Money Management PART 2

The dividing line between success and failure

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In this second part of Money Management, we shall cover the concept of position sizing and the ideal capital exposure in trading.

Let us take a quick recap of the first part and the topics we covered therein.

Money management is the most crucial aspect of trading, which ironically, is ignored by most traders.

The statistics say that approximately 85% of traders lose money in forex trading and in my opinion, the ultimate cause of failure is the lack of awareness of the 3Ms which are 'Money, Mind and Method' ... in that order.

If we distribute the 3Ms on a scale of 10, then Money – the 'money management' would constitute five parts. Mind – the 'discipline and patience' would constitute three parts.

Method – the 'technical analysis' would constitute two parts.

This tells us that the Method, the technical analysis (or fundamental analysis), is the least important part of trading.

The first priority of a trader is to conserve the capital

The trader's capital is his bloodline. Without it, one cannot trade, so preserving it becomes a matter of utmost importance.

A single loss is not only a loss of capital; it also puts a trader

two steps behind in the quest to profitability. *This is because the percent gain needed to recover from a loss increases geometrically with every loss.*

Simple rules of money management:

- Expect losing trades.
- Placing correct stops.
- Trading is a business of probabilities.

Now let's examine the principles of money management.

A sound money management policy is based on two simple concepts:

1. The proper risk-to-reward ratio.
2. Correct position sizing, where the position sizing simply means the amount of capital that a trader should risk on any trade.

In the earlier article, we discussed the first principle that *one must always keep the risk-to-reward ratio at a minimum of (1: 2).*

Let us now look at the second factor – position sizing.

The golden rule for the ideal position sizing is: "*Never risk more than 2% of your trading capital at any time.*"

Very few traders and investors realise the importance of balanced position sizing.

Additionally, proper position sizing is often a combination of the correct risk management and money management factors.

Risk management:

- Make sure you are well capitalised. This is not a business for those who are not.
- The only way to win at trading is to have larger and more positions when you are right and less positions when you are wrong.
- Maintaining the same number of lots for each trade reduces the profitability of a trade.
- Varying lot sizes is the MOST important thing you must do, if you want to be successful.

Money management:

- Never let a winner become a loser.
- Adjust your stops as the market moves with you.

In the earlier article, we looked at a trade example of a Harmonic pattern (a bearish 'Gartley') since these patterns give excellent risk-to-reward ratios.

Let us apply the concept of position sizing on this same trade.

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Position sizing protects you by limiting the amount of capital, when you are the most vulnerable, thus controlling the total amount of loss.

Position size formula

The correct position size can be determined by a mathematical formula.

For a standard account:

PS = (E / 2500) – 1.

(Where E is the account equity.)

For a mini account:

PS = (E / 500) – 1.

As can be seen, the position size is entirely dependent on the account equity, thus underlying the importance of an account being well capitalised.

Let us assume we traded this setup in a mini account with a capital of $ 10000.

As per the position size formula - PS = (E / 500) – 1.

Thus the position size for this trade = (10,000 / 500) – 1 = 19

This says that we can trade a maximum of 19 mini lots on this trade.

But we will give priority to the golden rule of not exposing more than 2% of the entire capital at any given time.

Trading with 19 mini lots at a stop loss level of 80 pips would put our entire risk at 1,520 pips.

On a mini account this equates to $1,520

This risk of $1,520 on a capital of $10,000 works out to 15.20% which goes against the money management rules and is not acceptable.

Thus to keep the maximum capital exposure to 2%, we need to reduce the number of lots to be traded.

Ideally one should enter a trade with multiple lots and I would recommend minimum three lots.

This keeps our money management policies flexible, as we tend

to take initial profits when price goes in our favour and follow up the balance lots with trailing stops.

Thus three mini lots at a stop loss level of 80 pips would put our entire risk at 240 pips.

This risk of $240 on a capital of $10,000 works out to 2.40% which is still outside the rules ... but just about acceptable.

We now have our position size and money management rules precisely defined and can manage the trade, based on the principles of risk management.

Let us go back and reflect on a very important point.

This trade was taken on a daily timeframe and had a stop loss of 80 pips, which is the average stop loss level on this timeframe.

We can thus conclude that trading three mini lots on a daily timeframe would require a minimum capital of $10,000.

Translating this, it simply means that your capital decides the timeframe you can trade on.

Once again, this simple fact is ignored by most traders, thus leading to the over-exposure of trading capital.

Let me end with some practical trading tips:

- If you are trading with standard lots, I would recommend dividing the standard lot into mini lots. This gives you the flexibility to take profits at different stages and thus protect your capital.
- One must be sufficiently capitalised. Under capitalisation puts you at a disadvantage, as you cannot manage your trades effectively.
- If the trade does not fit within the rules of money management, do not take the trade. It's just as simple as that. One does not have to trade every setup and there will be other opportunities.

Finally the principles of money management have to be decided by the risk factor, amount of capital available and the profit that the trader is looking for.

There are various factors to be juggled to get the correct system ... but hey, nobody said that trading is easy.

Trading is a business. Like everything in life, you have to visualise what you want to accomplish before you can get there. With the proper planning there are very few surprises. You won't get rich overnight, but you will be able to get there. Many have done it and so can you. YTE