Money Management PART 1

The dividing line between success and failure, says **Sunil Mangwani**.

Successful traders do not have a 'Holy Grail' to the markets. If you ask any professional trader, he/she would most likely mention 'money management' as the deciding factor between success and failure. 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. With an increasing number of traders entering the 'Shark pit', unfortunately this number seems to be growing.

Is there a particular method/technique that the successful traders follow to succeed in the markets?

Not really!

I have been trading for over 10 years and having coached a large number of traders, I have seen that the ultimate cause of failure is the lack of awareness of the 3M's.

Lets us have a look at the 3M's which are 'Money, Mind and

Method' in that order.

If we distribute the 3M's on a scale of 10, then:

Money – 'money management' would constitute five parts.

Mind – 'discipline and patience' would constitute three parts.

Method – '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.

But let's be fair here. It really is not the trader's fault, since most of the information available says otherwise.

If you purchase a course or a book, they all talk about technical indicators, chart patterns etc., but rarely will you come across a book or course which tells you to concentrate on the Money and Mind.

Most new traders will purchase a book, open the charts, look at the indicators, and buy/sell based on the crossover of the indicator lines or moving averages etc.

What about money management? What about the discipline and patience to prepare a trade plan and follow it?

Zilch!

Is it surprising that these traders lose money?

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.

As traders we are all here to make money from the markets. But what should be the first priority of the trader?

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.

Without implementation of proper loss control techniques, a sudden large drawdown can shrink an account to such an extent that the possibility of attaining profitability becomes remote.

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.

Table 1 illustrates the concept, and ultimately the importance of controlling the loss of capital.

Therefore a trader must have a money management policy. A money management policy is nothing more than a set of techniques that help a trader minimise the risk of loss, while still enabling him/her to participate in major price gains. It is probably the most critical aspect of trading

TABLE 1: LOSS OF CAPITAL/GAIN TO RECOVER

Loss of Capital	Gain to recover
%	%
5	5.30
10	11.10
15	17.60
20	25.00
25	33.30
30	42.90
35	53.80
40	66.70
45	81.80
50	100.00
55	122.00
60	150.00
70	233.00
80	400.00
90	900.00

and the most overlooked.

A sound money management policy becomes an absolute must in the forex markets, due to the availability of high leverage.

As the popular saying goes "take care of your losses, and the profits will come by itself".

I want to put down certain facts and some simple rules of money management which would help the trader achieve the desired success.

1. Expect losing trades

It is only natural that when we take a trade, we tend to focus on potential profits than dwell on possible losses. We are usually so convinced that the trade will be profitable, that we tend to ignore the possible losses that would occur should the trade go wrong. One must accept that losses in trading are inevitable, and a successful trader is one who manages and controls these losses.

2. Placing stops

Trading without stops is akin to walking a tightrope without a safety net. As far as possible, one must have stops in the market since this is the only way to control the losses. While this becomes a 'double edged sword' since a trader may get stopped out of a trade for no reason, it is still the best 'safety net'.

3. Stop loss levels

The most important rule is that the stops should never be mere 'dollar value' stops, but technically correct stops. Which simply means that one cannot decide on the stop level based on his/her personal risk level. A trader cannot say, "I am going to risk only $50 for the trade."

The market does not care about your comfort levels; it respects the technical levels. Hence a stop must be at a technical level, regardless of how far it is away from the entry. If one does not follow this simple rule, the 'comfortable' dollar values stop would probably get stopped out more often, which defeats the very purpose of placing a stop.

4. Trading is a business of probabilities

You are in control only until the moment of the entry. Once you are filled in the trade, the market will dictate where the price will go. You cannot control this, just like you cannot control with 100% certainty, the amount of profit (or loss).

But what you can control is minimising your losses and protecting gains through a well-defined money management strategy.

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 this article, we will have a detailed look at the first principle.

5. Risk-to-reward ratio

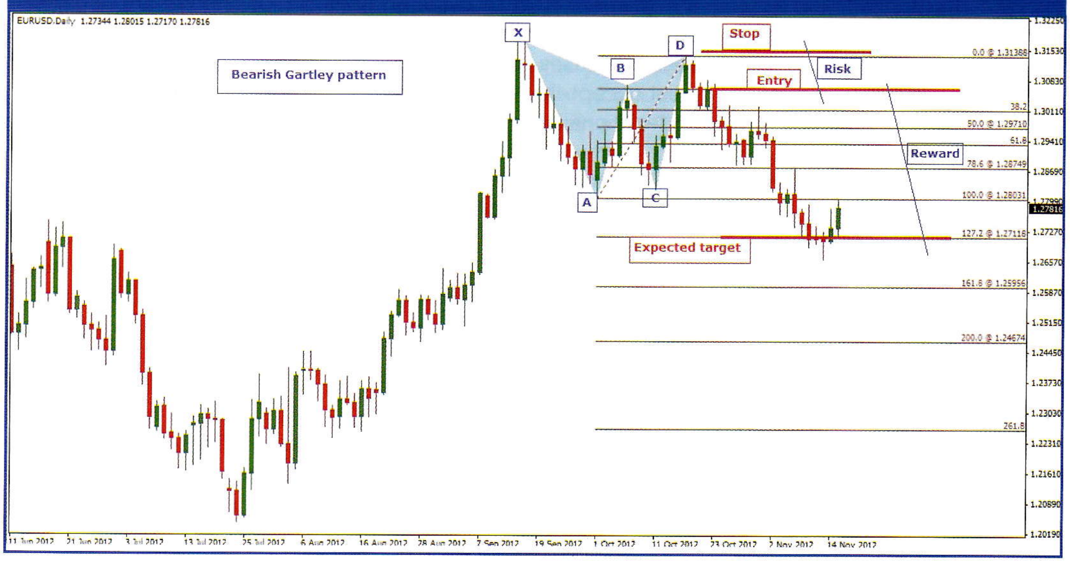
One must always keep the RR ratio at a minimum of (1:2).

Let us use simple mathematics to understand the concept of the RR ratios.

First and foremost, one must accept that losses are a part of trading and one will have losing trades.

Let's assume that a trader has a win-loss ratio of 60%.This means that out of every 10 trades taken, a trader would get six winning trades and four losing trades.

FIGURE 1: EUR/USD DAILY CHART



The only way to achieve gains in the account is by maintaining the required RR ratio.

Hence, if a trader is maintaining an average stop loss level of 25 pips, then the expected profits from the trade must be at least 50 pips.

Scenario 1

The trader has four losing trades @ 25 pips = (-) 100 pips.
The trader has six winning trades @ 50 pips = (+) 300 pips.
Net result after 10 trades = (+) 200 pips.

Hence a trader can achieve gains in the account, even after getting four losing trades out of 10.

Scenario 2

Now change the RR ratio to (1:1) and the net result comes to (+) 50 pips, which drastically reduces the gains in the account.

Scenario 3

Now reduce the RR ratio to less than (1:1), say (0.50:1) which is what scalpers tend to do – look for a profit of 10 pips and keep a safe stop of 20 pips.

The net result comes to (-) 20 pips.

To be honest, if I do not get sizable gains in my account after 10 trades, I am simply wasting my time. To achieve a worthwhile increase in the capital (after spending the time and effort) one must maintain the correct RR ratio. Unfortunately this simple fact is ignored by most traders.

Let us have a look at a trade example, which was taken and managed by incorporating the above mentioned aspects. I have taken a trade example of a harmonic pattern, for the simple reason that these patterns give excellent risk-to-reward ratios.

Figure 1 was a live trade taken in our 'trading room' of a bearish Gartley pattern on the Daily time frame on EUR/USD.

As seen in the chart (Figure 1), once the pattern confirmed with the formation of point D, we determined the precise entry, stop and exit levels.

- Stop was placed above point D.
- Expected price target was the Fibonacci projection ratio 127.2%.
- The entry is a very crucial factor and was decided on a combination of three different factors.

As one can see in the chart, these parameters gave a fantastic RR ratio of (1:4).

Not only does this give a highly profitable trade, it also enables the trader to take profits in between, thus locking in the profits as the trade progresses.

There are two reasons for mentioning this trade:

1. We can draw a simple conclusion that as traders we must look for techniques/strategies which assure the minimum RR ratio.
2. This trade will be used to explain the concept of 'position sizing' in the next article.

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