

## Risk Management Science or an Art?

The business of managing commodity risk is the fastest paced, most emotionally intense business I know of today. The amount of information that is at the finger tips of any grain or livestock producer in today's world is simply amazing. Any producer could invest their entire day researching and contemplating what is currently taking place in the commodities that they produce. And the day after tomorrow, we can be certain that that information will be "old news". Unfortunately, this puts many producers in a tough position. As difficult as it is managing, one's price risk in commodities, it is also one of the most important jobs a producer has today. As a grain farmer in the upper Midwest, almost every year the price of the grain you are producing, ranges from an opportunity to give you a healthy return on your investment, to a chance to sell well below the cost of production. Livestock producers have had a much tougher time in recent years. In these businesses, the opportunity to sell their production at a profit has been very slim. Certainly the business of managing price risk is close to people's pocket book and close to people's heart.

At Professional Ag Marketing, we have spent much time and many resources on helping our customers master the business of managing their price risk on the commodities they produce. We'd like to share a few tips of how to be a successful risk manager in today's volatile markets. 1) Know your cost of production. 2) Define your revenue expectations. 3) Create a plan and get it on paper. 4) Put in your buy or sell orders in advance. 5) Manage carry and basis.

Knowing your cost of production could be the most important piece of being a successful risk manager. We encourage our customers to go through the exercise of figuring your costs of inputs line by line, and determine how these prices have changed and why. Things like herbicides, fertilizer, and the cost of land can and will change the cost of producing a crop. For livestock producers, it is important to create two categories for your input costs. One category is all of the inputs that do not change very often. Things like yardage, trucking, and interest, will be included in this number. The second category will have items that change on a daily basis. Corn, SBM, and dried distiller grains, for an example. It is important to set these items apart and then focus your attention on those items that change very rapidly. For many of our customers, we are evaluating this on a weekly or even daily basis.

The next natural step in managing the price risk of your business is to define some revenue expectations. This can take on many different shapes and colors, but the end result should be a net revenue per acre, animal unit, or probably most useful, net revenue for a calendar or fiscal year for the entire business. We then can use the cost of production and revenue numbers and start determining sell targets for the

commodities that you will be marketing. How do I know if my revenue goals are too high or too low? It is important to subject both your cost of production, and revenue numbers, to much evaluation. There is a plethora of historical information that can determine how your plan would have performed in past years. Analysis of market fundamentals and "what if" scenarios, if the market goes up or down from today's levels, are also very important in determining if your cost of production and revenue goals are accurate and obtainable. If all else fails, compare your numbers with a friend, neighbor, or trusted risk management advisor.

When the market is going up, it feels like it will go up forever. When the market is going down, it is going to feel like it is going down forever. This kind of mind set is hard to avoid and is the biggest reason why very good risk management plans do not get implemented. Two ways to successfully out maneuver this mind trap are: 1) Put your risk management plan down on paper. 2) Get your sell orders in before the market is approaching your targeted levels. Once you have invested the work of figuring and updating your cost of production and revenue goals, you might as well put together a plan for seamless execution. This plan should be very detailed and center on your goals for the year. A corn marketing plan may look something like the one shown below. Start selling corn at \$4.30 futures and be completed if/when we see \$4.60 corn futures. From today's prices to \$4.60, you should have a good understanding of how the business will perform at each price level.

CORN MARKETING SHEET						
Name		Year	2010	County		Last Updated: 2/16/2010
Account #:						
	Acres	Projected Yield	Projected Production	Storage	Delivery at Harvest	Harvest Basis
	700	185	129,500	80,000	49,500	(0.40)
Futures						
	Bushels	Delivery Period	Delivery Point	Fut. Px	Basis	Cash Price
proposed	10,000			\$4.30	(\$0.40)	\$3.90
proposed	10,000			\$4.35	(\$0.40)	\$3.95
proposed	10,000			\$4.40	(\$0.40)	\$4.00
proposed	10,000			\$4.50	(\$0.40)	\$4.10
proposed	5,000			\$4.60	(\$0.40)	\$4.20
Proposed	40,000			\$3.90	(\$0.40)	\$3.50
*\$4.00 - \$5.20 Put/Call sprd., Purchase price of \$10, protects \$3.90 futures, price can improve by \$1.20 with higher markets.						
<b>Total:</b>	<b>85,000</b>					<b>\$3.77 \$320,500</b>
Puts						
	Bushels	Strike Px	Premium Cost	Basis	Minimum Cash Px	Revenue
proposed	40,000	\$4.00	(\$0.20)	(\$0.40)	\$3.40	\$136,000
<b>Total:</b>	<b>40,000</b>	<b>\$4.00</b>			<b>\$3.40</b>	<b>\$136,000</b>
Open Option Equity (\$8,000.00)						
Notes:						
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Bushels per Acre	% of Production
Futures	121
Puts	57
Total	179
Unmanaged	6
Min Gross Revenue Acre	\$652.14
Min Total Gross Revenue	\$456,500.00
Min Price	\$3.65

A common practice at our firm is to create your plan, designating specifically how much product you want to sell and at what price level. When these decisions are made, we will put the orders in to be filled when/if the price reaches those levels. This can be done with a commodity broker or at most end user locations, whether this is your packer or your grain elevator you sell to. Simply put, at today's market of \$3.60 you can have orders working to sell 5000 bushels of corn at \$3.80 and another 5000 if the market goes up to \$3.90.

The small things can make a big difference. Most of a producer's price risk is going to be in the large swings that can, and probably will, occur in the futures markets during any given marketing year. Not to be forgotten, are the smaller things that do not fluctuate as much, thus can be more easily managed and can make a big impact on a business's profitability. Carry and basis are two of these items that we spend a lot of time and resources on managing today. In our corn example, how carry and basis are managed can impact your profitability by \$.20-\$.40 per bushel. Carry is the value that the market place puts on storing a commodity and selling it at a later date. For grain producers, this can be storing their grain in a bin to sell later in the spring or summer. A cattle producer might design a feeding program to target a specific delivery period. Basis is the difference between the futures price and actual cash price of the commodity and can also be managed to increase profits. This usually is a decision of whether or not we think the basis will be better or worse for a delivery period.

Grain producers have traditionally used grain bins as a mechanism to speculate on price for a longer period of time. Grain elevators have learned how to use grain storage to enhance margin. It is imperative that farmers develop that same skill set. We believe it is important to align yourself with someone that can assist you with developing the thought process of managing carry and maximizing basis opportunities.

Managing your price risk is clearly a combination of science and art. Our most successful clients have found the right combination of accessing market information, time allocation, and managing emotion to make them successful risk managers. We encourage you to give us a call to learn more details.

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