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Risk Management

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Why "Risk Management”

- Provides for milk price and input cost management.
- Helps a business stay profitable in spite of “Volatility”.
- In recent years “Volatility” has had severe financial consequences on many dairy farms.
- Protecting the business from volatility can allow business goals to me met.
- Stress is reduced which allows the dairy to make better management decisions for the cows and the future of the operation.

How to get Started

- Find the right resource/broker/advisor.
- This individual needs to serve as partner and together with the dairy create a risk management plan that is unique to that business.
- Many dairy farms prefer to have their advisor analyze financials, develop targets and thresholds, and execute trades, but not all.
- Not all brokers or advisors are equipped to provide this level of service.

Need to Know “Margin Account”

- Learn, understand and plan for margin account requirements.
- The Chicago Mercantile Exchange requires each trader to open and maintain a margin account.
- The CME guarantees that when each trade settles the money due will be collected from and paid to, the buyer and seller of the contract.
- This reduces the risk of default of either the buyer or seller of contracts.
- Each trade has an initial “margin requirement” or a deposit on the contract.
- If the value of the contract should change you may need to add money to the account or may be able to take money out.
- As the market changes on a daily basis so does the value of the margin account.

Need to Know “Hedge Line of Credit”

- Producers should consider the establishment of a “Hedge line of Credit” with their lender.
- Used to add money to the margin account so that a marketing plan can be executed without deterioration working capital or liquidity for the business.

- Need to know that different risk management strategies will have different margin requirements.
- These strategies need to be discussed with the lender so the correct exposure limits can be established.

The Big Picture

- Create a strategy that will protect the business, provide peace of mind, and allow the business to prosper.
- Historically producers worked with a broker for the wrong reasons – they traded with the idea of making money.
- A RM plan should work towards making money in the farm business on a consistent basis regardless of actual market price.
- RM strategies should involve trading that reduce price volatility and protect a margin between the farm's cost of production and the available milk price.

Class III Milk Price

- Class III is not the gross farm price however, it does relate to the farm price and needs to be used.
- The difference between the all milk price and class III is called basis.
- Basis is different from farm to farm and month to month but is relatively consistent over time.
- Heavily influenced by management due to component and milk quality levels.

Risk Management Strategies

- Futures Contract – By selling a futures contract a producer can fix their class III milk price. Protects the price from declining but offers no upside potential.
- Buy a put – Protects their milk from declining below a certain level. A producer purchases a put, pays the premium and gains protection against price declines below a certain level. If the price moves higher, the higher price is received by the farm and no loss of upside potential. Functions like insurance.
- Buy a put option, sell a call option simultaneously to provide a range of prices they can receive. Also termed a "Fence, Collar, or Min/Max. This strategy gives the producer and price floor and ceiling and is used because it can provide a higher level of protection than a put alone with the premium cost being greatly reduced.

Keys To Success

- Reliable and accurate accrual accounting system.
- Reliable and accurate production management systems.
- Understand your "cost of production" and what influences it.
- Develop a budget and monitor actual to planned performance.

- Understand the cash flow requirements of the business
- Work with multiple expert resources: financial consultant, market advisor, broker, lender, etc.
- Take a marketing class – Get educated!
- Work with your lender.
- Use a “Hedge Line of Credit” if you qualify?
- Processor marketing programs can be a good tool.
- Avoid making decisions that are not interrelated to cost of production or tied to a pre determined business goal.
- Execute their risk management plan with consistency and discipline.
- Must understand the cost of production and cash flow breakeven milk price for the business.
- Be satisfied with singles and doubles – you cannot always hit the home run.