7-1-2010

Choosing from Livestock Marketing and Insurance Tools

Matthew Diersen
South Dakota State University, Matthew.Diersen@SDSTATE.EDU

ExEx5079
July 2010
Economics
2 pages

Extension Extra

SDSU

South Dakota State University / College of Agriculture & Biological Sciences / USDA

Choosing from Livestock Marketing and Insurance Tools

Matthew Diersen, Extension risk and business management specialist

The insurance industry has introduced several livestock products in recent years to manage different types of price risk. The change adds insurance tools such as *Livestock Risk Protection* (LRP) and *Livestock Gross Margin* (LGM) to the list of traditional marketing tools such as cash sales, forward contracts, futures contracts, and options contracts. The challenge is to pick the right product at the right time at the right price. This decision aid leads you through choices to a specific tool or small set of tools that would help manage the risk in a cost-effective way.

As you move through the guide, be aware that all products may not be available at a given time or for a given type of livestock. You may also not be willing or able to use a product, whether for lack of a contract with an intermediary or because of a disparity in the number of head you want to cover and the number allowed or represented by contracts.

The key first decision concerns the certainty of your price outlook. If you expect price to move in a given direction (including sideways), then follow the "certain" path that leads to pricing-focused tools. If multiple price levels can be reasoned, then follow the "uncertain" path that leads to protection-focused tools. If you reach a tool you are not willing or able to use, then look for a different path.

CERTAIN PATH

With relatively certain price changes expected, the next decision relates to direction of the price change. If prices are expected to be steady or higher, a good tool to use is the *Cash Market*. The transactions cost is generally the lowest for this default tool. If prices are expected to move lower, then basis expectations dictate the best tools. If basis risk is low or if no firm basis expectations exist, then one has to wade through all the tools on this sub-path.

"Basis" is defined in this publication as the cash price minus the futures price. If basis is expected to become higher, then *Selling Futures* is a good tool to consider. Place a classic hedge to lock in the price and benefit as the basis improves; a drawback is the margin requirements. Alternatively, if the number of head is small relative to the futures contract size, then *Buying LRP* is a good tool. If basis is expected to become lower, then a *Forward Contract* is a good tool; it locks in the price and the basis at favorable levels, but a drawback is the counterparty risk with the buyer.

UNCERTAIN PATH

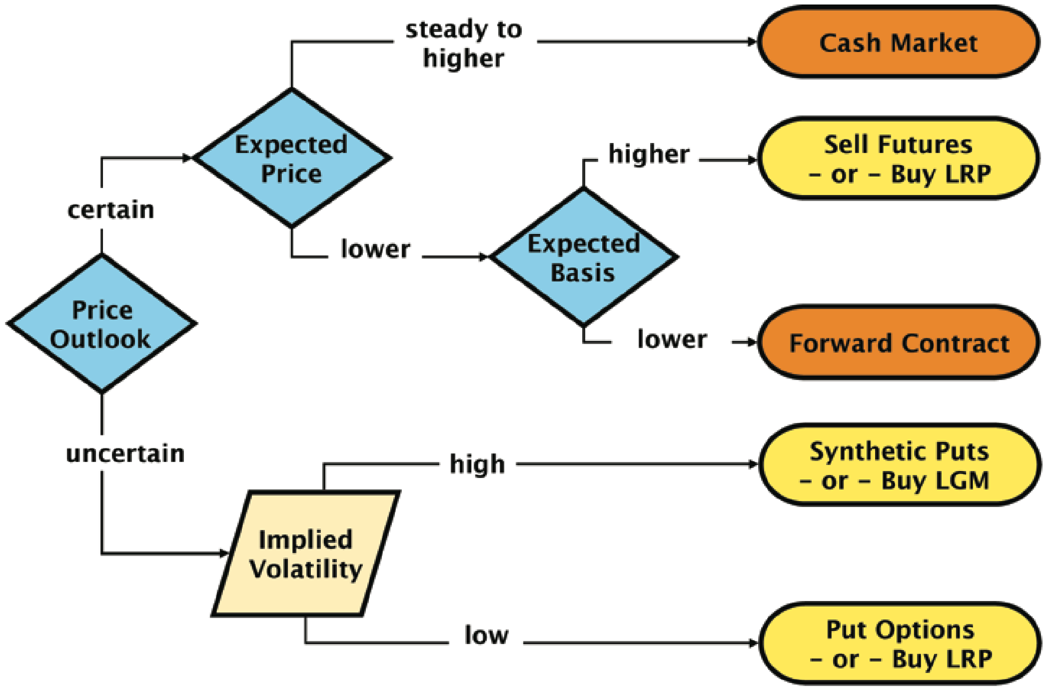
Following the uncertain path leads to a node where you need to gather data. There is no decision or choice here, but rather a judgment call about the level of volatility implied in the market. If the implied volatility is high, the cost of protection tools will also be high. On this path, one could use *Synthetic Puts* as a tool. In this setting, a standard put option would be expensive, and the synthetic would be a combination of selling futures (or forward contracting) and buying an out-of-the-money call option. This would establish a floor price close to the futures price and have a lower expense using the call option. Another tool could be *Buying LGM*. While only for finishing livestock, LGM is not priced like the trading options, so its cost is not directly tied to high volatility.

If the implied volatility is low, then the classic protection tools are best. Using *Put Options* is a good tool. Its drawback is giving up the premium for the protection. Alternatively, if the number of head is small relative to the futures contract size, then *Buying LRP* is a good tool. Fixed basis adjustments may also favor using LRP. A drawback of LRP is the inability to roll the coverage ahead if needed.

SUMMARY

With multiple insurance and marketing tools available, those looking to manage risk want to choose the right product at the right time at the right price. The certainty of price movements, expectations of price and basis changes, and volatility affect the choice of an effective tool. Please see page 2 for a graphic based on information from this publication.

Choosing from Marketing and Insurance Tools Producers are Willing and Able to Use



Notes:
- LGM is available only for finishing livestock.
- LRP and LGM may reduce basis risk.
- Futures and options contracts are of a fixed size.

EXEX5079 Access at http://agbiopubs.sdstate.edu/articles/ExEx5079.pdf.