FIELD & RURAL LIFE
FARMING & AGRI NEWS

Use a Hedge to Manage Your Income

Last Updated on 07 February 2012

agricole
Grain brokerage and marketing advice

A hedge, a hedge! My kingdom for a hedge!", to paraphrase Shakespeare's Richard 111, Act 5.

So, I left you last month to ponder what you can do to protect your cereal margins, if the systemic grain market volatility could not be reduced.

The answer lies in the ability to use the volatility as an asset and advantage rather than an enemy. One of the skills when using self-defence techniques, or playing sports, is to not fight an opponents' strength with strength if you are weaker, but to use their power to your advantage when the case arises. The same is true in the grain market, use the volatility when you can and just minimise its effects when not. After all speculators enter volatile markets to potentially make profits from the market's movements, they do not invest in stagnant markets with pre-ordained, controlled or predicted growth.

The grain markets over the past 5 years have become much more volatile than the 5 years before that due to two major influences; Intervention in the UK has been effectively removed from the feed wheat market, so the market is open to the vagaries of world market fluctuations. Secondly, President GW Bush began burning 50% of the US corn crop to produce 3% of the US's ethanol supply and so reducing the US corn stocks: use ratio to 5-6%, when 20% is deemed getting low. The second reason alone should have cereal farmers the world over on their prayer mats, daily praising the uber-interlectual GW for their present prosperity.

Over the previous 5 years the UK wheat market has moved in a range of up to £100/t in a 'season', meaning the life of any particular futures month. Each future runs for two years, ie the November '11 future opened in July '09. This means that for two years before the grain for harvest 2011 was harvested, there were prices available to the farmer and grain trade to sell or buy. For two years the income of the UK farmer is being decided and altered, before it is eventually in the barn.

So with up to £100/t movements in the price, the potential gross margin for the producer is varying by up to £1000/ha on a 10t/ha wheat crop. This is a staggering number, when considering that a couple of years ago it was well documented that 'the typical' UK farmer was achieving a zero margin for growing and selling their crop, and living only on the single farm payments.

The fantastic advantage, that any crop which is linked to a regulated futures market has, is that the crop has a known value before it is harvested. In the case of UK wheat and the LIFFE futures market it's even better, two years before harvesting and even a year before drilling. What other 'manufacturing' businesses has such an advantage?

OK, the costs associated with that crop may not be know two years ahead, but they most certainly could be estimated and whacked into the myriad of farm accounts, land agents and independent advisors' programs. However, as the crop is being drilled (or hopefully a few months before) the costs for that crop are certainly pretty well known. As a result, with a price in the future known too, a margin can be easily calculated.

If a negative margin, then why drill at all? Every grower does however, as high fixed costs and the problem of an alternative use for the land dictate they do/must. If a positive margin seen, why not fix a margin and just concentrate on growing as many tonnes as possible?

Several points arise from this; firstly, what happens if the price does rise **significantly**? Think of the margin that could have been achieved, or perhaps interestingly, what the producer's farming neighbour may have achieved! Secondly, even if the price in the future was 50% higher than present prices and the margin was positive, who would dare sell 100% of their crop 1-2 years ahead? Not many farmers that I trade with would/do. The 'unsaleable' crop, due to unpredictable yield reasons, would remain unsold for 1-2 years until it was in the barn and a yield estimate possible. During the intervening time the market could be, on present form, +/- £50/t easily and possibly +/- £100/t. This applies to at least 25% of the UK wheat crop and half of the UK OSR crop, a staggering 4mt and 1mt respectively. That in itself causing marketing problems of its own, affecting logistics and even the futures price.

The futures market is influenced not only by 'producer' and 'consumer' supply and demand factors, but increasingly by speculators with billions in cash to 'invest' in whichever 'asset' they feel will give the largest rate of return in the shortest possible time. The latter are in effect influencing, and to a great extent determining, the incomes of all UK arable farmers, but sadly would not know what a tonne of wheat or OSR was if it fell on their head.

Fortunately, UK producers can use this market power, volatility and future valuations to their advantage by understanding and using Financial Price Risk Management, FPRM, tools to hedge their crop against a pre-set budget and therefore their present and importantly, their future income.

More of which will be in the March issue if FRL magazine.

Jeremy M.G. Cole runs a grain brokerage and marketing advice company from Cambridge. He has written a by-subscription weekly grain report for UK farmers since 1995. BSc Agricultural Economics, University of Reading and is at present researching for a PhD on the subject of Price Risk Management

For more information visit **www.agricole.co.uk**

For more information on Agricole, please visit the Agricole Website.

Previous Issues:

Jan 12 - Volatility makes a mockery of crop marketing but not necessarily your income

< Prev Next >

Tweet 0

Like Be the first of your friends to like this.

Recommend this on Google

Back to Magazines

Back to Agri News Magazine