



How to Manage the Size of Your Trading Positions

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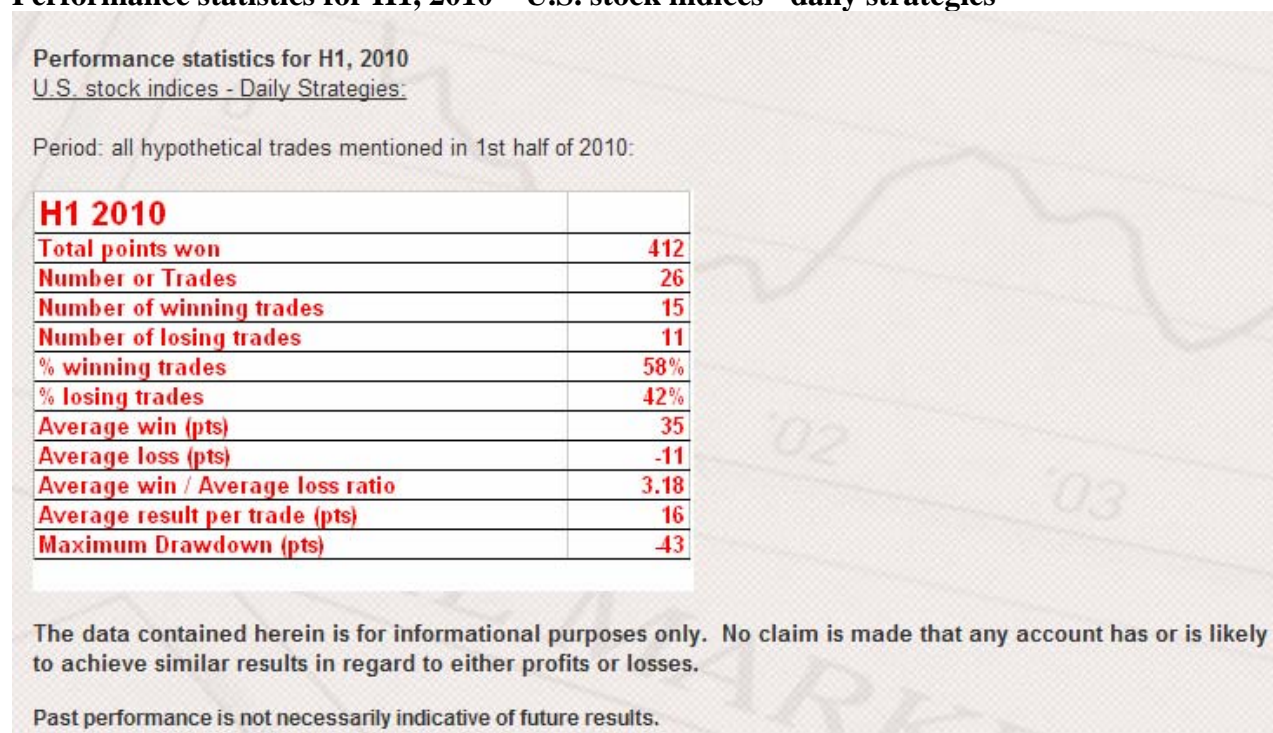
The article discusses some money management issues. We look at two examples from the hypothetical performance data published on our web site to see how one can behave to try to avoid the big losses that typically most of the people face in trading. We show that following strict money management rules is key to achieving success in trading consistently. If one does that, he or she can have very good results even if they are wrong most of the time.



How to manage the size of your trading positions – this is called money management and many books have been written on that subject. However, despite the huge amount of literature available, most investors fail to follow strict money management rules. When they get overconfident (and almost anyone can get overconfident at one point or another), they start opening huge positions using lots of leverage and risking significant part of their capital. And if a bad streak comes (a series of losing trades), it is quite often that many traders ruin their capital before they enter their winning streak. Some people are, of course, aware of this problem and apply strict money management rules. However, there are many pitfalls in money management and sometimes even if you want to be conservative in your trading, you can deviate from your system when the losses in your account build up. For example, think of you as a speculator who is conservative in trading and wants to survive after 20 losing trades in a row. That means, you calculate that if you risk less than 5% of your account per trade, after 20 losing trades, you still may have enough capital to open a position. However, the truth is that any loss, that is greater than, let's say, 30% or 40% can significantly affect your trading decision. That is, if you have lost 40% of your account after 8 losing trades, then you start to be either too cautious, or too impatient about your next trade. In other words, some psychological factors start to impact your trading decisions and you can easily deviate from the approach you have followed up to this moment. Therefore, in my opinion, if one wants to survive after a series of 20 losing trades, he or she should risk no more than 2% of their account on each trade. That will leave you with 60% (or more) of your account after a losing streak of 20 trades and you may still feel comfortable to trade.

Let's take a look at some examples from the performance statistics published on our web site to see if we can draw some conclusions.

Performance statistics for H1, 2010 – U.S. stock indices - daily strategies



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The table above shows the results of our hypothetical trades that we suggested in the 1st half of 2010 for U.S. stock indices in our daily updates. As you can see, this performance is more than



excellent as we managed to be right more often than wrong and to capture some really big moves. However, even with that excellent performance (and we cannot rely we can keep this extremely good track record for a long time), one can easily lose a lot or even lose his/her entire account if he or she does not follow strict money management rules. Notice the last line on the table – the maximum drawdown – 43 points. As you know, that means at some point we suffered a 43 points form the top that we have achieved in our performance before we can recover back to the top. That hypothetical loss of 43 points occurred in 4 consecutive losing trades in April and early May. Consider now, one trades one futures contract on e-mini S&P500 where one point move results in 50\$ profit or loss. If one trades only these trades (our daily strategies) with an account of \$5,000, he/she would have lost \$2150 during that time of 4 losing trades (not to mention the commissions and possible slippage). That would have been a 43% loss of the account value which most likely would have resulted in some serious deviation in one's trading strategy, i.e. it would be unlikely to expect this trader would continue to follow the same trading approach. For example, such a person may decide that after so big loss, the futures are not for her and to start trading only cash instruments (SPY exchange-traded fund for example). In doing so, this trader would not have participated in the excellent trades that followed that brought a total return of 412 points for the entire period.

So, even when someone has extremely good performance for a certain period of time, it may happen that actually he or she loses money in trading if he or she does not follow a consistent strict money management system. To avoid this, one should properly manage his risk. One way to do this is the following: If I figure out my average loss when I am wrong is 11 points (as the table above shows), I'll decide to open a position in such a way that if I lose, I will lose only 1% or 2% of my capital. Following that approach, I can easily sustain a much deeper drawdown than the one achieved during that period with our hypothetical strategies. But unfortunately most of the people do just the opposite – they risk 5% or 10% or even more on one single position and easily go bankrupt even with such a nice track record as shown on above.

Let's look at another performance example, one that is more natural to have (again, we have been very good in forecasting U.S. stock indices on our daily analysis but it is unlikely the performance will continue to be so good in the future).



Performance statistics for H1, 2010 and for 2009 – major currency pairs – Short-Term strategies

Performance statistics for H1, 2010

Currencies - Short-Term Strategies

all hypothetical trades that were mentioned in 1st half of 2010:

H1, 2010	
Total points won	1233
Number of trades	17
Number of winning trades	5
Number of losing trades	12
% winning trades	29%
% losing trades	71%
Average win (pts)	559
Average loss (pts)	-130
Average win / Average loss ratio	4.30
Average result per trade (pts)	73
Maximum Drawdown (pts)	-735

Performance statistics for 2009

Currencies - Short-Term Strategies

all hypothetical trades that were mentioned in 2009:

Total points won	723
Number of trades	19
Number of winning trades	10
Number of losing trades	9
% winning trades	53%
% losing trades	47%
Average win (pts)	171
Average loss (pts)	-110
Average win / Average loss ratio	1.55
Average result per trade (pts)	38
Maximum Drawdown (pts)	-466

The data contained herein is for informational purposes only. No claim is made that any account has or is likely to achieve similar results in regard to either profits or losses.

Past performance is not indicative of future results.

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Notice the headline results for H1, 2010 (1233 points) and for 2009 (723 points) are very good. However, if one traded these strategies aggressively, he would have lost almost everything before he could recover and achieve such results. Notice here the drawdown numbers are much more negative: the whopping 735 points in the 1st half of 2010 and 466 pts in 2009. And despite that huge drawdown and the fact that the percentage of winning trades is only 29%, the total result in 2010 is very good (1233 points). That is an indication that this result has been achieved by capturing some very big moves (see our average win/average loss ratio – it is 4.30 for H1, 2010!), but it also indicates we have been wrong most of the time. The fact that one can have very good result even with such small number of winning trades shows how important the money management is. Consider the maximum drawdown in H1, 2010 – 735 points – it happened after a series of five consecutive losses. Again, if you risk 10% of your account in one trade, then, after



such negative streak, you will find it very difficult psychologically to recover and to continue following your method. If however, you keep your losses small, i.e. you risk only 1% of your account in one trade, than there should be no problem to sustain such a drawdown and at the end you end up with a nice return.

Conclusion

Even if you have excellent performance, you can find serious difficulties in trading if you do not follow strict money management rules consistently. At the same time, if you are consistent in your trading method and keep the losses small on your losing trades, you can have very good total return even if the percentage of your winning trades is significantly less than this of your losing trades. Actually that's the magic of the money management.

Unfortunately, most of the traders either fail to accept they should follow strict money management rules or, if they know they should do it, fail to actually achieve it. One way to follow, is to assume you can be wrong 10, 20 or even 30 times in a row and risk 1% or 2% of your trading account in each trade (that is, if stopped out, your loss is no more than 1% or 2% of your account). Following such a rule will allow you to sustain a long period of unsuccessful trades. And if you have a favorable average win / average loss ratio, then you can recover quickly after such a losing period and then have nice results at the end.



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