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| **Lesson 1: Setting Realistic Profit Expectations** |
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The first step in understanding and building a solid money management plan, the key component in successful trading strategies, is setting realistic profit expectations. All too often I see people open trading accounts with balances of $10,000 or under expecting to make enough money to support themselves from their trading profits within a short period of time. After seeing all of the hype that is out there surrounding most trading education, trading signal services, etc it is no wonder that people think this is a reasonable goal, but that does not make it a realistic one.

As most any truly successful trader will tell you, the stock market has averaged somewhere in the neighborhood of 10% a year over the last 100 years. What this basically means is that if you would have invested in the 30 stocks that make up the Dow Jones Industrial Average, the index which is designed to represent the overall market, you would have earned about 10% on your money on average over the last 100 years. With this in mind, what most any truly successful trader will also tell you, is that if you can consistently double that return, on average, over the long term, then you will be considered among the best traders out there.

So does this mean that if you are a new trader starting with a small account balance that you have no chance of earning a living or even becoming rich from trading? No it does not. But what it does mean is that in order to be successful your expectations need to be in line with reality, so you can develop a stock, futures or forex trading strategy that will allow you to succeed over the long term, instead of following the path of most small traders who swing for the fences on every trade until they eventually blow their entire account up.

With this in mind lets look at a couple of scenarios. What most successful traders will also tell you, is that as a small trader you have much more flexibility regarding what you can put money into as your small trade size is an advantage in the sense that you do not move the market or catch the attention of other traders who may try to profit off what you are doing at your expense. With this in mind I think that most successful traders will tell you that it is not unreasonable to target 30% a year while you are small. Now, assuming you left your profits in your trading account at the end of each year so that you could compound your returns and averaged 30% each year (with obviously some years being worse than this and some years being better) your returns and account balance would look something like the following assuming you started with $10,000.

Now depending on where you live and what your financial requirements to live are, you may be satisfied with this. If you are not however does this mean that you are doomed to never live your dream of being a professional trader? No it does not. If you can produce those types of returns consistently what most successful traders will also tell you is that there will be people lined up at your door to offer you money to trade, and after the 3rd year or so with a successful track record, you should be able to raise enough money to make a very good living trading other people’s money.

Most successful money managers charge management and performance fees somewhere in the neighborhood of 2 and 20 (that is 2% of assets under management yearly and 20% of net new profits) as their compensation for managing other people’s money. With this in mind if you were able to produce a track record similar to the one above for two to three years running and then raised $5 Million (what should be an easy feat with that track record) then your yearly management fee would amount to $100,000. On top of this if you were able to return 30% on that $5 Million then your performance fee would be $300,000 earning you a total compensation of $400,000.

With this in mind, contrary to popular belief which is if you have a small account the only way to be successful is to swing for the fences at first and then scale back when you are large, a much higher probability and most likely faster way to success is to focus on building a consistently profitable trading strategy and then taking on capital from others in order to earn your living trading.

That completes our lesson for today. In tomorrows lesson we are going to look at different ways of protecting one’s capital while trading so we hope to see you in that lesson.

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| **Lesson 2: Learn to Protect Capital First** |
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In our last lesson we looked at what one can reasonably expect to earn from their trading over the long term, and how one can avoid the common misconceptions of most traders which ultimately cause them to fail. In today’s lesson we are going to look at the next step in developing successful money management strategies which is how to manage your losses.

One of the main key’s to successful trading is the preservation of capital. Beyond the obvious point here that if you loose your trading capital then you will be out of the game, is the fact that it takes much more to come back from a loss than it does to take the loss you are trying to come back from.

As an example here lets say you start with $10,000 and loose $5000 from a string of bad trades. That $5000 loss represents a 50% loss on your account which now has $5000 left in it. Now ask yourself this question. What percentage gain will you need to make on the $5000 left in your account in order just to be back to break even (the $10,000 level) on your account? If you have done the math correctly you will see that in order to make back the 50% loss you took on your account you will need to make a 100% return or basically be twice as successful in your comeback as you were unsuccessful in your draw down.

It is this concept that is one of the most important to understand in trading, as it underscores the importance of protecting one’s trading capital, as it shows the difficulty of coming back from a loss in relation to the ease of taking a loss. It is also most traders lack of understanding of this concept that causes them to take risks which are way to large and is a major contributor to the high failure rate among traders.

That’s our lesson for today, in tomorrow’s lesson we are going to talk about how to design a plan before entering a trade or managing the position in case it starts to move against you so we hope to see you in that lesson.

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| **Lesson 3: Determining Your Initial Stop Level** |
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In our last lesson we looked at the difficulty of overcoming a loss in the market to further emphasize the importance of protecting your trading capital as a critical component of any successful trading strategy. In today’s lesson we are going to start to look at the first and one of the best ways of protecting one’s trading capital, setting your initial stop loss.

As we learned about in our lesson on the effects of trading losses, 50% or more of the trades made by many successful trading strategies are losers. These trading strategies and traders are successful not because they are highly accurate on a trade by trade basis, but because when they are wrong they cut their losses quickly and when they are right they let their profits run. While the trading strategy that you eventually end up trading for yourself may have a higher success rate than what I mention above, any strategy is going to have loosing trades, so the first key to staying in the game is to have a plan for managing those losses so they do not get out of control and wipe out your chances for success.

With this in mind, what most traders will start with when designing a plan for setting their initial stop loss is the amount they can afford to loose on a per trade basis without having a detrimental affect on their account. While this varies from trader to trader and from strategy to strategy, as Dr. Alexander Elder mentions in his book Trading for a Living, many studies have shown that trading strategies and traders who risk more than 2% of their overall trading capital on any one trade are rarely successful over the long term. From what I have seen most traders risk way more than this on an individual trade basis, another large contributor to the high failure rate among traders.

Traders who set their per trade risk level at 2% of their trading capital or less, not only put themselves in a situation where a fairly lengthy string of losses will not knock them out of the game, but also put themselves in a situation where any one trade is not going to make or break their account. This is important not only from a money management standpoint but also from a trading psychology standpoint in that they are not attached to any one trade and are therefore more likely to stick to their strategy.

In order to have a true understanding of what this number should be for a specific strategy you will need to know what the expected accuracy rate is for the strategy, something which will cover in later lessons. For now however it is sufficient to simply understand that you need to have a feel for how much you plan to risk on a per trade basis as a first step in designing a successful money management strategy, and that you should be very wary of any strategy which risks more than 2% of your trading capital on any one trade.

Now that we understand that determining how much to risk per trade is the first step in any successful money management strategy, we can move on to other methods of setting your initial stop which fit within the limit set by the amount a trader is willing to risk on a per trade basis.

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| **Lesson 4: Setting Stops Using Volatility** |
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In our last lesson we looked at determining how much you are willing to risk on any one trade as the first step in developing a successful money management strategy. Now that we have established this, in today’s lesson we are going to look at some of the different ways that you can then set your stop, which fit within this initial criteria.

As we learned in last lesson, risking more than 2% of total trading capital on any one trade is a major reason for the high failure rate of most traders. Does this mean that when setting a stop we should simply figure out how many points away from our entry represents 2% of our account balance and set the stop there? Well, traders could obviously do this and to be honest it would probably be a lot better than most of the other money management strategies I have seen, but there better ways.

Although many traders will look at other things in conjunction, having an idea of the historical volatility of the instrument you are trading is always a good idea when thinking about your stop loss level. If for instance you are trading a $100 stock which moves $5 vs. a $100 stock that moves $1 a day on average, then this is going to tell you something about where you should place your stop. As it is probably already clear here, all else being equal, if you put a stop $5 away on both stocks, you are going to be much more likely to be stopped out on the stock which moves on average $5 a day than you are with the stock that moves on average $1 a day.

While I have seen successful traders who get to know a list of the things they are trading well enough to have a good idea of what their average daily ranges are, many traders will instead use an indicator which was designed to give an overview of this, which is known as the Average True Range (ATR)

Developed by J. Welles Wilder the ATR is designed to give traders a feel for what the historical volatility is for an instrument, or very simply how much it moves. Financial instruments that exhibit high volatility move a lot, and traders can there fore make or lose a lot of money in a short period of time. Conversely, financial instruments with low volatility move a relatively small amount so it takes longer to make or lose money in them all else being equal.

As with many of the other indicators we have studied in previous lessons, Wilder uses a moving average to smooth out the True Range numbers. When plotted on a graph it looks as follows:



What you are basically seeing here is a representation of the daily movement of the EUR/USD. As you can see when the candles are longer (which represents large trading ranges and volatility) the ATR moves up and when the candles are smaller (representing smaller trading ranges and volatility) it moves down.

So with this in mind, the most basic way that traders use the ATR in setting their stops is to place their stop a set number of ATR’s away from their entry price so they have less of a chance of being knocked out of the market by “market noise”.

That’s our lesson for today. In tomorrow’s lesson we are going to look at how you can use volatility based stops in conjunction with another method traders use for setting stops based on technical levels so we hope to see you in that lesson.

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| **Lesson 5: Up Your Chances for Profit When Setting Stops** |
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In our last lesson we learned about the Average True Range (ATR) and how traders use this to get an idea of the volatility in the market so they can incorporate this into their stop levels. In today’s lesson we are going to add an additional factor that most traders consider important when setting stops, support and resistance.

As we have learned in previous lessons many traders will use technical analysis to determine where support and resistance is in the market, and look for trading opportunities based on what that chart analysis tells them. In addition to using technical analysis to find support and resistance levels in which trades can be entered, many successful traders also use this method of analysis to determine where their stops should be placed.

One of the most popular methods which we have touched on in previous lessons where many traders use support and resistance in their stock, futures and forex trading strategies is when trading ranges in the market. Many traders favor ranges, as they provide traders with the ability to enter trades with tight stop losses and much larger potential returns. The reasoning here is that traders can enter a trade just below resistance or just above support in the range, place their stop just outside that level and then their profit target at the other end of the range. Generally the distance between the stop level is much shorter than the distance between the other end of the range, providing traders with a great opportunity for a relatively low risk and potentially high reward trade.



This is also another example of using tech levels (the bottom and top of the range) to place trades and set stops. Often times however as many traders are employing this type of trading strategy, the market will jump up or down above/below the resistance/support level stopping traders out of trades before quickly reversing and moving in the favor of the traders original entry price. Because of this traders are faced with the dilemma of how far to place there stop outside of the range that they are trading, so that they can be in a position where they are protected but are less likely to be stopped out on market spikes. One way that this can be done is by incorporating the ATR.



Although the example above shows 1 ATR. as the level at which the stop is placed outside of the range. That number could be a percentage such as 50% of the ATR. or any other multiple of the ATR such as 2 ATR’s outside the range, depending on the traders time frame, profit target, and strategy.

To finish off this example we now have several components which make up a basic strategies for placing stops based on technical levels and can now analyze the feasibility of one of the trades here to see if it fits all of our criteria.



So in this instance with $10,000 in trading capital and our 115 point stop we are not only well within the recommended 2% loss limit, but we also seem to have a healthy profit ratio on the trade.

That’s our lesson for today. In tomorrow's lesson we are going to look at another method of placing stops with a look at placing stops with chart patterns so we hope to see you in that lesson.

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| **Lesson 6: How to Guard Your Stops** |
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In our last lesson we looked at how many successful traders incorporate support and resistance into their long and short term trading strategies. In today’s lesson we are going to expand on this concept by looking at how many traders look for multiple support or resistance levels when placing trades as well as how many chart patterns incorporate this concept already, providing traders with areas in which they can place their stops.

As we learned about in our last lesson, when setting a stop many traders will find a level of support if they are buying to enter the trade or resistance when they are selling to enter the trade and place there stop outside of this level. When entering trades many successful traders will also look for trades which have few if any levels of support/resistance in the direction they are trading, but several levels of support/resistance in the direction in which they are placing their stop.



As we have also learned in previous lessons, one of the key reason’s why traders favor or recognize certain chart patterns is because they often times signal what is next to come in the market. What is often overlooked however about almost all of the most popular chart patterns, but perhaps just as important, is their ability to point out potential places where you want to place your protective stop loss.

As you can see from the below chart the head and shoulders pattern is a perfect example of this. By entering the trade on a break of the neckline and placing the stop just above the right shoulder of the pattern traders ensure that there are at minimum two resistance levels in between their entry price and their stop level if not more.



For patterns such as the triangle pattern which do not already incorporate this multiple support/resistance levels between your entry and your stop concept, it is often wise to find entry opportunities which provide these additional levels naturally in addition to the setup when looking at the chart pattern in isolation.

That’s our lesson for today. In tomorrow’s lesson we are going to look at another way traders use to set their stops: Indicator based stops so we hope to see you in that lesson.

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| **Lesson 7: Incorporating Indicators in Stop Placement** |
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In our last lesson we learned how many successful traders look for entry opportunities which allow them to set their stop so that there are multiple support or resistance points between their entry point and stop level, and few if any support or resistance points between their entry price and their target. In today’s lesson we are going to look at another factor that many traders use when deciding where to place their stops, the use of technical indicators.

As you hopefully remember from watching my previous lessons we have already covered two indicators and gone over specific trading strategies on how they can be used to set stops which are the Average True Range and the Parabolic SAR. While these indicators were designed specifically to help traders gauge where to place their stops, many of the other indicators which we have looked at using to pick trade entry points can also be used to decide when to exit a trade.

With this in mind the question then becomes, with all the options available how do you choose which indicator if any to look at when deciding when to exit a trade. Which indicator if any you choose to include in your money management strategy for setting stops is going to depend largely on the type of stock, futures or forex trading strategy that you are trading. As a general rule however if you use an indicator to signal for example a buy entry on a trade most traders will keep an eye on that same indicator and take into account when that same indicator signals to exit a trade.

As an example of this, lets say that your analysis of the Average Directional Index (ADX) shows that the chart of x is about to start a nice trend and you decide to place a trade on that analysis. Using the knowledge you have gleaned from our lessons on stops so far you also pick a level for your stop which has some nice protection and is close enough that it fits within your two percent loss limit. During this trade however if the Average Directional Index (ADX) which is the indicator you used primarily to enter the trade begins to signal that the trend is weakening and the market is about to range, should you remain in that trade? The answer to that question is going to depend on the strategy and what other things are going on in the market at the time, but I would say at minimum most successful traders would take this into account when deciding whether or not to continue with the position, regardless of whether their stop had been hit or not.

Lastly on this point there is one indicator that so many traders watch that many traders will at least keep an eye on what happens with this indicator and that is the 50 and the 200 day moving average. These indicators are in general thought to be representative of the overall trend in the market and a break above or below these levels and/or a crossing of the 50 day moving average above/below the 200 day moving average is normally seen as significant for a market and as such many traders will take this into account and place their stops accordingly.

As you probably have noticed when thinking about placing stops using indicators, as you don’t know where price is going to be when your indicator signals for a trade exit, you do not have a hard stop in the market, are in the very bad position of not being protected in your trade. This is why, as we have talked about many times in our other lessons, that if this method for setting stops is used it should always be used in conjunction with another method which allows you to set a hard stop and stays within the 2% loss limit rule we have established.

This concept of the stop being a sort of “moving target” is a nice lead in to our next concept and lesson where we are going to be talking about what is known as a trailing stop.

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| **Lesson 8: Why Traders Cut Their Winners Too Quickly** |
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In yesterday’s lesson we looked at how many traders use technical indicators as an additional factor they consider when deciding when to exit a trade. In today’s lesson we are going to begin to move into the next phase of our series on money management strategies, with a look at how traders go about taking profits once a position moves in their favor and some of the difficulties that are associated with this.

Before getting into the details of what a trailing stop is and how many traders incorporate this into their stock futures or forex trading strategy, it is first important to understand the trading psychology behind taking profits.

From the last several lessons you should now have a good understanding of some of the psychological difficulties people have in taking losses, and some of the different money management strategies that can be put into place to help overcome these difficulties that are the downfall of so many traders.

What may come as a surprise to many of you is that just as many traders have problems letting their profits run as they do in cutting their losses. To help illustrate this I am going to give a quote from one of my favorite books on money management strategies Trade Your Way to Financial Freedom by Dr. Van K. Tharp. When explaining this concept in his book he gives the example below:

When given a chance for “1. a sure $9000 gain or 2. a 95% chance of a $10,000 gain plus a 5% chance of no gain at all….which would you choose?”

A study which was done on this showed that 80% of the population chose the sure thing even though the second opportunity represents a $500 larger gain on average.

Similar to the way that human’s are raised in a way that does not allow them to accept losses our environment also teaches us to seize opportunities quickly, or “that a bird in the hand is worth two in the bush”, a rule that goes against the second half of the most important rule of trading:

“Cut Your Losses and Let Your Profits Run”

With this in mind we can now move into the next phase of our series of money management strategies with a look at some of the different ways that traders go about managing their position once it begins to move in their favor starting with a look at trailing stops.

Once a position has begun to move in a traders favor, many traders will implement a trailing stop which is basically a strategy for moving the stop they have implemented on their position up when they are long or down when they are short to lesson the loss or increase the amount of profit they will take should the market reverse and begin to move in the opposite direction of their position.

As you may realize from watching my previous lessons we have already gone over one precise method which many traders use for setting trailing stops, the Parabolic SAR. In tomorrow’s lesson we are going to go over several other methods, so we hope to see you in that lesson.

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| **Lesson 9: How to Lock in Profits with Trailing Stops** |
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In yesterday’s lesson we talked about some of the psychological difficulties people have with letting their profits run and introduced the concept of the trailing stop as one way traders can overcome these difficulties that are the downfall of so many traders.

As we spoke about briefly in yesterday’s lesson, once a position has begun to move in a traders favor many successful trader’s will manage that position through the use of what is known as a trailing stop. The simplest type of trailing stop is what is known as a fixed trailing stop which simply moves along behind a position as that position begins to move in the traders favor. The beauty of the fixed trailing stop, is that while it will move up behind a long position or down behind a short position as the position moves in the traders favor, if at any time the position begins to move against the trader, the stop does not move, essentially locking in a large portion of the gains the trader has made up to that point.

Let’s say for example that you had been following the trend in the EUR/USD chart below which started back in August and were looking for an opportunity to get into a trade. Based on your analysis you decided that if the market broke out above the little resistance point that I have highlighted on the chart below and the Average Directional Index (ADX) was in a good position that you were going to enter long at 1.4360 to try and ride the trend.

To manage the trade if it moved in your favor you placed a 100 Point trailing stop on the position at 1.4260. Now in this example if the market moved against you from the start 100 points your stop at 1.4260 would not have moved and you would have been executed on that order when the market touched 1.4260. As you can see from the chart below however, in this example the market did not pull back but went higher.

As our stop is a 100 point trailing stop once the market moved up from 1.4360 the stop is going to continue to move up remaining 100 points behind the current price. If the market moves down however the stop does not move. So in this example once the market stoped moving higher at 1.4752 so did our stop and since the market pulled back 100 points from that level we were stopped out in this example at 1.4652.



Most trading platforms will allow you to set a fixed trailing stop on the platform so you do not have to manually manage the order.

As we have touched on briefly in previous lessons, indicators can also be used as trailing stops. One of the more popular indicators which was designed specifically for this purpose is the Parabolic SAR which we covered several lessons ago and you should review if you have not done so already.

As we discussed in our lesson on the Average True Range (ATR), this and other methods for measuring volatility in the market are often used to set hard stops by traders when entering the market so they do not get stopped out by market noise. In addition to using the ATR as a hard stop, this and other volatility based indicators can also be used as a trailing stop, moving your hard stop along behind the position a set number of ATR’s for instance as it moves in your favor. As with a hard stop this protects your position from market noise, while allowing you to look in profits should the market begin to move against you.

Many if not all of the other indicators could also be used as trailing stops with the Moving Average probably one of the more popular here as well.

Aside from fixed and indicator based trailing stops another strategy that many traders implement is a fixed percentage of profits trailing stop. Using this method a trader will set his hard stop his profit target, and then once the market hits his profit target will then begin trailing a stop which could be any combination of the methods above. This method gives the trader a greater chance that the trade will hit his profit target but provides less protection should the market reverse and begin to move against him.