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RightRisk™

RightRisk News

How Much Risk is Right for You?

Dates to Remember

Spring crop acreage reporting deadline
- July 15

Annual Forage Insurance Plan
- July 15

Margin Protection Program Dairy (MPP-D)
- 2018 crop year
July 1 - Sept. 30th, 2017

Forage Insurance
- September 30th

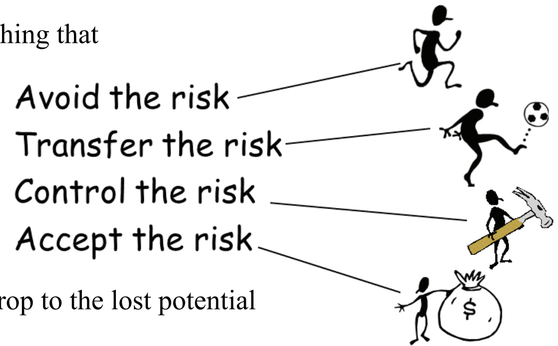
RI-PRF Coverage
November 15th, 2017 for 2018 crop year coverage

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

Evaluating Risk Management Strategies

When it comes to risk management strategies there are four basic actions a manager can take: (1) avoid the risk; (2) transfer the risk; (3) control the risk; or (4) accept the risk.

Avoiding risk is simply choosing to not do something that exposes you to the risk. For example, if you are not comfortable with the risk of growing a particular crop, you can avoid it by simply not growing the crop. If you don't grow it, you don't have the expenses associated with growing it nor do you have resources tied up in growing it. To evaluate this strategy, the manager would compare the benefits of not growing the crop to the lost potential income and the uncertainty around it.



Transferring risk outside the farm or ranch is usually accomplished through insurance or marketing contracts. Insurance contracts provide protection from downside risk in exchange for a premium expense. By paying the premium, you essentially transfer some of the potentially bad outcomes to a large insurance company that can better withstand the negative consequences. This has the effect of truncating your distribution of possible outcomes on the downside, in exchange for subtracting the insurance premium from every outcome (Figure 1). Marketing tools such as put options work in the same way.

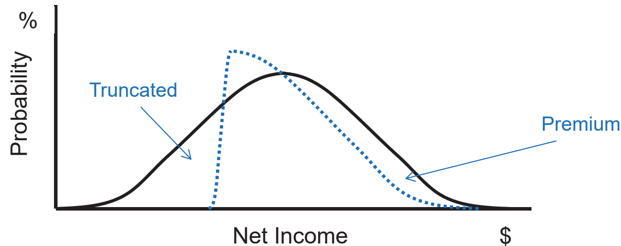


Figure 1: The effect of insurance on the distribution of outcomes for net income.

A marketing contract that locks-in a price on some or all of your production would have the effect of squeezing your distribution of outcomes into a tighter range of possibilities (Figure 2). In this case, the risk associated with the full range of outcomes is transfered to the person you are contracting with. In exchange, you pay a risk premium collected up front in the contract price that is slightly in the other parties' favor, when compared to the price expected at the end of the contract period.

The more production you lock-in, the tighter price the range. This makes sense when you consider that as you contract more and more production, you transfer more of the potential upside and more of the risk premium to the other party, in addition to transferring more of the downside risk.

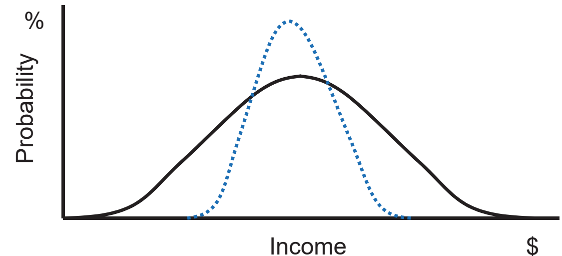
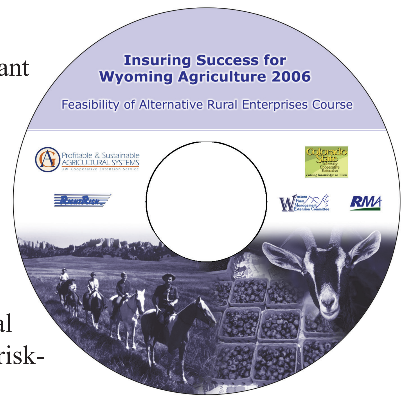


Figure 2: Contracting part of your production is one of the ways to squeeze the distribution of income.

Evaluating insurance and marketing contracts can be frustrating, especially when considered looking back in time. Once the outcome has been determined, it is tempting to declare the decision good or bad based on whether the contract worked in your favor. That is a bad habit to get into. Managers should always make a sincere effort to evaluate any decision at the time it is taken, in terms of what it will cost in premium and, in the case of marketing contracts, the benefit of the upside potential associated with transferring the risk to a third party.

Highlighted Course



The ability to select, plan, and evaluate new and existing business enterprises is an increasingly important skill to help reduce business risk. The *Feasibility of Alternative Rural Enterprises* course presents a step-by-step approach to defining an agricultural enterprise, setting goals, planning for success, and evaluating and managing the risks.

Breaking down an agricultural business into individual enterprises is a great start for evaluating an existing business and determining if a new enterprise will fit. This course encourages producers to think beyond traditional production goals. Another section of the course involves planning and analyzing existing or planned enterprises. SWOT analysis (Strengths, Weaknesses, Opportunities, and Threats) should be performed for each enterprise. A market assessment follows. This includes the study of potential markets and customers. Risk analysis and management is the final lesson. It discusses different risks and risk-management strategies.

For More Information on the *Feasibility of Alternative Rural Enterprises* course, see http://RightRisk.org > courses.

Evaluating Risk Management Strategies continued from pg. 1

Controlling risk is by far the most active form of risk management. There are two primary means for controlling risk: either by controlling the probability of various outcomes occurring or by controlling the impact of those outcomes if they do occur. Very seldom can a manger do both at the same time. For example, a piece of machinery may break down at any moment. You can control the risk of a machinery breakdown by properly maintaining the machine and reducing the chance of failure, thus extending its useful life or saving money on a costly repair. To evaluate if this is a good strategy, you need to compare the extra expense of maintaining the machine versus the effect it has on reducing the probability of a breakdown.

Controlling the impact of a bad outcome (consequence) involves using strategic risk management tools like diversification, keeping extra resource reserves on hand, or maintaining flexibility. The goal here is to reduce the impact of a bad outcome or increase the impact of a good outcome. For example, having extra cash reserves could reduce the impact of poor revenue in a given year. To evaluate such a strategy, the manager would evaluate the cost in potential income for keeping the cash reserves on hand, versus the benefit the reserves offer for weathering the storm of a bad year and the associated piece of mind it brings.

Finally, *accepting* risk is also a risk management strategy. Risk or uncertainty about the future, may include both positive and negative changes (benefits or costs). In some cases, there are simply no tools available to either control or transfer a particular risk. In other cases, the tools available are just too expensive to justify their use.

Agricultural managers routinely speculate on risk. That's where a lot of the profit in farming and ranching resides. However, such decisions should be made only after careful evaluation of the potential impact and your willingness to accept the probability of their occurrence. Risk management is an activity that can return big dividends. Thoughtfully evaluating available risk management strategies as a habit for conducting your business can lead to a more stable and prosperous business future.

RightRisk™

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

- *Education*
- *Coaching*
- *Research*

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RightRisk News is brought to you by the RightRisk Team

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How much risk is right for you and your operation?

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