Facing Reality: Feed Price Volatility

How are you preparing?

by ***Kindra Gordon***

Last fall the question being pondered was how high could the price of corn possibly go? $9? $12? By when? This year, the price-of-corn pendulum has swung the other direction — further proof that volatility is here to stay — and it's anyone's guess what the market might do next.

Scott Stewart, CEO and president of the commodity marketing firm of Stewart-Peterson Inc., notes that no one really knows where the price will land. So, rather than focus on the possible price predictions, Stewart, who has 30 years of tenure working with ag commodities, advises there is one certainty to bank on and prepare for: Volatility will continue and it can be managed by preparing for the "likely," "potential" and "possible" events.

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Winds of change

In fact, Stewart has been trying for the past seven years to get the ag community to prepare for volatility. In 2006 he wrote a paper titled "$12 Corn Special Report." Stewart says, "I wrote the report with that provocative title in order to get people's attention — everyone wants an advisor to pinpoint a price."

But, the report's overall message was not "prepare for $12 corn." It was "prepare for the volatility that could bring us $12 corn." He notes that sometimes that message gets lost in the desire to pinpoint a price level.

In 2006, when the report was released, corn prices hovered around $2.50 to $3. At that time the word "volatile" historically referred only to the weather. However, change loomed on the horizon. The effects of freedom to farm, stepped-up world demand, ethanol production and a just-in-time delivery mindset lowered year-to-year carryover stocks and began shaking up what had been relatively stable markets.

As an example, Stewart recalls June 2008 when corn rallied 37.5% past its previous high and went to $7.62, with some deferred contracts eclipsing the $8 mark. It stopped climbing there; however, it also swung all the way back down to $2.90 in a period of six months.

Anticipate future scenarios

Corn has not hit the $12 mark; however, Stewart notes volatility is more prevalent than it has ever been and those who have not prepared will struggle as it continues. Supplies of corn continue to be uncertain, and as this scenario unfolds each growing season, Stewart says producers' focus should not be solely on what might happen with prices — rather it should be on preparing for volatility.

Stewart's recommended approach, which he calls market scenario planning, includes these essential steps:

1) Survey the data and expert opinions.
2) Develop scenarios of what could possibly happen to the price. He emphasizes including all the possibilities and says, "For this exercise, don't get caught thinking: 'That could never happen!'"
3) Imagine how your operation will fare in each scenario, thus determining your greatest risks and opportunities.
4) Create strategies that manage risk and maximize opportunity in each scenario (Plan A, B, C, D and so on).
5) Implement the best strategies and continue to develop new strategies as scenarios unfold and new market conditions evolve. "In other words, continuously repeat steps 1 through 5," Stewart says.

Stewart emphasizes that the key in this approach is to keep an open mind and to avoid the temptation to follow one single "marketing plan" based on someone's price predictions or bias.

He says, "In this new world of price volatility, an advisor's role should be to paint possible price scenarios, not predict price levels. It's so important to look at all the possibilities. Otherwise, you will be scrambling to adjust when a price level you hadn't envisioned comes along."

Stewart also says it is important to become familiar with risk-marketing strategies and tools before decisions are needed.

More extremes ahead

Looking ahead, Stewart is cautious, saying, "When we look at the conditions that have led to the volatility we have today, we see that they haven't changed. If anything, the risks have become more pronounced."

Among the risks he foresees continuing to influence corn price volatility include:

- Weather data
- Yield patterns
- Just-in-time mentality — Stewart says, "The world has come to rely on supplies of crops and commodities being readily available. No one wants inventory in advance of need. The most recent economic collapse has accelerated this thinking. Almost no one has stockpiles of agricultural commodities."

Stewart surmises, "As a result of all this, the cost of protecting prices has jumped. Options that used to cost pennies to buy are now many times that, increasing the importance of good decision-making. When markets move fast, you can lose money so quickly if you do not know what you are doing."

He adds, "In this kind of high-price, high-risk environment, advanced option strategies or combinations of both futures and options will be necessary to keep marketing costs low while protecting a price range." HW

Editor's Note: *Stewart-Peterson Inc. is based in West Bend, Wis., with branch offices in Illinois, Nebraska and Maryland.*