

Do Not Trim Your Hedge
“Protecting the margin when the market won’t.”
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Dairy markets have always had their peaks and valleys, but since around 2007 those swings have become sharper and harder to predict. In the U.S., milk prices received by farmers rose from \$14.50 to \$21.60 per hundredweight between January and July 2007, illustrating just how quickly market conditions can change. Since then, dairy producers have repeatedly experienced periods when milk prices, feed costs, or both moved rapidly, sometimes in opposite directions. For dairy farmers, these movements are more than lines on a market chart. When milk prices fall while feed, energy, labor and other costs remain high, margins can deteriorate rapidly. Cash flow tightens, investments are postponed, and decisions that made sense only months earlier suddenly look very different.

This is where hedging can become useful. Put simply, hedging allows producers to protect part of their future milk price or input costs using tools such as futures, options and forward contracts. The objective is not to predict the market or always obtain the highest possible milk price. It is to create greater certainty around a profitable margin.

When the peaks and valleys get steeper, it may be wise not to trim your hedge.

Think margin, not milk price

The first step is knowing what it costs to produce milk. Feed is usually the largest variable expense and the one most directly influenced by changing commodity markets, but it is certainly not the only cost. Labor, energy, replacements, veterinary expenses, debt service and other costs ultimately determine whether a particular milk price represents an opportunity or merely looks attractive.

A \$20 milk price is not necessarily better than \$18 if feed and other costs have increased enough to consume the additional revenue. Producers should therefore stop asking only, “Is milk high enough to hedge?” and instead ask, “Does the relationship between milk revenue and my expected costs provide a margin worth protecting?” Once that margin is known, a dairy farmer can establish targets before the market starts moving. A farm might identify a minimum acceptable margin, a target margin and an exceptional margin. The specific numbers will differ among farms because debt, cash flow, production costs and tolerance for risk are different. What matters is making those decisions before emotion enters the equation.

Do not make it all or nothing

One of the difficulties with hedging is the fear of locking in a price only to watch the market move higher, and that is understandable. Hedging, however, does not need to be an all-or-nothing decision. Dairy producers can layer protection as margins improve. For example, when the market first offers a minimum profitable margin, a farm might protect 10% to 20% of expected production. At its target margin, coverage could increase to 25% to 40%. When an unusually attractive margin becomes available, perhaps 40% to 60% could be protected. These percentages are not

recommendations or rules. They simply illustrate a way of spreading risk while retaining some opportunity if markets continue to improve.

How much to hedge depends on the farm.

A highly leveraged operation with limited working capital may place greater value on certainty. A farm with low debt and substantial cash reserves may be comfortable accepting more market risk. Expected milk production also matters. Producers should avoid hedging more milk than they can reasonably expect to produce, particularly when herd size or milk production may change. For example: a farm expecting to market 10 million pounds of milk might comfortably hedge 4 million. Hedging the entire 10 million, however, leaves little room for fewer cows, lower production, or other unexpected changes that reduce the amount of milk available to sell. The same principle applies to feed costs. Protecting an attractive milk price while leaving major feed costs completely exposed can still leave the farm's margin vulnerable. Effective risk management therefore considers both sides of the equation: the price received for milk and the cost of producing it. Hedging will never eliminate dairy market volatility, nor should its success be judged by whether the market later moved higher or lower. A hedge that protects an acceptable margin has done its job even if someone else eventually sells milk for more.

Dairy farmers put a lot of effort into managing the biological risks they can control, from forage inventories and reproduction to cow health and milk production. Market risk deserves the same attention. The objective is not to outsmart the market. It is to recognize when the market offers a margin the farm can live with and protect enough of it to keep the business moving forward. After all, the purpose of a hedge is not to make the farm richer when markets cooperate. It is to keep the farm standing when they do not.

References

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