by David Jenyns

Entry Price: $10.50
Stoploss: 3xATR = $9.99
Trailing: 4xATR = $9.82
No Shares: 360 / 0.51 = 705.88
Position: 705 x 10.50 = $7,402
Max Loss: $348.15
Entry Costs: 360 x 10.50 + 30 = $3,962.50

The Art of Money Management
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Acknowledgments

I wish to thank all of you – the readers of this powerful money management manual. My purpose in writing it was to make these proven strategies for success available to you, the private trader, whether you’re a beginner or trading veteran.

I would also like to acknowledge and thank the following people for the part they have played in my trading evolution. My own passion for this exciting and challenging world has been further fuelled by the inspiring seminar presentations, published materials and works of Dr Van Tharp, John Piper, Jack D Schwager, Edwin LeFevre, Nicolas Darvas, Stan Weinstein, Stuart McPhee and the team at HomeTrader.
Introduction

Achieving financial success in the markets is not easy. It takes discipline, determination and a well-tested (and well-followed) plan. Despite what some might say, the skills required to become a successful trader are not inbred. Anyone can learn. And, as trading guru Dr Van Tharp points out, it’s more about mindset and psychology that anything else.

The reason psychology is such an important part of becoming a successful trader is that a lot of what you have to overcome is counter intuitive. *Cut your losses and let your profits run.* It’s one of the golden rules of trading. We all know that. But sticking to that rule when you’re in the trenches is the hard part; it goes against what many of us see as the ‘natural’ thing to do. Our inclination is to let our losses run in the hope they will turn around and to cut our profits short in fear of losing them.

But, to win in trading, you have to learn to go against the grain. That’s where this book comes in.

The fact is, there are literally hundreds of perfectly good entries and there are just as many ways to make money in the markets; but that’s not what makes a good system. At the core of any successful trading system is the same critical component: excellent money management. You need to have a method in place to protect your capital. No system is going to trade with 100 per cent accuracy. All it takes is one bad trade to lose it all and that’s why money management is so important.

In my book *Ultimate Trading Systems* I introduced you to the basic skills of becoming a successful trader. I talked about the importance of defining why you want to be a trader, the differences between ‘good’ and ‘bad’ traders, and how to design a winning trading plan. I talked briefly about entries, exits and money management and I introduced you to charting software, the basics of choosing a broker and the art of back testing. In *Ultimate Trading Systems* I said, next to your psychology, that the most important aspect of trading is money management. That said, to date, I haven’t yet found a course that explains this critical aspect of trading as I believe it should be explained. That’s why I wrote this book.

I don’t claim to be the only one to recognise that money management is the Holy Grail when it comes to trading. In fact, many other successful traders cite money management as a core principle of their success in the markets. For this reason, I’m not going to attempt to reinvent the wheel here. My goal for this book is to bring the best of the best in money management all together in one concise package that can then be applied to any trading system. No matter the market, timeframe or method (long or short). The fact is, the money management rules I set out need to be applied to all systems regardless of what you’re trading. No exceptions.
Administration note: for the ease of continuity I will talk mostly in terms of ‘stocks’, but please be aware the concepts apply to all markets.

Moreover, some of these concepts may not be new to you; however, I would like to put forward the idea that if you’re not currently successful trading the market, or you’re not achieving the success that you would like to achieve, the problem will most likely be poor discipline with money management. It’s one thing to know these rules; it’s another to actually apply them.

Everyone is at a different point in their trading journey. So, for some people who read this book, it will be a new idea a minute. For others who are familiar with money management, you may pick up only a few finer distinctions. Please remember that all it takes is one new idea, one finer distinction, and you can watch your trading profits soar.

I’ve tried to avoid using confusing financial stock market jargon. Some of these terms are not well understood by the public and make the world of stock investing seem like some sort of alchemy. The emphasis here is on keeping it simple. This will not be the most complicated or scholarly book that you have ever invested in, but it may be one of the most simple and most practical. Why complicate things unnecessarily?

In this book I will cover: defining your trading float; setting initial stops; position sizing; calculating trailing stops; and the best and worst trading strategies. I will also give you a fully worked example using all the material you’ve learned. I’ve also provided a Q&A section as an appendix to help you review the major learning points.

I want you to understand what you’re doing and why you’re doing it. Once you have a good system in place, you won’t need to follow market gurus, full-service brokers, tip sheets or anything like that.

I want you to have the confidence of knowing that once you enter into a trade you’ll already have your exit strategy predefined, enabling even the busiest person to manage an aggressive portfolio of securities with only five minutes a day. Most importantly, you’ll be able to sleep at night because your risks will be tailored to fit your level of risk tolerance and confidence level. Let me assure you all these goals and more can be achieved by setting excellent money management.

Finally, before we get into the guts of the book, I want you to note that this book is set out in a particular order for a reason. It has been designed as more or less a step-by-step guide to money management that will work best if applied in this order. Looking back might help you at times, skipping ahead won’t.

Now, go to it!

David Jenyns | Professional Trader, Author & Coach
Chapter 1:

It’s not in the entry

It’s funny. Despite the proven importance of money management, many of my clients, when they first come to me, still focus their time and energy on looking for the perfect entry. It’s that search for the Holy Grail. They want a perfect indicator. They believe it’s going to be the perfect indicator that slays the market. Not only is this indicator going to get them in right at the bottom of the trend, but it’s also going to tell them the exact point at the top of the trend when to get out.

Unfortunately, even though I don’t like to disappoint my clients, I need to let them know one thing upfront when they come to me: there is no perfect indicator.

So why do people believe there is?

Trading guru and author Van Tharp suggests it’s due to the fact that many novice traders feel that by being intrinsically involved in the selection and entry into a particular trade they subconsciously believe they are somehow in control of the market. He calls this the lotto bias and it can also be witnessed in people who pick numbers that are significant to them – for example, dates of birthdays or other anniversaries – when playing the national lottery.

Picking these numbers gives the punter a sense of control and power. They feel that somehow these numbers are better than any other and are more likely to win. In reality, the numbers chosen are no more significant than any other combination available. It is the fact that they have linked an important emotional attachment to certain numbers that gives the player a sense of control – it has nothing to do with increasing the likelihood of winning. Traders do the same with their entry.

When entering into a trading position you are in absolute control of the entry. You decide whether or not to pull the trigger. Unfortunately most traders hold onto this sense of control; however, once you are in a trade you have absolutely no control over the direction the market takes – it will do what it wants!

The fundamental truth is: it’s not when you buy the stock that determines how much money you make, it’s when you exit and most importantly how much you put into the trade.
The following example may clarify this point.

**Example**

You are interested in buying stock XYZ. Your trading system tells you to buy the stock at $10. Your exit signal is generated when the stock hits $12. Let us consider two scenarios where you invested (1) $1,000 and (2) $5,000.

(1) For $1,000 you will be able to purchase 100 shares at $10. You will sell these shares for $1,200 when they hit $12. This results in a profit of $200 on the initial investment.

(2) For $5,000 you will be able to purchase 500 shares at $10. You will sell these shares for $6,000 when they hit $12. This results in a profit of $1,000 on the initial investment.

It sounds elementary but it is not the entry that determines how much you will win or lose, it is actually the amount of money that you put on the trade in the first place. This is a core principal in setting excellent money management.

**You can be wrong more than you’re right and still make money!**

The truth is you’re going to have a system that sometimes wins and sometimes loses. So, even if you have the world’s most accurate method, over time you will go broke if you don’t recognise the individuality of every trade and practice good money management. The good news is I know of many successful speculators who have success rates of 30–50% and they’re still hugely successful. They’re not successful because they predict prices well, they’re successful because their profitable trades far exceed their losses.

The story of the ‘Turtle Traders’ is a good example here. Richard Dennis, a well-known systems trader, decided to test his theory that successful traders are made, not born. To do it, he trained up a group of students and oversaw their progress as they traded his own system to the letter.

The system Dennis imparted to his protégés lost 60% of the time and won only 40%, but they still made money. In fact, this system overall was incredibly successful. Why? Because the losses were small and the wins were big.

Let’s look at this idea in a more concrete example.

Let us assume that your trading system provides a profitable trade only a third of the time. That is to say for every three trades, one is profitable and two are not.

Let’s say that for every profitable trade it is four times more profitable than the equivalent loss in the losing trade. In other words, if a winning trade generates a profit of $400, the equivalent losing trade will make a loss of $100.

Let us now take six random trades (see table 1.1). According to your system, two of these should be profitable and four of these should not.
Study and research into the state-of-the-art in money management will pay enormous dividends.

Richard Dennis

Table 1.1: Winning while you’re losing

<table>
<thead>
<tr>
<th>Trade number</th>
<th>Winner or loser</th>
<th>Profit/loss ($) on the single trade</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Loser</td>
<td>-100</td>
</tr>
<tr>
<td>2</td>
<td>Loser</td>
<td>-100</td>
</tr>
<tr>
<td>3</td>
<td>Winner</td>
<td>+400</td>
</tr>
<tr>
<td>4</td>
<td>Loser</td>
<td>-100</td>
</tr>
<tr>
<td>5</td>
<td>Winner</td>
<td>+400</td>
</tr>
<tr>
<td>6</td>
<td>Loser</td>
<td>-100</td>
</tr>
<tr>
<td><strong>Total profit</strong></td>
<td></td>
<td><strong>+400</strong></td>
</tr>
</tbody>
</table>

As table 1.1 shows, even though the system wins, on average, only one-third of the time, the final result is still a profitable one.

The reason for this is simple: each winning trade more than compensates for the losing trades.

The point I’m trying to make here is that you don’t need to find the pinnacle of all indicators since it’s not about getting the entry ‘just right’. It’s certainly part of it but there’s a lot more important things to worry about... like money management.

What is money management?

In trading, the key to success is simply to manage your risk. In short, money management is simply a set of rules and guidelines that keep your risk at a level at which you’re comfortable. If you play too risky in the market, you will certainly lose in the long run.

Your money management rules will prevent you from making this mistake.

A key understanding to remember in trading is that each trade is independent of the previous trade. It has no bearing on whether you will win or lose in the next trade.

I’m often reminded of this when I think back to a strategy I developed for gambling at the casinos. I thought I’d come up with the ultimate system for playing roulette. My system was: look for a string of the one colour, so either five red or five black, and then bet on the opposite
colour. If I didn’t win that one I’d double up and then keep doubling up until I came out on top. Needless to say, I ended up losing all my money.

That’s how I learned the key rule of money management. It doesn’t matter if there are five reds or five blacks in a row, it has no effect on what is going to happen next.

Trading is exactly the same – it is inevitable that a certain number of trades will go against you. The trade you placed and won previously has no bearing on the next trade you place.

Knowing no system gets it right 100% of the time and that each trade is independent of the previous, excellent money management rules ensure our positions are small enough that we don’t blow our capital, yet large enough to maximise profit.
Chapter 2:

Trading float

The first step you will take in setting your money management rules is to define your trading float, in other words, the amount of capital that you have to trade with. In fact, one of the most commonly asked questions I get is, ‘How much do I need to actually start?’

To help you answer that question you need to first define your objectives. I listed these in *Ultimate Trading Systems* as:

- *How much time do you have to spend trading?* That might be full time, part time or hardly any time.
- *How much capital do you have to work with?* Remember, you shouldn’t trade money you’re not comfortable losing.
- *How much risk are you comfortable with?* As we all know, markets move. There’ll be times when you have a drawdown. The question then becomes: how much of a drawdown are you comfortable with? 20%? 30%? You need to decide.
- *What annual rate of return do you want?* This includes what you expect to make and in what time frame. Be realistic about this. Decide what you honestly think will be returned based on what you’re willing to risk. For example, you’re not going to have a system that will return 100% per year if you’re only prepared to risk a drawdown of 5%.
- *How do you want to take your money from the market?* Are you looking for cash flow (consistently taking profits out of the market) or capital growth (looking to grow your capital in the market over time, using the magic of compounding)?

All these decisions need to be based on your income objectives. Are you in it to make a steady income or are you looking at long-term growth?

And remember, there is no set pay cheque in trading. It’s not a reliable income. You will have good months, even great months, but then a lull. So don’t quit your day job just yet!

**Top tip**

*I want to make 200% a year – that isn’t unreasonable is it?*

Many expert investment fund managers barely make more than 20–30% a year (and many even make a loss). You have the advantage of moving quicker but still avoid overestimating your return potential. Generally speaking, you should avoid focusing on your ROI too much in the first one to two years. Use this time to finalise your plan and develop good trading habits – the profits will then follow.
Fixed costs

Although there is no perfect amount of capital to start trading with, it’s no secret that the bigger the trading float you do begin with, the easier it is to trade. That is, of course, because of the fixed costs associated with trading.

The major one to be aware of is brokerage. Depending on which broker you go for, many brokers charge a flat fee and it’s the traders with the larger fund size who have it a little bit easier.

For example: two traders are looking at opening a trade; the first trader’s position is valued at $1,000 and the second’s is at $10,000. Assume both traders have identical brokerage costs at $100 per trade. The trader with the larger account size has the advantage because our first trader (who’s trading $1,000) would have to make back 10% before she would even reach break even. Trader two, however, only needs to increase her capital by 1% before she reaches break even.

There’s nothing stopping you starting out trading with a smaller trading float; however, those who do start with a smaller trading float are slightly disadvantaged.

Float size and trading style

Your trading float size is going to determine what type of system you’re going to trade, too.

If you’re looking at trading very short term systems such as day-trading systems, they’re best suited to larger trading sizes. I recommend that when you first begin trading that you look at trading a longer term trading system. There are many reasons for this, one of the most obvious being that you can easily manage a very successful long-term trading system while still working full time. Once you’ve tasted a little success, you might look at shortening your time frame and focusing more time on trading itself. Also, with a longer term system, you’ll be incurring a lot less brokerage.

Table 2.1 looks at the differing attributes of short and long-term trading systems.
Table 2.1: Attributes of short and long-term trading systems

<table>
<thead>
<tr>
<th></th>
<th>Short term</th>
<th>Longer term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade length</td>
<td>1–30 days</td>
<td>1 month +</td>
</tr>
<tr>
<td>Number of trades</td>
<td>More trades taken</td>
<td>Less trades taken</td>
</tr>
<tr>
<td>Win–loss ratio</td>
<td>Higher number of wins</td>
<td>Lower number of wins</td>
</tr>
<tr>
<td>Trading objective</td>
<td>Income</td>
<td>Capital growth</td>
</tr>
<tr>
<td>Time required</td>
<td>More time</td>
<td>Less time</td>
</tr>
<tr>
<td>Capital required</td>
<td>More capital</td>
<td>Less capital</td>
</tr>
<tr>
<td>Experience required</td>
<td>More skill</td>
<td>Less skill</td>
</tr>
</tbody>
</table>

Sourcing the money to trade

Maybe you’ve been planning to trade for a while and you’ve amassed a wad of money. That’s good planning. Or, maybe you’re planning on borrowing it. Maxing out your credit cards is probably not the best way to get started in the trading business. If you’re a bit more experienced, borrowing from the bank (like you would when starting any small business) is fine. But remember: the more money you have to invest, the more your results will be magnified. If you win big, you will win really big. If you lose big, the same applies. It’s best to get a little experience behind you before you go and start spending the volume of money you would on, say, an investment property.

Worrying about trading profits is hard enough without having to worry about debt service on your credit card as well. In this case, you’re not concerned with good trading, you’re focused on making payments. Don Miller talks about this in Trading Markets World Meet the Traders when he tells new traders to worry about trading well, not making money.

Quitting your day gig to day trade is a bad idea unless you’ve got a pile of money to keep you afloat with no worries for at least two years.

A fantastic way to learn is to begin trading on a part-time basis. That way you’ve still got an income stream while you’re honing your skills. The advantage here is that you’re not trading your rent money.

In summary, how much capital you start with will depend on how much money you’ve got, your level of risk tolerance, the instruments you’re looking to trade, and what time frame of system you’re planning to trade. There is no perfect amount of capital to begin trading with. The key is to simply define how much capital you’re trading with and have it set up as a separate business. That way you’re not drawing on the profits all the time and losing your focus.

Remember, your trading is a business now. I would recommend having a minimum of $10,000.00 to get started.
Chapter 3: 

Maximum loss

After defining your trading float, the next thing you need to do in setting excellent money management is to define your maximum loss. The maximum loss is quite simply the maximum amount of capital that you’re willing to lose on any one trade. The reason for defining this upfront (before we even open a trading position) is to make sure we can stick to one of the cardinal rules of trading and that is to keep our losses small. We want to make sure we set our maximum loss as a small percentage of our trading float so it won’t have a detrimental effect if we have a string of losses.

Most traders fail in the markets because they risk too much. As I said, the goal is to keep our losses as small as possible while also making sure that we open a large enough position to be able to capitalise on profits as well.

Former Australian test cricket captain Steve Waugh says the best advice he was ever given on the cricket pitch was to simply not go out. What he meant was if you’re dismissed, you can no longer score any runs and therefore not win the game. Getting runs, Waugh suggests, should not be your primary objective; you should focus on staying in the game. It’s the same in trading. You need to protect your float just as you would protect your wicket in cricket. If you’re bowled out, you can no longer play.

I realise it might seem like a somewhat negative or defeatist attitude to spend time thinking about the maximum you can bear to lose but, like I’ve said before, much of the psychology of a good trader is counter intuitive. It’s a question of survival. You want to take a defensive stance when it comes to trading.

Top trader Ed Seykota defined the three elements of trading as: (1) cutting your losses; (2) cutting your losses; and (3) cutting your losses. If you follow those rules, he said, you might have a chance.

The first step is to acknowledge that losses are a part of trading – everyone has them. You need to accept it when it happens and move on. Getting upset about a loss only clouds your judgement, which can be trading suicide. A clear head is everything.

Defining your maximum loss

So, the question remains: what should be your maximum loss? Maximum loss is usually represented as a percentage of your trading float and studies suggest you should never risk more than 2% on any trade – known as the ‘2% rule’. However,
many pros will tell you that this is way too much. They’ll risk anywhere from 1% to even as little as a quarter of a per cent on any one trade. The core principal being that no one loss is really going to affect you. That said, typically speaking, your losses may be small, but so will your profits.

Let’s look at an example of the 2% rule in action. If we had a trading float of $20,000, applying the 2% rule would mean our maximum loss would be $400 on any one trade. The beauty of having made losses so small by using the 2% rule is that we need a huge string of losses before our entire trading float is eroded.

We would need a string of 50 losses in a row before we had no more capital left to trade with. In most trading systems the chances of getting 50 losses in a row is very, very slim. However, the chances of going broke are even smaller than that because when you implement the 2% rule correctly, that 2% is actually calculated on the current float size, not the initial float size.

Let me explain.

We already established that 2% of $20,000 is $400. However, if we experienced a loss first off, our trading float would now be reduced to $19,600. If we then calculate 2% of this new trading float value, we should then use this figure as our maximum loss for our next position. Two per cent of $19,600 would be $392. So, you can see that with every fall in equity our maximum loss falls too.

Here’s what would happen if we sustained six losses in a row based on these numbers.

<table>
<thead>
<tr>
<th>Float</th>
<th>$20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>After loss 1:</td>
<td>$19,600</td>
</tr>
<tr>
<td>After loss 2:</td>
<td>$19,208</td>
</tr>
<tr>
<td>After loss 3:</td>
<td>$18,824</td>
</tr>
<tr>
<td>After loss 4:</td>
<td>$18,447</td>
</tr>
<tr>
<td>After loss 5:</td>
<td>$18,079</td>
</tr>
<tr>
<td>After loss 6:</td>
<td>$17,717</td>
</tr>
</tbody>
</table>

Our trading float, after receiving six losses in a row, would have decreased to only $17,717. That means we’ve only lost $2,283. That’s what I call managing your risk!

Being such a small percentage of our trading float makes it much easier to gain back. In this example, we’ve lost a little more than 10%.

It’s important to understand that there’s a little more to recovering after drawdowns than meets the eye, as demonstrated in figure 3.1 and table 3.1.
**Figure 3.1**: Recovery after drawdowns – graph

**Table 3.1**: Recovery after drawdowns – table

<table>
<thead>
<tr>
<th>Drawdowns</th>
<th>Gain to recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>5.3% gain</td>
</tr>
<tr>
<td>10%</td>
<td>11.1% gain</td>
</tr>
<tr>
<td>15%</td>
<td>17.6% gain</td>
</tr>
<tr>
<td>20%</td>
<td>25% gain</td>
</tr>
<tr>
<td>25%</td>
<td>33% gain</td>
</tr>
<tr>
<td>30%</td>
<td>42.9% gain</td>
</tr>
<tr>
<td>40%</td>
<td>66.7% gain</td>
</tr>
<tr>
<td>50%</td>
<td>100% gain</td>
</tr>
<tr>
<td>60%</td>
<td>150% gain</td>
</tr>
<tr>
<td>75%</td>
<td>300% gain</td>
</tr>
<tr>
<td>90%</td>
<td>900% gain</td>
</tr>
</tbody>
</table>

**Calculating your percentage risk**

When you’re starting out, applying good money management is hard with a very small float – and that’s why in the previous chapter I mentioned starting with at least $10,000. If you are trading with less than $10,000 you may need to take on slightly more risk. How much you risk really depends on the size of your float and your tolerance for risk.
A rough guide might be:

<table>
<thead>
<tr>
<th>Float size</th>
<th>Percentage risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>$5,000–9,999</td>
<td>4%</td>
</tr>
<tr>
<td>$10,000–99,999</td>
<td>2%</td>
</tr>
<tr>
<td>$100,000–199,999</td>
<td>1.5%</td>
</tr>
<tr>
<td>$200,000+</td>
<td>1%</td>
</tr>
</tbody>
</table>

As I’ve said, your goal in trading should be survival. If you can survive in trading, the profits will come. To do that, you need to position yourself so that you can endure long strings of losses. In this way, when the market does turn around, you’ll be in exactly the right position to capitalise on the upturn. That’s what setting a maximum loss is all about.

Most people get scared off when the market goes down. They quit. Ironically, that’s when the market usually turns around and, by the time they’ve realised it’s turned around, that’s when it usually falls. So what’s the aim of the game? To stay in the market the whole time. When the market drops you reduce your losses and when it springs up again you’re all cashed up and ready to take advantage.

Sidenote: Once you have open positions, how then do you value your trading float? Let’s say you get a signal to open up a new position. You then need to calculate the new value of your trading float so you can determine your maximum risk. In short, you should always value your positions based on their initial stop or trailing stop, whichever is closer to the price. I’ll talk more about stops in the following chapters.

**Calculating your trading float for leveraged instruments**

It’s important that novice traders calculate their trading float for leveraged instruments on what they have – not the leveraged value. Using leverage instruments only magnifies the results you’re already getting and should only be used by those who know their system’s metrics and have proven it trades profitably. Just because you put $1,000 down in the forex market and get control of $100,000, don’t then make the mistake of basing your trading decisions on having $100,000. Only advanced traders with a proven system should ever value their trading float based on the leveraged out value.
Chapter 4:

Initial stop

How many times have you held a position too long? Everyone has at some point in their trading career. Over the years I have learned that it’s much easier to take a small loss than a big one and the important thing to remember is that every big loss started out as a small loss. The art of placing initial stops is to catch a loss while it remains small. It only gets harder as the loss gets bigger and your ego gets more and more squashed into the ground.

You’re protective stop is like a red light. You can go through it, but doing so is not very wise!

Richard Harding

The initial stop is a predefined point at which we exit a position, should the trade not go in your favour. When we enter a position, we don’t know at what point in the trend we are. We might be entering just before the trend changes. Who knows? Accordingly, we need to set an exit point. It’s like drawing a line in the sand underneath the price and saying, ‘If the price falls below this line, then the stock hasn’t done what we thought it was going to do, therefore we’ll exit the position.’

Figure 4.1 shows a basic representation of this concept.

Figure 4.1: Setting an exit position

Setting an initial stop

As I mentioned in the introduction, being a successful trader requires making decisions that are counter intuitive and one of our natural tendencies is to hold losing positions too long. That’s why it’s important to place an initial stop.
One of the most common questions I receive when traders are first introduced to the concept of an initial stop is ‘How wide should I set my stop?’ Or, in other words, how much room should I give the price to move? Unfortunately, there really are no definitive answers because it largely depends on what time frame you’re trading.

If you’re a shorter term trader, you’re going to have an initial stop that’s set closer to the price. If you’re a longer term trader, you’ll give the price a little bit more room to move by setting your initial stop wider.

Once you’ve identified what time frame you’re looking at trading, your initial stop must ignore the normal fluctuations within that particular time frame. That is to say, you don’t want to have to close out of a position just because the price moved as part of its normal trading volatility. Figure 4.2 demonstrates what I mean.

**Figure 4.2: Setting initial stops**

As figure 4.2 shows, an initial stop that is set too tight (1) will be triggered too early and the trader would be kicked out of the trade before the price had a chance to go up. Setting your initial stop at position 2, on the other hand, will mean an exit is not triggered prematurely.

Setting tight stops has its drawbacks. First, by having tight stops you’ll decrease the reliability of your system because you’ll get stopped out more often. Second, and probably a little bit more importantly, by setting tight stops you’ll dramatically increase your transaction costs. To give yourself a fighting chance, especially if you’re starting with a smaller float, you’ll want to trade a system that doesn’t chew through brokerage.

Consequently, this is one of the major reasons I steer my clients into trading systems over a slightly longer time frame.
Initial stop methods

There are essentially four ways I suggest clients calculate an initial stop. You need to select the one that seems ‘right’ for you. The secret is not in which method you choose but rather that you just choose one.

1. Percentage method

What is it?

A predefined percentage of the price that you subtract from your entry price.

Example

**Figure 4.3:** Applying the percentage method

Benefits

It’s easy to calculate and is a better solution than not applying an initial stop at all.

Drawbacks

The calculation doesn’t consult price action and/or the volatility of an individual instrument. Different trading instruments have different risk profiles and don’t move at the same rate. Using a fixed percentage method can limit you, causing you to get stopped out too early or too late.
2. Average true range (ATR) method

What is it?

The ATR is the (moving) average of the true range for a given period. The true range is the greatest difference between:

- the current high and the current low
- the current high and the previous close
- the current low and the previous close.

Very simply, ATR determines a security’s volatility over a given period. That is, the tendency of a security to move in either direction. It’s a great indicator used in many money management calculations. Most charting packages supply it.

This method simply subtracts a predefined multiple of the ATR from your entry price. For our examples henceforth, we’ll calculate the ATR over 30 periods (I recommend calculating the ATR over a minimum of 14).

Example

Figure 4.4: Applying the ATR method

![Figure 4.4: Applying the ATR method](image)
**Benefits**

It consults volatility, giving more volatile trades greater room to move and less volatile ones a tighter stop.

**Drawbacks**

The calculation doesn’t consult price action; this can mean we might calculate the initial stop but it might not be at a support level. This method works best for longer term systems with wide initial stops such as 3–4 ATR multiples.

**3. Technical method**

**What is it?**

Some traders enjoy reading charts and/or looking at indicators. For many traders it’s a matter of looking at price action and setting a stop based on the price action. I recommend setting the initial stop a few points below support to give it room to bounce should it need to.

**Example**

**Figure 4.5:** Applying the technical method

**Benefits**

If you’re good with chart analysis, technical stops can work very well. I find technical stops are best suited to short-term trading.
**Drawbacks**

The calculation can be subjective because it requires a certain level of intuition. This means there’s a real danger of letting your emotions get in the way. Technical stops must be applied in a disciplined way. If possible I recommend still having some rules in place for setting these stops.

**4. Lowest low method**

**What is it?**

Look for the lowest low over a predefined period where the period is determined by the timeframe you’re trading. Similar to the technical stops I like to set my stop a couple of points below the identified low.

**Example**

If your price entry was $24 and your look-back period was 21 days during which the lowest low was $21.55, you might set your initial stop level at $21.53.

**Benefits**

It consults both price and volatility.

**Drawbacks**

The calculation can cause an anomaly if the stock shifts sideways for an extended period and volatility dries up. The stop can leave little room for a stock to move.

**Additional tips**

*Time stop:* You might want to add in some sort of time stop in the case that your stock is moving sideways for an extended period of time and your money is sitting there dormant. For example, your rule might be if it hasn’t moved 2 per cent within a certain time frame you’ll exit the position. After all that’s what stops are all about – putting a line in the sand that says, ‘This stock hasn’t done what I thought it would do so I’ll get out.’

*Leveraged products:* Where you’re trading derivative product your initial stops should always be calculated on the underlying instrument. For example, avoid calculating stops based on an options value. Always look at what the derivative has been based on and do your analysis on that. This is a general rule and may not apply to all derivatives since their calculations/makeup can vary widely.

*Shorting:* All the methods outlined in this chapter apply on the short site. Simply take the principal and turn it upside down.

*When to exit:* If you’re trading end-of-day (or longer) systems you may further finesse your system by timing your exits. You can either exit on an intra-day break of your stop or wait for a close below.
Through my testing (and as a general rule) I find for longer term systems it’s best to wait till price closes below your stop before exiting. Shorter term systems should exit on any breach of your stop. With that said, appropriate testing should always be conducted before reaching any conclusions.

The secret: Although I prefer the lowest low method, there really is no right or wrong stop method. By simply having a stop in place you’re on the right track. Once you have a stop you must then determine how wide to set it. That’s the trick and unfortunately there’s no definitive answer... other than to test and see what works best.

When you first begin outlining your initial stop, just keep in mind what successful trader Tom Baldwin said: The best traders have no ego. You have to swallow your pride and get out of your losses. He’s simply referring to having a stop loss set and, more importantly, having the discipline to stick to it.
Chapter 5:
Calculating your trade size

We have now reached the point where we need to discuss the most important aspect of money management: position sizing. When we talk about position sizing, we’re asking the question, ‘How much are we going to put into a trade?’

If you have an approach that makes money, then money management can make the difference between success and failure ... I try to be conservative in my risk management. I want to make sure I’ll be around to play tomorrow. Risk control is essential.

Monroe Trout

Many traders I’ve encountered believe they are doing an adequate job of position sizing by simply having their initial stop in place. This is where the novice trader goes wrong. Calculating your position size is critical and it pulls together both the initial stop and maximum loss into play.

Before I get onto the formula I recommend for calculating your ideal position size, remember it’s not when you get in or when you get out that determines how much you make in a trade but rather how much you put in.

The formula

Although very simple, the following formula is extremely powerful. Since we’ve already calculated our maximum loss and our initial stop, we can simply take these values, plug them into a formula and calculate how many units we can purchase without ever exceeding our maximum loss.

The formula goes like this: the number of units is equal to our maximum loss divided by our initial stop size.

\[
\text{Maximum loss} \div \text{Stop size} = \text{no. of units}
\]

You’re already familiar with what our maximum loss is. The other term you may not be familiar with is stop size. This is simply the difference between our entry price and our initial stop value, calculated as in figure 5.1.
Figure 5.1: Calculating the stop size

Let’s now look at how this formula works in practice. If our trading float was $20,000, and we were risking 2%, our maximum loss would be $400. If our entry price was $1 and our initial stop value was $0.90, our stop size would be $0.10.

Now, to use the formula, the number of units we can purchase is equal to our maximum loss divided by our stop size.

\[
\frac{400}{0.10} = 4,000
\]

We calculate that we can purchase 4,000 units and we know if this trade reaches our initial stop, and we have to exit the trade, we know we’re not going to lose more than 2% of our float ($400). This formula is simple, but very effective.

Please note: For the sake of excellent money management you should always round down. For example, say you calculate that you can buy 766.73 units. Because you can only buy whole units, be sure to round down and buy 766 units. Even though it’s only a small amount, you are taking on more risk by rounding up.

The only other cost you may wish to take into consideration is brokerage. For example, if brokerage was $40 for a return trip ($20 in and $20 out), we’d subtract $40 from our maximum loss. So, instead of entering our maximum loss as $400 into the formula, we’d now enter $360. Once this is computed out, we can determine how many shares we’d buy, and we know that we’re including brokerage as part of our maximum loss.
If we continue with the above example, it would look like this:

\[
\frac{360}{0.10} = 3,600
\]

**Additional tips**

*Maximum position size:* As I’ve said, how many shares we can purchase is determined by our maximum loss and also the size of our stop. Accordingly there are only two ways to increase our positions sizes: (1) increasing our maximum loss; and/or (2) shrinking our stop size – in other words, a tighter initial stop.

So, to avoid a situation you open excessively large positions that might put your trading float at risk, you may also introduce an extra rule that limits the dollar value of a position to be no more than a set percentage of your entire trading float. This protects you from trading halts, busts or unexpected and significant falls.

For example, you might say you’ll never open a position that has a dollar value of more than 25% of your entire trading float. This rule would only ever get executed if, after using the position sizing formula, you find the dollar value of that position would be an excessively large position and greater than 25% of your trading float. If this was the case, you would simply scale back the position to be 25% or you could widen your stop.

The maximum position size percentage value you decide to choose will depend on the type of system, the size of your float and also your personal tolerance for risk. As a guide though, smaller trading floats ($20,000) might use 25%; whereas, larger trading floats ($200,000) might use as little as 10% or even 5%.

*Leveraged products:* It cannot be over stated that new traders should only open positions where they can own the entire position outright. They should trade the float as it was not leveraged. Only advanced traders should value positions based on their leveraged value.
Chapter 6:

Trailing stops

How many times have you sold a position too early? I know I have. And it’s frustrating! Overcoming this tendency to sell before a stock has reached its full potential is, again, about counter intuitive actions creating success.

Generally, what inexperienced traders do is, once they see a little bit of a profit, they sell to crystallise that profit straight away. Psychologically speaking they don’t like to lose and they falsely believe that those profits are their profits – they don’t want to give them back to the market.

In this way they are looking to pick the top. A top is a very difficult exit to identify. It requires great skill in technical analysis and even then there is no guarantee that you will be right. Worse still, you will be kicking yourself if the trend were to continue after you had just exited!

This is a misguided tactic. You need to master the counter intuitive approach.

The best way, therefore, of exiting a position is to wait until the trend changes and exit at a point slightly lower than the top. This does mean that you will be sacrificing some of your profit but, in the long run, your trades will be much more profitable. You will be letting your profits run until you’re signalled to exit.

As mentioned, you generally want to ride the trend as long as you can. The problem is that when the trade starts to lose steam, it will inevitably begin to decline in price. This means that the best time to exit is not actually at the ‘top’ but when the share price has just begun to fall. You’ll never pick the top so make sure you exit just as it rolls over.

Figure 6.1 shows this in a little more detail.
As you can see in figure 6.1, there is a small gap between the peak and the exit point. This means you will never pick the top and you will have to give up a small proportion of the profit when the trend starts to reverse.

Note: The only exception may be some very short-term derivative strategies where you may need profit targets (but they are the exception rather than the rule).

**The role of trailing stops**

A simple example can illustrate the importance of a trailing stop. Say we received a buy signal, purchased XYZ stock and set our initial stop. The stock then rises and continues to rise a few hundred per cent. Without a trailing stop and with only an initial stop set we would not get out of that trade until it reverts all the way back down to below where we bought it (at our initial stop point). The result is we end up losing money even though there was potential for some fantastic gains. This situation is all too familiar in boom/bust times in history such as the tech crash of 2000.

So how do we lock in that profit while we have the chance?

Enter: the trailing stop.

Trailing stops are similar to initial stops, the only real difference being that trailing stops are adjusted periodically. For example, after the first day of trading if the price moves in our favour then the trailing stop is moved closer to price. It literally ‘trails’ behind price.

The key to trailing stops is that you need to continually make adjustments to make sure that the stop locks in profit. Typically the way in which a trailing stop
loss is calculated is very similar to the way in which we calculated our initial stop. As mentioned, the only difference being that rather than calculating our trailing stop from the entry price, we calculate it from the highest price since entry (for ‘long’ trades).

In other words, the trailing stop moves closer to price only as price makes a new high. If price decreases the trailing stop remains fixed.

For example, say we bought XYZ stock at $10 and have placed our initial stop at $9.90. We have decided to have a trailing stop of $0.10. Figure 6.2 displays this graphically.

**Figure 6.2:** Increasing trailing stops graph

Looking at figure 6.2, you can see that between days 5 and 7 the position started making lower highs but the trailing stop remained fixed. A similar thing happened between days 11 and 15 except that on day 15, the low actually went through the trailing stop. Accordingly we exit the position at $10.20. This means that we have made a $0.20 profit per unit using a trailing stop loss.
Methods of calculation

The methods used for calculating a trailing stop are the same as for initial stops (as defined in chapter 5). Here are some quick examples.

**Percentage method**

Highest high since entry: $3.31
Percentage applied: 10% (10% x 3.31 = $0.33)
Trailing stop: $2.98 ($3.31 - $0.33 = $2.98)

**Figure 6.3:** Calculating a trailing stop using the percentage method

![Image of previous high and trailing stop calculation using percentage method]

**ATR method**

Highest high since entry: $4.89
ATR(30): 0.17
ATR multiple: 3 ($0.17 x 3 = $0.51)
Trailing stop: $4.38 ($4.89 - $0.51 = $4.38)

Extra point: If the position moves sideways, and volatility dries up causing the value of the ATR to shrink, this stop will get tighter as a result.
Technical method

Highest high since entry: $7.52
Support: $7.00
Trailing stop: $6.98

Caution: technical stops are even more subjective once a trade is open. Your emotion really takes over once you have committed real money to a trade.

Lowest low method

Highest high since entry: $27.00
Look back period: 21 days
Lowest low in past 21 days: $26.42
Stop level: $26.39

Advanced tips

Setting wide trailing stops: As part of your testing you might look at setting tighter initial stops and wider trailing stops – I have done this with great success. For example, you might set a 2 ATR initial stop and then your trailing stop might be 3 ATR. What you’re then doing, in effect, is limiting your initial risk. Once your trade is in profit, it gives price more room to move.

In this way you become risk seeking when in profit position. Unsuccessful traders do the opposite: being greedy when they should be fearful and fearful when they should be greedy.

With that said, there is no technique that is ideal in all situations and you may find that one technique may be good in one stock and not another. It is therefore important that you back test your trading system. Above all, keep it simple and manageable.

Trading float size: As I mentioned briefly in chapter 2 when talking about your trading float size, you should always value your trading positions at their stop value. That is to say, the number of units multiplied by the stop price equals the position value. You can then use these figures, added to any cash in reserves, when calculating your trading float size and subsequently your maximum risk/new position sizing.

When you dig a little deeper, and consider you will always give profits back to the market, this becomes self-evident.

System analysis: Avoid calculating a system’s risk–reward ratio based on your projected profit targets. The problem with doing this kind of analysis before you enter a position is that you know the initial risk but you don’t know your reward. This ratio can only be correctly calculated when back testing a system.
This is a good point in the book to take a breather and review everything we've learned. The next chapter features a fully worked example that incorporates all aspects of what we've covered up until this point.
Chapter 7:

Fully worked example

In this example, assume that you have identified a trading candidate that you believe has great potential.

The initial rules

<table>
<thead>
<tr>
<th>Float</th>
<th>$20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum risk</td>
<td>2%</td>
</tr>
<tr>
<td>Maximum loss</td>
<td>$400</td>
</tr>
<tr>
<td>Brokerage</td>
<td>$40</td>
</tr>
</tbody>
</table>

Max loss ex. brokerage $360

Trade size

Maximum loss ($) / stop size ($)

Position size limit 30% ($6,000)

Initial stop 3 ATR(30)

Trailing stop 4 ATR(30)

Time stop N/A
Day 1: Entry Triggered

Figure 7.1: Day 1: Entry triggered and exits predefined

Day 1 events: You enter the stock and define your stop losses.

Entry price $10.50
ATR (30) $0.17
Initial stop 3 x ATR = $9.99 ($10.50 - $0.51 = $9.99)
Trailing stop 4 x ATR = $9.82 ($10.50 - $0.68 = $9.82)

Number of shares 360 / 0.51 = 705.88 (inc. brokerage)
Position size 705 x 10.50 = $7,402

The position sizing calculation result exceeds our maximum limit therefore, it would be advised to scale the position down to be no larger than 30% of the float (i.e. $6000).

The calculation for this would be:
$6000 - $40 brokerage / 10.50 = 567 units (rounded down).
(567*10.50 entry price) - (567*9.99 initial stop) + 40 brokerage) = $349.15

New maximum loss $349.15
Entry costs 567 x 10.50 + 40 = $5,993.50

Footnote: For the ease of the example the ATR(30) will remain static.
Day 2: Alteration of trailing stop loss

Figure 7.2: Day 2: Trailing stop moves up

Day 2 events: The stock moves slightly higher. The initial stop remains fixed and does not move. The trailing stop moves up slightly. However, because the initial stop is still higher, the trailing stop remains inactive.
Day 3: Making the initial stop obsolete

Figure 7.3: Day 3: Trailing stop overtakes initial stop, making the initial stop obsolete

Day 3 events: The stock moves higher again. The initial stop remains fixed and does not move. The trailing stop moves up and overtakes the initial stop, making the initial stop obsolete and the trailing stop becomes our new exit price. Although the stock has moved 25 cents in our favour we haven’t made a profit until our trailing stop is higher than our entry price.
Day 5: Leaving stop loss unaltered (1)

**Figure 7.4:** Day 5: Highest high achieved yesterday (day 4); trailing stop does not move

**Day 5 events:** Two days later a new high is achieved. Today the stock retraced from that new high. Our trailing stop is pegged to the highest high since entry and as such remains static.
Day 22: Leaving stop loss unaltered (2)

Figure 7.5: Day 22: Highest high achieved (day 4) trailing stop does not move

Day 22 events: Seventeen days later the stock fails to achieve a new high. Note: During periods where a stock moves sideways the only way our trailing stop could have moved up was if the volatility dries up and the ATR(30) value declined.
Day 23: Increasing trailing stop loss

**Figure 7.6:** Day 23: New highest high achieved (day 24); trailing stop moves up

**Day 23 events:** Two days later our stock begins to move in our favour. It makes a new high and once again our trailing stop is on the move. On this day our trailing stop is greater than our entry price and we are now in a profitable trade.
Day 63: Getting stopped out

Figure 7.7: Day 67: Highest high achieved (day 62)

Day 67 events: 44 days later we receive an exit signal when the current period’s low breaks our trailing stop loss. We exit with a profit.

Final trade summary

<table>
<thead>
<tr>
<th>Entry</th>
<th>$10.50</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exit</td>
<td>$11.77</td>
</tr>
<tr>
<td>Profit/Loss</td>
<td>11.03%</td>
</tr>
<tr>
<td>Risk-reward ratio²</td>
<td>1:1.8</td>
</tr>
<tr>
<td>Profit/loss</td>
<td>$657.55 = 565 \times 11.77 - 30 - 5,962.50</td>
</tr>
</tbody>
</table>

In summary, this trade has produced a profit of $657.55 or a return of about 11% on our initial investment.

² A ratio used by many investors to compare the returns of an investment to the amount of risk undertaken to capture these returns. This ratio is calculated mathematically by dividing the amount of profit (i.e. the reward) by the amount he or she would lose if price hit the initial stoploss (i.e. the risk).
Chapter 8:

The worst trading strategy

As you've no doubt come to realise, there are a million and one strategies that can be applied to all aspects of trading. I'm going to share with you what I consider to be one of the worst if you consider yourself as a trader.

You may be wondering why I would want to spend time illustrating the worst trading strategy around. It's simple. By showing you how it works (or, in this case, doesn't work), I hope to show you clearly what not to do while encouraging you to do the exact opposite.

Averaging down: the worst trading strategy of all time

Unfortunately, for the beginner, averaging down seems quite logical but it is fundamentally flawed. Many people have become stuck in its claws and have lost substantial amounts of money because of its apparent logic. Do not be one of them!

Averaging down is the process of buying more and more units of a falling stock in a desperate attempt to recoup your losses and reduce your effective buy price. When you look at it closely, it's really just throwing good money after bad.

The mental state behind this type of strategy is denial. People believe they can reduce their initial entry price by continuing to buy more as the stock's price falls away. It's the modus operandi of distressed traders, traders in a panic. As a strategy it is hardly ever effective. To make matters worst, you'll magnify your losses if the stock keeps dropping.

Please understand, just because it's cheap now does not mean it's not going to get any cheaper.

Here's how this strategy works in action. Let's say you bought 1,000 shares at $40. Step one, don't have an initial stop in place. Step two, watch the price fall to $30 and do nothing. Here comes the stupidity of this strategy – step three, buy another 1,000 units at $30 to lower the average cost per unit already purchased. Your average cost per unit would now be $35.

It gets worse. Price may fall even further and the novice trader will again buy more units to reduce the effective average cost per unit. The effect is such that he buys more and more into a stock that's losing his money.

Now, imagine this strategy being applied to a portfolio of stocks. What ends up happening is that all your trading capital is allocated to the worse performing
stocks in the portfolio. The result is, at best, a disastrous underperformance versus the market.

If a trader averages down and is using margin, then you can only imagine this would magnify those losses even further. The effects can be devastating. So, hear me now: never average down.

**Averaging up: the smarter way to go**

Let’s turn this strategy on its head and see how we can use this idea in a positive, more profitable way. Averaging up (or ‘pyramiding’) works by simply doing the opposite of averaging down. That is to say, we add to already profitable positions. There’s no hard and fast rules here but the basic premise is that you’re adding to an already performing position.

To implement this strategy the two decisions you need to make are:

- at what point do you add to your position, such as:
  - when you get a new entry signal
  - when you have made x per cent profit
  - a technical point such as breaking a previous high
- how much to add
  - some people double up, others add a percentage of their original position such as 25–50%

A couple of points to note. This strategy lends itself best to a trend following/longer term system.

Also, treat each position as though it was were an independent. You will probably end up using the same stops but when you calculate your percentage risk, apply it as though it’s a new trade.
Chapter 9:

Taking profits and learning from mistakes

Now that you know how to protect your money with good money management, here’s a simple but important lesson.

The point at which you take your profits out of the market (out of your trading float) depends on your objectives. If you’re trading for income you’re obviously going to need to pull money on a more regular basis. If your aim is capital growth, you should leave your capital for a three to five-year term, letting the magic of compound growth take effect.

Compounding: The eighth wonder of the world

I know you’ve probably heard it before but... compounding is a very useful and powerful method of growing your capital by reinvesting your profits into your investments. The power of this principle is demonstrated in the following example.

Let’s assume that we have $10,000 and that our trading system returns approximately 20% per year. If we take all the profits we earn out of the market, without reinvesting, the annual return on a $10,000 account is approximately $2,000. In 10 years’ time, we will have profited to the tune of $20,000.

Let’s now add in the practice of compounding our winnings. In other words, we will not withdraw the 20% profit but will reinvest the money into our account, allowing the money to compound. The example below shows how much more we can expect to make by using this simple and effective method.

Table 9.1: The power of compounding

<table>
<thead>
<tr>
<th>Year</th>
<th>Total account value at 20% growth and compounding the winnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>10,000</td>
</tr>
<tr>
<td>1</td>
<td>12,000</td>
</tr>
<tr>
<td>2</td>
<td>14,400</td>
</tr>
<tr>
<td>3</td>
<td>17,280</td>
</tr>
<tr>
<td>4</td>
<td>20,736</td>
</tr>
<tr>
<td>5</td>
<td>24,883</td>
</tr>
<tr>
<td>6</td>
<td>29,859</td>
</tr>
<tr>
<td>7</td>
<td>35,831</td>
</tr>
<tr>
<td>8</td>
<td>42,998</td>
</tr>
<tr>
<td>9</td>
<td>51,597</td>
</tr>
<tr>
<td>10</td>
<td>61,917</td>
</tr>
</tbody>
</table>
Table 9.1 shows that the initial seed capital has grown to almost $62,000 in 10 years, producing a return of approximately $52,000! This is approximately two and a half times the amount you can expect from not compounding your winnings. Just imagine what the results will be once you have mastered trading and produce a return higher than 20% per annum.

Learning from mistakes

Mistakes will inevitably happen in your career as a trader. The same applies to anyone taking on something new. For example, when most people start a new job, they need lots of hand-holding until they are comfortable with their new role. Trading is no different. Unfortunately, most traders don’t have that ‘somebody’ to look over their shoulder; there is no one to guide and correct them when they have made a mistake. The trader, for the most part, needs to look at her own trading patterns and be self-correcting. This can be a tall order, especially when you don’t realise you have done anything wrong!

Two types of mistakes

I believe there are two types of mistakes: mistakes you have made and mistakes made by someone else. The fact is, it’s human nature to link more pain to the mistakes that you have made yourself as opposed to the mistakes of others. As a result it’s easier to learn from your own painful mistakes than the mistakes of others.

Mindful of this, I encourage traders to think of the first one to two years of their trading career as an opportunity to learn from your own mistakes. The more mistakes you make initially, the more you will learn – but only if you consider them as learning experiences as opposed to events you beat yourself up over!

The biggest mistake I ever made

The biggest mistake I ever made in my trading career was trying to trade without a plan. We all know a well-designed trading plan is the essential element of any good trader. The plan is there to instruct you what to do, when to do it and how much to do it with.

In my opinion, unless your plan is written down, you don’t have a plan. A plan will make you trade consistently and help you to minimise your losses while magnifying your gains.

Throughout this book you have learned about the most important aspect of trading plan: money management. Following what you’ve learned you now need to document it and include it in your own plan, such as demonstrated in table 9.2.
Table 9.2: Sample money management rules

<table>
<thead>
<tr>
<th></th>
<th>Long term</th>
<th>Short term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Define float</td>
<td>$20,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Initial stop method</td>
<td>2 ATR</td>
<td>7-day low (2 points below)</td>
</tr>
<tr>
<td>Maximum loss</td>
<td>2%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Maximum position size</td>
<td>30%</td>
<td>10%</td>
</tr>
<tr>
<td>Trailing stop method</td>
<td>3 ATR</td>
<td>7-day low (2 points below)</td>
</tr>
<tr>
<td>Will you average up? If so, how?</td>
<td>Yes. Add 50% of original position if entry triggered again</td>
<td>No</td>
</tr>
</tbody>
</table>

As mentioned, money management is the most important aspect of your trading plan but that doesn’t discount the fact that there are other areas (such as your entry rules) you must consider.

For more information on designing other parts of the system please visit www.freetradingsystems.org
Trading without a coach

I wanted to finish this book with a note about trading coaches. I do so because I think it’s important.

Ask yourself this: If you want to learn a new language, how would you get started? You would most likely go to a class and learn from somebody more experienced.

In a similar manner, if you wanted to improve your trading skills, you should find a coach. Trading is generally a lonely vocation. What’s more, due to the solitary nature, many traders find it difficult to improve their skills.

Coaches are necessary to help you identify where you are going wrong and steer you in the right direction. The fact is, all top performers have coaches. Take Tiger Woods, for example. He’s considered the greatest golfer of all time and yet he still has a coach. Why do you think that is?

Coaches are required for those who wish to perform at their peak. I believe five hundred dollars spent on improving yourself through a trading coach is much better than losing $10,000 in the markets.

Further trading support can be found by visiting www.onlinetradingmastermind.com