Invest in the farm or ...

Editor's note: Kent Vickre and Dwight Raab write a tax and finance column for each issue of Pioneer GrowingPoint® *magazine. Vickre is state coordinator of the Iowa Farm Business Association. Raab is state coordinator of Illinois Farm Business Farm Management. They address issues that influence agribusiness success.*

The concept of investing takes on a different meaning for those actively involved in production agriculture. In fact, anyone who's self-employed must look at investments in a different light.

Production agriculture is a capital-intensive business. Consider the array of equipment necessary to farm even the average farm. You need to invest a considerable sum just to have a place to go to work (see the accompanying graph).

If you own the farmland for that average-size operation, the capital requirement skyrockets. Illinois Farm Business Farm Management (FBFM) field staff report the average farm size in Illinois is about 1,100 acres. About 23 percent of that land is owned by the growers. Do the math, and it's easy to arrive at a land value well over $1 million.

Back into the land?

Most farm operators quickly think about investing available profits back into the farming venture. The advantage is you don't need to do much research. You make the investment in assets that you understand, assets about which you have direct knowledge.

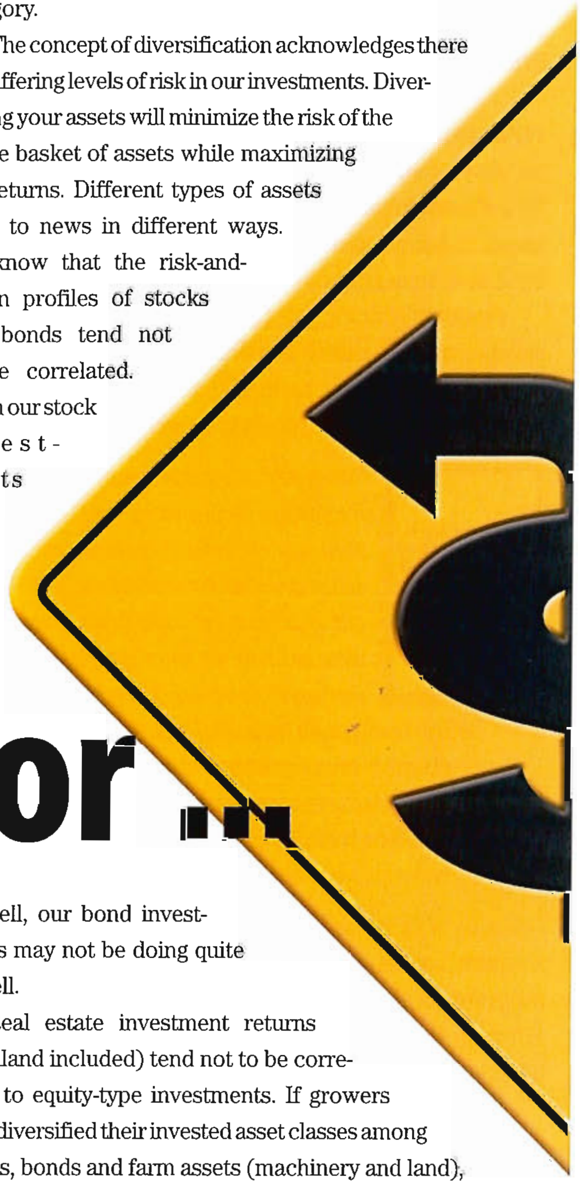
This can be at odds with the desires of the spouse, who might prefer to invest in non-farm household assets. If you only consider the profit levels available from Midwest grain farming enterprises in the past five years, it's easy to convince yourself that more capital invested in a profitable venture means more profits are possible in the future. This thought is especially prevalent the earlier you are in your farming career.

Living beneath your means — being tight with a dollar — also can go a long way in making funds available either for investing on the farm or off the farm. The disadvantage in investing in farm (machinery or land) assets is the lack of diversification for your asset base.

There are alternatives

Financial advisers have taught the concept of asset diversification for years. The old saying, "Don't put all your eggs in one basket," holds true for all ages and all professions. Financial advisers will suggest their clients not place all investable assets into one stock or even one particular asset category.

The concept of diversification acknowledges there are differing levels of risk in our investments. Diversifying your assets will minimize the risk of the whole basket of assets while maximizing the returns. Different types of assets react to news in different ways. We know that the risk-and-return profiles of stocks and bonds tend not to be correlated. When our stock investments do well, our bond investments may not be doing quite so well.



Real estate investment returns (farmland included) tend not to be correlated to equity-type investments. If growers have diversified their invested asset classes among stocks, bonds and farm assets (machinery and land), their overall return can be good while lowering the amount of risk they've taken.

Living costs money, too

There always are demands on the earnings of the farm operator. Those demands can be future demands such as debt obligations for farm assets previously purchased. Or those demands can be current demands such as living expenses.

Either way you'll need after-tax earnings to fund those demands. Debt payments are just a type of "forced savings" necessary to retire the debt on an asset where we've made the investment decision earlier.

FBFM

IOWA FARM BUSINESS ASSOCIATION

We can't ignore family living expenses on our after-tax earnings. Our Illinois FBFM field staff reports the average living expense for 1,200 Illinois farm families is nearly $75,000 annually. Ordinary items like food, utilities and so on make up just over $52,000 of this total. Medical expenses, including health insurance, make up just under $9,000 of the total.

What about old age?

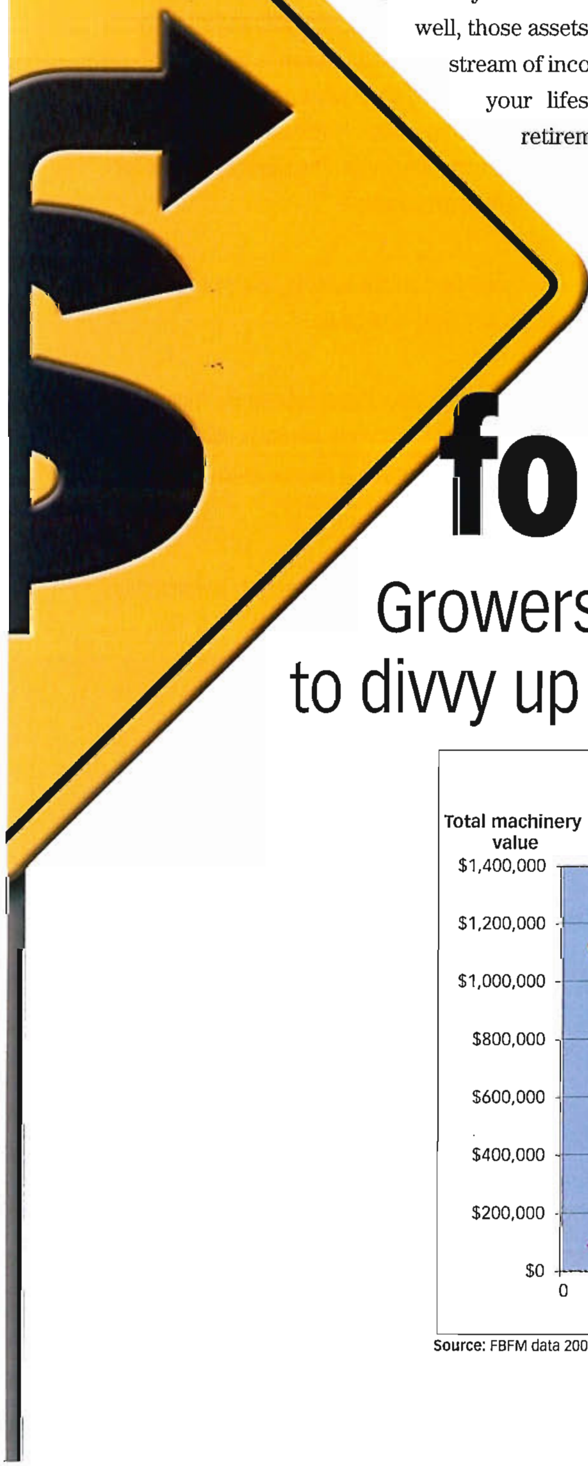
We all dream about retirement. To make retirement a reality, we need to save well and invest well to create a portfolio of assets. If you've saved and invested well, those assets can provide a stream of income to support your lifestyle in those retirement years.

If you own farmland, you can rent it to produce a revenue stream. Or you can sell it and reinvest the proceeds in more-liquid assets to produce revenue. You can convert machinery into cash by selling it, reinvesting proceeds in income-producing assets.

If you sell any asset with a low basis relative to the sale price, you should understand the resulting tax implications. The sale of land or machinery with a low basis can trigger large tax liabilities.

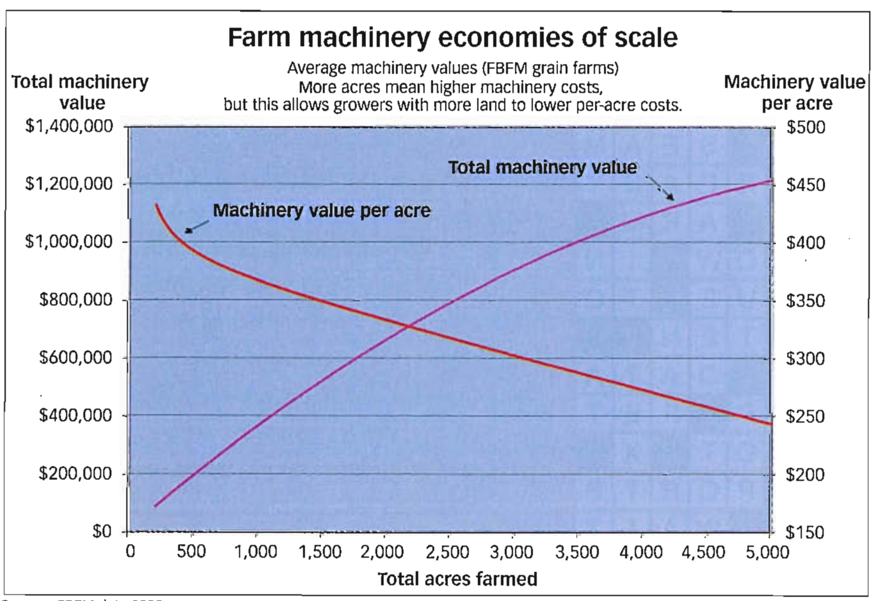
Social Security will be available to most of us in retirement to provide additional income. Assume that Social Security will be funded at adequate levels, then remember that Social Security acts much like a bond in your portfolio: It produces a lifetime stream of income. The only difference is you don't "own" the asset.

A little thought and planning can help us choose the best ways to invest our incomes. A reasonable goal for many people may be to balance investment in the farm and off the farm with a comfortable — not necessarily luxurious — lifestyle.



sock away for retirement

Growers face tough choices about how to divvy up income during profitable years.



Source: FBFM data 2008