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CHAPTER 1.5

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 decimate in six months.

If you've ever watched a poker tournament on television, you 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. On the other hand, 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 you 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 investors who have established clearly defined rules that govern their trading. These rules help them avoid the money management pitfalls you just learned about and keep their emotions under control. Following are three money management rules you will want to incorporate in your own trading:

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

LIVE TO TRADE ANOTHER DAY

Live to trade another day is perhaps the greatest piece of advice you could receive in your 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 more money. The subsequent two rules will show you exactly what you must do to survive every day in the Forex market, but as long as you understand and believe this first rule, you will already have an advantage over most investors.

The single factor that causes most investors to overextend themselves and blow up their accounts is greed. When investors get greedy, they take unnecessary risks. They also spend countless hours trying to find the one technical indicator or the one economic announcement that is the "Holy Grail" of investing. They believe that if they only follow what that one indicator says or what that one economic announcement points to, they will never have to worry about being unprofitable in their trading again—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. Sure, they may be able to identify a technical indicator that provides outstanding returns during a given period in market history, but the market changes, and soon another technical indicator will come into vogue. Or they might find an economic announcement that the market has been paying particularly close attention to for the past few months 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 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 enter a trade. This rule is the basic tenet of living to trade another day. If you don't risk too much of your account in any trade today, 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 trades. 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 trade. Once you have decided that, the rest is a simple math formula. Most investors feel comfortable risking approximately 2 percent of their total account balance in any one trade. While this is a general rule of thumb, you will need to determine how aggressive or conservative you want to be in your individual account. If you want to be more aggressive, you would risk a larger percentage of your account in any one trade. If you want to be more conservative, you would risk a smaller percentage of your account in any one trade. 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, consider risking 2 to 5 percent in any one trade. If you want to be more conservative, 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 you feel comfortable risking, all you have to do is plug 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 trade. If you plug 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 trade. You may have more than this at risk in your overall account if you are in more than one trade. If you were in three trades at once, for example, you would want to risk only $1,000 per trade, 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 trade size.

KNOW HOW TO DETERMINE TRADE SIZE

Know how to determine trade size to prevent unnecessary exposure to risk. Trade size is the amount of currency you purchase 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 you are comfortable with. It doesn't do you any good to know what your risk tolerance is and then enter a trade that exposes too much of your account 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 many pips lie between the point where you are going to enter the trade and the point you have determined to use as your stop loss. Now all you have to do is plug that amount into another simple equation that builds on the equation you just used to determine the amount you want to have at risk in any one 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 using. If you can eliminate fear from your trading, you will make much better trading decisions.

> Amount at risk ÷ (pips at risk – value per pip) = size of your trade

STOP-LOSS ORDERS

A stop-loss order is an order you place that exits your trade if the currency pair reaches a specified price point. 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 is physically impossible for you to watch your trades 24 hours per day.

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

Here's how it works. Imagine you buy the EUR/USD at 1.4000. You notice that there is strong support approximately 50 pips below this price level at 1.3950, and you conclude that if the EUR/USD breaks below this level it will most likely continue to move lower. Since you bought the currency pair, and you will be losing money if it moves lower, you decide you do not want to hold onto the trade if the EUR/USD breaks below 1.3950. To protect your account, you set a stop-loss order at 1.3940 that exits the trade if the EUR/USD touches the 1.3940 price level. Whether it is in the middle of the night or it is the middle of the day, if the price of the EUR/USD drops to 1.3940, the trade will automatically be exited 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 never place a trade without one.

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