Would you rather have a CAT or a hedge?

Market uncertainty means we all need to minimise our exposure to risk, writes **Jeremy Cole**.

Over the past five years, the international and domestic grains and oilseeds markets have become more and more volatile, with swings of up to 100% on the upside and 50% on the downside.

Who ends up getting it in the neck if a decision was wrong? – the producer. It doesn't matter whether it is the arable farmer producer or the livestock farmer producer, the volatility affects them both, but usually in the opposite direction. Higher arable crop prices increases arable farmers margins in general but lowers the livestock farmers' margins, or vice-versa.

How can this be avoided? Well it's simple, Commodity Analyzing Trends – also known as CAT. There is a myriad of information available, from a multitude of sources around the globe, on the agricultural grain markets and commodities. There are probably even more pundits available for comment both domestically and internationally. You and they all receive information from different sources and allocate a weighting to them, in terms of importance, and then list them in descending order of importance. This results in an order of preference that gives an outlook on the market. Bullish, bearish or neutral.

The market is going to rise? The market is going to fall? The market is neutral? This determines what the analyst, a professional in an office with lots of computers or a professional farmer, will decide to do. For a straight speculative trader, with no actual physical stocks of the commodity he is trading, these are his options; he can buy (go long), sell (go short) or do nothing (no position/level). Which does he choose?

However, a 'real' producer of an agri-commodity has only two decisions to make after analysing price information on any day, to sell or not to sell. A consumer of the same product, for example a livestock farmer, has the opposite decision – to buy or not to buy).

Easy. Except it isn't easy to get a consistently correct answer. Apparently, 75% of speculative futures trades by 'day traders' lose, and not 50:50 as you may expect.

I have in fact tried my own CAT analysis experiment, using my own pet cat – a 12-year-old female moggie. For three weeks, I decided fictitiously to buy futures if the cat turned left after I let her out in the morning, and sell if she turned right. The results were almost 75% against. Amazing. She mostly kept turning right, selling, and the market kept rising.

Sure, it was not a very scientific experiment. But even if you are right half the time, that means you are wrong half the time too. The question is therefore, by how much are you right or wrong? Maybe it should just be narrowed down even further to, how much do you want to be wrong, before you think your decision was incorrect and is damaging your business and dismiss worrying about how right you are as it doesn't matter, you're quids in.

This decision analysis can easily be converted to a more scientific, formal and acceptable 'hedging strategy', an option strategy. Sell or not sell but apply a hedge at the same time, so when you are wrong and the market hurts your margin, and it will at least 50%-75% of the time, your damage is limited to the hedge's premium.

Dump the cat, get a hedge.

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Programme:

Thursday 17 January "Green energy – benefits & issues"
We kick off the New Year with a look at the 'green' energy opportunities that are open to farmers and landowners as Sam Jennings and Alexander Creed from Strutt and Parker join us for our January breakfast. As well as sharing with us the outcome of some existing green energy projects Sam and Alexander will provide a tour around the current opportunities and give us their honest views on what makes such projects successful.

Thursday 14 February "Economic update"
Rhys Herbert, Senior Sector Economist at Lloyds TSB Financial Markets will provide an expert view of how farming, farmers and the UK are faring in the current economic climate. Rhys' role is to provide research and analysis to a range of industries that are of most importance to the UK and global economies. Prior to joining the team at Lloyds, Rhys worked at Oxford Economics in economic consultancy and has also worked at the Office for National Statistics, Prudential Assurance Corporation, Credit Lyonnais Bank and the National Institute of Economic and Social Research.

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