LESSON FIVE: RISK MANAGEMENT AND CAPITAL ALLOCATION

Many factors determine a mature, experienced trader's success. Risk management and capital allocation are two of the most important and interrelated. Risk management can be thought of as managing the odds of success. There are several ways to do this, and we will discuss each.

Risk Management Techniques

Understanding risk is critical to all traders. If you think of trading as an exercise in probability, the worst you can do is fifty-fifty, as in a coin toss. Of course, those risks will quickly break your account. So, we need to improve our probability as much as we can. There are proven ways to do this, which are listed here.

Set profit and loss thresholds at the start of the trade.

Have a Trading Plan

As in any business endeavor, you should consider how you want to trade. How often do you want to trade? Every day, every week, or what? This will tell you how carefully you need to think through your trades. Manual trading done every day can be challenging because it requires time to plan the trading to be done. If you have a "day job," this may cramp your style and interfere with your other obligations and responsibilities. Trading requires preparation to remain objective and defensible. The following will discuss many of the matters to be considered before trading.

When you open the trade, consider setting a stop-loss. This value sets the low point in the stock price, and if it is reached, the trade automatically closes. Setting this value takes experience but is critical. In most trades, there is a point when the price falls below the entry price. This is called a drawdown, and it is to be expected. If you set the stop-loss to close to the entry, you will be stopped out of trade too soon and miss the predicted rise to be profitable. You should also set a take-profit price value. You want the trade to end at this price, capturing the gain. You do not have to watch the trade as much by correctly setting these values because it will close when it reaches these values. This also eliminates the opportunity for emotions to corrupt your trade.

The 1% Rule

There is a trendy bit of advice that experienced traders will hand out. It says you should only trade in a single asset (stock) that takes up to 1% of your available trading fund. For example, if you have $10,000 to invest. Then, don't place a trade with more than $100 in any single trade. As you can see, this is pretty limiting but is still an excellent conservative piece of advice. Some would raise this to 2%. The critical thing to remember is that you must keep the amount small enough so that if a trade or two goes south, you can still stay in the game.

Diversification of Trades

However, you need to be aware of the relationship between your trades so that you focus on things other than trades that are likely to react the same way during market swings. For example, if you traded Ford stock and then GM stock, because they are very similar, they may respond almost identically to a rise in interest rates or another general change that impacts them.

Making many smaller trades is an even more critical action to diversify your trading. If you consider probability (the chances of success or failure), if you have 20 trades open and 1 or 2 have losses, then the great majority will have gains, and the overall result will be a gain.

Hedging

Hedging refers to taking a balanced approach to trading. If you trade a stock, that will rise if there is higher unemployment. Then hedging suggests that you also find a stock that would have gains if the unemployment rate went down. This is hard to do at first, but with more experience, you will find it more manageable. Some will look at this and say that this pollutes the potential for gain since one will win and the other will lose. Point taken. Nonetheless, hedging is a valuable tool and has its place in your trading tool kit.

Capital Allocation

When setting up your trading accounts, it is essential that you only deposit funds that you can afford to lose. Never deposit funds needed to pay rent, a mortgage, or other " must-pay" items. We always hope to win, but it must be Okay if we lose. Setting aside a monthly amount is suitable for setting up your trading account. Also, reinvest the amounts you gain in trading when building this account. By using these methods to set up and maintain your trading account, you will not put yourself in the wrong place, which can add stress and anxiety to trading. Putting yourself under financial pressure to do trading is just not brilliant and will usually not be successful. Be organized, safe, and intelligent.

In the next lesson, we will discuss some broad trading strategies.