Money Management

Hello, I trust everyone had a good week and weekend....

Over the last several months I've been doing a lot of research on Money Management. I know that's a pretty vague term, but for me it covers everything from; risk, reward, percent of cash, and how many lots to buy. I'm a true believer in the fact that money management is the "Holy Grail" of trading. I've read about it and have personally seen in my own trading how it will make or break a trader.

I urge all of you to make this a top priority in your push to becoming a successful trader. The following link was sent to me by a gentleman that I met in a trading room. It's an excellent read, and maybe some of you will be able to gather some good information from it.

http://members.aon.at/tips/moneyMan.htm

One of the most important concepts I came across during my research was how to properly determine the correct lots I should purchase. I learned quickly that buying the same lots on all of my trades was not a good idea and here's why. Say I have a $10,000 account and I consistently use 1 mini-lot for every trade. It doesn't take long to figure out that this way is not good money management. Take for example that I open two trades. The first trade I'm risking 50 pips and the second trade my risk is 25 pips. Let's say for simplicity sake that my risk reward ratio is 1:1. So if I lose on my first trade and win on my second I've still lost money for the day. Even though I've won 50% of my trades I'm in the red.

So how do we resolve this dilemma. Well I personally use the following formula.

$S = (e*r) / (p-x)$

Where:
S = Size of trade
e = portfolio equity(Cash and holdings)
r = maximum risk percentage per trade
p = entry price on the trade
x = pre-determined stop loss or exit price (based on TA)

Using the example above lets put in some numbers. We already know that the account size is $10,000. We already know that risk/reward ratio is 1:1. Lets say that I'm willing to risk 1% of my account on each trade.

First Trade Example (Buying EUR/USD)
$S = (e*r) / (p-x)$
$S = (10,000*1\%) / (1.2600 - 1.2550)$
$S = \$100 / .0050$

S= 20,000 (So I'm purchasing 20,000 units)

Second Trade Example (Buying GBP/USD)
S=(e*r) / (p-x)
S=(10,000*1%) / (1.8500- 1.8475)
S= $100 / .0025
S= 40,000 (So I'm purchasing 40,000 units)

Now on each trade we are only risking $100 of our account value. So now when I lose on the first one and win on the second I'm losing $100 on the first trade and winning $100 on the second trade. Thus breaking even for the two trades. This may not sound like much, but I hope you can see the impact over several trades.

I've created a couple of spreadsheets that automatically figure your lot sizes for you (based on the above formula), so if anyone is interested please drop me a comment.

I hope the above example also shows you how important it is to only pick trades that have a good risk/reward ratio. Personally I'll only take swing trades that are 2.5 to 1. Meaning for every $1 that I risk I have a potential of making make $2.50. I'm still putting numbers together on intraday trading. I've also been studying the Kelly formula, and I'll be publishing some comments on it later.