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Marketing Risk: Current Issues for Risk Management

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Background

Marketing is a vital component of any business; it is the process that transforms production activities into the financial performance and success of the operation. In an ever-changing environment, marketing agricultural commodities can be a challenging endeavor. Unanticipated forces, such as weather or government action, can lead to dramatic changes in crop and livestock prices. As agriculture continues to move to a more global market, these forces increasingly derive from a variety of world forces. The ability to recognize, anticipate and understand those forces and integrate them into a risk management strategy is critical to successful marketing.

In addition to understanding the forces that could impact prices for commodities, a successful risk management strategy also reflects linkages between marketing decisions and other farm business decisions. Marketing decisions can impact the production, financial, legal and human resource aspects of the business and should be considered in a comprehensive risk management strategy. Likewise, decisions made in several of these other components of the operation can impact marketing options and market access.

Because all these operational and strategic decisions must be made with a degree of uncertainty and risk, the successful risk management strategy does so based on obtaining as much relevant and credible information as possible. One component of an efficient market is that all market participants have equal access to market information. Given this availability of information, members of the market are expected to act rationally in an attempt to maximize profits. With increased globalization of agricultural markets, shifts in production and consumption patterns and changing domestic farm policy, the amount and frequency of information that must be internalized into decisions has become increasingly more difficult to manage. Increased volatility in commodity markets, uncertainty for both domestic and global economic growth and changes in government policy have impacted both the production and market environments for many agricultural commodities. These commodity market influences have occurred in conjunction with rising production costs heightening the importance of risk management as producers attempt to protect shrinking profit margins.

The remainder of this publication will attempt to identify and detail a few of the current issues regarding marketing risk and risk management strategies. It is certainly not meant to be viewed as an exhaustive list of issues facing agricultural marketing but to highlight a few issues that may be significant to Southern agriculture.

Increased Market Volatility

Since the mid-2000s the agricultural industry has seen tremendous shifts in agricultural production. With the passage of the Energy Independence and Security Act of 2007 and the establishment of Renewable Fuel Standards (RFS), the evolution of

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USDA United States Department of Agriculture National Institute of Food and Agriculture

the biofuels industry created a significant new demand source for grains and oilseeds. This growing demand source for these commodities helped, in part, to create significant shifts in agriculture production throughout the South and the entire United States. These shifts helped to drastically change the supply and demand dynamics for not only grains and oilseeds but for many of the agricultural commodity markets. The result has been a shift in the price levels of many of these commodities from their historical trading range to much higher levels. Although higher prices are certainly a welcomed sight by agricultural producers, the accompanying increased volatility brings a new challenge for producers.

Riley (2013) showed that volatility of the feeder cattle, fed cattle and corn markets had increased substantially since 2005 and that, given this increased volatility, the forecast error of these futures markets had also increased. With the ability to predict or project future price movement becoming increasingly difficult, producers are faced with greater uncertainty than in the past. This makes the role of management strategies in mitigating market risk increasingly important. However, the use of many traditional risk management strategies has become increasingly expensive as market volatility has increased and has likely reduced the attractiveness of many of these strategies to agricultural producers.

In addition to increased price volatility, issues regarding market efficiency have also been raised. In theory, futures markets and cash markets are expected to converge over time as we move to the expiration of the futures contract. Since the mid-2000s there have been growing incidences in which a lack of convergence in futures and cash markets have been noted. Irwin, et al. (2009), examined the role of index funds in non-convergence in corn, soybean and wheat future markets. They pointed out it was evident that a lack of convergence existed for extended and varied periods particularly since late 2005. Implications of this lack of convergence are two-fold. First, failure to converge leads to bias in the price discovery process, as futures do not represent subsequent cash prices. Second, uncertainty in basis behavior increases as markets bounce unpredictably between converging and not converging, leading to marked declines in hedging effectiveness.

In addition to volatility experienced in the commodity markets, there has also been significant volatility in the input markets. Sharp changes experienced over the last 5 to 10 years in many input prices have created significant burdens to agricultural operations. While rising commodity prices have helped to partially offset some of these increased input costs, the volatility in these input markets has made farm management planning much more difficult and has created increased risk for agricultural operations.

Changing Farm Policy Environment

Farm policy can have significant impacts on markets through a variety of avenues. Some provisions can help distort market signals causing unexpected shifts in crop acreage and production. Others, like the renewable fuels standards, can significantly impact demand for commodities. With the agricultural industry anxiously awaiting passage of new Farm Bill legislation, the proposed provisions suggest that significant changes are likely to occur to the farm policy environment known to agricultural producers over the past 10 to 15 years. Elimination of direct payments and counter-cyclical payment programs could have significant implications on producer's crop choice. The elimination of direct payments will undoubtedly impact cash flow projections for many commodities and could limit the ability of producers of these commodities to obtain needed financing. As such, there could be significant acreage shifts that impact supply and demand dynamics and therefore prices for many commodities.

The growing sentiment for farm legislation to place additional emphasis on crop insurance and shallow loss revenue protection programs versus direct payments and counter-cyclical type programs of previous legislation will likely create a significant new environment for many agricultural producers. Without the level of safety net that has traditionally been provided by the Farm Bill, producers will likely increase their use of other available risk management tools such as crop insurance. The role of crop insurance in developing comprehensive marketing plans in managing risk is not a new phenomenon. Hart and Babcock (2001) showed that combining crop insurance with traditional marketing strategies provided the greatest level of risk protection. However, adoption of these strategies has historically been slower in the South than in other regions of the country. Higher direct payments associated with many Southern crops coupled with lower coverage levels and higher premiums for crop insurance than in other areas of the country have likely limited the attractiveness of crop insurance to Southern producers.

With these and other proposed changes likely to be included in the next version of the Farm Bill, it will be critical for agricultural producers to understand these new provisions and adjust their risk management strategies in this new policy environment. Regardless of the exact nature of changes, it is safe to say that given the issues surrounding the national debt and shrinking budget, the level of safety net protection the Farm Bill will be able to provide the agricultural industry will be limited. Greater emphasis will be placed on the individual agricultural producer to manage risk versus relying on the safety net provided by the government.

Reduced Market Information

With increased attention on the growing national deficit and the desire to reduce government spending, one area impacted has been the government's traditional role of market information dissemination. For many agricultural markets, the primary source of market information has been the United States Department of Agriculture (USDA). However, budget issues and reduced funding in USDA are eliminating and/or curtailing many market reports traditionally used by producers to make marketing decisions.

The recent government shutdown (October 2013) provided a temporary glimpse of impacts that a lack of market information can have. While markets continued to operate, there were several reports of potential impacts on market efficiency if the shutdown persisted. Although it is likely that private sources of market information would develop to fill this void, there would continue to be questions of the accessibility of this information and potential cost to all members of the market. The potential for uneven dissemination of this information from the private sector could create significant disadvantages for certain factions of the market.

The role of market information is critical in maintaining market efficiency. The efficient market hypothesis states that an efficient market has large numbers of rational traders with access to important, current, freely available information about markets. The traders all compete for profit and the result of all their rational competing – buying and selling – automatically brings prices into line. Therefore, a lack of information and restricted access of information to members of the market can lead to market inefficiencies. From a risk management standpoint, lack of market information and price discovery will make it more difficult for producers to develop marketing strategies in managing risk.

Growing Interest in Specialty and Niche Agricultural Production

A trend that started to develop over the last several years and appears to be continuing is growing interest in small-scaled agricultural production. As the local foods and community-based production phenomenon has evolved, it has generated a growing interest in agricultural production by non-traditional participants. This trend has been strengthened as population has started to migrate back to more rural areas with a desire to experience the rural lifestyle.

One of the challenges is that many of these new entrants into agricultural production have very limited experience and resources. Another challenge associated with these new entrants into the industry is that for many, the agricultural operation is considered a secondary business endeavor or hobby. This creates significant challenges in educating these producers as their goals and objectives can be strikingly different from those producers that rely solely on the agricultural operation.

Several programs have developed throughout the South to address the unique requirements of this new producer group. Given the limited knowledge and resources of this group, specialty or niche agricultural production is often the only feasible option. The single most difficult hurdle that must often be faced by these operations is establishing and maintaining reliable markets. In addition, some traditional risk management strategies that have historically been utilized by larger-scale commercial agricultural operations may simply not be a good fit for these smaller-scale operations that are often more a hobby to these producers rather than truly a commercial operation. Therefore, these producers require information to gain understanding to how these thin markets operate and effective strategies to target these emerging niche markets.

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