7 Steps For Risk Management

Commodity market specialist shares tactical tips.

by ***Kindra Gordon,*** *field editor*

"The market is going to do what it's going to do. From a risk standpoint, we want to take what the market will give us." That's the advice Tom Clark asks cattle producers to consider as they devise a marketing and risk management plan. Clark is director of agricultural products for the Chicago-based CME Group, the world's largest and most diverse derivatives exchange, and made a presentation to producers in San Antonio, Texas, during the 2015 Cattle Industry Convention and Trade Show.

"If you raise cattle, technically you are in the market, and you have a lot of risk," Clark likes to point out.

Across the livestock sector, he notes, the industry has never seen these types of prices before. Along with that, the market has never seen such dramatic changes in factors affecting prices — the seasonal, cyclical, weather and cost aspects.

"Producers must look at all elements; just looking at one slice is not adequate anymore. Products all have different volatility, and volatility is not going away," Clark says.

Volatility in the market is not necessarily bad, he emphasizes. Rather, it gives an idea of how active the market is.

35 Keys to Success

Business Planning

"I hear some people say, 'We'd use futures if the market wasn't so volatile,' but if volatility goes away or is flat, I associate that with a flat-line heartbeat, or death," he explains. "You have to have some activity."

Devise a plan

Human nature — emotion — often affects our decision making, Clark says. "Naturally, we tend to think-hope-wish that the market has to go higher."

Clark emphasizes, "The market doesn't have to do anything. The words think-hope-wish are from a speculative standpoint. That approach means you are taking on more risk than you are mitigating."

Clark has coined a term for this: hedulating — a combination of hedging and speculating.

"Don't be a hedgling," he advises. "You have to manage what you own. Do today what you need to do in the future."

Clark says this is why it is important to remember the definition of risk management, which is a structured approach to managing uncertainty. He reiterates, "Remember, 'it's a structured approach.' "

In a nutshell, he says risk management means looking at the big picture, evaluating your overall business for financial risk, determining where you are vulnerable, and then employing a plan to mitigate risk. To do so, he suggests following these steps:

1. Know your cost of production. "If you don't know the cost of your production, how do you know what is a good price?" Clark asks. He points out that cost of production changes regularly.

"There are a lot of moving parts," he says. "The more you have this down, the better."

2. Determine your breakeven levels.

3. Utilize sound market information. "There's always a lot of news and noise," Clark says. "The point is, you need to know what is noise and what is good information. Try to get value out of the information you listen to."

4. Set target prices.

5. Evaluate pricing alternatives such as cash sales, forward contracts, futures/options hedging or over-the-counter (OTC) markets. Know your costs, the contract specification, basis, hedging costs,

Additional risk management mantras

Tom Clark with the CME Group offers these additional guidelines for risk management:

- Every sector within an industry has inherent risk. Your choice is to accept it or mitigate it.
- Potential strategies to manage market uncertainty include transferring the risk to another party, avoiding the risk, reducing the negative effect of the risk, and accepting some or all of the consequences of a particular risk.
- Volatility will always exist in the market.
- Take a holistic view to risk management. In addition to the products you market, consider hedging inputs that you use — feed, energy, transportation.
- Utilize a mix of pricing tools at various times.
- Build a risk-management team that includes your broker and your lender, so everyone is on the same page.
- A marketing plan will — and should — change over time, but it's not a good idea to change the plan at the time you are buying or selling.

commission and interest, Clark advises.

6. Execute when target prices are reached.

7. Review results to determine what works best for your operation.

Clark says, "Having these things helps you gauge and take what the market will give you. Taking a little bit of money is better than no money."

Regarding target prices he emphasizes, "We have a tendency to try to get more than we want or need. For instance, the target we've set is $1.60, but the market gets there and you change the plan. When you set a price and set a target and six months ago there was profit in the trade, don't forget that; stick to it."

He adds, "If you change the plan, you are not hedging anymore; you're speculating … Remember, when it hits the target level you set, you've got to pull the trigger."

As a final piece of advice, Clark notes the importance of reviewing the results and the marketing plan and changing it over time. He concludes, "Coming from the CME Group, I believe futures and options are incredible tools to mitigate risk; but, that said, you need to have a mix of pricing tools and, at various times, depending on what's going on in the market, you will use certain tools more than others."

Editor's Note: *Nov. 30, 2014, marked the 50th anniversary of live-cattle futures, allowing cattle producers to manage risk the same way grain producers had been doing for 100 years. The contract opened the door to contracts in other live commodities; hogs began trading in 1966. Kindra Gordon is a freelance writer and cattlewoman from Whitewood, S.D.*