Volume 5, Issue 3 March 2017

RightRisk™

RightRisk News

Dates to Remember

Crop Insurance Sign Up
(Most Spring Planted Crops)
- March 15, 2017

Noninsured Crop Disaster Assistance Program (NAP)
Deadline for spring-seeded forage and all other crops
- April 1, 2017

For more information see:
http://www.rma.usda.gov
http://www.fsa.usda.gov

How Much Risk is Right for You?

Marketing Risk Management Strategies

There are five basic strategies for managing or controlling risk: (1) avoid it; (2) reduce it; (3) transfer it; (4) increase capacity to bear it; or, (5) accept it. Agricultural producers are often described as price takers but there is much that can be put into selecting one or more strategies to manage market risk.

Strategies (1) and (5) can be thought of as the extremes. Managers can simply choose not to become involved where they don't want to be exposed to the market risk associated with a particular enterprise. This is avoiding risk, strategy (1). This decision can be made on an annual basis in some cases, such as not planting a particular crop in a given year after considering the market outlook and the projected costs of production.

In other cases, this decision is a multi-year decision because of the investment involved with the particular enterprise and the inability to get into and out of it quickly. Crop rotations and livestock production are examples where decisions can be locked in for a multi-year time frame.

The other extreme is simply accepting risk, strategy (5). This is the right thing to do where the risks are in your favor. It can also be a good strategy where the costs associated with mitigating risks that are not in your favor are too high given the level of effectiveness. Risks can be in your favor in the market place when most of the uncertainty is to the upside. In those cases, managers should think through how much to control risk and how much to accept, given the opportunity to participate in a potential market upswing.

Common Risk Strategies

(1) avoid it;

(2) reduce it;

(3) transfer it;

(4) increase capacity to bear it;

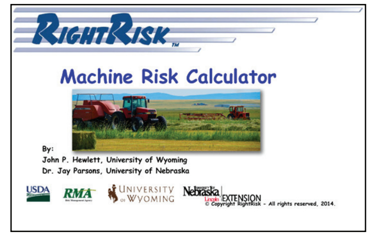
(5) accept it.

Downside market risk can be a considerable worry, especially where the offer to lock in a price to mitigate the risk is not attractive. This doesn't make it a bad strategy if your financial situation warrants it. However, in some cases, managers may rationally turn down the offer as being "too expensive."

In a similar way, a tool to manage market risk may be deemed ineffective. Take, for example, an operation that is marketing product and the primary risk is basis risk exposure--the difference between the local price received and some "national" price. Risk controls designed to address national price risk will not provide effective risk control where the objective is to manage basis risk.

Most agricultural producers actively managing market risk use one of the strategies (2)-(4). Quite often they are focused specifically on strategy (3): transferring the risk outside the business through the use of risk controls such as crop insurance and marketing contracts.

Highlighted Tool



One of the most important, yet often overlooked, aspects of risk management planning in production agriculture is estimating accurate operating costs for various machinery and equipment. Because these costs represent one of the largest categories of expense, an off-base estimate can skew the entire planning process. Educated guesses for machinery and equipment expenses lead to flawed budgets, which in turn could result in inaccurate values used to determine crop insurance or other risk management analysis.

The ***Machine Risk Calculator*** is designed to help calculate total machinery ownership and operating costs and, in addition, evaluate the risk sensitivity of those costs to changes in input factors. The tool allows users to analyze costs on powered equipment (tractors, windrowers, etc.) and up to three different implements – as well as vehicles, powered irrigation equipment, non-powered irrigation equipment, and actual field operation costs. Users enter information for a particular machine and the calculator generates charts showing annual costs and average operating costs.

Results include an estimate of risk sensitivity for the particular machine or activity on selected input variables – the probability of a selected cost per acre being at or lower than a selected value. The user can either enter their own machinery data or utilize tables (included in the tool) showing ranges of reported rates and information for the selected activities as a basis for analysis.

To access the *Machinery Risk Calculator* see: http://RightRisk.org > Resources > Risk Management Tools

Marketing Risk Strategies continued from pg. 1

Disciplined marketing plans can be a great way to earn a competitive advantage by preparing the manager to lock in higher returns when the opportunities present themselves or to protect the overall price received when markets could move against the position. Insurance and marketing contracts come at a cost in the form of a premium paid and/or potential to forego profits from a favorable movement in the market place.

There are several ways producers can employ the strategy of increasing capacity to bear market risk. The two most common approaches are to maintain a financial cushion and to maintain flexibility. Financial reserves can help you absorb lower market prices without putting the solvency of the business in danger. Flexibility can help buffer changes in market conditions with a good plan B. For example, the flexibility to feed a portion of your annual crop production to livestock can add value by capitalizing on the internal transaction efficiencies between two enterprises.

Reducing market risk, strategy (2), can be achieved by controlling the probabilities or by controlling the impacts of market price movements. Controlling probabilities is difficult to do and is usually only accomplished in direct marketing situations where relationships with people and product differentiation matter a lot. For example, maintaining favorable contacts with customers for direct-marketed beef can reduce the probability of receiving a lower market price, should national prices decline and increase the probability of receiving a higher market price, should national prices increase. However, in most cases, managers are only able to control the impact of market price movements. In addition to some of the strategies discussed above, diversification can be an effective risk management control when it comes to reducing the impact of unfavorable price movements. Diversification can take many forms, including diversified market timing or diversified production output with a mix of different crops and/or livestock.

It is always a good time to start thinking about managing market risk and which risk management strategies will be most effective in helping to achieve your marketing goals.

RightRisk™

RightRisk helps decision-makers discover innovative and effective risk management solutions.

- Education
- Coaching
- Research

E-mail: information@RightRisk.org
Web: www.RightRisk.org

RightRisk News is brought to you by the RightRisk Team

Contributing authors:
John Hewlett, Ranch/Farm Management Specialist - University of Wyoming, hewlett@uwyo.edu
Jay Parsons, Risk Management Specialist - University of Nebraska-Lincoln, jparsons4@unl.edu
Jeff Tranel, Ag and Business Management Specialist - Colorado State University, Jeffrey.Tranel@ColoState.edu
Editing and Layout: John Hewlett, hewlett@uwyo.edu

Past issues of RightRisk News are available at: http://RightRisk.org > Resources > RightRisk News
To subscribe/unsubscribe, email information@RightRisk.org subject line "Subscribe/Unsubscribe RR News"

How much risk is right for you and your operation?

Colorado State University Extension
University of Wyoming Extension
Nebraska Extension