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"THE MYSTERY OF RISK MANAGEMENT"

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I would first like to thank the Australian Cotton Growers Research Association, Inc. for inviting me to talk about a topic which I get excited about and hope I possess a bit of knowledge, risk management in cotton marketing. Second, I must confess that I am about to read most of the material I will be presenting and that which you have in your notes. This is the second speech of this nature that I have ever read and I apologise for being so mundane; but I do not want to miss the key points and specific issues which I am privileged to convey.

Many of you have attended our workshops on "Commodity Hedging for Cotton Producers" over the past couple of years and similar sessions I held while I was with Colly Farms and contracted with Queensland Cotton. I am not going to attempt to conduct a two day workshop in a twenty minute speech. Too often, speakers attempt to educate an audience in an afternoon seminar which takes months and even years to absorb and understand. Though the fundamentals of risk management and cotton marketing are basic business, ie. the same basic activity which you do everyday in your "Cotton Producing Factory", the tools come in different colours, shapes, and sizes, and are called very strange names. It is more like learning a foreign language than understanding a new business contract. I will return to the mystery again later.

I have been asked to address three major points:

1. Why is risk management important?
2. Does a grower need to know all the details of a market before he can become involved with risk management?
3. What are the main considerations that a grower should assess in managing risk in the current negative market situation and the future?

Let me begin with the infamous quote by the 19th century American author and humorist Mark Twain with which we begin all of our workshops. To me this quote says it all, especially in the context of farming. We all know that life involves speculation and primary producers are the biggest gamblers of all. Unlike the poker player, the stock jockey, or the punter at the track, the agricultural producer puts his well-being on the line every year. He or she is not in the short-term trading game as the local speculator on the floor of the Sydney Futures Exchange, but rather the long-term strategic hedger trying to manage a business and yield an attractive return year in, year out. The nature of the beast is "volatility"; whether the cause be political, economical, or just plain weather; producers need risk management to assist in dealing with these uncertainties and tools which take as much of the speculative element out of farming as possible. You have enough problems already, you don't need any more.

Risk management offers producers the tools with which to formulate insurance programs against periods of price downturns. It also offers tools to conduct enhancement programs where one can benefit from a price rise after a crop has been sold. The key element we are focusing on is "flexibility". Without bad, we have no good and vice versa; thus volatility is what the risk manager and business minded farmer desire. Understanding how to manage these risks, give the grower

the extra edge over his fellow farmer (but still competitor) next door or overseas. Doing nothing at all in today's small world of global telecommunication and political chaos is the most speculative and gambling position one can take. Taking action which secures favourable returns or obtaining cash flow, and yet positioning one's operation for a possible resurgence in prices, is why risk management is important.

Cotton growers do not need to be professional analysts keeping up with every piece of fundamental or technical information that has ultimately influenced the Australian cotton price to go up or down. They also do not need to function as the dynamic trader who is trying to profit from every move in the futures, basis, or currency. But the average grower should possess a reasonable level of understanding of how his cotton is marketed, the price is derived, and the tools available to construct profitable marketing strategies.

A good educational background is the best place to start in laying a foundation of understanding. Marketers, merchants, and individual consultants are constantly conducting workshops, seminars, grower meetings, and most of all one-on-one discussions to promote their marketing products in hopes of not only obtaining your cotton but also to help you stay in business. Without you the merchant and co-operative have lost their means of existence; you can never sell anything if there is nothing to buy. The jargon is foreign, the tools are strange, but believe me with a bit of time, exposure, and experience, it will begin to come together and you will realise that all this fancy risk management is basic business.

By no means am I saying that marketing and managing cotton income exposure is a simple task. There are massive amounts of strategies to choose from and different ones suit different organisations. Whether or not a particular

organisation decides to manage its exposures itself, or hand the management over to someone else, doesn't matter. What matters is that they understand what is going on and they are taking advantage of every opportunity directly themselves or indirectly through an external manager. Cotton producers are very fortunate that they have the ability to choose how their income is managed and their commodity is marketed; whether through pools, call pools, cash sales, or individually tailored hedging strategies. "Different Strokes for Different Folks" and this certainly applies to risk management; but my advice is make sure your organisation or the organisation that manages your position is aware of the latest techniques. All of the various marketing techniques serve different purposes at different times and situations and in general we don't discourage or encourage any particular one; it all depends on the organisation and the situation. I must be biased a bit and add that we do see a degree of personal satisfaction (or dissatisfaction) in managing one's own destiny.

As I said earlier, I won't go into detail about specific strategies but I do want to discuss briefly two basic fundamental strategies which we regard as common sense.

From the graph we can see that prices over the last six years for Australian cotton have ranged from under AU\$250 per bale to just over AU\$550 per bale. The normal high has been AU\$500 and the normal low AU\$350 with the average price right at AU\$425 gross ex-gin. Since the early 70's, we have experienced very volatile commodity prices and it is unlikely that cotton prices will stay under AU\$350 or over AU\$500 for very long. Therefore, if you remember anything from this presentation, I hope you remember these two points:

1. When prices are above average, ie. AU\$425 to AU\$500 or higher, do something. This means hedge your cotton through cash sales if you are certain of production or purchase put options if you are concerned about yields.
2. When prices are below average; ie. AU\$425 to AU\$350 or lower, exercise patience. This means don't panic; but if time is running out and you need to sell for cash-flow, buy calls to still benefit from a market rise.

Certainly we can add plenty of spice to these two policies and find many exceptions to the rule, but implementing these basic strategies is "percentage" risk management which yields above average returns.

Therefore in today's current market situation (and this was written in late June) for the 1993 crop, the irrigated grower who is certain of water would sell the first bale at AU\$400 gross to secure some income (whether to borrow against or receive a crop advance). The second bale should be hedged with puts for both a minimum price and non-commitment of delivery in case things change. With prices where they are it is 50/50 whether or not to buy calls against cotton already sold. Regardless, the producer should have two bales hedged but at least two bales able to benefit from higher prices through the use of options. The grower with greater yield risk, should weigh the position more with put options than cash sales.

At this point, I would like to get back to the purpose behind risk management and the overall program a producer should undertake. We can all get very excited about the implementation of strategies and the execution of trades (I shouldn't use that word) but everything needs to be put into perspective.

The Australian dollar cash price for cotton consists roughly of 70% New York Cotton Futures, 10% Australian basis (ex-gin or CNF), and 20% US/Australian exchange rate. Having all three at favourable levels is rare but having each variable independently at an historically workable level is likely. Thus we have the flexibility to manage each separately and the odds favour that over the two year marketing period each will be better than average at some point.

Too many people, merchants and farmers alike, have become too carried away with either a cash position or futures position. Certainly the producer is not going to balance his position prior to harvest as the merchant. The merchant should consistently match buys and sells, longs and shorts, where the farmer keeps a balanced book with respect to time, price, yield, finance, and last forecast. Every organisation has different policies with regards to its hedging activities but every operation should define its limits and balance point.

As Joe O'Neill stressed in his talk in Moree last February, options are the number one tool for farmers and spinners and futures are the number one tool for merchants. I think that options are the greatest invention for cotton farmers since the mechanical picker. The one advantage which is not on the list as it pertains to put strategies is "you don't have to deliver" if the put option is paid for up front through your marketing organisation or futures broker. Remember there is no free lunch and to obtain these potential benefits, all you pay is the premium.

Too many organisations jump into risk management like jumping off the Harbour Bridge in Sydney. They plunge right into the deep water without an understanding and a set plan; the result is usually not good. Again, what I have outlined for a risk management program is common sense but many fail to follow through each step. Before you take the family on a trip to a beautiful Queensland

beach, I hope you would pull out a map, locate where you are going to depart from, where you are going to go, decide how fast you are going to drive, your primary route, secondary route, how much fuel is required etc. The same goes for cotton marketing and risk management; know your position, your budget, target, how much money you can afford to spend, choose a primary and secondary strategy, track its results, fine tune it if necessary, and stick to your plan. Your intuition is right for you and if you stick to your plan it will work.

All of this takes discipline. We are humans and we can get very excited about forecasting the future and making a quick buck. The hype of trading is exciting but the nature of the farming business is producing and marketing, not trading futures, options, and the Australian dollar to generate revenue. If most of you stayed up all night watching the New York markets, you would never get out of bed during the day to grow a crop. I don't need to tell most of you where your best returns will be made in the long run.

In closing, I would like to step back for a moment and look how risk management fits into the whole scheme of things in the Australian cotton industry and how it can play a greater contributing role.

As I said in a couple of speeches to the wool industry recently, "The Australian Cotton Industry is one of the most exciting agricultural industries to be involved with in the world. There are very few places a primary producer can venture and independently manage his or her own destiny in a free society." Wool, sugar, wheat, and beef all have their regulations and statutory boards restricting the primary producer from managing his own income and future. The fact that producers and marketers alike have to stand on their own two feet accounts for the progressiveness, innovation, and non-governmental interference right through

the different facets of the industry. Competition has bred efficiency and profitability to those who think and work hard. This holds true in risk management and marketing as well as anything else.

Where risk management needs to strengthen is in its consistency in terminology and reporting. Too often our clients complain of not understanding reports generated by merchants or futures brokers regarding hedging activities. Either the format looks like a Chinese accounting manual or the trade abbreviations are written in French. Even our management information reports baffle accountants and bankers to the point a per acre return is confused with a gross income. Some complain that the products and names are always changing but that is not necessarily the case; the techniques we use today in cotton have been around for many years, in cotton they just haven't been utilised until recently.

As risk management is firmly upon us, maybe it is only a matter of time until these misunderstandings and complications get worked out. After all, call pools have only been actively used since the early eighties and cotton options since mid-1988. Who would have thought back in the 1960's that in the 1990's a common conversation at the Royal Hotel in Wee Waa between two cotton growers would be using foul words like mini-max, strip, rolls, collars, caps, etc. The industry has standardised things such as module tagging, classing, and ginning; perhaps it is time to initiate a uniform language of terms, physical contracts, and reporting systems between merchants/marketers and growers. We certainly do not want to over regulate and create more bureaucracy; but a bit of standardisation may fully take the mystery, education and communication, out of risk management.