Risky Business

Using the futures market to manage risk can be a money-saving practice, especially in such volatile times.

by **Sara Gugelmeyer**

It's no secret input costs are rising for all cattle producers as the price of fuel and feed skyrocket. It's also true that for many this means losing money or barely breaking even. So what's a cattleman to do? Well, there is no easy answer, but using the futures market to manage risk is one way to help.

Minimizing risk

Risk management can be defined in many ways, says Kevin Good, senior market analyst for CattleFax, "In a traditional sense of the word, risk management can mean a lot more than just the futures market. It can mean geographically having the cattle spread out so you minimize risk of losing cattle during the winter. It can mean being spread out at all times just because of the differences in the grain costs and feed costs. In some cases producers would buy and sell cattle every week of the year and that is their form of risk management; they were betting on the average."

But now, most commonly, cattle producers use the futures market to manage their risk. They could place a hedge, which is using the futures market to offset a cash purchase or sale they plan to make.

A hedge is probably the most basic way to use the futures market to minimize price risk. Overton, Neb., cattle feeder Travis Edeal says, "Straight hedging is not as commonplace as it used to be; now it's usually a combination of a hedging strategy with options and other opportunities along the way."

Good agrees there are many options cattlemen can take advantage of to reduce risk now. "Today cattlemen can do a number of things," he says, "such as a straight hedge, or they can basis contract, which is pricing cattle straight off the board and letting packers do the actual trading. Or they can do a number of things as far as puts, calls and straddles and things like that." (See "Futures market terms defined," below.)

Because using the futures market can be so confusing, many producers would rather skip the headache, which Edeal says can be a big mistake. He says if he were to just try to guess what the market was going to do and revolve his marketing plan around that estimation, he may be right 50% of the time. That sounds okay, but remember that means he would be wrong 50% of the time as well. And if you are wrong about what the market is going to do, you are exposing yourself to a risk of enormous losses because a small change in the market multiplied by however many head you have in a pen multiplied by however many pens you have can be enough to put you out of business.

Good agrees, "Generally speaking, I think, in the environment we are working in today of increased volatility, the producers that are using sound risk management practices are getting along better than those that are not."

No guarantees

That's not to say just because you start out with a risk management plan from the beginning and stick with it you are going to make money every time. There are still challenges because you are not in control of the market, Edeal says.

"Sometimes the market starts to move against me, and I have to make a decision on whether or not I am going to go ahead and sell now that I am going to lose money," Edeal says. That is a tough decision. "But, if I had my plan in place when the cattle came in, I have a better idea of what to do, and my margin is already set."

In these situations it's hard but necessary to stick with the plan. Even harder though is knowing that sometimes being hedged is going to restrict the amount of money that can be made.

"The hardest thing is the realization that the market could go up or move in a direction that I could have the opportunity to make more money, and I am not able to fully take advantage of it, because we are hedged," Edeal says. "And even if we do have an option strategy in what we are doing, we are still not able to totally capture the actual market."

This is a time when it is important to have a team to help remind you of your initial goals. "That's when the team working on this is reminding each other of what we started out to do, and we have to realize that we made the plan knowing where the market was at the time and it could have just as easily gone the other way and we would have looked really good," Edeal says. "So sometimes the hardest part is to not get too greedy."

That's why having a team of people to help you devise and implement a risk management plan may be as important as the plan itself.

Jerry Hoagland operates a 250 head Hereford commercial cow-calf operation near Melba, Idaho, where he typically backgrounds and/or feeds out some of his calves to sell. But, this year he decided to try something different. The seedstock producer from whom he buys his bulls suggested he get in touch with Jim Williams, Certified Hereford Beef (CHB) LLC vice president of supply, for advice. He did and Williams connected him with Edeal to help him explore risk management possibilities as well as how to add value to his Hereford feeders.

Edeal manages a 3,500 head feedlot that is primarily filled with cattle destined for special programs like Hereford Verified or

Futures market terms defined

Futures market lingo can be very confusing. The Chicago Mercantile Exchange (CME) has a comprehensive Web site glossary of terms. Check it out at: *www.cme.com*. The Chicago Board of Trade (CBOT) also has a glossary on its Web site: *www.cbot.com*. Here are a few of the most common terms used in risk management:

Contract — An agreement to buy or sell an exchange-specified amount of a particular commodity at a specified price. Also, a term of reference describing a unit of trading for a commodity future, as in "5 live cattle contracts." The contract specifications detail the amount and grade of the product and the date on which the contract will mature and become deliverable if it is not liquidated, or offset, earlier.

Short — Selling futures contracts or initiating a cash forward contract sale without offsetting a particular market position.

Long — Buying futures contracts or one who owns a cash commodity.

Hedge — The purchase or sale of a futures contract as a temporary substitute for a cash market transaction to be made at a later date. Usually involves simultaneous, opposite positions in the cash market and futures market.

age- and source-verified programs. He also helps his customers develop risk management plans to help minimize losses, which are unavoidable in such a volatile marketplace.

Hoagland says his goals were simple: try to add value to his calves by selling them through a premium program like Hereford Verified and use risk management strategies to help minimize risk and, hopefully, be profitable.

Don't be afraid to ask for help

Hoagland's situation is not unlike many other producers who are concerned about rising corn prices in a volatile cattle market. Also like many others, Hoagland had done some research on using the futures market to reduce risk but was uncomfortable making such important decisions on his own. He says, "I've been studying it and reading about it over the years, but when it gets right down to it, you need someone that knows what they're doing."

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> ***— Kevin Good***

Edeal agrees, saying, "Finding someone to work with that you trust and can help you devise a plan can be a valuable tool in profitable feeding in today's high input market."

For Hoagland, his team consists of himself, the feedlot operator and a broker, but if a producer wants to operate a feedlot himself, where can he turn? Well, a commodity broker is a good place to start, and Good says CattleFax provides many services, including advice on risk management.

CattleFax is a producer-owned company that collects and analyzes all types of data related to the industry. Although the people at CattleFax aren't brokers, they can help members with risk management decisions.

In fact, Good says CattleFax can help members with nearly any question. "One might strictly want market advice, such as, 'What do you think the cattle market is going to do this week, how big are the showlists, are the packers going to be aggressive?' type of questions. And the next one might ask, 'I've got some yearling cattle offered to me at X level, the back end of fed cattle futures are at this level, do you think we need to be hedging or not?'"

No matter whom you turn to for advice, Edeal says the important thing is to not be afraid to ask questions. "Don't be afraid to ask, 'If I buy a call what does that really mean for me, if I spend $2 per cwt to do that, what's my opportunity cost, what does that mean for my bottom line?'" he says.

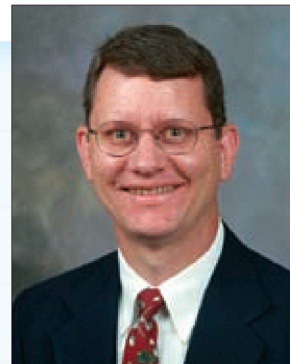
Edeal stresses that it's also necessary to know how much risk you are comfortable with. "I always ask, 'How much risk are you willing to assume in your feeding?' and lots of times that has to be followed up with, 'Well are you willing to risk losing X amount of dollars per head and are you willing to risk only making a certain amount of dollars per head?'"

Of course, the answers to these questions are going to depend on what each person's goals are. If it's a producer retaining ownership of his cattle through the feedlot phase, he may have a much different perspective than someone investing in feeders to earn a certain return on investment.

That's why you want to spend some time getting to know the people you are going to use to help you make these decisions. Edeal says, "What we try to do is try to get to know each other, what it is they do, how they view feeding cattle and what that means for them, is it something they do regularly or is it something they are just doing because calf prices are low and they want to add value."

Remember using the futures market to help manage risk is just another tool producers can use to defend themselves from major losses. It is not a get-rich-quick guarantee. Good says, "A lot of times it is just being willing to take the premiums or take what the market is offering and being able to hold your equity together or be satisfied with a small profit rather than leave yourself uncovered." HW

Expert advice


James Mintert

For those who are already managing their risk using the futures market, James Mintert, Kansas State University (K-State) professor and livestock marketing Extension specialist, answers a few general questions which may help producers consider managing risk in the future. Mintert has more than 20 years experience working as an economist for K-State and has received several awards for his dedication to Extension. For more from Mintert and other economists visit *www.agmanager.info*.

Generally speaking, what sort of risk management plan would you suggest for cattle feeders in order to reduce their risk on the price of cattle and inputs?

First, there is a lot of potential upside risk in corn prices if we experience any crop production problems this summer, so I would encourage feeders to consider purchasing corn call options to cover any corn they have not purchased in the cash market. Second, I also think there is downside risk in deferred live cattle futures, so I would encourage feeders to consider buying put options to cover future fed cattle marketings.

It seems at this time, there are many cattle feeders who are struggling with high feed costs and high feeder cattle prices. What words of wisdom would you share with them to help deal with this?

Feeder prices have held up somewhat better than expected, given how high corn prices are. This is primarily because deferred live cattle futures have shown a lot of strength, which supported feeder prices. So, the first thing for feeders to do is make sure they know their breakeven levels when considering the purchase of feeders. Second, cattle feeders need to manage corn price risk on any cattle they buy. They can either lock the corn in directly in the cash or futures market or use options. Call options protect the buyer against the risk that prices will rise above the call option's strike price, and they also offer the call option buyer the right to benefit if corn prices go down during the feeding period, but they do so at a cost, namely the option premium. But leaving oneself exposed to feed price risk in an environment of tight corn stocks is very high risk, so I believe feeders need a feed price risk management plan for every set of cattle they feed. Third, manage fed cattle price risk on every set of cattle. I lean toward using put options to do this, because you retain the opportunity to benefit if prices subsequently increase.

It seems while feedlot operators take advantage of the futures market to hedge, not many cow-calf operators do. What sort of risk management plan would you suggest for their situation, if any?

I would encourage cow-calf operators to consider managing the risk on calf prices in 2008 via the use of futures, or in most cases, options. Having said that, I also think it's important to note that one reason that cow-calf producers have not, historically, been big users of futures and options is that they face multi-year price risk on their calves and futures and options only allow them to manage the risk on one year's output. Stated another way, if a producer decides to hold back a heifer, it's really an investment decision. They're making a capital investment that will produce a stream of income over a period of years (perhaps six to eight years). So, to really manage their risk exposure, cow-calf operators would need to manage the risk on more than one year's calf crop. Feeder cattle futures and options on feeder cattle futures are not traded far enough into the future to allow producers to manage multiple years of price risk. HW

Long hedge — The purchase of a futures contract in anticipation of an actual purchase in the cash commodity market. Used by processors or exporters as protection against an advance in the cash price. Opposite would be a "short hedge."

Put option — A contract that provides the purchaser the right (but not the obligation) to sell a futures contract at an agreed price (the strike price) at any time during the life of the option. A put option is purchased in the expectation of a decline in price.

Call option — A contract between a buyer and seller in which the buyer pays a premium and acquires the right (but not the obligation) to purchase a specified futures contract at the strike price on or prior to expiration. The seller receives a premium and is obligated to deliver, or sell, the futures contract at the specified strike price should a buyer elect to exercise the option.

Basis — The difference between the spot or cash price and the futures price of the same or a related commodity. Basis is usually computed to the near future, and may represent different time periods, product forms, qualities and locations. Simply put, the local cash market price minus the price of the nearby futures contract.

Short the Basis — Position where a hedger is short the cash market and long the futures market. Opposite would be "long the basis." HW