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Risk Management Strategies

for Traders of Futures, Options, ETFs, and Stocks

by Quad G

The KEY to making money in the markets is not great technical analysis, instincts, using news sources to the best advantage, or even winning more trades than are lost!

The key to making money in the markets is **RISK MANAGEMENT.** Even a beginning or mediocre trader can learn to mitigate losses and maximize gains, creating a winning strategy to keep him or her trading for years.

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Risk - Nothing Is Certain

Life Is Risky

Life has inherent risks involved in everything we do. There is always a lurking chance of loss. Nothing is certain. Houses run the risk of suffering catastrophic fire. Drivers of cars run the risk of being involved in accidents that could ruin a car at best, ruining a life at worst. Illness can also strike without much warning, requiring the attention of expensive doctors and hospitals that can help our bodies mend. All of these horrible calamities are not very common for each individual. Often times we live out our lives at home, work, and play without giving much thought about risks that surround us.

Insurance does not remove risk, but it mitigates the potential consequences.

The probabilities of losing a house to fire, or a car to accident or theft, or becoming sick enough to require medical intervention are very low. Yet even with such low probability the consequences of these occurrences can be devastating to one's life. So much so that an enormous industry called insurance has become a very common purchase for most. Insurance does not remove the risk associated with our daily living, but it does mitigate the potential consequences of those improbable risks if they were to occur.

Insurance is a unique business that has essentially made a science of estimating the probability for various types of unwelcome calamities and then applying a profitable business model around those probabilities. They have become so good at calculation and estimation of probabilities that they know just how much to competitively charge customers for the amount of insurance protection that they provide. They know just how much inflow they need to meet their pay-outs and make some profit.

Manage Trading Risks

Now, what does this all have to do with trading? There is nothing certain in trading either. Predictions are often made about this direction or that direction in a particular market or stock, but not even the best traders on the planet are 100% accurate all the time. There is and always will be an element of risk and consequence. Because nothing is 100% certain, trading also resides in a world of probabilities. Just like the Insurance company, if you can become good at calculating and estimating those probabilities, you can provide yourself with your own protection and profits. Managing those probabilities well with effective risk and money management can make even the most mediocre trader a profitable trader.

Even the most mediocre trader
can be a profitable trader.

Probably 90% of all first time traders burn through their initial account balance in a matter of months. The little known secret that most first time traders don't realize is that they didn't bomb their trading account because of a few 'bad calls'. They blew up their account because they didn't have a plan on how to effectively manage the risks and probabilities involved. They either fell prey to over-leveraging, not taking initial profits, or failing to stop-out for small losses. **I've personally been there, done that, didn't even get the t-shirt.** I'm lecturing from humble personal experience, having gone through the same school of hard knocks. If you can read, hear and apply what I am teaching in this book, you can help yourself avoid many of the pitfalls that swallow up most other traders.

Too many traders approach the craft as though they are saddling up to a Texas Hold'em table or a slot machine, thinking that a turn of the handle or a few good hands will make them rich quick, but then so often leave empty handed. The best poker players in the world understand the role of probabilities and how to handle them. They approach poker more as a business and less as a game. The key difference is establishing a disciplined business model of methodologies and strategies on how to manage the probabilities in conjunction with money.

Trade with your head, not your gut!

The keys to successful risk and money management that I express in detail in this ebook are the same strategies that I employ and demonstrate to subscribers of Major Market Movements every day. Every trade signal sent to subscribers is not just a money making opportunity, but also a lesson on how to approach trading in a logical, plan driven, methodical way, getting rid of the often erroneous ‘gut feeling’ decisions and instead observing and moving on technical indications that afford the greatest probabilities.

The Stop-Loss

The Foundation of Every Trade

I tell my subscribers constantly, "There is only one thing that you can control in trading 99% of the time: How much money you are willing to lose." You cannot control the direction of the market, you can guess, but as I said previously nothing is certain. If the market chooses to go in your favor then and only then do you have the chance to take profits. Your account can afford any amount of increase, but it cannot suffer any amount of decrease. It can move to zero or worse. If the market moves against your position, not controlling the amount of loss can be fatal to your trading account. Since loss is the one area of trading you have 99% control over, its best to become very familiar with the foundation of every trade (which is the stop-loss function) and use it to your advantage. I say 99% of the time, because 1% or less of the time there is the chance that a stop-loss can be over-run by the market.

How much money am I willing to risk losing if the price moves against my position?

The very first question that needs to be asked before ANY entry into a market is this: "How much money am I willing to risk losing if the price moves against my position?" This needs to stir an amount in your mind, how much is up to you. I will get into appropriating the right amount of leverage in the next chapter.

Once you establish the amount of money that you are willing to lose on an entry, you can then start to build a trade. This information alone (how much you are willing to lose) will be used to dictate exactly when to enter the market.

Too often traders enter a market thinking about how much money they stand to gain if the price moves in their direction. This, in my experience, is putting the cart before the horse. Potential gain lies deep within the realm of probability, but it is a fantasy until it is actually realized. Potential loss is far more concrete in comparison, thus good foundation material for all trades.

Loss control is job #1.

You might be asking, "Why is focusing on losing a good thing, shouldn't I be focused on winning?" The simple answer is no. **Loss control is job #1.** The other big concept that I tell my subscribers all the time is the common phrase: "Cut your losers short, but let your winners run." I'll demonstrate my point using the track record of two average traders: Larry and Sam.

Average Traders Larry & Sam

Larry averages a win/loss ratio of 45% wins to 55% losses in his trading. He loses more times than he wins. Sam, on the other hand, enjoys a slight edge over Larry with a W/L ratio of 55% wins to 45% losses. However, at the end of a year's worth of trading, Larry has increased his account while Sam has gone backward, losing in his account for the year. How is this possible? Larry traded 100 times last year, so did Sam. Larry averaged a $1000 profit for each winning trade, so did Sam. This equals $45,000 in profitable trades for Larry, and $55,000 in profitable trades for Sam. Sam is certainly looking like the trading guru at this point.

Larry uses a method to control the amount he loses on his trades.

However, Larry employs a strategy that Sam doesn't. **Larry uses a method to control the amount he loses on his trades.** Larry, using his disciplined risk control method, ends up losing on average $600 for each losing trade, or about $33,000, giving him a net profit of $12,000 for the year. Sam doesn't use a 'method' to control his losses, that would be contrary to his gut level, free-wheeling trading 'instincts'. Sam, with his nearly non-existent risk control scheme, loses on average $1,400 for each losing trade or about $63,000, giving him a net loss of ($8000) for the year. Between Larry's profit and Sam's loss, there is a spread of $20,000, not because one had more wins than the other, but because the amount of loss was minimized by one and ignored by the other.

	Larry 45/55	Sam 55/45
Beginning Balance	$100,000.00	$100,000.00
Wins	$45,000.00	$55,000.00
Losses	($33,000.00)	($63,000.00)
Ending Balance	$112,000.00	$92,000.00
Net Profit/Loss	$12,000.00	($8,000.00)

Neither one of these gentlemen are great traders, but Larry will survive to trade another year, gaining more experience, and likely improve his win/loss ratio, which combined with his risk management techniques, will likely propel him to satisfying profits year over year. Sam has a good W/L ratio, but will steadily move backward in his account if he doesn't employ a solid method to control his losses.

Know Your Risk Tolerance

The #1 most important determinant for entering any position is knowing your risk tolerance, i.e.: How much you are willing to lose on any one given trade. Do not compromise that measure. If the market moves toward a line of resistance or support with corresponding stop-loss, the time to enter the trade will be when the amount of risk (price distance from entry to stop-loss) fits your risk tolerance. If the market does not move to a point that agrees with your risk tolerance then by all means ignore the trade and wait for something to develop that meets your criteria. New trading opportunities pop up all the time, just kick back and relax waiting for one that fits your risk tolerance. It is far better to let a trade run away, missing an opportunity, than to ignore your predetermined risk allotment by entering too far way from a predetermined stop-loss level. **If the market is not going to give you a trade on your terms, then let it go.** There is no point chasing after a trade like a starry eyed love sick teenager. There are plenty of fish in the sea, just be patient.

If the market is not going to give you a trade on your terms, then let it go.

There is much more to a good risk management method than simply setting stops, but the other techniques involved in the method cannot be used without it.

Over-Leveraging

The Destroyer of Trading Accounts

How much is too much to risk on a trade? Most traders don't even ask themselves that question. Instead they simply go with what looks good and feels right. If the market goes in their favor, they add more leverage (more shares or contracts) in anticipation of even more gains, or if the market moves against them then they add more leverage by 'doubling down'. Neither of these is necessarily bad, most of the time using time to average in or out of a position is an advantage. An undisciplined use of leverage, however, can get a trader in a pickle very fast.

Guess work and gut feelings are not appropriate limit-setting tools.

Guess work and gut feelings are not appropriate limit-setting tools. There is a better way, but it takes discipline. What happens if you routinely risk 10%, 20%, or even 30% of your trading account balance on 1 trade? How many losses in a row would it take at that kind of leverage to drain your account? At 20% per trade, 5 bad trades in a row torpedoes your account, game over. That doesn't afford much room for error. Sadly, this type of over-leveraging is all too common with many traders.

They pile into the ‘sure thing’, only to be crushed when it falls apart.

Leveraging 30%, 20% and even 10% is too much. Adding that kind of leverage is often a function of greed and should be avoided.

How to Protect a Trading Account

Now let’s flip this poorly devised practice upside down. From my experience, if the amount of leverage per trade is kept to 5% or less of the trading account balance, the survivability increases substantially. At that level, a drawdown of 5 losing trades in a row would suffer your account only 25%, certainly survivable, far better than 100%. At such a minimal amount of leverage it would take 20+ strikes in a row to toss you out of the game. The odds of that happening are far less than if you were leveraged at 20%. For example, a $100,000 trading account abiding by the 5% or less leverage discipline would not risk more than $5000 on any one single trade.

	20% Leverage	5% Leverage
Beginning Balance	$100,000.00	$100,000.00
5 Losses	($100,00.00)	($25,000.00)
Ending Balance	$0	$75,000.00

It is true that keeping leverage limited to no more than 5% is not going make you a bundle overnight, but you'll probably sleep better, keeping your body in homeostasis and absent of the typical fight or flight reactions that usually form bad decisions. This technique will probably slow you down, which is a good thing. Patience is a virtue and will benefit you in the long run. This practice will afford you and your account time to find some excellent winning trades. For new traders especially, leveraging only 1-3% is very important in the midst of learning new trading disciplines, techniques, and market dynamics.

Fight or flight reactions usually form bad decisions.

Staying calm, cool and relaxed with reasonable trade risk sizes will make for better decision making and better sleep. Worry is an enemy that should not be entertained or given quarter. Too much leverage is an open door for him.

The Three Tranche Trading Habit

Price and Time

The price on a chart is just one vector. It is the one that receives the most attention. But a chart is actually made up of two very important vectors, price and <u>TIME</u>. It is impossible to make a chart without both. Time is the one vector that is most often ignored by traders. Anxiousness to act often causes traders to enter or exit a position all in one shot. I call this the 'all-in' or 'all-out' trading method. Though very simplistic, it is a very impatient method that often does not consider time. Price has value, but time also has value, and most traders short change themselves by not taking advantage of time.

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Now, since we don't know what the future holds, let's prepare for the worst case should it arise. Generally when trading speculative methods, I like to set up my whole position with at least 3 subdividable tranches (portions of a whole position).

The 3 Entry Tranches

The first entry tranche is a pick, your first stab into a suspected top or bottom in a market. This gets your foot in the door only. Markets can move very fast, so when the price enters a suspected entry zone for a trade, the first tranche is set to respect your risk tolerance with an appropriately placed stop-loss level with the entry. The first tranche is not necessarily being triggered by topping or bottoming action, but rather just being mindful of the price as it relates to your predetermined stop-loss level. Obviously the closer the price moves toward the stop-loss level, the lower the risk. It is often a good idea to place a limit order for the first tranche so that a quick move can be captured in most cases.

The first tranche is mindful of the price as it relates to your stop-loss level.

The second entry tranche is more patient than the first tranche, though a second can be entered with the first if a quick volatile market condition is expected. In most circumstances, though, it is best to take a pause after the entry of the first tranche, watching for signs of the market producing a reversal in the suspected entry range. This could take several minutes or even hours using technical analysis tools to find a reasonable entry.

This is a good place to work on patience. Greed and fear usually try to get you to move in a hurry. It's best to resist that urge.

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The third entry tranche is usually entered when either the price moves very close to the stop-loss level reducing risk, or after a price move appears to be confirming a reversal, such as a trend-line break. If you don’t have much time to watch the market for a good 3rd tranche entry, an immediate entry with the 2nd tranche is also acceptable, especially if the 2nd tranche is in a better than average position.

‘Budgeting’ of the 3 entry tranches

Based Upon the 5% or less leverage limiting principle, a certain amount of money can apportioned for a trade. That amount of money is then divided into 3 equal amounts, set aside to buy (or short) each of the 3 tranches.

For example: Say I am willing to lose $ $1.20 between 3 tranches for a silver trade. That's an average of $.40 loss for the whole position.

A signal is as follows:
Spec buy signal #1: between 20.00 and 20.30
SL: 19.80
TGT: 20.70 to 21.00, TBD

The price then moves down into the buy zone between 20.00 and 20.30. The first tranche is bought comfortably in the zone at 20.19, with a SL at 19.80, $.39 was spent of the $1.20 budget. This leaves $.81 to spend on the next 2 tranches. Thinking that the price may dip lower, the second tranche purchase is held out for a lower-buy.

The price action obliges for a lower-buy at 20.14 for tranche 2, another $.34 of the risk budget is spent. There is now only $.47 left in my budget. This means that with a SL of 19.80 I can enter the last tranche no higher than 20.27. If the price were to shoot up beyond that point and not come back, then one would have to be satisfied with only having 2 long tranches in and will have to wait for a better pull-back.

Fortunately, the price lingered a little longer between 20.00 and 20.30, a small trend line was breached to the upside and the decision was made to enter the third and last tranche at 20.20 before it ran away. Could it have gone lower and saved more of the 'risk budget'? Sure it could have, but the buy at 20.20 was still well within the budget.

In general, as the price moves closer to the stop-loss the more it saves on the risk budget.

In general, as the price moves closer to the stop-loss the more it saves on the risk budget. This is an area that sometimes very short term technical analysis can fool traders and cause them to pause and not enter, while the risk management technique is telling them “good deal - get in.” I typically lean to the risk management technique which gives me a lower-risk entry, though the price may be rapidly moving toward my stop-loss. Sometimes it's better to trade blindfolded and just stick with the risk management plan.

Often times when traders are picking a top or bottom in a market they often try to be penny wise, but end up being pound foolish. In other words, there is little point in nitpicking your first tranche when the price is right in relation to your risk tolerance and stop-loss level. What is a few cents in silver when a potential $1+ run is lurking ahead? If the entry fits inside your risk budget then take it, if it doesn't then don't.

If the entry fits inside your risk budget then take it, if it doesn't then don't.

That kind of risk management is far more important than trying to use very short term technical analysis and timing in an effort to get the best price. Very short term technical analysis can be beneficial for judging good entry and exit points, but TA is very speculative, and it should take a back-seat to the pre-planned 'risk-budget' for your 3 tranche position as it is far more important than short term technical analysis for gauging entry. Mastering risk management is a far better pursuit than mastering short term technical analysis. Both are good, but start with the former first.

Tranche Trading Part 2

The 3 exit tranches

Now that 3 tranches of a whole position is filled for silver, the wait is on for the market to move in your favor. This is also a time to be disciplined and not add another position outside of your 3 tranche appropriation for the trade. In some cases, it is good to divide a position into 4 tranches when you think that the position has a better than average chance of capturing a multi-week or multi-month trend bottom or top. The 4th tranche would be a longer hold, one that may endure a few ST pull-backs in a larger trend.

The first exit tranche is primarily for taking profits early.

The first exit tranche is primarily for taking profits early. When the trade is going your way, you want the first tranche to exit at a profitable target. I prefer to set up the initial profit taking target on the first tranche to be enough of a gain to cover the potential loss that could be incurred if the other 2 tranches are stopped out. This mitigates a potential loss to a wash, a break-even trade, far more preferable than taking a loss, especially after seeing some initial gains.

For example: If 3 widget futures contracts are bought at $18, $14 and $16. with a Stop-loss of $12.00, the average risk of loss for the position is $4.00 per tranche. Therefore it is usually best to have the initial target be as much or more than the potential loss of the 2 other remaining tranches, in this example it is $8.00. So let's figure a first initial target of $24.00 (16.00 +8.00). One tranche will exit at the $24.00. With last-in, first-out accounting, the $16.00 entry will exit first with a profit of $8.00. That gain will now be enough to cover any potential loss that may be incurred by the remaining 2 tranches being stopped out. If that were to occur, the position would resolve as break-even, no loss.

Widget Trading	Purchase Price	Exit Price	Profit (Loss)
Tranche 1	$18.00	$12.00	($6.00)
Tranche 2	$14.00	$12.00	($2.00)
Tranche 3	$16.00	$24.00	$8.00
Net Total Profit/Loss			$0

The importance of taking profits early cannot be understated. When a trade goes your way the first instinct is often to hold on, watching the valuation of the trade continue to climb into the green. The typical thought is, "Everything is going my way, Woo-

Hoo! I am such a smart trader. Look at my position score big!" It is at these times the market is rewarding you for your good decision making in picking the correct direction. However, the psychology of the moment enjoys the euphoria so much that it makes it hard to let go.

The importance of taking profits early cannot be understated.

The tendency is to just let your whole position ride, hoping for even more spectacular gains. This is a mental trap, an arrogant entertainment of the idea that you know what tomorrow brings. Oftentimes the whole position is held on too long, even as the price later moves against you. Soon the bright green turns to a dull green, almost grey and then shades of red.

There is a cure for this problem, it's called “taking profits early.” The first thing to reconcile is the fact that you don't know the future; no one does. Every trade is a guess, a play on probabilities. There is no trade that is certain. This is a healthy realization that every trader needs to hold tightly to. This thinking will help temper the misleading emotions attached to a sense of euphoria. Since we do not know the future, it is a good practice to take profits early.

The second exit tranche is the one for searching out a larger gain. It is a patient move that may endure a pull-back in your position. If played out as expected and the profit target is hit, the whole 3 tranche position is guaranteed to be a winner. Even if the 3rd tranche is stopped out, by this time the stop-loss level can often be moved in your favor, reducing risk for the position even further.

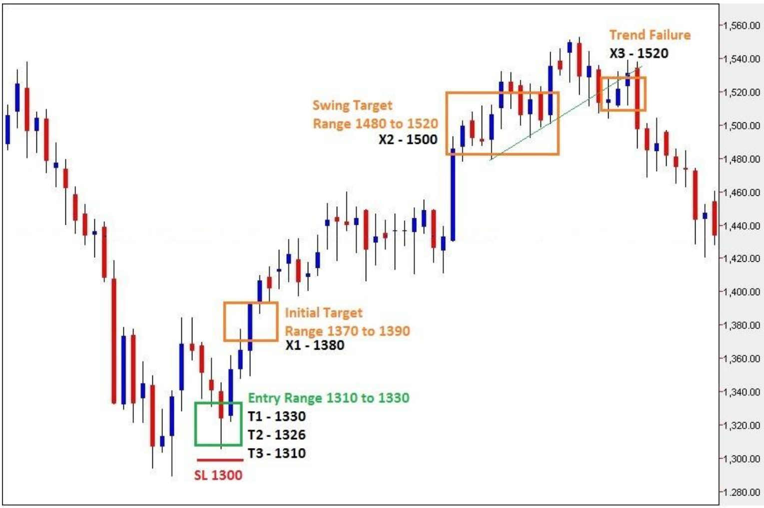
If played out as expected, the whole 3 tranche position is guaranteed to be a winner.

The third tranche is gravy. This one you can freely let ride without any serious repercussions. Since the 2nd tranche is locked with a profit, you are now free to be much more lenient with how the 3rd tranche is dealt with. Perhaps the price will continue to cruise in your direction: Great! Sit back and enjoy without feeling any pressure. Less pressure usually translates to better decision making. If the trend that you are following appears to be making a decisive reversal then consider exiting the 3rd and/or 4th tranche and perhaps get ready to set up a trade for a swing in the other direction.

Platinum Three Tranche Example

Filling the Three Tranches

The daily Platinum price chart below depicts how the 3 tranche method of trading would ideally be executed during an uptrend:



The Entry Range - Suspecting some bottoming action between 1310 and 1330, a stop-loss level is established at 1300. This sets a risk tolerance max of no more than 30 points per tranche (1330 is the top of the entry range, minus the stop-loss level of 1300, equals 30 points of potential loss).

However, this particular trader based upon the risk budget allotment determined by the 5% rule can only afford to risk up to 70 pts on this particular trade. This prevents him from entering all three tranches at the 1330 level, that would exceed his risk budget by 20 pts. (3 tranches x 30pts = 90pts - 70pts = 20pts too much). Therefore this trader will have to manage his 3 tranche entry on the entry range, finding lower prices toward the stop loss level that will fit in his risk budget.

The first tranche T1 is entered at 1330, this subtracts 30pts from his risk budget, leaving 40pts remaining. Time goes by and the price dips a little further and allows for a second tranche entry T2 at 1326. This debits another 26pts from 40pts for an updated remainder of 14pts.

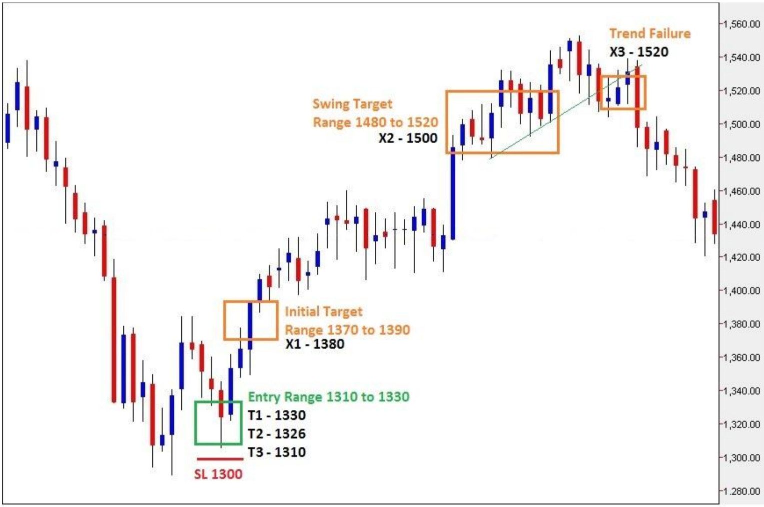
At this point, the trader is very limited on whether or not a third tranche can be entered. Since only 14pts are left in his budget, his entry threshold is now limited to 1314 or lower (stop-loss level of 1300 + 14pts = third tranche can only enter at 1314 or lower).

The trader then becomes fortunate as the price dips even further to accommodate a third tranche entry under his threshold of 1314, entering at 1310. If the price did not enter below his 1314 threshold, then the third tranche would have had to be left unfilled.

Initial Profit-Taking

Now that all three tranches are filled with an acceptable level of risk, the next step is to determine an initial target to take early profits. Typically, the goal is to find an exit point for 1 tranche that will earn enough profit to cover most of any losses that may occur with the other 2 tranches if stopped out. In our Platinum trade above, the level is about 1370 to 1390. A profit on 1 tranche from 1310 (T3) to 1380 would profit 70 pts, this would cover any potential loss on T1 and T2 if they were suddenly stopped out at 1300.

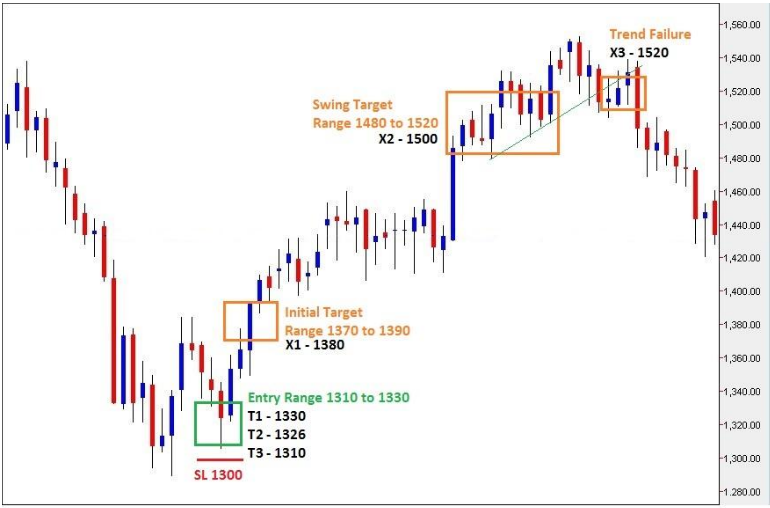
The early profit taking tranche protects the rest of the position from the loss that often comes from unexpected turns.



In the chart above the price continued an impulse upward; this is an ideal case. However, if you have been trading long enough you know that not all trades are ideal. Sudden unexpected turns happen all the time. **The early profit taking tranche protects the rest of the position from the potential loss that often comes from those unexpected turns.** In the case outlined above, if an unexpected turn was to occur, the whole 3 tranche position would end near break-even, no loss, even a small gain. This is certainly far more preferable than taking a large loss.

Exiting the Second and Third Tranches

Once the initial profit target is hit, the last two tranches are held and moved along with the trend, adjusting stop-loss levels as appropriate. In the Platinum example T2 was sold higher when the pattern in the upward trend looked close to topping out. T3 is often left to exit when the trend change is confirmed, perhaps by a trend line break or strong topping candlestick.



The platinum example above demonstrates the three tranche methodology in an ideal uptrend. The same can be applied to a market moving down as well.

My three tranche habit was born out of painful experiences in my own trading.

This three tranche discipline is a little more time consuming and more hands on than the typical 'all-in or all-out' type of trading 'method', which almost every trader, including myself, has cut his or her teeth on. My three tranche habit was born out of painful experiences in my own trading. I hope that my pain will be your gain if you choose to adopt this trading discipline. Check out MajorMarketMovements.com for more risk-management ideas, technical analysis information, and trading insights.

I hope that my pain will be your gain!

Ready to take your trading to the next level?

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