BETTING FARM NOT CONSERVATIVE

There is a belief among a segment of dairy farmers that being "conservative" means avoiding the use of futures and options. This belief is well-intentioned and understandable, but misguided. The dairy farmer who runs his farm as efficiently as he can, and then sells his milk for the best price he can get is taking on a great deal of risk in his operation. No matter how hard, smart and effectively he works, he cannot control all of the factors involved in his business.

Going to feel pain

If there is unusually wet weather that causes corn prices to spike and his feed costs to explode by 30%, he's going to feel pain. His revenues can be affected as well, as decreased exports, uncompetitive world prices and increased production in other parts of the country can all work against him. Unless someone has a crystal ball, or the supernatural ability to accurately predict the future, no one knows where markets are going. No matter how many high-profile dairy economists or big city brokerage houses claim they can tell you where the markets are going, the truth is they can't.

The implications of this reality for dairy farmers seeking to conservatively manage their operations cannot be overstated. If one does not know where milk prices will be in the future, then all of the time, energy, money and work invested in running a dairy are exposed to the inevitable swings of the market. This is okay when times are good. But when the tide turns, as it has in recent years, even the largest gains are quickly erased. It is amazing how quickly an operation that has lasted for decades can disappear entirely.

The word "conservative" is defined as "risk averse; disposed to preserve existing conditions." Any sensible dairy farmer wants to preserve his existing conditions – or to put it bluntly, to stay in business. This is the right mindset, as protecting one's life's work implies simply running the business profitably, building wealth over the long haul and not treating the operation as a casino.

> ***"Some folks feel comfortable assuming risk, speculating that feed grains purchased today...will yield profits on milk sold tomorrow."***

What is best strategy?

The question to ask here is what is the most conservative strategy to employ while running your operation? Is it to hope the market offers a favorable price when it comes time to sell your milk? Or is it to employ strategies to protect profits when possible and proactively manage risk? Consider some of the actions taken by farmers who use the futures market to compliment what they do in the cash market:

- Use futures on corn, meal, and milk as a tool to identify opportunities for deferred periods before making physical commitments.
- Use flexible strategies involving options on futures that could allow for an improvement of either the feed purchase or milk sales price.

By employing these strategies, and taking full control of all of the opportunities available to him, this farmer is the one most likely to conserve his operation. He is reducing the role of chance and minimizing his downside while still participating in the upside, he is hedging, and by definition, reducing risk. There is a cost to reducing risk, but the conservative –minded farmer accepts this, and sleeps peacefully at night knowing that he has taken every possible action to protect his exposure and secure profitability. This modest investment is similar to the one made in buying an insurance policy.

No implications here

Does this imply that farmers who do not use the futures market are making a mistake? Of course not. Some folks feel comfortable assuming risk, speculating that the feed grains they purchase today will yield profits on milk sold tomorrow.

Similarly, this does not imply using the futures market as a compliment to cash contracts automatically makes the operation more conservative. The big mistake many farmers make when evaluating whether or not to use these strategies is assuming they all lead to increased risk. They assume that using them inherently goes against their naturally conservative mindset, when in fact these contracts can reduce risk.

Essentially, there are three strategies available to dairy farmers. These are: 1) Ignore the futures market all together, 2) Use the futures market to reduce price risk. 3) Use the futures market to increase potential upside, accepting the risk of increased losses.

The conservative-minded dairy farmer employs the second strategy. In closing, think of your business as you would a construction project. Inevitably, one is going to face challenges, some of them unforeseen. It is best to have every available tool (cash contracts, futures & options) and the knowledge to select the appropriate tool at the appropriate time to identify opportunities and protect profits. ❐

FYI

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