CHAPTER 2

The Importance of Money Management

Money management includes trading wisely and husbanding your trading resources. FOREX speculation involves significant risk taking. Never risk what you cannot afford to lose. You cannot trade without trading capital, so capital preservation is critical. One key to holding on to your capital is the appropriate use of leverage. The required Commodity Futures Trading Commission (CFTC) warning statement on the Global-View web site contains a lot of wisdom for traders of any instrument. This chapter also discusses appropriate leverage strategies and provides a list of trading rules.

Coming into the trading game, it is important to realize that all traders have many losing trades. Be aware of this before starting. Stop loss orders are often not used by novice traders; use them, as they are critical to your trading survival.

It is not our intention in this chapter to be negative, but the majority of the items covered here are "don'ts" as opposed to "do's" if only because new traders seem to major in "don't." The following are some important thoughts from an experienced European trader.

> *Trading is not mainly about making money but more about CAPITAL PRESERVATION. Think about it. NO CAPITAL, NO TRADING!*
>
> *Each time you enter a trade you should think "How much I am ready to lose!" and not "How much I am HOPING to make!"*
>
> *Trading is simple, but it is not easy!*

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CFTC WARNING

Many of us see a warning label or disclosure statement and just gloss over it. The required CFTC warning statement about FOREX trading on margin contains useful information that is worth taking a few minutes to read and think about. Many of the topics covered in this chapter relate to the items mentioned in this required statement:

> *Trading foreign exchange on margin carries a high level of risk, and may not be suitable for all investors. The high degree of leverage can work against you as well as for you. Before deciding to invest in foreign exchange you should carefully consider your investment objectives, level of experience, and risk appetite. The possibility exists that you could sustain a loss of some or all of your initial investment and therefore you should not invest money that you cannot afford to lose. You should be aware of all the risks associated with foreign exchange trading, and seek advice from an independent financial advisor if you have any doubts.*

KEY TO SUCCESS AS A TRADER: PRESERVE YOUR CAPITAL

Capital preservation is the key to trading success at all levels, from the small individual trader to the sophisticated large hedge fund manager, and it must be goal number one. Without sufficient capital, a player cannot participate in the markets. In the warning statement, the CFTC states that "The high degree of leverage can work against you as well as for you."

A common error of new traders is overleveraging their trading capital. Later in the chapter we discuss how to calculate your leverage and recommend a commonsense approach to how much of your trading capital to put at risk on any given trade.

THE INSIDE SCOOP (JAY MEISLER)

Typically, it seems that traders don't come to us until they are about to blow their accounts. The source of the problem is usually a lack of discipline that turned a manageable loss into a crisis situation. I remember one instance where a trader who used to be in regular contact disappeared from sight. I sensed something was amiss when attempts to contact him went unanswered. He was embarrassed to tell what happened as he saw the capital in his account dwindle with each passing day. By the time he contacted me, he had already blown his account.

The problem started with a short-term trade taken following the release of some economic news. The market moved against him and he never recovered. An attempt to earn 20 pips wound up losing over 700 pips as the market trended the other way. Doubled-up trades failed. Hope replaced solid analysis. Prudent money management and discipline were tossed aside. Proper risk/reward measurement had long since passed.

In situations like this, when a trader asks for advice on a losing position (I would hope before it reaches a critical point), I ask one question: "If you were to start with a clean slate right now, would you take this position?" If the answer is no, then the trader has answered his own question and should exit the position. If asked for my advice before a trade is placed, I ask: "What is your profit target and what is your stop?" This is because a trader needs to establish a risk/reward objective on a trade before trading. Also, one *must* have a stop in place in order to live to trade another day if the trade does not work out as planned.

WHAT IS LEVERAGE?

Since outright percentage price moves in currencies often tend to be significantly smaller than those on equities or on some commodities, a 10 to 20 percent annual price swing in the value of one currency versus another is considered to be substantial. FOREX trading in the commodity markets or with an online broker is done on a leveraged basis to amplify (or leverage) potential trading gains or losses. In other words, a small margin deposit can buy control over a much larger position. A margin deposit is best described as good-faith or earnest money. *It in no way limits the potential loss on a position.* The buyer or seller of a position in the FOREX market *is liable for any losses on the full position*, and of course would benefit from any gains. For example, a USD500 margin at some firms might control a EUR100,000 position (equal to $148,000 at an exchange rate of EUR/USD 1.4800).

Leverage is often expressed as a ratio:

Leverage = Trading Position/Required Margin

Thus in our example:

EUR100,000 @ 1.4800 = USD148,000

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The typical required margin is USD500:

$$\text{USD}148{,}000/\text{USD}500 = 296$$

The leverage is:

296:1

On the regulated commodity exchanges, the comparable FOREX leverage might be about 65:1. Some FOREX brokers advertise leverage as high as 400:1.

EXAMPLE OF A HYPOTHETICAL TRADE

With a trading margin of USD500 controlling a EUR100,000 (USD148,000 equivalent) position, a 1 percent increase in the value of the EUR/USD would generate a *gain* of $1,480 on a long position. A 1 percent decline in the value of the currency would generate a comparable *loss* of $1,480—and as an account holder, you would be liable to make good on the entire loss.

Calculation:

A EUR100,000 position is worth USD10 per one-pip movement.

A 1 percent change in the value of the EUR/USD would be:

$.01 \times 1.4800 = .0148$
$.0148 = 148$ pips (smallest whole number)
$+148$ pips $\times$ \$10 per pip $=$ \$1,480 gain

Note: Some firms now quote prices in fractions (tenths) of a pip.

Leverage is a powerful force that can work for or against the currency speculator. Because it is so powerful, we recommend that traders of all levels of experience keep their leverage well below the levels allowed by most online firms. Remember that capital preservation is the number one goal of the trader. Here is some money management advice from a successful North American dealer:

> *If you're long USD like I am, you need to make sure your money management is in order. That means appropriate stops, appropriate leverage, appropriate position sizing with respect to your account size.*

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Also . . . if the position moves too far against you, then don't be afraid to accept the loss. It's better to live and fight another day than to draw down your account so much that you can't trade anymore.

Keep in mind that the account holder is held financially liable for the full losses taken on any account regardless of the margin initially required. A missed margin call (demand for additional funds) will see the trading position closed swiftly by the broker to limit its exposure to losses, and the broker will pursue the account holder for any deficit in the account.

MONEY MANAGEMENT RULES

Some simple guidelines may help keep you in the game long enough to learn winning ways. Breaking even is okay, too.

- **Go slow.** If you are new to trading, start out with one of the paper-trading demo accounts offered by most brokerage firms. Get a feel for the mechanics of trading and for how the markets operate. Read the free Global-View FOREX Forum. Use the Learning/Help Forum to ask questions about *how* to trade. On the FOREX Forum you will see a lot of trading ideas posted by a wide range of traders 24 hours a day when the markets are open. You will also see a wide range of trading styles. Pick some posters you like and follow their trading ideas and how they make their decisions. Don't look for them to tell you what to do. *In the end, it's YOUR decision how to manage your money, not theirs.* Develop your own trading approach as quickly as possible.
- **Start out with a mini-account.** Trading with real money is a lot different than paper trading. Try out a mini-account and *keep your leverage low*. Forget the dollar value of your profit/loss (P/L). Trade for pips. You can always increase your leverage later. In the ideal case, you might be able to fund a full-sized account with the profits from your mini. Take your time!
- **Expect to have *many* losing trades.** They come with the territory in FOREX trading. If you talk to some of the professionals in the big institutions who have survived for many decades, the best will tell you that the markets have taught them humility. Most will say that they would be happy to be correct 51 percent of the time. They will also tell you that, given the global scope of the markets, things often happen that surprise even the most experienced participants.

- **Have the strength of your convictions, but don't be stubborn.** If you find it hard to admit when you are wrong, then you might not be suited for trading. However, flip-floppers have a hard time as well. Do your preparation for a trade. Have the strength of your convictions but don't get married to an idea that is not working for the reasons you thought it would.
- **Avoid "Jubbs."** There supposedly was a London bank trader named Nigel Jubbs who was well known for putting his stop losses at the most obvious of chart points, and he was constantly being stopped out. Consequently, those placing stops at obvious chart points are often called Jubbs. Avoid them.
- **Avoid the myth of diversification.** Some currency pairs are highly correlated to others. These correlations tend to change over time, though. Check out the correlations before diversifying your portfolio of positions, or you could find that there is more risk in your position portfolio than you thought.
- **Don't overtrade, and don't be afraid to sell currencies short.** Professional traders trade as comfortably from the short side as the long one.
- **When in doubt, stay out.**
- **Trade with the trend, not against it, especially when momentum is accelerating.** Retail traders often prefer to play extremes of ranges rather than trading breakouts. So, when trading against the trend, be quick to take your profits (or losses).
- **Use positive risk/reward objectives.** The expected gain from a trade should be two to three times the amount you figure you might lose.

The following are words of wisdom from a successful Australian speculator to a less experienced trader on a Global-View forum:

> *There's no security in FX due to the use of leverage for the retail size trader. You need a substantial amount of capital to overcome this.*
>
> *Also, as pointed out, demo accounts aren't manipulated and provide a false sense that you can beat the market. It's got to do with risking nothing vs. risking real dollars. The mental aspect of trading is difficult for people with little or no experience.*
>
> *One small businessman lost everything he had in \$/cad, something like 1.2 mln dollars—this can be the reality of this business and something you must establish rules for in your trading. Also just because someone says I made a ton of money last year or last month is irrelevant—it's more in their ability to weigh their risk vs. reward over the long haul.*

THE INSIDE SCOOP (JOHN BLAND)

A good lesson is the story of Long-Term Capital Management (LTCM), which was a hedge fund founded in 1994 literally by some rocket scientists and Nobel Prize winners in economics, among other luminaries. To make a long story short, in 1998 it created a mini-financial crisis that spilled over into the FOREX market when it lost $4.6 billion in less than four months. LTCM folded in early 2000. Its losses were not in FOREX but do illustrate how the best-laid plans of the best and the brightest traders can go badly astray. This has been repeated on a much larger scale that led to the global financial crisis in the second half of 2008. Trying to forecast where the FOREX market is headed is often like trying to build a computer model to predict the weather. There are just too many unknown variables to track.

USE STOP LOSSES

From a Far East trader on the Global-View Forums:

> *Do not worry about what market will do. Just worry about what you will do when market reaches your "pain point" or "happy point." You will have an easier life as a trader that way.*

The FOREX market is not just the province of speculators. Currencies are the basic medium of exchange for countries. Governments and politicians have a vested interest in managing the values of their currencies. Thus, while an economist might be looking at relative rates of growth, interest rates, trade balances, or other macroeconomic indicators to anticipate future values, money can suddenly move in massive amounts due to financing equity investments, mergers and acquisitions (M&A) flows, infrastructure plays, central bank reserve management, and so on. It's because of these frequent and unexpected distortions to the rhythm of the markets that it is vital that a stop loss point be determined for *every* position *before* it is entered. To protect themselves against unforeseen price moves, all successful professional traders operate with stops. You never know what is going to happen out of the blue in FOREX markets.

There is a tendency for less experienced traders to be reluctant to take losses, counting on ranges holding to see their levels again. This strategy works during range markets but can prove disastrous when markets trend and momentum accelerates. This results more often than not in seeing an account wiped out as hope replaces sound analysis and money management. One thing is certain: If you start out trading without stop loss protection, you are just setting yourself up for learning the hard way that stops are required for long-term survival.

One word about stop loss orders: They do not guarantee a trade at a specific price. If your stop loss price is touched, it triggers a market order to buy or sell (depending on your position). That could be executed very close to your price or quite distant from it, depending on market conditions.

HOW MUCH TO RISK ON A TRADE

> Markets can remain illogical longer than we can remain solvent.
> —Gartman's *20 "Not-So-Simple" Rules of Trading*

How much of a loss should be at risk on a trade depends a lot on what kind of trading you are doing. A day trader is likely to risk considerably less than a long-term position trader, but as a rule of thumb it is inadvisable to risk any more than 5 percent of the total risk capital in your account on any individual trade. So if you have $10,000 in your account, risk no more than $500 on any individual trade. Remember, you are going to have a lot of losing trades!

You can calculate the appropriate position size for a trade by dividing the dollar amount you are willing to lose by the number of pips to your stop loss. Don't confuse your percent of equity loss tolerance with the margin requirement, though. They are unrelated. Assume:

$500 loss tolerance

EUR/USD 148-pip stop (1 percent) or .0148 based on 1.4800 spot price
Calculation:

$500 ÷ .0148 = EUR33,783 position (or EUR30,000 in round numbers)

Thus, if you are willing to risk $500 on a trade with a 148-pip stop, your position should be EUR30,000.

You can adjust your stop loss requirement and increase or decrease your leverage to arrive at a proper balance. The point is that you don't want to blow your entire trading account on a handful of unfortunate trades.

THE INSIDE SCOOP (JOHN BLAND)

Take the case of my first speculative customer back in 1979. This was a sophisticated assistant treasurer of a major corporation who had previously been a consulting customer of mine in corporate currency exposure management and had been quite successful. This individual opened a personal FOREX account and lost virtually his entire balance over several weeks on his first (long Deutsche mark) trade. His leverage had been modest, but he refused to accept the fact that his trade was not working for the reasons he thought it would. This happens much too often with new traders. Manage your money. Conserve your equity. Also, risk capital must only be money that you can afford to lose.

READY TO TRADE?

> To trade successfully, think like a fundamentalist; trade like a technician.
>
> —Gartman's *20 "Not-So-Simple" Rules of Trading*

Here are some trading rules:

- **Get organized.** Keep records of your trades. What was the rationale for the trade, and what happened? It's a fact that you will learn more from your losers than from your winners. You can be right for all the wrong reasons, but when you are wrong, try to figure out why.
- **Be a specialist.** Don't trade a lot of currency pairs randomly. Pick out two or three and find out everything you can about them in depth.
- **Find the best broker for you.** See Chapter 7 for more on this topic.
- **Get information on the current economic situation.** Technical traders often eschew the fundamentals. Granted, it can be hard to learn how the fundamentals work, follow them, and make trading decisions based on them, but the effort is worth it. Start out with some basic knowledge of the fundamentals. A daily data calendar and forecasts for the top-tier indicators can at least improve the timing of your trading decisions (see Chapter 5, "Trading the News").
- **Remember the key market axiom that "It's not the news but the market reaction to news that matters."** So if the USD does not rally on good news, it tells you that there is something additional working against it just now.
- **Don't let a winner become a loser.** For heaven's sake, it's hard enough to be right on a trade. You can keep a winner from becoming a loser by letting gains accumulate and by running a trailing stop to protect the profits. A number of academic studies have shown that traders are often too slow to take their losses and too quick to take profits.

- **Don't pyramid your position.** Some recommend adding progressively smaller positions to a winning trade. This is called pyramiding. It might work in some markets, but we don't like it in FOREX trading.
- **Don't hedge to cover a bad position.** Some brokers now offer traders a chance to hedge an existing position with an equal and offsetting one. All a hedge does is increase the brokerage fees you pay because of the bid/ask spread. Rather than hedging to cover a bad position, just get out. Clear your head and move on.
- **Think of a trade as taking a calculated risk on which you either gain or lose.** Don't let emotions rule your decision. Don't chase your losses, and at all costs avoid doubling up to try to recoup a loss. Take your loss and move on. Losses are just a part of the business. Expect to have many.
- **Don't put on a straddle to avoid taking a loss.** Cross positions (straddles) can be just as risky as (or more risky than) outright trades. A cross position (straddle) in FOREX is an equal (size) and offsetting position in another currency. For example, a long EUR/USD position could be offset by a short GBP/USD position in the belief that the EUR and GBP will more or less equal the USD.
- **Never meet a margin call.** Liquidate. You should never reach this point on a trade if you manage your leverage and stops prudently. If you get a margin call, you are probably risking too much. Reduce your leverage and/or make your stops closer. Trading is all about capital preservation.
- **Remember that errors happen.** We know a former bank trader unused to electronic trading who too frequently hits the "Buy" instead of the "Sell" button by mistake. If this happens to you, take your loss right away. Don't let a small error get away from you.

There are many approaches to trading. The following is a post from one of the Global-View forums from a West Coast trader. He favors pyramiding his winning positions.

> *Leveraging is the hardest thing, I guess.*
>
> *My attitude is to start at the easiest place.*
>
> *Enter maximum leverage at your support or resistance point. If the market does not respect your level, don't add to the position; just either reverse or close.*
>
> *If the market is volatile and able to break levels in a trading day, then add to winning positions on the break.*
>
> *So it's the same as you read in books. Manage your losses to as low as possible, book profits if it doesn't break levels and add to winning positions to maximize return should the market be trading*

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that way. It's definitely not easy to trade perfectly correctly every day but I think on the days where your levels are good and the market is moving a lot you must really trade aggressively leverage wise.

Just keep in mind I only focus short term so you need a different approach for wider trade parameters over multiple days.

SUMMARY

The CFTC warning statement for commodity and FOREX traders contains a lot of wisdom. Be aware of the message it tries to convey. Understand that everyone takes many losses in FOREX trading. Manage these losses and your trading capital and you will improve your chances for surviving in the long term. Allocate your trading capital to allow for a significant number of trading opportunities. Be sure you seek profits in a multiple of at least two or three times risk.

Money management—not trading method—is what separates the winners from the losers in currency trading.

Recommended Global-View Links

Learning Center: www.global-view.com/forex-education/forex-learning/

Help Forum: www.global-view.com/forums/forum.html?f=4

Basics of Trading Video Course: www.global-view.com/forex-education/trading-manual/dir.html