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FOREX Risk & Money Management

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Money Management

Many traders like to focus on the profit aspect of trading, thus they spend a lot of effort to master fundamental analysis and technical analysis. Yet they tend to neglect the loss aspect of trading, which is just as important. One of these most important concepts is that of capital preservation. Without trading capital, your account will be closed and you cannot trade. Hence, a money management strategy that allows you to live to fight another day is vital to the survival of any trader.

Position Sizing

The risk exposure of each position is directly related to its position size. Bigger position size leads to greater monetary loss and results in higher risk exposure. It is logical therefore that the position size you trade has to be evaluated based on the amount of trading capital at your disposal, as well as the trading losses that you are able to accommodate.

For example, you may decide to accommodate for the potential scenario of going through thirty days of continuous losses, at the maximum of 30 pips of losses per day. This means that you need to account for 900 pips of potential total losses. If you have a trading capital of US$9,000, then each pip can be equivalent to a maximum of US$10, and you should trade at a maximum average position size of €100,000 for your trades. Another rule of thumb to remember is that the greater the risk of your trades, the lower should be the position size. For example, when the holding time of a position is long, the uncertainty and risk will also be greater. Thus the holding time of a position should be inversely related to your position size.

The longer the expected holding time, the smaller your positions size should be. When you enter an intraday position, you can reduce the position size to a third of that for spot trades. So if you typically trade €100,000 position sizes for spot trades, your position size will be €30,000 for intraday position trades. For strategic position trades, you can reduce the position size further to €10,000 to account for the higher risk. By changing the position sizes accordingly, you can thus accommodate stop losses that are further away, and still be risking only the same amount of potential monetary loss.

Managing Margin and Leverage

Closely related to the notion of position sizing is the concept of margin and leverage. As mentioned earlier, FX brokers tend to offer very high levels of leverage, which allows the FX trader to trade much bigger position sizes. However, with bigger position sizes, the risk exposure is also correspondingly higher, and the risk of margin cuts is also substantially higher. Imagine a FX trader with US$1,000 initial capital, trading 100 times leverage at a position size of one standard lot. Each pip of profit or loss would thus be equivalent to US$10. As we can see, this is very risky, as just 100 pips of losses would wipe out the entire trading capital. FX traders thus need to be aware of these dangers, and choose an appropriate leverage and position size.

Risk Management

Beyond money management, risk management is also very important. Whereas money management focuses on the choice of leverage and position size, risk management focuses on the trade entry and exit decisions that the trader makes. As the saying goes, every battle is won before it is fought. Knowing your game plan and having a planned strategy before entering a trade is thus vital towards being a profitable trader. Always plan your trades. Just like fighting a war, planning ahead can often mean the difference between a profit and a loss.

Trade Entry

The trade entry decision is very important, as that is the point where the risk exposure starts. If we are square and have no open positions, we have zero risk. But once we are in an open position, anything can happen in the market and affect us adversely. Thus when trading, we should always know in advance what price patterns we are looking out for; and to enter a position, we need ample reason and justification. If we are not sure whether we should do the trade, then often it is better to just skip the opportunity. After all, countless opportunities will always be there, and we should only wait for the higher certainty chances.

Trade Exit

Beyond the entry plan, the exit plan is equally important. Stop Loss and Take Profit levels represent two key ways in which traders can plan their exit strategy ahead when trading. Successful traders analyse where the market may run to, and plan their Take Profit accordingly. Also, they will plan out what they would do if the market does not behave as anticipated, and know where they will cut their losses if their entry decision was proven wrong. Conversely, unsuccessful traders often enter a trade without having any idea of when they wish to exit. Like gamblers on a lucky or unlucky streak, emotions begin to take over and dictate their trades.

Greed

Greed is a powerful emotion, and can turn a winning trade into a losing trade. We can try to control for greed by deciding on the Take Profit level beforehand, and sticking to it even as prices shoot past it. After all, it is not realistic to aim to always predict market tops and bottoms, so we should not attempt to squeeze every last pip out of every move.

Also, another method to protect the wins is for the trader to shift his Stop Loss along as the trade moves in a favourable direction, so as to lock in the profits. On a related concept, the trader should consider taking out earnings from his trading account on a periodic basis, so as to “take money off the table”.

Loss Aversion

Psychologists have discovered that humans tend to experience loss aversion. Simply spoken, it means that we find the pain of losing $100 to be more than the pleasure of winning $100.

Figure 1: Psychologists Kahneman and Tversky found that humans preferred avoiding losses to acquiring gains

The implication of this is that we will tend to avoid even small losses, and will thus often hold on to our losing positions, in the hope of the market turning and us making our losses back. Unfortunately, this frequently leads to us incurring far bigger losses than if we had cut the losses early. With this understanding, we can see that when in a losing position; the prudent FX trader should try to stick to the Stop Loss determined beforehand, instead of shifting the Stop Loss further as prices move against him. Stop losses should only be shifted closer, not further. This discipline will help to minimize the emotional aspects of our trading.

More fundamentally, every position should always have an attached Stop Loss at all times. Trading without a Stop Loss can lead to disastrous results, as the risk exposure is unquantifiable. A single unforeseeable event like a natural catastrophe can send markets hundreds of pips in one direction, wiping out a substantial part of your capital.

Risk vs. Reward

A key concept in risk management is the idea of the risk-reward ratio. Basically, all rewards should be evaluated based on the risk we have to take to achieve them. One possible way to look at the risk-reward ratio is examine the magnitudes of the winning scenarios and losing scenarios, as well as their corresponding probabilities.

Mathematically, the risk-reward concept can be summarized by this simple equation below:

Risk vs. Reward = (*Probability of Win* X *Magnitude of Win*) – (*Probability of Loss* X *Magnitude of Loss*).

For instance, let us assume that we have a trading strategy that is able to deliver us wins 80% of the time. The average size of the wins is 2 pips, while the average size of the loss is 3 pips. The risk vs. reward is thus (0.8*2) – (0.2*3) = + 1 pip. As we get a positive value, it means we are making more than we are losing. Specifically, we are making an average of 1 pip for every trade we do.

An alternate example may have a trading strategy with a 50% win rate, but with the average wins at 12 pips while the average size of the losses is at 6 pips. In this case, the risk vs. reward is (0.5*12) – (0.5*6) = + 3 pips. The trading strategy is valid and we are making an average of 3 pips for every trade we do.

We can thus see that one of the key parameters in the risk-reward equation is the win rate. To tilt the risk-reward ratio in our favour, one possible way is to only do trades with higher certainty. Also, it is important to keep our losses small when we have losing positions. This goes against the human emotional bias of loss aversion, so the FX trader would need to actively control for their emotional biases. Ideally, the magnitude of the wins should also be higher, but the FX trader needs to be wary not to be greedy, or a winning trade can easily turn into a losing trade. Hence it is always better to perform analyses beforehand where the market may run to, and stick to the Take Profit levels that have been set.

Sticking to a Trading Plan

To summarize what we have said so far, it is very important for a FX trader to come up with a trading plan. The trading plan would include the fundamental analysis and technical analysis tools that the trader would use to analyse the market. It should also incorporate money management and risk management elements, to guide the trade entry and exit decisions of the trader.

Discipline

It is important to have a good trading plan, but it is even more vital to actually stick to it. This is especially so for traders doing discretionary trading. Many traders lack the discipline to follow their own trading plan, even if it is proven profitable. This often leads to revenge-trading and over-trading, which are two very dangerous pitfalls. Many traders feel the urge to execute a trade immediately after their Stop Loss has been triggered. Their emotions tell them they need to recoup their loss and they need to feel they are right. Such rashly executed trades are often against their trading plan, such as with regards to entry and money management. Thus some traders add a rule to prevent them from enter a trade right after having their Stop Loss triggered.

The bottom line is, you should never bring your emotions into trading. Always remind yourself of the right trading mindsets, so that they can be internalized into you. When you have an open postion, a good question to ask yourself would be: “If I am not in my current position, would I still want to enter it?” If the answer is no, then cut your losses, calm down and plan for your next entry.

Keeping a Trading Journal

A trade journal is helpful for logging down every trade that has been done, as well as the entry and exit rationales behind them. To make the journal clearer, pictures of price charts are often included as part of the trade rationales. By reviewing the trade journals, the FX trader can spot mistakes and try to correct for them.

For example, one category of mistakes is the losing trades that should not have been done. By reviewing what went wrong for those trades, the trader can spot recurring patterns, so that he can be more alert to the risk factors when trading next time.

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