Forex Money Management

Disclaimer; I am by no means a Forex expert nor an expert in money management or the psychology of trading. What I write are techniques and experiences that I have learnt through my years of trading and sharing with others that can hopefully shed some light on these critical subjects to becoming a successful trader.

Throughout ones trading experience, there is always a start and then a never ending curve of learning. At the start the curve is pretty much vertical as there is a lot to digest, the market itself, trading pairs, pips, lot sizes, characteristics, strategies and systems, fundamentals, technical analysis, and on and on. Luckily most brokers offer an introduction to forex via demo accounts, then super mini's, minis, and finally normal accounts. Somewhere embedded within this newfound education, many times a "newbie" gets introduced to money management. There are a hundred different interpretations of managing money within ones forex account, regardless of which one you choose, it is something that is probably without a doubt, the single most important part of ones trading experience, and often the most overlooked. We will discuss a few items critical to managing an account whether it is $300 or $3 million, the same principals apply. The main focus is preservation and longevity. Along with proper money management, you as a trader **must** establish a detailed report and record of your trading activity. This is not just for your accountant, but to determine what type of trades you are making throughout the year, how much you trade, what your drawdown is, how many loosing trades in a row have you experienced, your win loss ratio, reward/risk ratio. All of these items, although fluctuate from year to year, will give you a guideline as to the risk which is appropriate to meet your goals, while at the same time meet your risk tolerance as a trader as well as the risk tolerance of the technique or system that you use while trading forex. In other words, it is a roadmap of the past that can be incorporated to follow in the trades to come.

Record Keeping/ Trading Log

Record keeping can be as simple as logging your trades as they occur, there is no magic here. Some of the items to include are; Date entered, closed, Pair, entry price, target price, stop loss, potential, Reward/Risk, Win/Loss on pair, present capital, lots, realized pips, cumulated pips, gain/loss in $, ending capital.

Example:

Date Ent.	Date Clsd	Pair	L/S	Entry	Target	Stop	Potent.	R/R	W/L	Capital	Lots	Rlzd Pips	Cumu Pips	Gain/Loss	New Capital
6/11/06	6/15/06	EUR/USD	L	2625	2725	2525	100	1	72%	$10,000	3	100	300	$300	$10,300
6/13/06	6/14/06	GBP/USD	L	8530	8685	8375	155	1	67%	$10,300	3	155	465	$465	$10,765
6/17/06	6/20/06	AUD/USD	S	7450	7370	7530	80	1	63%	$10,765	3	**-80**	**-240**	**-$240**	$10,525

In addition to a spreadsheet Log of your trades, it is good to keep a written journal of your trades, which include your thoughts on the trade, why you took the trade, any move of stops etc.

Why do we do this? This allows you to paint a picture of an accurate win/loss ratio which will determine how much of your capital you can expose yourself to in a worst case scenario. You must always be thinking defense.

Reward/Risk ratio is simply the potential pips divided by the stop loss pips. The R/R in any system should never be less than 1 to 1 and if your win/loss ratio is less than 50%, then your R/R must

proportionately be better than 1 to 1, or you will be in a spiraling loss over time. The W/L and the R/R work hand in hand. You may have a 30% W/L and still be very profitable if your R/R is 4 to 1 as the few trades that do win for you overcome the string of losses, and at the end of the day, that's all that matters, more cumulated pips in than out. As a traders skills improve and systems are adapted and refined, the goal is to have a high % of W/L and a higher than 1 to 1 R/R. That my friend will lead to huge profits. In the meantime, find a system or technique that's suits your trading style and quickly determine what the W/L vs. the R/R is best suited for that specific technique.
My WaveTrade system uses a 1.2 to 1 R/R on average against a 77% W/L so at year end with proper lot positioning, I know that system will be profitable.

Lot Sizing

Determining how many lots one should play depends on a few factors;

1) Capital
2) R/R
3) W/L %
4) Target pips
5) Stop Loss

The R/R and W/L % will determine your stop loss and your risk tolerance.

If you have a record of trades or can back test a system that you use, you should be able to determine with some degree of accuracy your W/L and a suitable R/R. Lets assume that 3% of capital is a maximum, you want to expose, keeping in mind "Defense"

Example:

Short EUR/USD
Entry Price 1.2855
Target Price: 1.2705
Stop Loss: 1.2930
R/R: 2 to 1
W/L: 50%
Potential: 150 pips
Risk: 75 pips

Capital: $10,000.

Determine how many lots you can expose using 3%.
$10,000 x 3%= 300   300/75(risk)= 4
On a mini account you should short 4 lots (40). Maximum loss will be $300 and potential gain is $600.

Another method is using an <u>average exposure</u> of past trades. This works only if you have a considerable amount of back trades that you can get an average drawdown figure from, such as > 100 trades and are using an R/R close to1 to 1, with a high W/L ratio. Out of those 100 trades if you can determine the average pip gain/loss is 100 pips for example, then we can use that as a baseline for lot sizing as well.

Example:

Long EUR/USD
Entry Price: 1.2800
Target Price: 1.2950
Stop Loss: 1.2650
R/R: 1 to 1
W/L: 70%
Potential: 150 pips
Risk is 150 pips.

Although this particular trade is above the average of 100 pips, you still use the 100 number in the calculation, as the next one could be well below the 100, this is why it is called average exposure.
Formula: (Capital x 3%)/100
($10,000 x 3%)/100 = 3 (round out to nearest tenth if not whole)
On a mini account you would expose 3 lots (30). Maximum loss would be $450 and potential gain is $450. The advantage here is that the W/L is 70% and if history repeats itself over the next 100 trades you will be profitable 70% of the time without risking more than what you would gain. Even though on this trade you actually expose 4.5% of capital, the next trade may be only 2%, all things being equal.

With both systems, you should always be exposing a fixed % of capital or average % of capital from one trade to the next regardless of win or loss. As your account grows, you will expose more lots. If it loses and goes down in value, you expose fewer lots, preserving your capital. This method is called an anti-martingale approach. What you never want to do is increase lots as you lose trades. This is often an emotional move that will spell doom in the long run of trading. One can wipe their accounts out in only a few trades using this approach.

One of the critical items to look at with any Lot sizing formula is to determine how many losses you can sustain consecutively before your capital is diminished. What is the likelihood of such consecutive losses, and how many consecutive losses have you experienced in the past. Use that as a guideline, because it will happen again, guaranteed!

Compounding

If you can open an account and employ a decent system of trading along with a good W/L % relative to R/R ratio, and leave the account alone never withdrawing, the compounding results will be astonishing.

Here is an example of an account started with $10,000 using 3% exposure rule, compounding. We use the average exposure for lot calculation. In this particular example, we use an average of 117 pips per trade, a R/R of 1.13 to 1, and a W/L of 4.14 or 80.5%. Also take note of the string of losses from trade lines 63-68. Obviously a bad stretch of losses, we are able to apply the anti-martingale approach, reducing lots with decreasing capital and ride though the storm. Even though the loss was approximately 20% of the account, we were able to survive such a brutal string of losses and recover the money lost within a few trades later. This is a perfect example of how proper lot positioning can save an account, as well as instill confidence in a traders psyche and even though bad stretches will occur, you will continue to be successful in the long run.

Example:

Each line represents the trades and pips gain/loss per currency pair.

		PIPS	PIPS	PIPS	PIPS	PIPS	Realized	**3%**		
		EUR	**GBP**	**CHF**	**CAN**	**AUD**	PIPs	Lots	Gain	Gross
1	**$10,000**	95					95	3	$285	$10,285
2	$10,244	232					232	3	$696	$10,940
3	$10,853	151					151	3	$453	$11,306
4	$11,273	201					201	3	$603	$11,876
5	$11,854	20					20	3	$60	$11,914
6	$11,915	160					160	3	$480	$12,395
7	$12,404	218	203				421	3	$1,263	$13,667
8	$13,743	69					69	4	$276	$14,019
9	$13,986	80	186				266	4	$1,064	$15,050
10	$14,940	20	253				263	4	$1,052	$15,992
11	$15,947	20	316				326	4	$1,304	$17,251
12	$17,280	199	-147				52	4	$208	$17,488
13	$17,511	20	347		157		524	4	$2,096	$19,607
14	$19,863	20	-159				139	5	-$695	$19,168
15	$19,155				-71		71	5	-$355	$18,800
16	$18,807				20		20	5	$100	$18,907
17	$18,903					117	117	5	$585	$19,488
18	$19,470	54					54	5	$270	$19,740
19	$19,740		-195		-48		243	5	-$1,215	$18,525
20	$18,510			185			185	5	$925	$19,435
21	$19,388			199			199	5	$995	$20,383
22	$20,377	99					99	5	$495	$20,872
23	$20,895					98	98	5	$490	$21,385
24	$21,420				135		135	5	$675	$22,095
25	$22,161			167			167	6	$1,002	$23,163
26	$23,110	20					20	6	$120	$23,230
27	$23,228				68		68	6	$408	$23,636
28	$23,633			62			62	6	$372	$24,005
29	$24,009			-214			214	6	-$1,284	$22,725
30	$22,692					129	129	6	$774	$23,466
31	$23,442				154		154	6	$924	$24,366
32	$24,368	225	350				575	6	$3,450	$27,818
33	$27,961	20		20			40	7	$280	$28,241
34	$28,247			207			207	7	$1,449	$29,696
35	$29,747	231					231	8	$1,848	$31,595
36	$31,509				-36		36	8	-$288	$31,221
37	$31,218				132		132	8	$1,056	$32,274
38	$32,274			-176			176	8	-$1,408	$30,866
39	$30,818			20			20	8	$160	$30,978
40	$30,976	20					20	8	$160	$31,136
41	$31,135				22		22	8	$176	$31,311
42	$31,310		408				408	8	$3,264	$34,574
43	$34,586				97		97	9	$873	$35,459
44	$35,446				-65		65	9	-$585	$34,861
45	$34,855				126		126	9	$1,134	$35,989
46	$35,982				38		38	9	$342	$36,324

47	$36,332					130	130	9	$1,170	$37,502
48	$37,543				-68		68	10	-$680	$36,863
49	$36,889	20					20	9	$180	$37,069
50	$37,078	-108	311				203	10	$2,030	$39,108
51	$39,008			152			152	10	$1,520	$40,528
52	$40,528	190					190	10	$1,900	$42,428
53	$42,503				-76		76	11	-$836	$41,667
54	$41,674	70					70	11	$770	$42,444
55	$42,422			149			149	11	$1,639	$44,061
56	$44,043				85		85	11	$935	$44,978
57	$45,003					61	61	12	$732	$45,735
58	$45,707			151			151	12	$1,812	$47,519
59	$47,476				-65		65	12	-$780	$46,696
60	$46,685	101					101	12	$1,212	$47,897
61	$47,894			20			20	12	$240	$48,134
62	$48,140		272		87		359	12	$4,308	$52,448
63	$52,571					-56	56	13	-$728	$51,843
64	$51,816			-225			225	13	-$2,925	$48,891
65	$48,827	-192					192	13	-$2,496	$46,331
66	$46,423	-93			-46		139	12	-$1,668	$44,755
67	$44,769		-145			-119	264	11	-$2,904	$41,865
68	$41,738		-221			136	85	11	-$935	$40,803
69	$40,828				122		122	10	$1,220	$42,048
70	$42,106					122	122	11	$1,342	$43,448
71	$43,423				141		141	11	$1,551	$44,974
72	$44,993				96		96	12	$1,152	$46,145
73	$46,100				158		158	12	$1,896	$47,996
74	$47,968	194					194	12	$2,328	$50,296
75	$50,354	113		166			279	13	$3,627	$53,981
76	$53,956	20	665				685	14	$9,590	$63,546
77	$63,433				98		98	16	$1,568	$65,001
78	$65,027			20			20	17	$340	$65,367
79	$65,360					129	129	17	$2,193	$67,553
80	$70,405	84	291				375	18	$6,750	$77,155
81	$86,201			103			103	22	$2,266	$88,467
82	$91,513				48		48	23	$1,104	$92,617
83	$94,141	200	273	174			647	24	$15,528	$109,669
84	$130,582					96	96	33	$3,168	$133,750
85	$138,083		267				267	35	$9,345	$147,428
86	$160,140	61		161			222	41	$9,102	$169,242
87	$181,410	-75	-173				248	47	-$11,656	$169,754
88	$154,493	20					20	40	$800	$155,293
89	$156,342			20			20	40	$800	$157,142
90	$158,213		-232			88	144	41	-$5,904	**$152,309**
		2759	2870	1361	1309	931				

Risk/Reward Ratio:	1.13 to 1
Win/Loss Ratio:	4.14
Success Rate:	80.5%

You can easily see that with the above 114 trades, over time with proper lot positioning, using sensible money management techniques, along with a compounding account, just how good things can become. Knowing what $10,000 can do in a 114 trades, can you imagine where the next hundred or so trades will take you?

Psychology

This is a subject that I am definitely no expert at. What I do know however are from past mistakes, blown accounts, and the resultant feeling of failure, anger, blame, and the blues when trades went bad. What I have learnt are the following:

- The market has no feelings.
- You can never “I’ll show you” to the market
- You will have losses…lots of them
- Losses will come periodically, all the time, consecutively, and will almost feel like they are targeting you.
- Good money management and record keeping will make the losses a lot easier to take, because you will have backup knowledge that will reinforce your trades in the long run.
- Never martingale with lot sizing.
- Set goals, such as staying disciplined and don’t gamble your money, this isn’t Vegas Baby!
- From one losing trade to the next, the odds do not favor you to win, every trade starts on a clean slate.
- Plan your trading and trade your plan!

Final Thoughts

All the above examples and techniques are nothing more than simple approaches to building a successful trading account. It definitely is not rocket science. Many in the Forex forums talk of finding the “Holy Grail” in trading. If there is such a thing, I truly believe it embedded within account management, lot position sizing, record keeping, and sensible goal setting. So many newbie’s get involved in Forex from friends, they go to the Forex introduction meetings that come to some local hotel banquet hall near them, get caught up in the “get rich quick, it’s so easy” hype from some guy’s speech resembling Tony Robbins’ pumped up speech on steroids. The reality is 95% of traders will blow up their $300 mini accounts in a blink of an eye. There is nothing wrong with falling down, especially with a $300 mini, just get back up, learn the market, learn technical analysis, fundamental analysis, patience, discipline, and set realistic goals. **Fact: You will not get rich quick!** Good things worth doing take time and patience.

With these items in place, you will have a good healthy start to trading to success and any losses or string of losses should minimize the ruffling of ones feathers. Most of all enjoy trading, trade smart with discipline, have a goal, a plan, and never stop learning.

Happy Trading,
Northpro

“Genius, genius nothing, I failed my way to success” Thomas Edison