DiversifiedTradingInstitute

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Market Insights for Trading Success

Risk Management

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Black Monday

It is very likely seeing these words may cause a sinking feeling in your stomach. Every major stock market around the world suffered devastating losses on that day. The Dow Jones Industrial Average lost about 22 percent of its value. The Nasdaq lost more than 10 percent. The Canadian market dropped over 20 percent. Across the pond, the London FTSE declined over 20 percent. The next day, Japan's Nikkei experienced its biggest loss in history…

Just about everyone who was exposed to the market on Black Monday will tell you that was one of the worst days of their trading career. Tom Busby is no different in that respect. Tom suffered catastrophic losses. After almost a decade of successful trading, Tom was left questioning his ability to trade. He had lost all of his self-confidence.

Tom will be the first to tell you he did not make any mistakes on that fateful Monday. His mistake came just a few days earlier. On Thursday October 15, Tom was holding 1000 S&P 100 puts short and 1000 S&P 100 puts long. The short puts were covered by the long puts just in case the market turned down. Tom was managing his risk.

On Friday the 16th, Tom's long put position expired. His short puts wouldn't expire until the next month. Tom was now exposed to significant risk, holding naked options. He had sold 1000 put options that he didn't own. This required him to deliver these options if the S&P 100 fell below the strike price. When the crash occurred the following Monday, Tom was left in anguish, wondering how and why he let himself be exposed to that much risk.

Manage Risk First

It has been nearly 30 years since Black Monday, and while Tom has long come to terms with this painful memory, he will never forget his mistake. He was focused on the potential reward when he should have been focused on risk. In the years since, Tom has realized that if he defines and manages his risk, the rewards will come.

Defining risk is easy. How much money are you willing to lose before you throw in the towel?

Simple, right?

Establishing that level for oneself is a different story. A trader with a $100,000 account may be willing to risk 10 percent whereas a trader with a $5,000 account may only be willing to risk 5 percent. Whatever amount you are willing to risk, there is one concept that will never fail: Only risk money you can afford to lose. This is a simple concept too many traders overlook due to overconfidence, neglect, etc.

You will trade differently if you risk money you are not willing to lose. Sometimes you will hesitate to enter a trade at the opportune time. Other times you will exit trades way too soon. Both of these habits are the result of fear arising because you are trading with capital you are not mentally ready to lose.

Setting Achievable Goals

Everyone should establish goals that they would like to achieve. Settings goals is the key to growing, not only in trading, but in life. Be sure to set your goals at an achievable level. These can be daily, weekly, monthly, and yearly goals. Setting achievable goals reinforces confidence in your trading. Setting unrealistic goals usually causes you to take on too much risk.

Believe it or not, you can be more profitable setting slightly lower goals than you normally would view as acceptable. For instance, let’s say you set a goal of $200 a day. You have a great week of trading, hitting your goal each day and finishing the week with $1000 profit to show for it. I don’t know about you, but that is a very acceptable week for me.

Now, let’s say you set a goal of $500 a day. The first trade of the week goes great, returning $300 to you. By all accounts this is a good day. Averaging $300 a day for the entire year adds up to $75,000! But your goal is $500 so you trade again. Only this time the trade goes bad and you lose $200. Now, with only $100 profit you say to yourself again: “My goal is $500 and I’m going to get there.”

This is a dangerous pattern that all too often leads to more losses, not more profits. Setting achievable goals will prevent you from overtrading. The end result is often times higher profitability. And I think we can all agree that a larger profit at the end of the week is our goal, regardless of how we get there.

Probability Matters

Every trade setup known to market analysts like you and I, has a historical track record. Some setups work more often than others, while other setups offer greater profitability. As each trade sets up you will be able to identify an approximate level of risk and reward.

Most traders find risk/reward ratios for the setups they see and decide to take trades solely based on that ratio. However, Geof Smith, DTI's chief instructor, believes most traders are leaving out a key missing piece. He is adamant that risk/reward ratios do not tell you the full story. That is because they do not account for probability.

Consider the following two trades if your reward to reward to risk ratio was 2:1…

Trade 1: 80% probability, 1:1 reward to risk

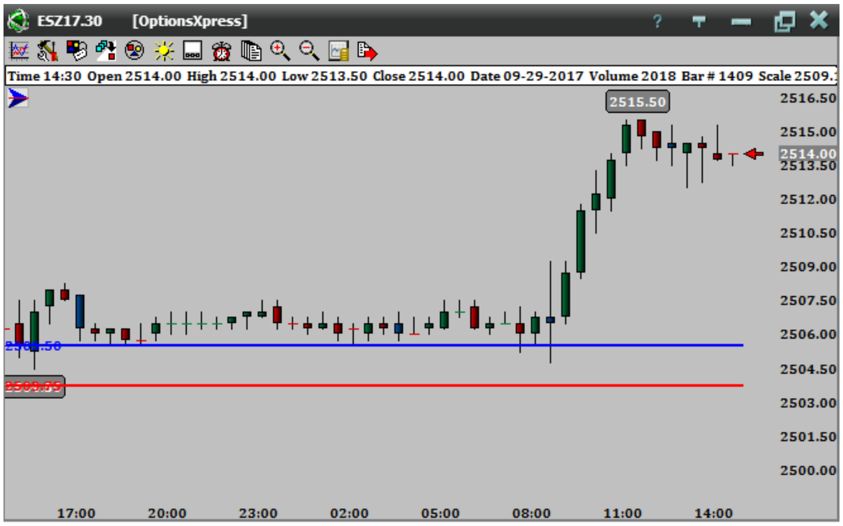
Trade 2: 20% probability, 2:1 reward to risk

Now which of these trade setups would you rather take? I would take the trade with 80 percent probability. Some traders would say this trade doesn't offer enough reward. They are not considering the probability of the trade actually paying them. Geof would say there is a lot of value in trading high probability setups. Over time, taking these setups will provide more consistent profits, not to mention confidence.

Profit Targets and Stops

Here at DTI, we teach our students to be reasonable when setting profit targets and smart when setting stop losses. The market will often inform you of how much profit target you should expect from a good trade and how much risk you should be willing to take. For instance, if the average true range of a stock is $0.50, why would you ever set a one day profit target for $3.00?

Take a look at the above 30 minute chart on the e-mini S&P 500 futures contract. As you can see from the data box, the ATR (average true range) is 11.71 points. Over the course of this particular morning, the ES rallied from a low of 2504.75 to a high of 2515.50. These high/low markers happened to be the high and low for the day. That is a range of 10.75 points, nearly the ATR. If you had gotten into this trade, your ultimate profit target should have been somewhere around 2516.50. That would have approximately been the ATR from the low of the day.



Now take a look at the same chart from a longer time frame. The ES traded within a small range during the overnight session. The prevailing trend in the market was bullish, and therefore the logical trade was to look to go long. Two different entries could have been taken, either buying at the 2505.50 support that I marked with a blue line or on the breakout to new highs. I marked a logical place for a stop loss entry with the red line, a few ticks below the most recent low from the previous day. Regardless of your entry, your stop loss would need to go in the same place.

This particular trade setup was very clear. A narrow trade range will often times present a trade setup with minimal risk. These are the trades that nearly all traders can afford to take. However, sometimes identifying risk is not that easy…

For every trade setup, recent past trading history will tell you where to put a protective stop loss. During volatile markets, a proper stop loss placement may require you to risk more money than you are willing to lose. Inexperienced traders will often disregard this, either placing an arbitrary stop loss at the amount they are willing to lose, or placing the correct stop loss and risking more than they are willing to lose. Do <u>not</u> do this!

As Geof Smith often says, “The market is what determines risk, not you.” If you cannot identify the correct stop loss order that is within your risk parameters, DO NOT take the trade. It is that simple. There will always be another trade setup.

Mental Preservation

The majority of your trading success will depend on your mentality. In fact, once you learn how to trade, your emotions are the most important factor to achieving success. If you risk too much on a single trade and lose, you may experience an emotion you've never felt before. Tom certainly did back in 1987. Since then he has made it his primary goal never to feel that anguish again. Tom manages his risk and the rewards follow. By doing so, he has become a more consistent and profitable trader. Manage your emotions by managing risk, and you will be well on your way to better trading.

"Manage risk and the rewards will come."

Trade to Win!

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