The Path to Trading Success

Part 10: Risk and Money Management

Previously the author demonstrated how to construct the entry criteria for a trading strategy. However, entering a trade is only half of the process, a trader also needs to know how much capital to risk on a trade and also when to exit a trade. Those two topics will form the basis of this article.

» When to Exit a Trade?

One of the main reasons why traders fail to be profitable is they don't have a predefined plan for exiting a trade. Successful traders always know before they enter a trade where they will exit, be that for a profit or a loss. These exit levels are always decided before the trade is placed and they never change these levels whilst in the trade.

A) Exiting for a Loss

Typically this level is called the trade's stop-loss, it is the point at which a trader admits the market hasn't done what they anticipated it would do and they exit the trade for a loss. As technical traders we use charts to tell us when to enter trades and therefore we use those same charts to tell us when to exit a trade for a loss. A logical location for a stop-loss is where the technical reason for entering a trade is no longer valid.

Continuing on with the breakout strategy example from the last article (TRADERS´ 05/2013), if we were to ask ourselves what were the main reasons for entering that trade they would be 1) the stock was uptrending, and 2) price had broken above a level of resistance. Therefore the point at which these reasons for entering were no longer valid would be when 1) the stock was no longer in an uptrend, and 2) price wasn't able to hold above the level of resistance. At the exact point when those two events occur on the chart would be a sensible place to exit the trade.

If price were to breakout above the resistance line in Figure 1 the trade would be entered. Reason 1 for entering the trade (the break above the resistance line) would be invalidated at point 1. Reason 2 for entering the trade (the uptrend) would be invalidated at point 2 as that is the point at which the most recent higher low in the uptrend would be broken and the market longer would no longer be in an uptrend. Consequently the stop-loss for this trade should be placed at point 2 as its at that point that both reasons for entering the trade are no longer valid.

B) Exiting for a Profit

Locating a sensible profit exit level should also be established from the charts. If price breaks above the resistance line (coloured blue) in Figure 2 and continues to trend up, a sensible place to take profits would be at the next strong resistance level. That level is shown in green in Figure 2 and the red arrows indicate the price touches on that level which give it its significance as a strong resistance level.

It is prudent to ensure that the ultimate profit target is further than a reward to risk of 1:1, which it is in Figure 2 (the

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trader is risking $0.60 to potentially make $1.15 which is a reward to risk of 1.91:1). It can also be prudent to scale out half of the position at 1:1 in order to lock in a break-even trade, with the final portion (or part of that final portion) being closed just before the ultimate target (ie the green line).

F1) Ideal Stop-Loss Placement

A logical place for a stop-loss to be located is the exact point at which the reasons for entering the trade are no longer valid.

Quelle: www.tradestation.com

How Much Money to Risk on Each Trade

In an attempt to achieve consistent returns a trader should risk a consistent amount of money on each trade. Whilst there are numerous methods available for calculating what this figure should be we believe the most effective and simplest method is to allocate a set percentage of your total trading capital as the maximum amount you are willing to lose on each trade. The author recommends that traders risk one per cent of their trading capital per trade. In his experience this still allows a trader the opportunity to achieve good returns whilst limiting their drawdowns to acceptable levels. For example if a trader had a $20,000 account and was looking to risk one per cent per trade then the maximum they would be willing to lose per trade would be $200 ($20,000 x 0.01).

Once again referring to the breakout example, the trader now knows before even entering this trade where they are going to enter and where their stop-loss is going to be. This information can then be used to calculate how big a position can be taken so no more than one per cent of the trader's account will be lost if the trade is stopped out.

One per cent of the trader's $20,000 account would be $200, therefore the most the trader would be willing to lose on this trade if they were stopped out would be $200. In order to calculate how many shares they could buy they need to work out the distance between the entry and the stop. Entry = $9.95 (blue line) and stop = $9.35 (red line). So distance between entry and stop is $0.60. The next step is to take the amount the trader is willing to risk on this trade and divide it by the distance between the entry and stop, ie 200 / 0.6 = 333. Which means that this trader can purchase 333 shares and if they are stopped out they won't lose more than $200.

Conclusion and Outlook

When to exit a trade is equally, if not more important than a strategy's entry criteria. It's strongly recommend that all strategies have clear exit criteria and that they are strictly followed.

In the next article we will discuss another very neglected aspect of trading; the traders mindset. «

F2) Ideal Profit Target Placement

A logical place for a profit target is just before areas of support and resistance.

Quelle: www.tradestation.com