Trading Basics Series

HOW DO I TRADE STOCKS.COM

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Risk Management

Without question, risk management is the most important area of trading. Bad risk management leads to large losses, which leads to stress and bad trading decisions. Good risk management, on the other hand, allows for non-emotional trading and minimized losses and that is what will lead to success in the markets.

Seasoned successful traders understand that when they trade, it's not about making money, it's about not losing money. While this sounds like a fairly dismal view of life for a trader, the net result is a lot more money in the bank account, and that's why we do it, right? They understand that, to be successful, they have to minimize losses and let their winners run. Think of trading as a marathon, not a sprint.

With bad risk management you can take a proven profitable trading system and lose big in the markets. Do the math. If you lose 50% of your money, you have to make 100% back to get back to where you started. You never want to be in the position where you have to have extraordinary returns to just break even. To demonstrate this, here is a simple example:

Account Balance	Profit/Loss	New Account Balance
$ 100.00	-50%	$ 50.00
$ 50.00	50%	$ 75.00
$ 100.00	-50%	$ 50.00
$ 50.00	100%	$ 100.00

Almost all traders stray from a proven technique they have heard at a seminar or read in a book because they take large losses and see the "shiny penny" of a new technique and go and try that. Good Risk Management allows you to stay with a winning technique and is therefore central to winning or losing in the markets.

Don’t “Bet the Farm”

As we just talked about, you can kill a perfectly good trading system with bad risk management. To illustrate this we are going to do a little example. Let’s say we start with $100 and we are going to flip a coin 100 times. Statistically speaking, coin flips are a 50/50 chance, right? With this theory in mind, at the end of the 100 flips, you start with $100 and therefore you should end up with $100 right?...wrong, very, very, WRONG! Your result will be entirely dependent on your risk management system.

A common risk management tool is to divide your account equity into equal portions ie. $100 into 10 equal portions is $10 per trade. This would appear to be a good system to reduce risk by “not betting the farm” on one individual trade. But let’s see how it really works out. If you bet $10 per flip, what are the chances that you will be wiped out? As it turns out, the chances are 95% of the time you will be wiped out before the coin flips reach anywhere near 100 turns.

Why are the chances so high? Simply speaking, all you need is a net loss of 10 times in a row and you are wiped out, and when you are wiped out, you have no money to trade. So, if you bet too high, the chances are you will not be trading long.

But, what if you bet only 1% of your $100 per flip? Well your chances of ruin become less than **1%!** So 95% chance of losing all of your money to a 1% chance...I much prefer those odds! You would need to have more than a <u>100 losing trades in a row</u> to get wiped out. Believe me, I tried this...yes I actually tried this, and I ended up with $121. A 21% return, not bad considering the randomness of the method! Here are my actual results:

Original amount			$ 100.00				
Heads WIN Tails LOSE							
			Fixed Amount $10 STRATEGY			1% STRATEGY	
Toss #	Result		$ 10.00	Balance		1%	Balance
1	T		$ 10.00	$ 90.00		$ 1.00	$ 99.00
2	T		$ 10.00	$ 80.00		$ 0.99	$ 98.01
3	T		$ 10.00	$ 70.00		$ 0.98	$ 97.03
4	T		$ 10.00	$ 60.00		$ 0.97	$ 96.06
5	H		$ 10.00	$ 70.00		$ 0.96	$ 97.02
6	H		$ 10.00	$ 80.00		$ 0.97	$ 97.99
7	H		$ 10.00	$ 90.00		$ 0.98	$ 98.97
8	T		$ 10.00	$ 80.00		$ 0.99	$ 97.98
9	T		$ 10.00	$ 70.00		$ 0.98	$ 97.00
10	T		$ 10.00	$ 60.00		$ 0.97	$ 96.03
11	T		$ 10.00	$ 50.00		$ 0.96	$ 95.07
12	H		$ 10.00	$ 60.00		$ 0.95	$ 96.02

13	T		$ 10.00	$ 50.00		$ 0.96	$ 95.06
14	T		$ 10.00	$ 40.00		$ 0.95	$ 94.11
15	T		$ 10.00	$ 30.00		$ 0.94	$ 93.17
16	T		$ 10.00	$ 20.00		$ 0.93	$ 92.24
17	T		$ 10.00	$ 10.00		$ 0.92	$ 91.32
18	T		$ 10.00	$ -		$ 0.91	$ 90.40
19	H		WIPED OUT			$ 0.90	$ 91.31
20	T					$ 0.91	$ 90.39
21	T					$ 0.90	$ 89.49
22	H					$ 0.89	$ 90.38
23	H					$ 0.90	$ 91.29
24	H					$ 0.91	$ 92.20
25	H					$ 0.92	$ 93.12
26	H					$ 0.93	$ 94.05
27	H					$ 0.94	$ 94.99
28	T					$ 0.95	$ 94.04
29	H					$ 0.94	$ 94.98
30	H					$ 0.95	$ 95.93
31	T					$ 0.96	$ 94.98
32	H					$ 0.95	$ 95.93
33	T					$ 0.96	$ 94.97
34	H					$ 0.95	$ 95.92
35	H					$ 0.96	$ 96.87
36	T					$ 0.97	$ 95.91
37	H					$ 0.96	$ 96.87
38	T					$ 0.97	$ 95.90
39	T					$ 0.96	$ 94.94
40	H					$ 0.95	$ 95.89
41	H					$ 0.96	$ 96.85
42	H					$ 0.97	$ 97.81
43	T					$ 0.98	$ 96.84
44	T					$ 0.97	$ 95.87
45	H					$ 0.96	$ 96.83
46	H					$ 0.97	$ 97.79
47	H					$ 0.98	$ 98.77
48	H					$ 0.99	$ 99.76
49	H					$ 1.00	$ 100.76
50	T					$ 1.01	$ 99.75

51	H					$ 1.00	$ 100.75
52	H					$ 1.01	$ 101.76
53	T					$ 1.02	$ 100.74
54	T					$ 1.01	$ 99.73
55	H					$ 1.00	$ 100.73
56	H					$ 1.01	$ 101.73
57	H					$ 1.02	$ 102.75
58	H					$ 1.03	$ 103.78
59	H					$ 1.04	$ 104.82
60	T					$ 1.05	$ 103.77
61	H					$ 1.04	$ 104.81
62	H					$ 1.05	$ 105.86
63	T					$ 1.06	$ 104.80
64	H					$ 1.05	$ 105.84
65	H					$ 1.06	$ 106.90
66	H					$ 1.07	$ 107.97
67	T					$ 1.08	$ 106.89
68	T					$ 1.07	$ 105.82
69	H					$ 1.06	$ 106.88
70	H					$ 1.07	$ 107.95
71	T					$ 1.08	$ 106.87
72	T					$ 1.07	$ 105.80
73	H					$ 1.06	$ 106.86
74	T					$ 1.07	$ 105.79
75	T					$ 1.06	$ 104.73
76	H					$ 1.05	$ 105.78
77	T					$ 1.06	$ 104.72
78	H					$ 1.05	$ 105.77
79	H					$ 1.06	$ 106.83
80	H					$ 1.07	$ 107.90
81	H					$ 1.08	$ 108.98
82	H					$ 1.09	$ 110.07
83	H					$ 1.10	$ 111.17
84	H					$ 1.11	$ 112.28
85	H					$ 1.12	$ 113.40
86	H					$ 1.13	$ 114.53
87	T					$ 1.15	$ 113.39
88	H					$ 1.13	$ 114.52

89	T					$ 1.15	$ 113.38
90	H					$ 1.13	$ 114.51
91	H					$ 1.15	$ 115.66
92	H					$ 1.16	$ 116.81
93	H					$ 1.17	$ 117.98
94	H					$ 1.18	$ 119.16
95	T					$ 1.19	$ 117.97
96	H					$ 1.18	$ 119.15
97	H					$ 1.19	$ 120.34
98	H					$ 1.20	$ 121.54
99	T					$ 1.22	$ 120.33
100	H					$ 1.20	$ 121.53

In these two examples we are using exactly the same system (the coin toss) but clearly our risk management (only risk 1% vs a Fixed Amount of $10 on each toss) produces dramatically different results.

1% Golden Rule

Many successful traders use, what I like to call the 1% Golden Rule. You may hear it referred to as "Risk Percent Method" or "Fixed Fractional Method" both fancy technical names for a very simple risk management system. The 1% Golden Rule helps traders figure out exactly how much money they should put on any given trade in order to manage their risk effectively. This is a practical method with no rigorous theoretical justification for its use, other than the fact that **IT JUST WORKS!**

A smart trader rarely risks more than 1% of available account equity i.e. the total amount of money in your trading account, on any given trade. This risk calculation appears to offer a good trade-off between risk and reward, while keeping the probability of ruin very very low.

Using the 1% Golden Rule for calculating the size of a particular trade requires two pieces of information:

1) The price at which you intend to buy the stock
2) The price at which you intend to place your stop loss, i.e. the price at which you sell if it all goes horribly wrong and the trade goes against you.

The risk is the difference between the buy price and the stop loss price, for example:

1) Sue would like to buy some stock for $100.00,
2) She understands that if the stock price goes below $90.00, she really needs to get out of the trade, and is going to place her stop loss accordingly
3) Sue is prepared to risk $10.00 per share. ($100.00 - $90.00 = $10.00)
4) Sue has $10,000
5) 1% of $10,000 is $100
6) $100/$10.00 risk per share means that Sue is going to buy 10 shares. ($10.00 x 10 = $100.00)

Now let's use the real world for the same example.

7) Sue would like to buy some GMCR (Green Mountain Coffee Roasters) stock for $107.40,
8) She understands that if the stock price goes below $98.08, she really needs to get out of the trade, and is going to place her stop loss accordingly
9) Sue is prepared to risk $9.32 per share. ($107.40 - $98.08 = $9.32)
10) Sue has $10,000
11) 1% of $10,000 is $100
12) $100/$9.32 risk per share means that Sue is going to buy 10 shares. ($9.32 x 10 = $93.20)

Now just to make one thing clear, this risk strategy does not mean that you can only place one trade at a time, it simply means that if you have 3 trades on, then each one only has the ability to lose 1% of your current account balance.

I firmly believe that when you use good risk management you could (NOT that I'm advocating this!!!) literally take a dart board, place a whole list of stocks on it and use this to pick your trades. But even with this type of ludicrous stock picking system your results would still be better that 95% of other retail traders out there. The sad fact is that most trader/investors in the markets, especially home based traders, don't use effective risk management and get burned or worse, wiped out.

The bottom line is risk management can make or break your trading or investing. As a small retail trader, you have an advantage over the large Hedge Funds and Mutual Funds out there, which represents about 80% of the money in the markets. Many of these funds must stay close to 100% invested at all times and are not always able to use stop losses like we can, in fact some cannot use stops at all, only, what they call, "re-balancing" at the end of each month. Makes you feel really great about the money you have in Mutual Funds – doesn't it? Let's take the next largest group, you and me, the Retail Investors. Less than 5% of Retail Investors use good risk management. Many of them are wiped out only a few trades in. By following this simple risk strategy, you can now be well ahead of the pack, and in fact be in the top tier of successful traders in the world!

I'm going to touch again on the subject of stop losses. As a stop loss is vital to your trading success. Do not even think of putting a trade into place without having a stop loss. The stop loss is your protection, your bullet proof vest, if you will, against the evil villains of the Dastardly DOW and the Nasty NASDAQ. Your stop loss armour prevents large losses, and as we talked about before, trading is all about minimizing losses. Do you remember all those poor souls who lost everything in 2008? NO stop losses…

You are now in the elite of traders and investors. I will emphasize again, the key is cut losses, cut losses, cut losses. If you are an experienced trader or investor, go back and think of the times when you took a large loss in your portfolio, imagine where it would be if you didn't take those large hits and only made small losses along the way. It is an impossibility to think that every trade will be a winner – no matter how great your instincts or your trading system, just as the chances of heads always coming up in our coin toss are.

Little losses don't psychologically and financially debilitate you but large losses do both!!

It may sound simple now that you understand that 1% Golden Rule, but you now have the means and understanding to go out and be in the elite of <u>all traders</u>. Your chances of success can be increased even more if you have good techniques and systems that have been proven to make money over many years. Proven profitable systems, combined with great risk management, mean trading and investing profits year after year and before you know it, you only have to work if you choose to.

About the author:

My name is John Bannan. I was a Market Analyst for 5 years who ultimately decided to become a full time Trader in 2009. Over the years I have trained with some of the best academies and training institutes as well as being mentored by some of Wall Street's foremost traders, including Phil Town* and Courtney Smith*.

I have valued mentorship from these trading and investing gurus highly as they have given me the real world insight to enhance the training I received from the Online Trading Academy and Better Trades, two of the leading stock market education companies.

It has taken me thousands of hours and tens of thousands of dollars to become the trader I am today. Along the way, like many traders, I became very frustrated that I was learning how to trade but not learning how to make money. I decided that once I had my systems down, I would reach out and help others to make money in the stock market, not just teach them how to trade. As a systems based, risk adverse trader I choose systems that have shown consistent results and that analyst in me insists on back testing them myself for a minimum of 10 years to prove their worth. My wife says that I'd probably be happy if I was left alone in a cave with my spreadsheets. Whether there is truth in that or not, the fact is, systems trading means consistent results over time, and that's what all of us want for our investments.

My new site HowDoITradeStocks.com is dedicated to helping experienced and beginner traders make money first, while you learn about the stock market in easy to understand ways. My Follow My Trades proprietary DPR Management Tool enables my members to see what stocks I'm buying, how much I'm paying and when I'm selling – all BEFORE I actually place the trades. In addition, the tool helps members calculate proper risk management decisions should they decide to trade. It is my hope that I will help as many Retail Investors as possible to find the same success I have in the marketplace.

For more information and to know my trades before I make them, please visit

www.HowDoITradeStocks.com

* I am so grateful to my mentors who gave me the hands on learning that I needed and that I can now bring to other traders. Phil Town is best known for his #1 best selling books Rule #1 and Payback Time, and is one of America's most widely sought after speakers on Investing. When Phil launched his Rule #1 University, I was one of his first students. Courtney Smith, with 40 plus years of trading experience, is the only person in history to have a high ranked mutual fund, stock picking newsletter, futures newsletter and a hedge fund – all at the same time. He is the author of seven books and has appeared on over 1000 TV shows and at 100's of events.