Managing market risk in today's world

by Chris Bastian

Unfortunately, agricultural producers cannot dictate what price they receive for their products. The transition to freer global trade and the changes in the most recent farm bill means the market will likely become more volatile. Too often marketing is an afterthought in the production process. As such, producers often are faced with accepting the price at harvest or weaning in a highly variable cash market. Thus, price variability in the market translates into price risks, which compound with production risks and increases income variability. Effective management of marketing activities will become increasingly important for firm survival as the market becomes more volatile.

Marketing alternatives

A number of different marketing alternatives are available. When looking at your alternatives you should consider whether the realized price offered meets your marketing objectives and goals. You need to subtract all transaction costs associated with that alternative in order to compare your realized price across alternatives. Subtract costs such as transportation, shrinkage, commission fees, and other fees or costs associated with that alternative. By doing this across your alternatives, you will be able to compare alternatives in terms of the money they actually put in your pocket. For example, a quoted video auction price may be slightly lower than what a buyer is offering for cattle, but you may find when you subtract all the marketing costs, your realized or net price may be better with the video auction. It is important to your marketing program to compare apples and apples.

Three basic types of marketing alternatives are available to producers. These types of alternatives include price at delivery, forward pricing, and group marketing. The price at delivery alternatives such as selling at the auction barn or the elevator have some advantages. Producers receive payment almost immediately after the commodity is sold, and the quantity sold is very flexible. Unfortunately, from a risk management standpoint the price at delivery strategy increases price risk faced by producers. Producers only can control when they take the commodity to market with this alternative. Therefore, this strategy compounds with production risks to increase income variability.

A number of forward pricing alternatives can be used by producers to smooth out income variability. Forward pricing alternatives offer opportunities for producers to take advantage of a favorable price or place a floor under their selling price prior to the end of the production process. These alternatives include different types of forward contracts, video auctions for livestock, futures hedges, and options contracts.

Forward contracts usually allow producers to negotiate price, quantity, quality, and terms of delivery before the production process is completed. These type of contracts remove price uncertainty but do not allow selling at a higher price if prices rise later in the year. It is important to evaluate the forward contract pricing opportunity and see if it meets with your price or market objectives. These types of opportunities allow you to ensure some level of cash flow. Many of these types of contracts can be used in conjunction with crop insurance to reduce your risk of loss associated with production risk and non-performance on your contract.

Video auctions for livestock are another way to forward price your production and reduce your price risk. This market outlet allows producers to forward price their livestock, but the price discovery process involves more competition by buyers than the usual forward contract methods. Additionally, the video auction ensures performance of both parties to the sale. The disadvantages associated with this alternative include the inability to take advantage of higher prices later and higher commission fees. Higher fees can be offset if transportation and shrinkage costs associated with going to another market outlet are relatively high. Again, this points to the need to estimate your realized price after marketing costs when comparing your alternatives.

Hedging in the futures market is another way to forward price your product. This can be done by selling a futures contract that most closely represents your commodity and timing of your cash sale. Later, when you are ready to sell your commodity you normally would buy a futures contract of like commodity and month. Then you sell your commodity as you normally would in the cash market. Gains in the futures market offset downward price movements in the cash market, and conversely losses in the futures market offset rises in the cash market. In this way you forward price your product in a short futures hedge. This alternative is more complex and requires the producer to consider his marketing actions in both the futures and the cash market. This alternative also reduces the opportunity to take advantage of rising prices in the cash market. A short futures hedge can be a superior marketing alternative in a downward trending market. Additional costs associated with this alternative include brokerage fees and any interest on borrowed capital used to finance the futures position.

A put option can be purchased to place a minimum selling price on your commodity. When purchasing a put option, you are guaranteed the right to sell a futures contract at what is called the "strike price of the option." Option contracts guarantee your right, but not your obligation, to be in the futures market. You pay a premium for this right you pay a premium (dollars per hundred weight or cents per bushel) to be guaranteed a futures position at the strike price of the options contract. Not being locked into a futures position allows you to take advantage of price rises. If prices fall, you can sell the option and make money on the option to cover a loss in the cash price. This can be done without ever actually holding a futures position.

As a result, the option market can be used like an insurance policy against disastrous price moves. The higher the strike price level you insure, the higher the premium you must pay. You must pay broker fees in addition to the premium with this alternative. This marketing method allows you take advantage of price rises compared to the other forward alternatives, but you pay the additional premium cost. Again this alternative is a little more complex, but it is another tool that can be used to manage your market or price risk.

Group marketing is an alternative that offers producers the opportunity to add value to or increase the price for their product. This alternative allows groups of producers to put together large lots of commodities to sell. If you are a relatively small producer, pooling commodity and creating large uniform lots of cattle can improve the price buyers are willing to pay. A study conducted at Utah State University concluded that buyers at a video auction paid approximately $1.70 per hundred weight more for uniform lots of cattle sorted by sex and weight than unsorted lots. Group marketing techniques can include contracts between market participants, marketing pools, marketing associations, and cooperatives. These types of group marketing efforts usually do not reduce price risk, but they are an alternative that can improve an individual's price.

Developing a marketing plan

Perhaps one of the most important steps in marketing commodities profitably is to develop a sound marketing plan. A good marketing plan allows you to better control important decisions concerning when and how to market your product. The marketing plan is a written plan that clearly delineates what is to be done in your marketing program, and it includes who carries the responsibility for action and provisions for unexpected developments.

The four basic steps to developing a marketing plan are estimating a break-even price, determining market or price objectives, following through with the plan, and evaluation of the marketing program. Estimating the break-even price for your commodity is a good starting place. Unless you know how much it costs you to produce your product, a profitable marketing opportunity is difficult to recognize. Use last year's records as a basis for this year's projection. You should include both variable and fixed costs in your projection.

Market or price objectives will vary from manager to manager. Managers need to assess what their financial goals are. These goals depend on capital constraints, current debt load, cash flow requirements, and the manager's risk attitude. Managers must establish a price objective that meets their goals. These objectives must be realistic for the current market as well as the expected market conditions. An acceptable market objective is to limit losses in the short run. The manager must evaluate and take action on those marketing alternatives that achieve market goals and price objectives.

The most difficult part of any marketing plan is carrying it out. When markets start to move either up or down, your outlook and opinions may start to change. Develop a plan that you will feel comfortable carrying out, and you need to be willing to implement provisions for unexpected developments. Stay on track with your marketing plan rather than allowing emotions to cause you to take unfavorable actions.

Once you have completed the marketing year it is a good idea to evaluate your marketing program. Ask yourself whether you followed the plan and if the marketing program allowed you to achieve your goals. Then ask yourself if you need to modify the plan for next year. Make any changes necessary. A good marketing plan should be part of your integrated management approach to your business.

Chris Bastian is the Extension Marketing Specialist in the Department of Agricultural Economics at the University of Wyoming. He also serves as the Chairman of the Western Extension Marketing Committee.