

Fine Tune Your Money Management

By Michael Rocheleau

When you hear of someone making a killing on a trade using a small trading account, then it was probably luck! They sure were not using sound money management techniques. They most likely exposed their trading capital to excessive risk, the trade was surely happy but more than likely they will lose their entire account in the future. Money management involves using strict techniques with your own judgment. You will be exposed to financial ruin if you do not use sound money techniques. At a minimum, use a few essential money management techniques to improve your bottom line, to live to trade another day!

NOT EVERY TRADE WILL BE A WINNER

Everyone wants to win 90-100% of the time, don't we all. But the best trading systems will win 55-65% of the time. Knowing this fact, you need the mindset that you WILL have losing trades. That is right you WILL have losing trades. If you know ahead of time that you will lose 35-45% of the time then you better have some type of money management system. You better control risk; you can not eliminate risk so control it. Since you do not know what trades will be successful, then you will need to control risk on every trade. You can do very well with a success rate of 55-60% with effective risk control and money management. If you do not use proper trade sizes and money management you can go broke in a flash. Typically one might lose a few trades in a row, then they do not use proper trade sizes or money management and don't cut their losses soon enough. The trader will eat through his capital quickly and not be able to trade anymore, financially or emotionally.

CALCULATING PROPER TRADE SIZE

Calculating proper trade size involves an initial review of your capital and your risk tolerance. What can you stomach for drawdowns of your equity? A very simple position size might be: using 5% of your capital for each trade and having a 10% stop for each trade.

Account size \$20,000 10% of capital = \$ 2,000 and 10% stop of \$200

With this formula you could put on 10 positions at \$2,000 each and your maximum loss if all trades were stopped out would be \$2,000.

Now you would look at this and ask yourself, can I handle a \$2000 loss in equity? Is this too much? Will I be able to put on 10 more trades using this money management formula? Is a \$200 or 10% stop reasonable for what I am trading?

Lets look at a 60% win/loss ratio:

Out of the 10 trades you lose the maximum of \$200 each on 4 trades = \$800 loss

On the 6 trades you win, you have to profit \$134 each on average or a 6.7% gain each to breakeven. Now this is very simplistic since you should have a trading system that would take you out of a trade before the maximum loss on each trade. It is the catastrophic loss that you want to avoid.

Novice trades focus on the trade outcome and not risk. Professional trades focus on the risk and take trades based upon proven trading systems. The psychology behind each is as follows “ the trade’s outcome is unknown at the time you enter the trade - knowing and believing this makes us ask – *How much can I afford to lose on this or each trade!*”

Once you have answered based upon the money management rules you have devised, then you can put on the trade with stop losses. (Adjusting stop losses are a whole process and technique in itself). Mind these words, you will have drawdown periods and you have to be able to control risk and you know ahead of time when the losses become unbearable. When the losses become unbearable, you have to test and use other trading system as the one you were using is not appropriate with the current market conditions.

Another simple trade risk rule is the 2% rule – this is another simple rule that should keep you out of trouble providing that your trading system can have a win/loss ratio of 55% or better with a win of at least 1.6 to 1. So for every dollar you lose, your winning trade produces a dollar and sixty cents.

2% per Trade Rule:

Account size x 2% = Risk Amount

$$20,000 \times 2\% = \$400$$

So you would risk only \$400 per trade.

YOUR MINDSET AND THE PHYCOLOGY OF TRADING

You must have confidence in your trading system, and realize that you will have losses. You may have extended losses in a row even in a tested and proven trading system. You will experience a drawdown. When this occurs you have to be prepared to not abandon your trading system. You **MUST** be confident to pull the trigger on each trade and

follow your trading system. If you find yourself questioning your trading system after only a few losses then you may want to look at your money management system first, you may be taking on too much risk with each trade for your comfort level. If so, then reassess your money management system first. You will need to acquire a Trader's Mindset which will take time and experience to develop.

Here are well known traits & a partial list:

- Taking full responsibility for all trading results
- A sense of calm when trading
- You do not need to conquer the market
- Ability to focus on present reality
- Always look to improve skills
- Trading a trading system
- Keep open minded
- Disregard the market moves, the market will do what it wants to
- Do not feel victimized by the market
- Enjoy the process
- Absence of anger

SCALING OUT OF A TRADE

You can use this technique along with your money management system. By scaling out of a trade, you lock in some profits and reduce stress and this should help you stay in positions which are in a longer term trend. This technique will help with fear and greed, in reducing stress, you will be able to focus on the trade itself and it should increase your bottom line. Your initial position must be large enough to enable you to employ this technique. You must be able to do this without incurring additional risk from a large open position.

FUNDING YOUR TRADING ACCOUNT



Many traders start out with money they cannot afford to lose. This is a Big Mistake you are setting yourself up for failure, emotion will take over on each trade, and you are subject to market fluctuations which will cause fear in your trading. On each trade you take a loss, you increase your anxiety and you may not follow a trading plan and fail to use any type of money management or risk control system hoping to hit the big win. It takes great discipline to take your losses and go

on to the next trade without questioning your systems signals. My suggestion is that if you do not have enough capital to trade, then paper trade to improve your skills. When you have saved enough money to fund a trading account, you will already have practiced your trading skills and have a greater opportunity to be profitable and successful.

PROVEN MONEY MANAGEMENT TECHNIQUES

1. Develop a traders mindset
2. Never trade borrowed money
3. Always trade with money you can afford to lose
4. Never exceed a 2% or your trading account on any trade
5. Use proven and tested trading systems
6. Always, always use stops
7. Use scaling out of positions to boost your performance
8. Your trading account size should not be more than 10% of net worth

CONCLUSION

The market has a mind of its own; you can not and will not control it. You have to control your emotions, trading systems and risk and money management systems. You must not trade on FEAR since this will create anxiety, stress, negative emotions and self destructive behavior. You must come to terms with the fact that you will have losing trades and it is part of the business and market. You have to face the fact that a losing trade is not a failure on your part, it is not a broken system, and it is a fact of trading life. It is a fact that when you flip a coin, that the outcomes are head or tails, and most people can live with that fact. Well the market is the same, it is a fact that there are wins and losses but many traders have a hard time with losses. Losses are a part of the business. Enter trading the markets with your eyes and mind wide open, and pay very close attention to risk. This is the only way in which you will create a positive reality for yourself, and acknowledge both the good and bad (wins and losses) that can happen. Then you can fine tune your money management and risk systems for a more profitable trading life.