Fastone

Improve your trading using Risk Management

What is Risk?

Risk measures uncertainty and potential for loss. A good trading system delivers greater profits than losses over time. However, there is a strong relationship between risk and reward, therefore, risky trading activities typically offer the highest potential for profit.

Risk management is a systematic, logical approach to limiting or mitigating risk. It is called "management" because its purpose is not focused strictly on eliminating risk. In most cases, eliminating risk will eliminate the possibility for profit.

To be a successful trader, you need to learn risk management rules and strictly implement them.

Two Percent Rule:

For example, if you have $10,000 in your account, the 2% rule limits your maximum risk on any trade to $200. This is not the size of your trade, it's the amount you put at risk, based on the distance from your entry to your stop.

Let's say you decide to buy a stock for $50 and put a stop loss at $48, this means you will be risking 2$ per share. Dividing your total permitted risk of $200 by your $2 risk per share tells you that you may trade no more than 100 shares.

Technical analysis can help you decide where to place a protective stop, which will limit your loss per share.
Money management rules will help you protect your account. The single most important rule is to limit your exposure on any trade to no more than 2% of your account.

Professional traders tend to stay well below the 2% limit as it is the maximum permitted risk.

Six Percent Rule:

The 6% rule prohibits you from opening any new traders for the rest of the month when the sum of your losses for the current month and the risks in open trades reach 6% of your account equity.

Before you put on a trade, ask yourself: what would happen if all your trades suddenly turned against you? If you used the 2% rule to set stops and trade sizes, the 6% rule will limit the maximum total loss that your account may suffer.

Using protective stops:

Trading without stops exposes you to unlimited losses. By measuring your potential loss based on stop loss for all your open trades, you can get an idea of how much of your capital is at risk. That immediately acts as a trigger in case you need to appropriately cut your positions to reduce your risk.

Risk vs Reward:

Before opening a trade, the trader should know the entry level, profit target, and stop for every planned trade to compare the risk and the reward. The potential reward should be at least twice as big as the risk.
When calculating a trade's profit potential, we run into a paradox. The longer your expected holding period, the bigger the profit potential. A stock can rally more in a month than in a week. On the other hand, the longer your holding period, the higher the level of uncertainty. Technical analysis can be reliable for shorter-term moves. The trader can use moving averages, channels, and support/resistance levels to set targets.