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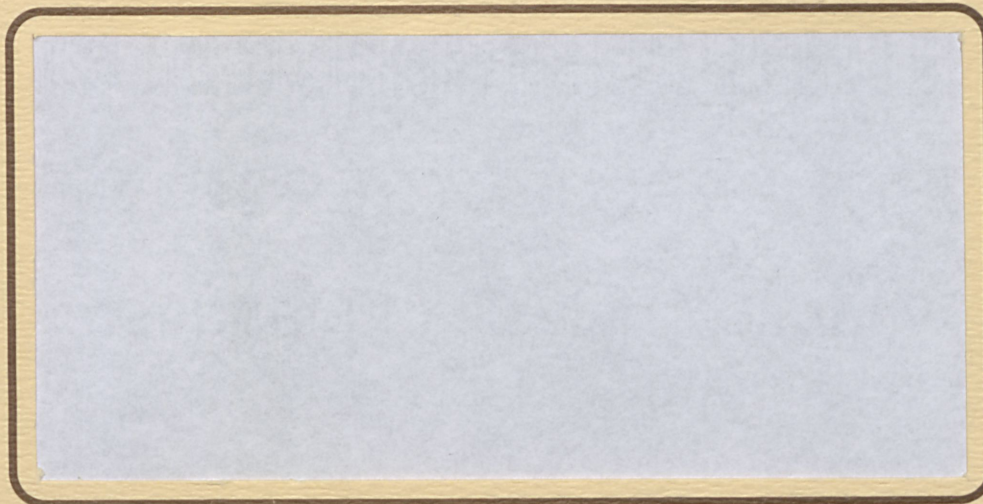
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# RURAL ECONOMY



## PROJECT REPORT

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**A Dynamic Analysis of Management Strategies  
for Alberta Hog Producers**

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Project Report 94-04

Farming for the Future Project No. 91-0917

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## Introduction

A number of authors have noted that off-farm investments have the potential to reduce risks faced by agricultural firms. For example, Young and Barry found that Illinois cash grain farms can reduce risks by holding a portfolio of farm assets, Standard and Poors 500 stocks, and passbook savings. In somewhat the same vein, Moss et al. found that farm assets enter into expected return-variance efficient portfolios containing off-farm assets.

These studies were static in that they do not consider firm growth. However, previous studies examining firm growth do not consider the possibility of off-farm investments (e.g., Gwinn, Barry, and Ellinger; Larson, Stauber, and Burt). Given that growth is a relatively risky process and that previous studies indicate that off-farm investments reduce risk, it is reasonable to expect that including off-farm assets in growth plans will reduce risk. In this paper, we examine risk reductions possible by including off-farm assets with farm assets in a firm growth context.

The investment model we use is cast in terms of a stochastic dynamic programming problem. It follows the theoretical development of a financial model that maximizes the expected utility of terminal wealth (Elton and Gruber). We use dynamic programming because it (1) allows investments to be lumpy and irreversible, characteristics common to many agricultural investments, (2) allows incorporating of dynamic relationships across asset returns, and (3) allows optimal decisions to be related to the current financial structure of the firm.

In our analysis, we examine alternative objective functions. These objective functions embody different preferences for risk that change as wealth level changes. Unlike most previous approaches, however, we specifically allow for farm bankruptcy. Incorporating bankruptcy allows for incorporating preferences for bankruptcy avoidance, a goal that seems important to many firm managers (Patrick and Brake).

Organization of the remainder of this paper is as follows: First, we detail considerations in specifying objective functions for a dynamic investment model. Then, a conceptual model for examining dynamic investment decisions is given and numerically solved for an Alberta hog finisher. Parameters and numerical results are respectively presented in the third and fourth sections of this paper. We follow by giving conclusions and suggestions for future research.

### **Objective Functions**

Financial theory suggests two alternatives for determining optimal investment decisions over time. One approach uses a multiperiod consumption-investment model to jointly find consumption and investment decisions that maximize the discounted, expected utility of consumption over time (see Fama, Merton, Samuelson, and Elton and Gruber). This model requires an objective function that incorporates both risk and time preferences for consumption. Alternatively, a terminal wealth model determines investment decisions that maximize a function of wealth in the terminal time period (see Elton and Gruber). In the terminal wealth model, the objective function incorporates only risk preferences.

We use the terminal wealth model in this paper. By using the terminal wealth model, time preferences for consumption do not have to be specified. Therefore, focus is given to the impacts of risk preferences on investment decisions. We justify this choice by noting that consumption withdrawals often are relatively small cash flows on mid- to large-sized farms. Moreover, changes in farm income have relatively small impacts on consumption (Langemeir and Patrick). These factors suggest that changes in consumption are likely to have little impact on investment decisions.

We use a terminal wealth utility function adapted for use in cases of limited liability (Robison and Barry, Robison and Lev, Collins and Gbur):

$$(1) \quad U(w_T) = \begin{cases} u_1(0), & w_T \leq 0 \\ u_2(w_T), & w_T > 0 \end{cases}$$

where  $w_T$  is terminal wealth and  $u_i(\cdot)$  are functions. This utility function has two parts: one for cases when terminal wealth is greater than zero (i.e.,  $u_2(w_T)$ ) and the other when wealth is less than zero (i.e.,  $u_1(0)$ ). The  $u_2(w_T)$  function is continuous and concave, representing the typical function for ordering risky choices. The  $u_1(0)$  accounts for truncations to the wealth distribution. In our model, truncation occurs because of bankruptcy. We define bankruptcy as occurring whenever a negative wealth level arises. When bankruptcy occurs, we presume that investment decisions are no longer made and zero terminal wealth results. Since bankruptcy truncates the wealth distribution, a discontinuity exists and a discrete probability mass may occur at the zero wealth level. Hence, finding the expected value of expression (1) with respect to investment decisions ( $\theta$ ) is equivalent to:

$$(2) \quad E[U(w_T)] = u_1(0)p(w_T \leq 0 | \theta) + \int_0^{\infty} u_2(w_T)g(w_T | \theta)dw_T$$

where  $p(\cdot)$  is the probability of bankruptcy and  $g(\cdot)$  is a probability density function for terminal wealth levels greater than zero (see Collins and Gbur for a more detailed discussion).

We solve the investment model using two variations of this utility function:

1. Expected wealth maximization: In the expected wealth maximization case, risk preferences are neutral and the utility function has the following form:  $u_1(0) = 0$  and  $u_2(w_T) = w_T$ .
2. Bankruptcy avoidance: Bankruptcy avoidance involves the following utility function:  $u_1(0) = -1.0$  and  $u_2(w_T) = 0.0$ . The values of  $u_1(\cdot)$  and  $u_2(\cdot)$  result from a constant absolute risk aversion (CARA) function as the Pratt-Arrow measure of constant absolute risk approaches infinity (i.e.,  $u(w) = e^{-\lambda w}$  as  $\lambda \rightarrow \infty$ ). In this case, investment decisions are made so that bankruptcy is avoided without regard to the ending value of terminal wealth. In essence, the bankruptcy avoidance case is the opposite extreme of the expected wealth maximization case. This case also represents a safety first objective function, when all weight is placed on "safety".

### **The Multiperiod Investment Model**

We specify a multiperiod investment model in which investment decisions occur at the beginning of each month. Investments are made in three assets: hog



finishing buildings, stocks, and financial holdings. The hog finishing building is a lumpy, irreversible investment, embodying the characteristics of many agricultural investments. The investment in a hog finishing building equals  $BNV$ . For this investment, a constant number of hogs ( $NH$ ) are marketed each month, with returns from marketings equaling:

$$(5) \quad NH \cdot (H_t - FC)$$

where  $H_t$  equals per hog revenue minus variable costs, hereafter referred to as hog returns, and  $FC$  equals per hog fixed costs.<sup>1</sup>

Stock holdings are invested in a market portfolio of publicly traded equity investments. This portfolio is equivalent to an unmanaged mutual fund in which investments are made in all traded stocks proportional to their relative values. Stock holdings generate returns ( $R_t$ ) consisting of dividends and stock appreciation. We presume that stock investments are perfectly divisible. Moreover, the individual can invest and liquidate stock investments at no cost.

Financial holdings represent positive or negative holdings of treasury bills. Positive holdings represent investments in treasury bills for which the agent receives a return equal to the interest rate ( $I_t$ ). Negative holdings represent debt on which interest payments are made. The interest rate for determining interest payment equals

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<sup>1</sup> The profitability of varying production levels was tested. We found that an objective of maximizing the present value of returns resulted in full production in almost all cases. We therefore chose to assume constant production.

the interest rate on treasury bills plus a borrowing differential ( $BD$ ) that represents costs of financial intermediation.

### Dynamic Returns and Investment Movements

Returns to the three assets are stochastic and are presumed to follow a first-order Markovian structure. Return movements can be modeled using the following general relationship:

$$(6) \quad f(H_{t+1}, R_{t+1}, I_{t+1} \mid H_t, R_t, I_t)$$

where  $f(\cdot)$  is a probability density function. This function gives the distribution of next month's returns conditional on the realizations of current month's returns.

Each month, the agent makes two decisions:

1. Invest in another hog finishing barn. This decision is denoted as  $DB_t$ .  $DB_t$  may have two values: 0 = do not invest in another barn and 1 = invest in another barn.
2. Invest (Disinvest) in stocks. This decision is denoted as  $DS_t$ . Positive amounts indicate that additional funds are invested in stocks while negative numbers indicate that funds are withdrawn from stocks.

A decision variable is not required for financial holdings because investments in finishing barns and stocks uniquely determine financial holdings.

Based on these decisions, we can determine how holdings of the assets move over time. Investments in hog finishing barns are modeled by the number of hog finishing barns ( $B_t$ ) according to the following relationship:

$$(7) \quad B_{t+1} = B_t + DB_t$$

which states that number of barns next month equals the number of barns in the current month plus barns acquired during the current month.

Stock holdings in the next month ( $SH_{t+1}$ ) equal the stock holdings in the current month plus returns from stock holdings plus the decision to invest (disinvest) additional funds in stocks:

$$(8) \quad SH_{t+1} = SH_t \cdot (1 + R_t) + DS_t$$

For expository and solution reasons, stock holdings are restated as a proportion of funds invested in finishing barns. Specifically, we define  $S_t$  as stock holdings as a proportion of finishing barn investment (i.e.,  $S_t = SH_t / (B_t \cdot BNV)$ ). The primary advantage of this definition is that it allows us to more easily compare relative investments in finishing barns and stock holdings. Using the definition of  $S_t$ , we can restate equation (8) as:

$$(9) \quad S_{t+1} = \frac{(S_t \cdot B_t \cdot BNV) \cdot (1 + R_t) + DS_t}{B_{t+1} \cdot BNV}$$

Financial holdings in the next month ( $FH_{t+1}$ ) equal the financial holdings in the current month ( $FH_t$ ), plus returns (costs) of financial holdings ( $FH_t \cdot IT(FH_t, I_t)$ ), plus returns from hog marketings ( $B_t \cdot NH \cdot (H_t - FC)$ ), less investment in hog finishing barns ( $DB_t \cdot BNV$ ), less investment (disinvestment) in stocks ( $DS_t$ ):

$$(10) \quad FH_{t+1} = FH_t \cdot (1 + IT(FH_t, I_t)) + B_t \cdot NH \cdot (H_t - FC) - DB_t \cdot BNV - DS_t$$

where

$$IT(F_t, I_t) = \begin{cases} I_t & \text{when } F_t \geq 0 \\ I_t + BD & \text{when } F_t < 0 \end{cases}$$

adds the borrowing differential to the interest rate when financial holdings are negative. Similar to stock holdings, we redefine financial holdings for expository purposes. Specifically we define  $F_{t+1}$ , which states financial holdings as a proportion of investment in finishing barns and stocks:

$$(11) \quad F_{t+1} = \frac{FH_{t+1}}{B_{t+1} \cdot BNV + S_{t+1} \cdot B_{t+1} \cdot BNV}$$

When financial holdings are negative,  $F_t$  is interpreted as the negative of the debt-to-asset ratio. When financial holdings are positive,  $F_t$  gives financial holdings relative to holdings in other assets.

### Terminal Wealth and Solution Procedures

Optimal investment decisions are found for each month by maximizing the expected utility of terminal wealth, where the general utility function is given in equation (1) and terminal wealth is defined as:

$$(12) \quad w_T = (B_T \cdot BNV + S_T \cdot B_T \cdot BNV) \cdot (1 + F_T)$$

This problem is solved recursively using Bellman's principle of optimality. The recursive objective function for each month's maximization is:

$$(13) \quad V_t(H_t, R_t, I_t, B_t, S_t, F_t) = \max_{DB_t, DS_t} E [V_{t+1}(H_{t+1}, R_{t+1}, I_{t+1}, B_{t+1}, S_{t+1}, F_{t+1})]$$

where  $V_t(\cdot)$  is the recursive objective function that gives the expected utility of terminal wealth, given that optimal investment decisions are made from month  $t$  to the terminal month. This problem has six state variables: hog returns, stock returns, interest rates, number of finishing barns, stock holdings, and financial holdings. Transition equations for the state variables are given in equations (6), (7), (9), and (11). In addition to the state transition equations, the maximization in (13) is subject to the following bankruptcy condition:

$$(14) \quad V_t(\cdot) = u_1(0) \quad \text{when } F_{t+1} < -1.0$$

This condition states that when debt exceeds assets, as indicated by a  $F_{t+1}$  that is less than -1.0, the firm is bankrupt, terminal wealth becomes zero, and the expected utility of terminal wealth is given by the portion of the utility function associated with bankruptcy.

### Numeric Specification of the Dynamic Investment Model

The multiperiod investment model was solved numerically for an Alberta hog finisher. For each finishing barn, 750 hogs per month are marketed, fixed costs per hog equal \$5, and investment cost per barn is \$290,000 (i.e.,  $NH = 750$ ,  $FC = 5$ , and  $BNV = 290,000$ ). Stock holdings occur in a market portfolio traded on the Toronto Stock Exchange. Financial holdings occur in Canadian treasury bills.

Stochastic, Markovian relationships were estimated for the three assets using data from January, 1980 through December, 1989. A series of hog returns was constructed to be representative of an Alberta finishing operation (Novak et al). Stock returns were calculated as the natural logarithm of the monthly change in the Toronto Stock Exchange 300 total returns index. Interest rates represent market rates on treasury bills. Both monthly stock returns and interest rates were stated as a yearly return.

Time series methods were used to determine the Markovian structures of returns. Results and statistical tests indicated that a first-order, auto-regressive model adequately captures the dynamic movements of returns over time. The following estimates using ordinary least squares resulted:

$$(15-a) \quad H_t = 1.800 + .8350 H_{t-1} \quad R^2 = .726 \quad S_e = 10.8$$

(3.20) (9.70)

$$(15-b) \quad R_t = .1689 + .0547 R_{t-1} \quad R^2 = .271 \quad S_e = .542$$

(3.78) (.783)

$$(15-c) \quad I_t = .0015 + .9890 I_{t-1} \quad R^2 = .962 \quad S_e = .0058$$

(.810) (60.83)

where  $R^2$  is the adjusted r-square,  $S_e$  is the standard error of estimate, and t-ratios are given below the parameter estimates.

Realizations of next month's returns were calculated using normal distributions. Expected values for each of the returns are respectively given by the equations in (15). Standard deviations of next month's realizations were presumed to equal the respective standard error of estimates. When borrowing occurred, a .03 borrowing differential was added to the interest rate given in (15-c) to arrive at the interest rate for borrowing (i.e.,  $BD = .03$ ).

We limited the range of number of barns, stock holdings, and financial holdings. Number of barns ranged from 0 to 8, stock holdings as a proportion of the barn investment ( $S_i$ ) ranged from 0 to 1, and financial holdings as a percent of finishing barn investment and stock holding ( $F_i$ ) ranged from -1 to 1.

### **Results for Differing Objective Functions**

Optimal decisions were found for the dynamic investment model given objective functions associated with expected wealth maximization and bankruptcy avoidance. Optimal investment decisions were recursively solved for 10 years and, in all cases, converged by the 5th year. In the next sub-section, we report a summary of the optimal decision rule and the expected financial position of the firm over a five year period given that optimal investment decisions are made according to the converged decision rule. For both objective functions, the initial financial position is to own one finishing facility and have an additional \$60,000 of financial holdings, giving an initial wealth level of \$350,000.

## **Expected Wealth Maximization and Bankruptcy Avoidance Results**

The optimal decision rule from the SDP model describes the levels of barn and stock investments as the levels of state variables change. The rule is summarized in Table 1 which contains decisions by month as the farm operation progresses through time with a wealth maximizing objective. In period one, the farm has one barn and no stock holdings or debt. Cash inflows from hog finishing total \$3,750. During the first month the model purchases \$308,213 of stock using debt and savings resulting in stock holdings equalling 80 percent of farm assets and a Debt to Asset (D/A) Ratio of .434. The farm continues to feed hogs, accumulate stock and pay down debt until the stock ratio reaches 0.9 and the D/A ratio is .370 at the beginning of year 2 where the model purchases a second barn and more stock. The resulting D/A ratio is .469. A similar investment pattern is repeated in year 3. Thus, the model accumulates both stock and barns, using debt and cash flows from operations.

The bankruptcy avoidance rule produces decisions like those in Table 1 with one notable exception, barns are not purchased. In this case farm size remains constant and stock is used as a vehicle for diversification. In all cases, the firms investment behavior is influenced by financial condition and farm profitability.

The progress of the farm operation is simulated over time and the results for the expected wealth maximizing and bankruptcy avoidance objective functions are reported in Table 2. Expected wealth at the end of year five is \$879,903 for the expected wealth maximizing objective and \$672,367 for the bankruptcy avoidance objective (see Table 2). The expected wealth maximizing objective yields \$207,536



Table 1. Time Path of Optimal Decisions for Wealth Maximization Objective  
(Return Realizations at Mean Levels)

Year	Month	No. of Barns	Stock Holdings	Cash Flow	Financing	D/A Ratio
0	0	1	0.0	3750	3750	
1	1	1	0.8	-308213	-304463	-0.434
1	2	1	0.8	5385	-299077	-0.426
1	3	1	0.8	5439	-293638	-0.418
1	4	1	0.8	5494	-288144	-0.410
1	5	1	0.8	5549	-282596	-0.403
1	6	1	0.85	-13896	-296492	-0.411
1	7	1	0.85	5758	-290734	-0.403
1	8	1	0.85	5815	-284919	-0.395
1	9	1	0.9	-13627	-298546	-0.403
1	10	1	0.9	6030	-292516	-0.395
1	11	1	0.9	6090	-286426	-0.387
1	12	1	0.9	6151	-280276	-0.378
2	1	1	0.9	6212	-274063	-0.370
2	2	2	0.8	-383726	-657789	-0.469
2	3	2	0.8	10282	-647507	-0.461
2	3	2	0.8	10385	-637122	-0.454
2	4	2	0.8	10489	-626633	-0.446
2	6	2	0.85	-8906	-635539	-0.440
2	7	2	0.85	11090	-624450	-0.433
2	8	2	0.85	11201	-613249	-0.425
2	9	2	0.85	11313	-601937	-0.417
2	10	2	0.85	11426	-590511	-0.409
2	11	2	0.85	11540	-578971	-0.401
2	12	2	0.9	-7845	-586816	-0.396
3	1	2	0.9	12162	-574654	-0.388
3	2	2	0.9	12283	-562371	-0.379
3	3	2	0.9	12406	-549964	-0.371
3	4	3	0.7	-377470	-927434	-0.466

Table 2. Simulation Results Over Five Years, Beginning with One Barn and 350,000 Wealth, Expected Wealth Maximization and Bankruptcy Avoidance Objectives

	Objective	
	Expected Wealth Maximization	Bankruptcy Avoidance
Expected wealth in year 5	\$ 879,903	\$ 672,367
Variance of wealth in year 5 <sup>1</sup>	849,895	300,862
Probability of bankruptcy		
year 1	.000	.000
year 2	.028	.026
year 3	.075	.063
year 4	.119	.088
year 5	.160	.106
Expected number of barns <sup>2</sup>		
year 1	1.13	1.00
year 2	1.50	1.00
year 3	1.93	1.00
year 4	2.39	1.00
year 5	2.84	1.00
Expected stock holding (S) <sup>2,3</sup>		
year 1	.84	.51
year 2	.78	.48
year 3	.77	.50
year 4	.77	.55
year 5	.77	.60
Expected financial holdings (F) <sup>2,4</sup>		
year 1	-.50	-.27
year 2	-.52	-.09
year 3	-.50	.09
year 4	-.49	.23
year 5	-.45	.36

<sup>1</sup>The variance is calculated for only positive wealth levels (i.e., it does not include bankruptcy wealth levels).

<sup>2</sup>Expectations are calculated conditional on the firm being not bankrupt.

<sup>3</sup>Stated as a proportion of investment in hog finishing facilities.

<sup>4</sup>Stated as a proportion of investment in hog finishing barns and stock holdings. Negative numbers are interpreted as debt-to-asset ratios.

more wealth than the bankruptcy avoidance objective. As one would expect, the variance of wealth and the probability of bankruptcy is higher under expected wealth maximization than under bankruptcy avoidance. By the end of the fifth year, there is a .162 cumulative probability of bankruptcy occurring between the initial and fifth year under expected wealth maximization; while the bankruptcy probability is .106 for the bankruptcy avoidance objective. For the bankruptcy avoidance objective, the bankruptcy probability may seem high; however, the high probability reflects the relatively high risks associated with finishing hogs.

Under the wealth maximizing objective, the expected number of hog finishing barns increases each year. By the end of year 5, the expected number of barns is 2.84 when the firm is not bankrupt (Table 2). In addition, significant stock holdings occur. Expected stock holdings as a percent of investment in barns ( $S_t$ ) equal .84 at the end of year 1, .78 in year 2, and .77 in year 3 through 5 (see Table 2). The financial holdings as a proportion of barn and stock investment ( $F_t$ ) are always negative, indicating that debt is held. As stated previously,  $F_t$  can be interpreted as the negative of the debt-to-asset ratio when  $F_t$  is negative. The expected wealth maximizing objective results in a .50 expected debt-to-asset ratio in year 1 and a .45 expected debt-to-asset ratio in year 5 (see Table 2).

Under the bankruptcy avoidance objective, investments in additional barns are not made, as indicated by expected number of barns equaling 1 in all years (see Table 2). However, stocks investments do occur. In our simulation results, expected  $S_t$  is .51, .48, .50, .55, and .60 in years 1 through 5, respectively (see Table 2). In early

years of the simulation, stock investments are debt financed as indicated by expected  $F$ , of  $-.27$  at the end of year 1 and  $-.09$  at the end of year 2 (see Table 2). Over time, debt is reduced and positive financial holdings occur: expected  $F$ , equals  $.09$  in year 3,  $.23$  in year 4, and  $.36$  in year 5. Use of debt may seem counter-intuitive for a bankruptcy avoidance objective. In our model, debt is used to purchase stocks which have zero correlation with hog returns. This diversification into stocks outweighs the risks associated with using debt capital. These results strongly support the idea that stock investments serve as an effective means of reducing risk for a hog finisher.

### Summary and Conclusions

Our results suggest that diversification into stock holdings can serve as an effective means of reducing risks during firm expansion. Under the alternative risk preferences we examined, stock holdings occur. Even under a bankruptcy avoidance objective, stock holdings occur when a hog finishing barn is already owned. We suggest that continued research concerning off-farm investments should be conducted. This research could compare the risk-reducing benefits of off-farm investments to other methods of reducing risks. Moreover, we suggest that outreach efforts directed at farm clientele concerning the benefits of off-farm investments should be conducted.

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## **Abstract**

In this paper, we examine risk reductions possible by including off-farm assets with farm assets in a firm growth context. We specify a dynamic investment model in which an individual can invest in hog finishing barns, stocks, and financial holdings. We solve this model for an Alberta hog finisher using alternative objective functions representing different types of risk preferences. Our results indicate that holding stocks is an effective means of reducing risks and increasing wealth.

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