CHAPTER 1.4

Money Management

MONEY MANAGEMENT

The most important part of investing is money management. Money management involves determining how much of your overall portfolio you are willing to put at risk in any one trade and how many contracts your risk tolerance warrants. Proper money management can be the difference between a successful account that you are able to manage far into the future and an unsuccessful account that you seriously erode in six months.

If you've ever watched a poker tournament on television you will have seen money management in action. Rarely will you see players push all of their chips into the middle of the table on a single bet. In most cases it would be foolish to do so. If poker players risk only a portion of their money in any one bet they know that, win or lose, they will have the means to play the next hand. Meanwhile if poker players bet everything in one hand the only way they will be able to play the next hand is if they are right. That is a lot of pressure and players have to be looking at some pretty good cards to justify making a bold move like that.

The investors who enjoy the greatest amount of success in their trading are those who have established clearly-defined rules that govern their trading. These rules help them to avoid the money management pitfalls which you just learned about and to keep their emotions under control.

There are really three money management rules you will want to incorporate in your own trading:

Contents	
	Live to trade another day
	Know what you are willing to risk
	Know how to determine trade size

You will also learn about one of the stock and CFD market's most important trading tools: a stop-loss.

LIVE TO TRADE ANOTHER DAY

Live to trade another day is perhaps the most valuable piece of advice you could receive on investing. Regardless of whether you are right or wrong in your trade analysis, if you live to trade another day you know that you will always have another chance to make money. The other two rules we are going to explain will show you exactly what you must do to survive every day in the stock and CFD market but, as long as you understand and observe this first rule, you will already have an advantage over most investors.

The single factor that causes most investors to over-extend themselves and empty their accounts is greed. When investors get greedy they take unnecessary risks. They also often spend countless hours trying to find a single technical indicator or the one piece of fundamental analysis that is the "Holy Grail" of investing. They believe that, if they only follow what that one indicator says or what that one piece of fundamental analysis points to, they will never have to worry about being unprofitable in their trading again – and that they will always be right. You will also hear this referred to as the "secret" of investing.

Unfortunately, all this searching and hoping is unproductive simply because there is no secret. Of course they may be able to identify a technical indicator that has provided outstanding returns during a given period in market history, but the market is dynamic and other technical indicators come into vogue. Or they might stumble across a piece of fundamental information and believe they have found the key to their investing success. But once again the market will change and they will be left looking for a new key to success. To help you to avoid the frustration that always comes from chasing your tail we are going to show you how to live to trade another day so that, no matter what changes take place in the market, you can be successful.

KNOW WHAT YOU ARE WILLING TO RISK

Know what you are willing to risk before you ever invest. This rule is the basic tenet of living to trade another day. If you don't risk too much of your account in any single investment today then you know you will have enough in your account tomorrow - even if you lose money on your trades today - to place another trade. In other words it is not sound investing practice to put all your money into any one or two investments. Because you never know what is going to happen in the market you never want to risk everything you have on one position.

The first thing you have to do is determine what percentage of your account you are willing to lose in any one investment. Once you have decided that, the rest is a simple maths formula. Most investors feel comfortable risking approximately 2 percent of their total account balance in any one investment. Whilst this is a general rule of thumb, you will need to determine how aggressive or conservative you want to be in your individual risks. If you want to be more aggressive you would risk a larger percentage of your account in any one investment. If you want to be more conservative you would risk a smaller percentage of your account in any one investment. It is up to you to determine how much you are willing to risk, but we will say one thing: avoid going to either extreme. If you want to be more aggressive then consider risking 2 to 5 percent in any one trade. If you want to be more conservative then consider risking 1 to 2 percent in any one trade. If you risk too much you probably won't be around to trade another day much longer. If you risk too little you probably won't make very much money in your investing.

Once you have determined the percentage of your account that you feel comfortable risking, all you have to do is pop that number into the following equation:

> Account balance × risk percentage = amount at risk

Here is an example of how this would work. Imagine that you have an account balance of £50,000 and that you would like to risk 2 percent of your account in any one investment. If you pop these numbers into the equation, you will see you should not risk more than £1,000 in any one trade.

> £50,000 × 0.02 = £1,000

One point to remember is that this is the maximum amount you want to risk in any one investment. You may have more than this at risk in your overall account if you are in more than one investment. If you were in three investments at once, for example, you would want to risk only

£1,000 per investment, but this may add up to a total amount at risk of £3,000. Once you have determined how much you are willing to risk, you are ready to determine your investment size.

KNOW HOW TO DETERMINE TRADE (INVESTMENT) SIZE

Know how to determine trade size to prevent unnecessary exposure to risk. Trade size is the number of stocks or CFDs you buy or sell in any one trade. Once you know how much you are willing to risk you need to know how to set up your trades so that you don't end up risking more than that with which you are comfortable. It doesn't do you any good to know what your risk tolerance is and then enter a trade that exposes too much a proportion of your funds to risk.

To determine your trade size you must first decide where you are going to set your stop-loss (which you will learn about next). Once you have determined where to place your stop-loss, you have to figure out how much distance lies between the point where you are going to invest and the point you have determined to use as your stop-loss. Now all you have to do is pop that amount into another simple equation to determine the amount you want to have at risk in any one investment.

> Amount at risk ÷ distance between entry price and stop-loss price = size of your trade

Knowing exactly how to size your trade will help you eliminate one of your worst enemies as a trader: fear. Traders who do not appropriately size their trades are constantly worried they may lose more of their account than they are comfortable losing. If you can eliminate fear from your trading you will make much better trading decisions.

STOP-LOSS ORDERS

A stop-loss order is an order you place with your dealer that instructs them to exit your investment if the stock or CFD reaches a predetermined price. Stop-loss orders allow you to protect your trading account even when you are not in front of your computer - which is essential since it may be difficult to monitor your trade for every second of the trading day.

If you buy a stock or CFD you will place a stop-loss order somewhere below the current price to protect you in the event that the stock or CFD turns around and starts moving lower. If you sell a stock or CFD you will place a stop-loss order somewhere above the current price to protect you in the event the stock or CFD turns around and starts moving higher.

Here's how it works. Imagine you buy 50 shares of General Electric (GE:xnys) at $35. You notice that there is strong support approximately $5 below this price level at $30, and you conclude that if GE breaks below this level it will most likely continue to move even lower. Since you bought GE, and you will be losing money if it keeps moving lower, you decide you do not want to hold onto the trade if GE breaks below $30. To protect your account you set a stop-loss order with your dealer at $30 that tells your dealer to sell if GE touches the $30 price level. If the price of GE drops to $30 at any time during the trading day your dealer will automatically sell for you.

Stop-loss orders provide safety and security when you are trading and they place a critical role in all of your money-management decisions. You should, therefore, never place a trade without one.

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