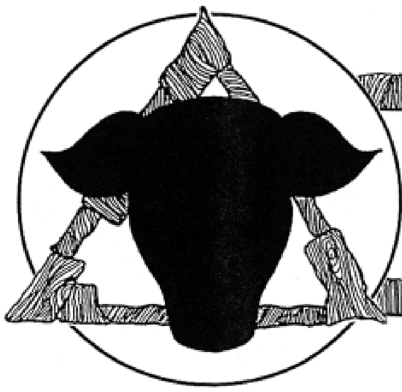

Managing for Today's Cattle Market and Beyond

Comparing Your Marketing Opportunities

By
Chris Bastian, University of Wyoming

The three management areas causing risk and uncertainty are production, marketing and financial. This article will discuss the advantages and disadvantages of the alternatives discussed in "Marketing Alternatives That Can Be Considered In Your Business Plan Today" and how they affect your ability to manage price risk.

Why Manage Risk?

There are three general and perhaps related reasons why a manager would be interested in taking steps to reduce risk and uncertainty. The first is to reduce the variability of income over time. This allows more accurate planning for items such as debt payment, family living expenses, and business growth. Second, there may be a need to ensure some minimum income level to meet family living expenses and other fixed expenses. A third reason for minimizing risk is to enhance the survival of the business. Several consecutive years of low income may threaten business survival or result in bankruptcy. Some recent studies show many managers rate business survival as their most important goal. They are willing to accept a lower expected income if it reduces income variability and hence the risk of business failure.

Auctions

Advantages & Disadvantages

The price at delivery marketing alternative has some advantages. It is usually very easy and typically a familiar alternative for producers. Just deliver the commodity and take the price determined by the auction or offered at the elevator. Producers receive payment almost immediately after the commodity is sold. Producers also have great flexibility in the quantity they sell. Some alternatives such as futures contracts may specify a certain amount of product to be sold at one time. In the case of the auction, the market is considered to be price efficient. Price efficiency is concerned with how accurately, how effectively, how rapidly, and how freely the marketing system makes prices which measure product values to the ultimate consumer and reflects those values through the marketing system to the producer.

Unfortunately, from a risk management standpoint the price at delivery strategy increases price risk. In fact, the price at delivery alternative maximizes a producer's price risk. Producers can only control when they take the commodity to market, but they still accept the price given them at the time of delivery. Ultimately, this strategy can compound with production risks to increase income variability for the firm.

Forward Contracts

Advantages & Disadvantages

If you forward price all of your expected production through forward contracts you can minimize

your price risk. However, you must recognize that there are some risks of non-performance associated with this method. There are some measures you can take to reduce those risks. Forward contracts offer you the advantages of being relatively easy, flexible in quantity and reducing your price risk.

Some of the disadvantages include risk of non-performance, not being able to capture higher prices once the contract is signed, and it is not very price efficient. Before signing on the dotted line and agreeing to the buyer's price, check around with other buyers and your neighbors to make sure this price is reasonable. Also, check other marketing alternatives which you might use to forward price your production to see if this is a good pricing opportunity.

Video Auctions

Advantages & Disadvantages

Some of the obvious advantages of this marketing alternative are the cattle are handled less, cattle remain on the place until sold and more competitive bids can be obtained than by just forward contracting with one buyer. The seller can determine desired delivery date. The forward price of the video auction reduces price risk. The video auction provides valuable services unavailable when negotiating a forward contract with a single buyer. For example, the auction guarantees buyer performance of the contract. The seller can also decide to no sale the cattle and faces less transportation costs than with the local auction or perhaps the forward contract alternative.

As in the case of forward contracting, one of the disadvantages of the video auction is that once the seller accepts the bid, he or she cannot benefit from price rises in the market for those cattle committed to the video sale. The video auction does have higher commission fees associated with it, but the transportation costs are typically less. Discounts are incurred for less than a full truckload of cattle. Length of time between videotaping of the cattle and the sale is sometimes a disadvantage. Frequency of video sales is less than that of regular auctions.

Hedging with Futures

Advantages & Disadvantages

The futures market offers the producer the opportunity to forward price his or her commodity. It also allows the producer the flexibility to forward price without negotiating a contract with a buyer. Thus, the producer can forward price production up to twelve months in advance and reduce price risk.

There are some disadvantages to using the futures market as well. In order to trade on the futures market a producer must get a broker and set up what is called a margin account. The margin account is used to cover losses on the futures position. In the case of a short hedge if prices rise above the price you get in, your account loses money, and you may have to deposit money with the broker for your margin account. The important thing to remember is that if the futures market is rising, the cash market is likely also rising. So remember, even though you may be losing in the futures market you may be gaining in the cash market.

Just as in the case of forward contracting, the producer cannot benefit from favorable cash prices because the futures hedge has locked in a price subject to basis risk. Additionally, the producer must pay a broker a commission fee for handling his market actions in the futures market. This is an added cost the producer must account for when comparing expected prices from different marketing alternatives. An additional cost to using this alternative would be interest costs associated with money borrowed to use in the margin account. Another possible disadvantage of using the futures market is that the contracts are standardized as to quantity. This reduces some of the quantity flexibility producers have with privately negotiated forward contracts. Overall, hedging in the futures market is more complex and requires more time managing its use as an alternative. However, hedging in the futures market is still a very valuable price risk management alternative.

Agricultural Options

Advantages & Disadvantages

The options market offers some real advantages compared to forward contracts and the futures market. You are able to reduce price risk without facing margin calls in the futures market. Also, you are able to benefit from rising prices as you are not locked in if the market trends favorably. The options market also offers many different strike prices or levels of price insurance.

The options market's advantages do not come without some disadvantages either. You pay a higher price for the insurance through the premium with this alternative than you would with just forward contracting or hedging in the futures market. Additionally, you pay a commission fee to a broker for executing your transactions in the options market. The commis-

sion fee is typically less for options transactions than futures transactions, however. As was the case with the futures market, the options market deals with standardized contracts and there are set quantities which reduces the flexibility for producers. Also, producers are subject to basis risk with this alternative just as in the futures market hedge.

Comparing Alternatives

Risk

These two articles, "Marketing Alternatives That Can Be Considered In Your Business Plan Today," and "Comparing Your Marketing Opportunities" focused on marketing alternatives, considerations using the alternatives, their pros and cons and their relationship to price risk. Price at delivery, i.e. just delivering your cattle to the auction barn and accepting the price offered, is an alternative which maximizes your price risk and increases your income variability. Forward contracting is a way to reduce your risk, but it also reduces your ability to capture gains from rising prices at a future point in time. Certain conditions should be written explicitly in the contract itself to reduce the risk of non-performance.

Video auctions for cattle are also a form of forward contracting except the cattle are videotaped and displayed to a number of buyers. This allows the producer an opportunity to expose the cattle to more buyers and perhaps get a more competitive price. The cattle are forward priced, reducing the price risk, but the cattle cannot be sold for a higher price at a future point in time if the cash market trends upward. The video auction also is responsible for contract performance by both parties. Hedging in the futures market offers an opportunity for producers to reduce price risk. This alternative is more complex, and requires margin deposits which are a disadvantage. The producer trades price risk for basis risk with this alternative. Using options is another way a producer can reduce price risk. Put options can be used to set a minimum price for a commodity, but the producer can take advantage of price rises with this alternative. Call options can be used to set a maximum purchase price for a commodity, but the producer can take advantage of falling prices with this alternative. Options offer some advantages over the futures market, but the option premium is the price you pay for those advantages. Producers are still subject to basis risk with options.

Costs

When comparing these alternatives producers need to consider all the costs involved with each of these. Costs associated with the cash market include transportation, shrinkage, commission and yardage fees, checkoff and inspection fees. Some of the costs associated with the forward contract alternative are negotiated into the contract, but in general, transportation, shrinkage and any quality inspection costs need to be considered. The major costs associated with the video auctions include a videotaping fee, commission fees, shrinkage and a sliding scale price if weight specifications aren't met. The commission fees tend to be higher with a video auction than a cash auction, but some of that cost may be offset with less transportation costs and less shrinkage costs depending on the individual's proximity to a cash auction and weighing facilities. Additional costs associated with the futures market include commission fees to the broker and interest on margin funds. Additional costs associated with options include premiums, broker fees and interest on borrowed premium funds.

In addition to deciding which alternative to use, livestock producers must decide when to deliver livestock and when to price livestock. When developing a marketing plan compare your marketing alternatives based on risk, costs and actual price after marketing costs, but also consider your price goals. These price goals should be set forth in your market plan and will give you the opportunity to decide whether you have good pricing opportunities throughout the year. The article entitled "Market Plan" goes into more detail as to how to develop a marketing plan, but it is important to remember with a little planning your marketing can take place throughout the year and allow you to take advantage of good opportunities rather than waiting for the price available after coming off pasture.

References

Bahn, H.M., R. Brownson and C.H. Rust. "Guidelines for Direct Sale of Feeder Cattle." GPE-4115. Great Plains Beef Cattle Handbook.

Bastian, Chris, and John P. Hewlett. WIRE: Marketing and Risk Management Handbook. Department of Agricultural Economics, University of Wyoming. Laramie. 1994.

Futrell, G.A., and R.N. Wisner. Marketing For Farmers. 2nd. ed. Doane Information Services. St. Louis, Missouri. 1987.

Guyer, P.Q. "Contract Feeding of Growing Calves." GPE-4004. Great Plains Beef Cattle Handbook.

Kay, Ronald D., and William M. Edwards. Farm Management. 3rd. ed. McGraw-Hill, Inc. N.Y. 1994.

Purcell, W.D. Agricultural Futures and Options: Principles and Strategies. Macmillan Publishing Co. N.Y. 1991.

Rust, C.H., and D. Bailey. “Current and New Beef Marketing Technology (Electronic).” GPE-4110. Great Plains Beef Cattle Handbook.