contract.

Fencing strategy: A strategy that combines calls and puts, establishing a range of possible hedge prices rather than just one price. By simultaneously buying a put and selling a call option, you create a price floor with your bought put and a price ceiling with your sold call. You are protected against downward moving prices with your floor price. Allowing a ceiling ensures a better floor price, even though it limits your upside opportunity.

In-the-money option: An option with intrinsic value; specifically, a call option whose strike price is below the current futures price (or a put option whose strike price is above the current futures price). Example: If you buy a \$20 put option for milk and the current milk futures price is \$19, your put option has an intrinsic value of \$1 and is said to be “in-the-money.”

Out-of-the-money option: An option with no intrinsic value; specifically, a call option whose strike price is above the current futures price (or a put option whose strike price is below the current futures price). Out-of-the-money options are typically used because they cost less to buy. They are further away from having value.

Note: Whether or not the option is “in-the-money” or “out-of-the-money” is dependent on what the strike price of the option is and where the futures market lies.

Glossary of terms provided by Stewart-Peterson

3. Weigh the level of protection needed

Dairying is a risky business and you need to evaluate every risk you are exposed to and protect yourself from that risk.

Purchasing risk-management tools to protect yourself can be compared to purchasing car insurance. You purchase insurance to protect against the risk of an accident. You purchase risk-management tools to protect against the risk of prices going higher or lower.

4. Know your break-even level

“If you don’t know your break-even cost, you aren’t in a position to use risk-management tools,” says Tim Beck, dairy business management educator at Penn State University.

Before you lock in your income, you need to have a good handle on what it takes to produce a hundredweight of milk, says Alfred Souza, branch manager for Yosemite Farm Credit in Merced, Calif. Knowing your cost of production is absolutely essential when trying to establish a future selling price. It also is important to have a handle on future input costs.

Producers who know their break-even cost say it helps them protect their profit margin. “If you know what your cost of production or break-even is, you can hedge your feed cost and lock in your milk and therefore lock in a profit margin you feel comfortable with,” says te Velde.

5. Talk to your bank

Make sure your bank understands that you plan to start using risk-management tools.

It is essential to have good communication with your lender, says Souza. In today’s world, borrowed dollars are larger and prices are so volatile that the borrower must work at stabilizing a milk price at levels that will allow his or her business to be sustainable.

There is a cost involved in risk-management, and you will need your lender’s assistance in covering them.

Risk-management is becoming so important to banks that some are holding risk-management education sessions between brokers and borrowers.

6. Look at both your milk and corn

In order to lock in a profit for the farm, you need to sell milk and buy feed at the same time, advises Kurzawski.

“I think we all learned a valuable lesson last year — high feed prices do not guarantee high milk,” says Kurzawski.

Be aware that risk-management tools have fixed contract sizes. One milk contract is the equivalent of 200,000 pounds of milk. A corn contract is the equivalent to 5,000 bushels of corn. Multiple contracts will likely be needed to protect milk prices and feed cost.

ADVERTISEMENT

HERE IS AN EXAMPLE OF HOW YOU COULD USE RISK-MANAGEMENT TOOLS TO LOCK IN FEED COST.

In December 2008, May corn futures were trading at \$4 per bushel and you could purchase a \$4.10 strike for 40 cents per bushel. If your local cash price in May is typically 25 cents higher than the May futures, then your expected maximum purchase price in May would be \$4.75 per bushel (\$4.10 strike + 40-cent premium + 25-cent basis).

If the market increased between December and May to \$6.25, and your cash price and May corn futures are at \$6, you will pay more for cash corn, but realize a gain in the options market. You could sell the \$4.10 call option for \$1.90 per bushel (\$6 - \$4.10). Your net purchase price for the corn would then be \$4.75 per bushel (\$6.25 cash price + 40-cent premium to purchase option - \$1.90 premium to sell option). If the cash market is at \$3 in May, you will gain in the cash market and you will forfeit your 40-cent call premium. Your net price for the corn would be \$3.40 per bushel.

7. Take the emotion out of your decision-making

If you're an emotional person, having the discipline to use risk-management tools will be tough, says Hogan.

If you can't keep your emotions out of it, you'll end up making emotional decisions instead of smart decisions, says Brian Gerrits, financial manager at Lake Breeze Dairy in Malone, Wis. Gerrits has been using risk-management tools for more than three years.

8. Find a broker that fits you

It is important to find a broker that meshes with your management style.

A broker is an addition to your management team, just like your nutritionist and veterinarian. "You need to trust the person you are dealing with," notes Souza. "Consult and use the broker just like you would any of the other professionals you hire."

9. Change your mind-set

Adjust your mind-set to think about profit margins, says te Velde.

He notes that you may feel like you got burned, if you lock in milk at \$18 and it moved to \$20. But if you knew your cost of production and locked in a profit margin you were comfortable with, you shouldn't feel like you got burned because you are making a profit.

There is a cost involved in using risk-management tools, but it's certainly worth it, says Gerrits. "I sleep easier at night when the market is this volatile."

"The fundamental question you have to ask yourself is: do you want to live with price volatility?" asks te Velde. 🐄