

## **Risk Management – How does it apply to me ?**

“Risk Management” must be two of the most overused words we hear today when talking about general Business and Commodity Risks in the world today. It can be pretty confusing whether Risk Management is the identification, the measurement or even the assumption of Risk and who and when would it apply to? Given the underlying topic of Grain Production in the Australian industry there seems to be many people entering the “Risk Management” space so what does that mean for the Grower?

The de-regulation of the wheat industry in Australia has effectively opened the door for the Australian Grower to participate in the world grains markets. So should Growers be excited or daunted by this? Probably a little bit of both! There are many factors affecting World Market Price that mean that looking out your window and seeing how the crop is faring is no longer enough to judge what sort of price you will be receiving for that tonnage; World Supply and Demand, Global weather phenomenon’s, Tariff/Export/Import issues in some countries and Commodity Funds views on the market will all have a daily impact on the price of a bushel of wheat.

Today we have a number of global price determinants of a Metric Ton of wheat; the most actively traded would be the futures contracts traded on the Chicago Board of Trade and Kansas Board of Trade. However, from an Australian perspective most Growers are looking at the local TRAC market and also the ASX Milling Wheat futures. As this article is written, a new contract is being launched which will predominantly price Australian West Coast wheat for export, there are many players globally who will be watching that with interest to see if it becomes a more effective tool to manage price risk in their areas than the existing futures contracts.

So how should Growers take all this information into account when looking at their business; production and marketing of Grains? Well Risk Management in this context should be looking at the very base of your business – what are your input costs and your costs of production and how can you generate a return.

In our business, the biggest mistake in my opinion that our customers make is confusing their underlying position with other market participants. For example, a Trading house who takes a view on whether the market will go up or down because of changes in all of those factors I listed above (and any others they consider to be relevant) will decide to buy or sell futures (as an example) on that basis. Next week they may decide that the market may move in the opposite direction and they effectively can unwind the original position and build the completely opposite position in a number of hours (presuming the underlying market liquidity enables them to do that). This position is a very different one from a Grower or a Company that produces Animal Feed for example.

The Company that produces Animal Feed buys inputs and then processes them into a ration that meets specific protein/fat requirements. Their business is effectively buying the Raw Materials and processing them into a product that they can sell at a profitable margin to their customers. They simply can’t decide to buy or sell the market because they think it will move in either direction. They need to keep

focused on operating margins in the context of their business and keep buying grains so they don't run out of product for their customers even if the current market is perceived as "high".

The same applies to the Grower. It's about ensuring that you safeguard your business in order to preserve value. Ensuring that you focus on operating margins (versus market highs and lows) will ensure that you are in business for as long as you want to be. So now we get down to the definition of Risk Management that is close to my heart – ensuring you are protecting value for your future generations.

At the Australian Grains Council meeting there was much discussion around the DDC method of Risk Management that I presented. Let me explain it in a little more detail. The DDC method looks at three concepts; Diversification; Discipline and Controls.

**Diversification;** This concept refers to spreading your risk across different baskets. In your own portfolio of investments, most advisers will tell you that spreading your risks across different types of investment returns (for example; Shares, Bonds, Term Deposits, Precious metals) is a solid long term strategy that will perform better over time. Potentially short term gains from investing in one ASX share or gold might bring an incredible return but unless you are following those markets on a daily basis and also have the expertise to enter and exit at exactly the right time, (which might be when you are out on the harvester!) you may find you give up a lot of those gains. Diversification for a Grower might mean considering different pricing alternatives when marketing; this could be using the amount of profit you are making to designate the amount of grain you have priced. It could also mean looking at different products that are available to spread the risk of the markets and production itself. It's very important to recognize your true level of expertise in navigating markets versus luck you may have had along the way. Luck is great but sometimes it brings with a hefty risk – the day it runs out!

**Discipline;** This is the hardest concept to adopt when looking at Risk Management. Why? Because as Human Beings we tend to act irrationally due to our make up. There have been many studies done on this, however, without going into details its important to put a structure in place that takes a lot of the "emotion" out of the decision making process and brings everything back to basics – bringing a positive return to your business. It doesn't matter if your neighbor claims to have priced at the "top of the market" for the last 5 years...your focus needs to be on receiving proceeds for your grains that ONLY looks to return your costs plus a margin. One other point, I have never met a farmer who believed that the market was going down...conversely I rarely meet commodity buyers who equally believe the market is going up. We get caught up in these underlying beliefs and confuse them with actual market facts (and of course our underlying business) and they can influence our decisions to be wrong.

**Controls:** This is merely about keeping track of what Grain you have priced, how much you have left to price (which obviously gets updated as your crop production cycle nears finish) and what exposure you still have to price risk given your overall "portfolio". For example, if you had sold some grain at ASX level \$250/MT and the market was now at \$300/MT does that have any cash implications for your business? (for example have you used a product where the seller asks for a cash margin to cover this difference?)

How much grain have you still left to price and what impact will that have on your overall business return.

So in summary, it's important when choosing Partners to market your grain that you look for reputable and reliable ones. Always go through specific examples of any products you are shown to assist you in maximizing your price. Always keep in mind your underlying target which is your cost of production plus a margin. Go through specific examples so that you understand all the different outcomes no matter what is happening with the underlying market (if it's a product that is somehow linked to an underlying market for example TRAC or ASX futures). Most of all good luck with navigating these markets as the last couple of years are some of the most challenging (volatile) commodity markets that the world has seen.

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