Higher Prices = More Risk

Don't be complacent with marketing.

*by **Barb Baylor Anderson,** field editor*

While it may be easy to put marketing plans on the back burner during periods of higher cattle prices, it's not a good idea. Record prices equate to greater price risk. Just consider the volatile activity in the cattle markets the last several months. Economists urge producers to understand the risk-management tools available, and which tools may work best for them.

Some suggest cattle producers have been in a "new market" for the last five years, with more moving parts than ever. The global marketplace appears to influence prices more than in the past, and the economy and consumer demand are bigger market factors than cattle inventory.

"It is a bit of a quandary. We don't know if the recent market relationships are transitory or a sign of the future," says Jim Robb, director and senior ag economist, Livestock Marketing Information Center (LMIC). "Most recently, beginning in December 2014, there was whirlwind discussion about the relationship between nearby futures and cash prices."

Robb notes part of the shift may come from more investors in the commodity markets. Today, investors may own and exit a basket of commodities when stock prices and oil prices go down, as opposed to being invested in just one commodity. Also, there appear to be more spread positions — for example, taking simultaneous positions in live-cattle and hog futures. Producers need to understand how such investments operate, as well as their impact on cattle futures.

Robb also says cattle futures have taken on a bigger role in price discovery now that government insurance programs are tied to them. While there is physical supply and demand in the cash market, there is paper supply and demand in the futures market. The two are linked by basis.

"Other factors affecting prices beyond core supply and demand fundamentals include federal budget debates, national policy issues and regulations, public interest in food production, weather and a host of issues beyond the control of individual producers," adds Iowa State University assistant economics professor Lee Schulz. "There is greater potential for profit, but also greater potential for substantial loss. Managing price risk is essential for success."

Further complicating risk management is the fact that equity and working capital necessary to operate the same volume of business has nearly doubled, adds Schulz.

University of Tennessee Extension Cattle Marketing Specialist Andrew Griffith agrees.

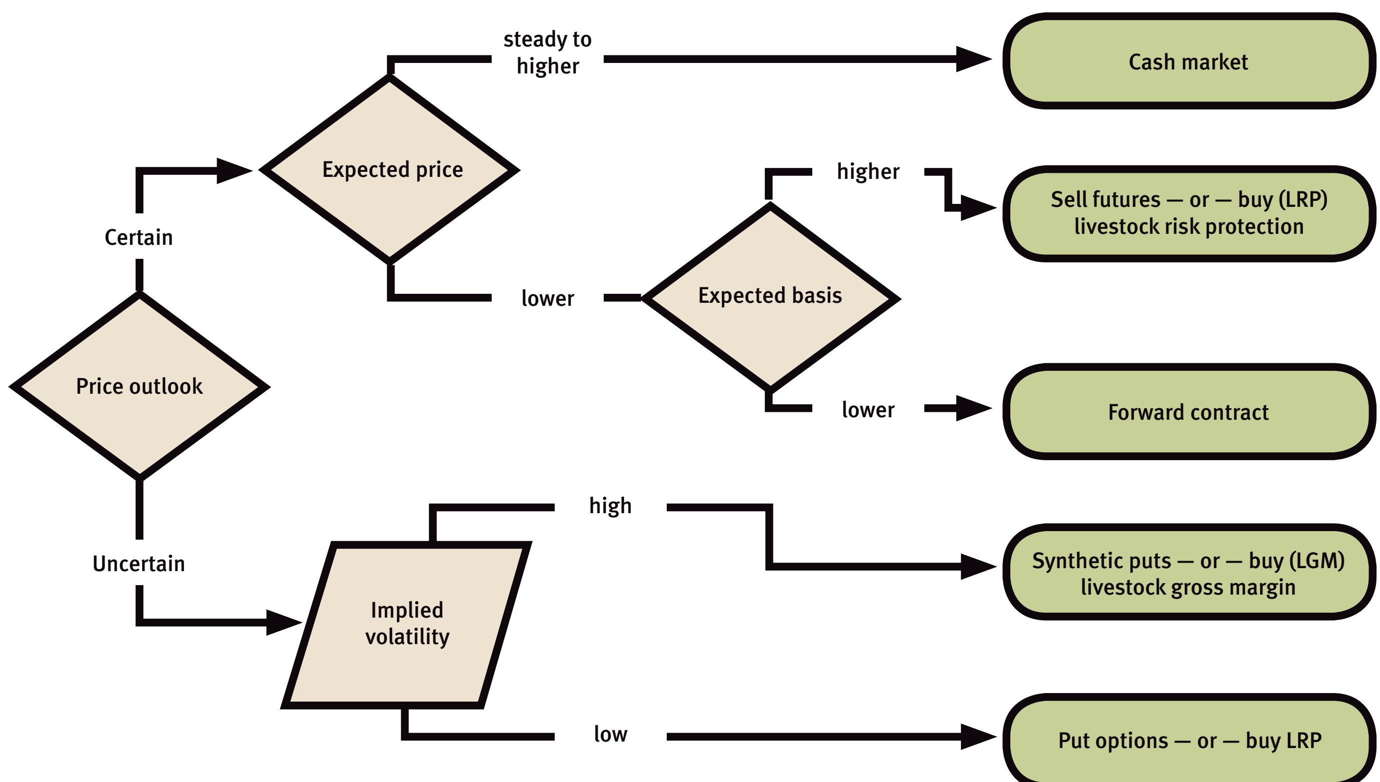
"Loan limits are not going up. Yet cattle prices are 40% to 60% higher, so producers can't run as many head. Producers have to protect prices to guarantee a per-head profit to make loan payments," he says. "Producers and loan officers need to understand all marketing possibilities."

Several tools available

That education process includes defining the best tools available for managing price risk, and outlining for producers and loan officers exactly how the tools work.

"Risk can actually be increased if these tools are used inappropriately," says Griffith. "Producers should understand cash, futures, options and Livestock Risk Protection (LRP) insurance."

Fig. 1: Decision flow chart for choosing from livestock risk-management tactics



35 Keys to Success

Marketing Commercial Cattle

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Several good resources are available online to assist with market understanding and decisions:

- Livestock Marketing Information Center (LMIC) *www.lmic.info/*
- Iowa State University Extension and Outreach Ag Decision Maker *www.extension.iastate.edu/agdm/homepage.html*
- Iowa State University Extension and Outreach Estimated Livestock Returns *www.econ.iastate.edu/estimated-returns/*
- Iowa State University Extension and Outreach Livestock Crush Margins *www.econ.iastate.edu/margins/*
- Iowa Beef Center *www.iowabeefcenter.org/*
- Kansas State University Ag Manager *www.agmanager.info/*

Paul Peterson, University of Illinois Clearing Corp. Foundation clinical professor of derivatives trading in the Ag and Consumer Economics Department, encourages producers to begin the market education process by identifying a hedge broker who can explain how to use markets for their risk-management needs and not as speculation or investment.

"Understand cash market risk-management tools and how to use them to protect your price," he says. "Futures and options also are important risk-management tools. Producers should never stop studying and learning how they can use these tools to manage risk in their operations."

Here are some risk-management tips Peterson and Griffith say cattle producers should know.

- **When you choose to use a cash forward contract, you have only production risk.** Your price is established with the contract. Typically, producers could rely on the seasonality of cattle prices to guide decisions, but unseasonal price action has occurred the last two years. Calf prices peaked in the fall instead of the spring in 2013. Griffith says 2015 may see more seasonal action, although price peaks and troughs may not be as defined.
- **Futures price discovery is a projection on what the price may be at delivery, when the contract expires.** Using futures contracts means you trade price risk for basis risk. You lock in a sales price. If the price goes up, you do not benefit from the gain and you may have to meet margin calls. If the price goes down, you are locked in at a higher price. Basis, or the difference between the futures and cash at time of delivery, can change.
- **Options are similar to insurance premiums — you pay for market coverage at a certain price, but are not obligated to use or exercise the option.** The further out you go on the board in selecting puts or calls, the higher the premium you will pay. The advantage is in market flexibility. If you think the market will go down, you can establish a price floor with options. Then if the market goes up, you can get the higher price by selling or abandoning the options position. There are no margin calls when you use options.
- **When you purchase LRP insurance, you pay a premium.** The benefit of LRP to producers is that you can insure on a per-head basis.

"I would not be surprised to see more tools added to manage risk," says Peterson. "Remember there is a difference between hedging and speculation. If you use the markets for risk management, don't fool yourself into thinking you are managing risk with speculative positions."

Robb encourages cattle producers to revisit their marketing alternatives frequently. "Establishing a marketing plan only once a year is behind us. You have to have a plan with alternatives based on what may happen," he says. "It is an ongoing process of recognizing when opportunities avail themselves and being more adaptable in managing risk."

Table 1: Advantages and disadvantages of risk-management tactics

Method	Advantages	Disadvantages
Cash sales	Easy to transact Immediate payment No set quantity	Minimize risk No price protection Less flexible
Forward contract	Easy to understand Flexible quantity Locked-in price Minimize risk	Must deliver in full Opportunity loss if prices rise
Futures contract	Easy to enter/exit Minimize risk Often better prices than forward contracts	Opportunity loss if prices rise Commission cost Performance bond calls Set quantities
Options contract	Price protection Minimize risk Benefit if prices rise Easy to enter/exit	Premium cost Set quantities Commission cost