

Risk Control – the only path to success!

By Tony Beckwith

In these immensely turbulent financial markets, the two words risk and control are probably being used together more than any other combination! If risk had been controlled with more discipline through the financial systems of the world, the consequences of excess would have been a whole lot more palatable...

Almost all of the most successful traders throughout history learned early on in their careers (and probably the hard way) that the “Holy Grail” in financial markets simply doesn’t exist. Novice traders invariably search for extraordinarily high win / loss ratios, comforting a demanding ego in their quest to be “right”. Psychologically, after all, this is very seductive.

But, this is addressing only one aspect of trading risk and, arguably, the weakest aspect. It is clear that a win / loss ratio of, say, 70 percent, ego-boosting though it may be, is merely a ticket to ruin if you’re losing twice as much on your losing trades as you’re pocketing on your winners...

This is not to deny that probability risk is a vital component of trading success. However, it clearly is how this risk relates to average wins and losses in actual money that determines whether an account can rise or fall. As we trade more and understand more, the importance of the overall “Profit Factor” becomes apparent -- the win / loss ratio multiplied by the average winner / average loser ratio. This must be above 1.0 over time to give an “edge” to the system or method being traded.

The Second Crucial Aspect of Trade Risk

Control over how much your winning trades deliver compared with the inevitable losses on your losers falls squarely into the category of money management. In simple terms, this is the second crucial aspect of trade risk -- call it money risk. Great traders know full well that they cannot control the profits because any future outcome is highly (if not perfectly) uncertain. What they can and do control tightly is the amount they’re prepared to lose in the event that a trade goes wrong.

The average loser component of the Profit Factor can then become a known and predictable quantity. In fact, it’s pretty much folklore in trading circles to risk no more than, say, 2 percent of

an account on any one trade -- though this could easily be far lower if you are trading plain vanilla stocks (with huge position values possible).

So, if we assume a US\$20,000 account, that would allow a maximum risk of \$400 per trade on this basic fixed fractional basis. This is in stark contrast to methods such as Martingale and anti-Martingale in which you either increase your bet size as you lose or decrease it.

By way of example, a run of 10 consecutive losing trades reduces account size only by a manageable 20 percent, the account requiring only a 25 percent increase from there back to its level before the drawdown. It’s worth adding, though, that a bigger drawdown could easily threaten a trader’s so-called Uncle Point -- the point at which a loss of confidence and general demoralization overwhelms any fancy mathematics...

However, the number of stocks or shares / lots (forex) / contracts (futures) that can be risked is then a function of the method of position-sizing used in a trader’s money management strategy. Some position-sizing strategies consider value, others risk. Say the \$20,000 account intends to trade 20 stocks, and the trader is willing to risk 2 percent of the account. Value-Basis position-sizing divides the account into 20 equal portions of \$1,000 each, one for each stock. Because stocks have different prices, clearly the number of shares for various stocks varies.

Risk-Basis position-sizing assesses the risk for each stock as the entry price minus the initial protective stop price. It divides the per-trade risk tolerance (\$400 here) by the risk per share, giving the number of shares that should be traded. The two methods may not indicate the same number of shares -- in fact, very close stops and a high risk per trade may mean the number of shares on the Risk-Basis could exceed the purchasing power of the account, as mentioned previously in this article.

One major advantage of Risk-Basis position-sizing for traders is that it is directly relating the size of winning trades to the size of losers over time. In this way, you can concentrate on targeting risk / reward levels on your trades, particularly if you know the win / loss tendency of your trading approach.

For instance, you need to target trades with a potential minimum risk / reward of +2x to combat a win / loss ratio tending below the 40 percent level -- especially factoring in commissions, slippage and the inevitable errors! It’s

only by aligning the gains from your profitable trades with the losses from your losers that you can have the hope of managing rewards relative to risk -- and of being a profitable trader...

That’s enough talking -- here’s a recent example on the globally-known US S&P500 stock EBAY, with the new MTPredictor™ v6.0 trading software. A SELL signal was automatically alerted on 12th August -- remember, the US SEC ban on US stock short sales was introduced later, on 18th September, and was applied only to financial stocks and other stocks with large financial operations, such as General Electric.



Using the integral, automatic Position-Sizer, this information is input and saved:

Account Size: US\$20,000

Percent Risk: 0.5 percent (US\$100)

Tick Size (intelligently already known by the software): 0.01 (minimum price movement)

Point Value (intelligently already known by the software): \$0.01 (full point value)

The Sizer shows 95 shares can be sold at an entry price of 25.97, with an initial protective stop at 27.02 and an initial risk of \$99.75. This is 0.5% of a \$20,000 account. For more risk control, it also confirms that reaching the 1st displayed profit target (orange colour) would yield a profit 2.1x the risk size -- in other words, a +2.1x risk / reward outcome.

Ebay subsequently fell sharply to well below \$20 (where the risk/reward was over 5.5:1) and on Monday 6th October announced a 10% cut in its workforce. So, this excellent trade could be managed with a controlled money risk and profit potential directly related to that risk.

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