A winning strategy with LGM-Dairy

Dave Wilkins for *Progressive Dairyman*

Want to protect profits from soaring feed costs and plummeting milk prices? A Livestock Gross Margin insurance policy may be just the ticket.

LGM-Dairy was created in 2008 by USDA's Risk Management Agency. Policies are available through authorized crop insurance agents – but don't dally. The agency began subsidizing premiums in 2010, sparking a huge increase in demand.

LGM-Dairy provides a minimum income over feed costs, so it works much the same way as buying options on the futures market.

One of the big advantages of LGM-Dairy, besides the subsidized premium, is that it can be customized to fit individual farms.

Do you grow most of your own feed or do you purchase most of it? The answer will help you calculate your total expected gross margin.

Policyholders can cover from one to 10 months during the 11-month contract. Coverage begins in the second month of the insurance period.

Participants can insure from 0 to 100 percent of their monthly milk marketings.

A team of dairy economists led by Marin Bozic of the University of Minnesota has written a paper, soon to be published in the *Journal of Dairy Science*, in which they analyze different LGM strategies and the resulting effect on income over feed costs had contracts actually been in place in 2009.

"Our basic finding is that farmers can do really well to protect their income over feed cost margins – but only if they regularly hedge distant months," Bozic says.

Here's an example of a winning strategy: At first sign-up, insure one-third of expected milk marketings and associated feed costs for the eighth, ninth and 10th insurable months. The following month (assuming program funding is still available), buy another contract, again insuring one-third of milk marketings and feed costs for the eighth, ninth and 10th insurable months.

Soon all expected milk marketings will be regularly insured if the strategy is followed month after month.

This strategy would have eliminated 93 percent of 2009 margin shortfall for producers with a home-feed farm profile.

"We have shown that, for producers who grow most of their feed, almost all of the risk is eliminated," Bozic says. "Think about it – it would be like 2009 never happened."

The results aren't quite so impressive for producers who buy all of their feed.

"If you're buying all your feed, you can't remove all of your risk – but you can remove half of your risk," Bozic says.

Whether you're buying LGM contracts or options contracts on the futures market, it makes no sense to hedge only nearby months, experts say.

"If you only hedge the next couple of months, then when bad times come, you will be out of options," Bozic says. "You will not have the opportunity to lock in good margins."

Buying a contract just once a year to cover the entire year is probably not a good strategy either.

"That strategy may seem appropriate on the face of it, but it carries a substantial hidden risk," Bozic says.

Suppose a dairyman bought an LGM contract in January 2008, with the idea that he would buy another one a year later to protect his 2009 margin.

It would be too late.

By the time January 2009 rolls around, "prices are already in the toilet and you couldn't protect margin in 2009," Bozic says.

Subsidized premiums are available only for policies that insure more than one month during an insurance period. Aside from that, there may be other reasons to insure multiple months.

LGM contracts insure average margins, so it makes sense to buy coverage for multiple months rather than just a single month, Bozic says.

"It's cheaper to insure average margins over three or four months than the margin for a single month," he says. "There really isn't any need to pay more for the insurance than you absolutely have to."

The ability to customize an

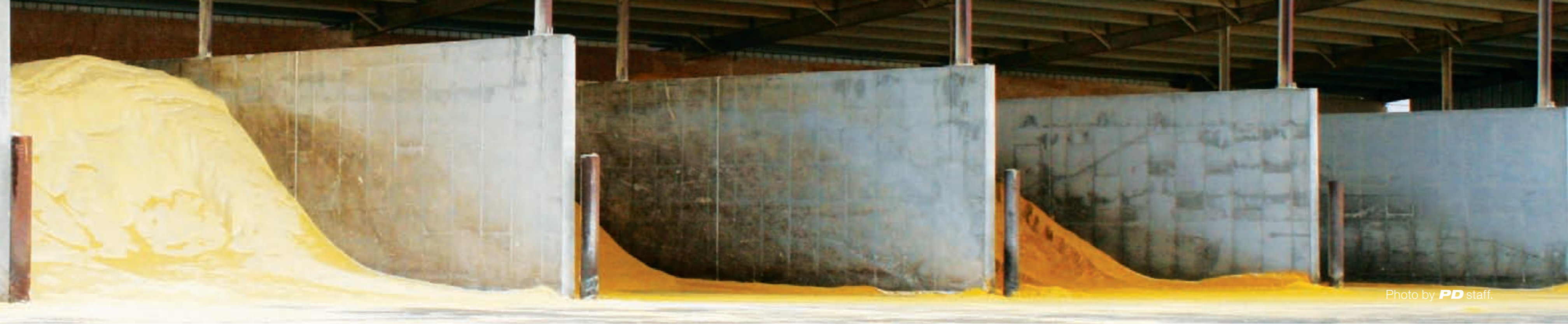
Photo by *PD* staff

LGM contract is perhaps its most attractive feature.

"What's nice about LGM Dairy is that you are going to be tailoring your ration to your operation," Brian Gould, a University of Wisconsin Extension ag economist, told producers attending a workshop in Idaho this fall. "You can differ how you define your feed for your margin calculation, and that's critical."

LGM Dairy uses CME futures prices for corn, soybean meal and milk (Class III) to determine the expected gross margin and actual gross margin. The indemnity paid out at the end of the 11-month insurance period is the difference, if positive, between the gross margin guarantee and the actual gross margin.

There is no minimum hundredweight of milk that a producer can insure but there is an upper limit of 240,000 cwt within the insurance period.

LGM policyholders must choose a deductible, in this case anywhere from $0 to $2 per cwt (in 10-cent increments) of milk marketed.

Premium subsidies start at 18 percent for those choosing zero deductible and max out at 50 percent for those choosing a $2-per-cwt deductible.

Premiums aren't due until 11 months after the contract is purchased.

"That's a nice characteristic. You're getting free use of that premium at no interest cost," Gould says.

Government-subsidized premiums are both good and bad, he believes.

"Obviously, the good side is that it reduces the cost. The bad side is that, because we have a fixed budget for this program, it reduces the number of hundredweights that can be insured," Gould says.

RMA has an annual budget of $20 million for all of its livestock risk protection programs. When it hits that level, it must shut down sales.

Since subsidized premiums were introduced in 2010, LGM-Dairy has become the most popular of RMA's livestock programs by far, gobbling up about 80 percent of the $20 million allocation every year.

Contracts are sold on the last business day of each month, subject to funding availability. Last year, LGM-Dairy funds were exhausted after just a few months.

If you've missed out this year, don't despair. There's a chance funding will be increased.

The 2012 Farm Bill, though still in limbo, would increase RMA livestock protection funding to $50 million annually under a House ag committee-approved version.

If you've missed out, use the next few months to do some advance planning. It could pay off when the next inevitable downturn occurs.

"When the bump in the road really comes, when margins just nose-dive, that's when your proactive strategy will pay the most," Bozic says. **PD**

For more information about LGM-Dairy, visit the University of Wisconsin dairy marketing website at http://future.aae.wisc.edu

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