Getting Started in Ag: Livestock Risk Management Options

Risk Management is Important

It is a great time to be in the livestock business, especially for cattle producers. Prices continue to top record highs and profitability seems guaranteed for most producers. However, developing a solid risk management plan to deal with downward price risk is imperative to success, especially with current high prices.

Those new to the livestock business may not realize the importance of considering the many risk management options available. Feed and other input costs remain high, or may be going up in many cases, and can wipe out profit margins if market prices dip. It is essential to have a firm grasp on your financials: your position, cost structure and break-evens. This can assist in determining what level of price protection is necessary. Let's take a closer look at some of the options for managing market risk.

Livestock Risk Protection Insurance (LRP)

LRP is an insurance policy designed for livestock producers to manage market price risk. LRP is available in Wyoming for feeder cattle, fed cattle and swine producers. To set up an LRP policy, a producer first determines the number of head (total pounds) and their marketing period. Contract lengths are available from 13 to 52 weeks in 4-week increments. LRP prices and coverages are determined, in part, by Chicago Mercantile Exchange (CME) prices, based on the length of the contract and are posted by the Risk Management Agency (RMA) daily.

Producers can insure from 70 to 100 percent of the expected ending value, with the premium paid at the beginning of the LRP contract period. If the actual ending value is lower than the coverage price, indemnities are paid on the difference. It is important to note that the actual price received for the insured animals has no bearing on the prices used in the LRP contract; prices are based on the CME index and are basically a reflection of the overall market.

There are limits on the number of head that may be covered, both per contract and for the overall year. These limits vary with the type of species insured. The main advantage of using LRP is that producers can buy some downside price protection for a set price; it is not like using futures and options, where the cost of use varies depending on market conditions.

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Livestock Gross Margin Insurance (LGM)

Livestock Gross Margin (LGM) insurance takes the concept of LRP a step further and protects against the loss of gross margin, which is defined as the market value of the livestock minus the feeder and feed cost. Producers can select a per-head deductible that includes a premium subsidy. Indemnities are paid at the end of an 11-month insurance period, based on the difference between the gross margin guarantee and the actual gross margin. As with LRP, the price you actually receive for your livestock has no bearing on the indemnity paid.

LGM is available for fed cattle, swine and dairy producers nationwide. LGM is a complex program that requires a close working relationship with an experienced insurance agent. It best suited for larger operations, especially those that feed to finish, and dairies.

Forward Contracting/Sales

Forward selling or contracting livestock is a viable risk management option for many producers. In essence, the producer agrees to sell production, such as a calf crop, for a set price at a future date. This can be done through avenues such as video auctions or private transactions. The main advantage is a known output price, which eliminates the potential for downside price risk. The downside to forward contracting is the inability to take advantage of upside potential if prices go up after the agreement has been set.

Futures/Options Market

Using futures and options contracts traded on the CME is another option for managing price risk. A livestock futures contract is a standardized contract in which a buyer agrees to purchase said livestock at a predetermined date and price. This contract can be traded until expiration and can be used to protect a market price. In simple terms, this involves buying or selling an offsetting position in the futures or options market. This risk management strategy requires a trusted and proven broker/market advisor to implement. It also has inherent risk, in that margin fees must be paid if the strategy does not work out as planned.

Don't Forget Feed Costs

The largest cost for any livestock operation is feed. Make sure to include feed expenses when developing a risk management plan. While prices for most feedstuffs, including alfalfa, other hay and corn, are down somewhat from last year's highs, they remain considerably higher than historical norms.

If you raise your own feed, make sure your production is covered by some type of insurance, if possible. With the wide variety of crop insurance and other USDA-based programs available, chances are good there is at least one program that fits your needs.

If you purchase feed, consider forward contracting or forward purchasing to mitigate as much price risk as possible. This should be done as early as possible; don't wait for feed availability to become an issue, especially in the winter months.

Useful LRP Links:

- **Cost Estimator:** https://ewebapp.rma.usda.gov/apps/costestimator/
- **Daily Prices, Rates and Ending Values:** https://www.rma.usda.gov/Information-Tools
- **Agent Locator:** https://prodwebnlb.rma.usda.gov/apps/AgentLocator/#!/

FOR MORE INFORMATION

Do not neglect risk management just because market prices are at all-time highs. Having a solid risk management plan is as important as ever. For more information on Livestock Risk Protection (LRP) and other insurance programs, as well as online tools, courses, risk management profiles and other information, visit RightRisk.org. For additional resources, visit farmanswers.org.

James Sedman is a consultant to the Department of Agricultural and Applied Economics in the University of Wyoming College of Agriculture, Life Sciences and Natural Resources, and **John Hewlett** is a farm and ranch management specialist in the department. Hewlett may be reached at (307) 766-2166 or hewlett@uwyo.edu.

University of Wyoming Extension
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