8 Day Intensive Course
Lesson 8

Money Management

A) Why Do Most Traders Lose Money?

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The fact is that most traders, regardless of how intelligent and knowledgeable they may be about the markets, lose money. What could be the cause of this? Are the markets really so enigmatic that few can profit, or are there a series of common mistakes that befall many traders? The answer is the latter, and the good news is that the problem, while it can be emotionally and psychologically challenging, can be solved by using solid money management techniques.Most traders lose money simply because they do not understand or adhere to good money management practices.. Part of money management is essentially determining your risk before placing a trade. Without a sense of money management, many traders hold on to losing positions far too long, but take profits on winning positions prematurely. The result is a seemingly paradoxical scenario that in reality is all too common: the trader ends up having more winning trades than losing trades, but still loses money.

Money Management is the Key

Key Money Management Practices

So, what can traders do to ensure they have solid money management habits? There are a few key guidelines that every trader, regardless of their strategy or what instrument they are trading, should keep in mind:

- **Risk-Reward Ratio.** Traders should establish a risk-reward ratio for every trade they place. In other words, they should know much they are willing to lose, and how much they are seeking to gain. Generally, the risk-reward ratio should be 1:2, if not more. This means risk should equal no more than one-half of the potential reward. Having a solid risk-reward ratio can prevent traders from entering positions that ultimately are not worth the risk.
- **Stop Loss Orders.** Traders should also employ stop-loss orders as a way of specifying the maximum loss they are willing to accept. By using stop-loss orders, traders can avoid the common scenario where they have many winning trades but a single loss large enough to eliminate any trace of profitability in the account.

B) Using Stop-Loss Orders to Manage Risk

Using Stop-Loss Orders to Manage Risk

Due to the importance of money management to long-term successful trading, the use of a stop-loss order is imperative for any trader who wishes to succeed in the currency market. The stop-loss order allows traders to specify the maximum loss they are willing to accept on any given trade. If the market reaches the rate the trader specifies in his/her stop-loss order, then the trade will be closed immediately. As a result, the use of stop-loss orders allows you to quantify your risk every time you enter a trade.

There are two parts to successfully using a stop-loss order: (1) initially placing the stop at a reasonable level and (2) trailing the stop – meaning moving it forward towards profitability – as the trade progresses in your favor.

Placing the Stop-Loss

Here are two recommended ways of placing and trailing a stop-loss order:

· **Two-Day Low.** This technique involves placing your stop-loss order approximately 10 pips below the **2 day low** of the pair. The idea behind this technique is that if the price breaks to new lows, the trader does not want to hold the position. For example, if the low on the EUR/USD's most recent candle was 1.2900, and the previous candle's low was 1.2800, then the stop should be placed around 1.2790 – 10 pips below the 2 day low – if a trader wishes to enter. As another day passes, the trader can raise the stop to 10 pips below the new two-day low.

· **Parabolic SAR.** One type of volatility-based stop is the Parabolic SAR, an indicator that is found on many currency trading charting applications. Parabolic SAR is a volatility-based indicator that graphically displays a small dot at the point on the chart where the stop should be placed. Below is an example of a chart using Parabolic SAR.

C) Different Styles of Trading

There is no precise definition, however the following are considered the general trading styles.

Day traders: will typically take positions for a few minutes up to a few hours, and day traders usually don't hold positions overnight. They will also usually use very short-term charts such as the 15-minute charts.

Swing traders: may take a position for a few hours to a few days or even a week or two. They may use 1-hour or more charts to do so.

Position traders: typically hold positions for an even longer period of time than the Swing trader and this may last a few weeks or a few months.

A carry trade: is one that is made based on the difference in interest rates (short the lower yielding currency to gain returns on a higher yielding currency), and may last for a few years or more.

The longer-term the trader is the longer the time periods used for the charts. Typically the use daily, weekly, or even monthly charts is popular. I believe every trader should at least start out with the longer-term charts to determine general trend as well as the significant support and resistance levels.

Keep in mind that if you are a Day-Trader you don’t want to use a 15-minute chart to enter a position and hold that position for days.

Conversely, if you are a Swing Trader you don't want to use an hourly chart and exit your position in 15-minutes.

D) Helpful Trading Tips

When to Increase/Decrease Position Size:

Whenever a trader is going through a difficult period, the first reaction should be to decrease the size of the trades. For example switch from trading 5 lots at a time to trading 2 lots at a time. Unfortunately, many traders try to recoup losses by increasing the size of their trades. This almost never works because it is a decision that is based on emotion rather than reason. The time to size up is when things are going well; that is the best time for traders to get aggressive.

How to Remove Emotion from your Trading:

The best way to remove emotion from trading is to plan as much of the trade as possible in advance prior to entering. Many traders focus on what happens after they enter a trade, but the movements in price are not under the trader's control. What the trader can control is planning where to enter, and place stops and limits, and determine ahead of time what to do in the event of any situation that may arise.

As a general rule of thumb, anytime you feel like your emotions are getting the better of you, take a step back from your trading to try and prevent making rash decisions. This can happen after one trade, or it can happen after a number of trades. I recommend that when you do find yourself getting frustrated with the results of your recent trades it is helpful to take a look back at why they were unsuccessful. Keeping a trade log will assist you with this. Each time you place a trade, jot down exactly why you placed the trade. For example, you decide to buy the EUR/USD because RSI crossed back above 30 and the most recent completed candle was a doji. If the trade is unsuccessful, you can look back to see why.

Also keep in mind that your emotions can get the best of you when you are booking both profits as well as losses. If you find that you are taking unnecessary risks with your trading as a result of a few good trades, continuing on with this type of carelessness can be just as detrimental. Take a step back and try to identify what you did correctly with your recent successful trades. Then, when you feel ready, continue with your trading.

Ideally, you want to avoid all emotion when trading. This is why the vast majority of successful traders practice good money management. They do things such as place stops and limits and never alter them after they have entered the trade. They let profits run and

well as limit their losses.

That being said, if there are one emotion above all others that can quickly hurt a trader, it is greed. As soon as greed enters the equation, you will find yourself making poor trading decisions. Trading is an emotional roller coaster. You go from the highs when you are profiting big, to the lows when you are down. It is always best to do yourself and your account balance a favor and control these emotions.

E) Assignment - Place a Trade

ASSIGNMENT: Using your demo account, place a trade that includes a stop-loss order using the tactics discussed in this lesson. Reply to this thread telling the class about your trade, and why you placed it. As always, feel free to upload an image or word document illustrating the trade.

F) Animated Lesson:

The following link(s) illustrate how the various indicators can be used to identify the best times to initiate a position, keep losses relatively small, and take advantage of trading situations that may occur over the course of a trading day. Please feel free to pause each animation or replay it as many times as you wish. In addition, please turn your speakers on to listen to the audio segment as well.

http://www.learncurrencytrading.com...anagement1M.swf

G) Question of the Day

Question of the Day

Aside from the 2-day low and the and Parabolic SAR stop-loss techniques, what are some other methods of determing stop-loss levels that seem reasonable to you?

H) Quiz

Quiz: Money Management

Please go to the Quiz Center and take the Money Management Quiz.
http://www.learncurrencytrading.com/main

I) The Psychology of a Good Trader

The Psychology of a Good Trader

Being a good trader involves more than just being able to analyze the market technically and/or fundamentally. One of the most crucial yet overlooked elements of successful trading is maintaining a healthy psychological outlook. At the end of the day, a trader who is unable to cope with the stress of market fluctuations will not stand the test of time – no matter how skilled they may be at the more scientific elements of trading.

Emotional Detachment

· Traders must make trading decisions based on strategies independent of fear and greed.

One of the premiere attributes of a good trader is that of emotional detachment: while they are dedicated and fully involved in their trades, they are not emotionally married to them; they accept losing, and make their investment decisions on a mental level. Traders who are emotionally involved in trading often make substantial errors, as they tend to whimsically change their strategy after a few losing trades, or become overly carefree after a few winning trades. A good trader must be emotionally balanced, and must base all trading decisions on strategy – not fear or greed.

Know When to Take a Break

· In the midst of a losing streak, consider taking a break from trading before fear and greed dominate your strategy.

As noted in the money management section of the course, losing is an inevitable part of trading. Not every trade can be successful. As a result, traders must be psychologically capable of coping with losses. Most traders, even successful ones, will go through a stretch of losing trades. The key to being a successful trader, though, is being able to come through a losing stretch unfazed and undeterred.

If you are going through a bad stretch, it may be time to take a break from trading. Often, taking a few days off from watching the market to clear your mind can be the best remedy for a losing streak. Continuing to trade relentlessly during tough market conditions can breed greater losses as well as damaging your psychological trading condition. Ultimately, it’s always better to acknowledge your losses rather than continue to fight through them and pretend that they don’t exist.