How to Build a Strategy, Part 5: Risk Management

By James Stanley, Trading Instructor

22 June 2012 17:12 GMT

Before you read any further, I want you to think about a simple question.

When I ask this question at our DailyFX Bootcamps, the most common answers are around 60-70%. Some traders will guess a little lower, answering with a number around ~55%.

Rarely do we get an answer below 50%.

This is not correct.

In trading, we can be right only 30% of the time and still be profitable. In this article, I will show you how.

We're also going to look at a question that is potentially even more important – which is investigating why you might not want to expect to be right much more than half of the time.

What is in current price?

When banks receive orders from their customers to exchange $1,000,000 US Dollars for Euros, Yen, or British Pounds, they accordingly transact their business and this additional supply or demand will cause changes to price.

Alternatively, if we get a surprise announcement from Fed Chief Ben Bernanke, prices will begin changing pretty quickly to incorporate whatever *new news* might be getting introduced to the environment.

But both of these factors affect future price, and, unfortunately – there is no way of knowing that these will happen until ***after they happen***.

Current price is just showing us a roadmap of those events that have happened in the past.

That's it. There is no free lunch.

As traders, we probably aren't going to exhibit a pattern of continually out-smarting the market on our way to a pile of riches.

Why?

Because the market is always right. Upcoming price changes will often be dictated by future events that we cannot forecast (such as large orders by banks, or news that has yet to occur). With these types of events, it's impossible to know what will take place, thereby; it's impossible to continue to successfully forecast future price movements *without* assistance from risk management.

Sure, we might be able to gleam a bias – and if no news enters that market that radically changes perspective, we might even be able to trade in the direction of this bias (the trend). We've published numerous materials attempting to help traders see this.

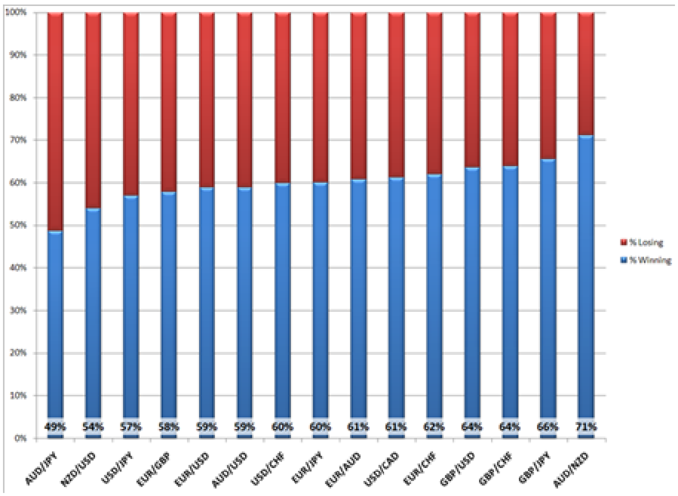
But as we place trades and build a strategy, we have to KNOW there is always a chance of being wrong on a trade – as there are no assurances that price will move up or down at any point in time.

Trading is managing probabilities.

At any point in time, what do you think the chances are of price going up or down?

It's important to look at this question when planning risk management. How often do you want to expect to be right?

From the DailyFX Traits of Successful Traders series, we found that retail traders are right more often than they are wrong in many of the most commonly traded pairs. The table below shows winning percentages in these pairs during the period of analysis:

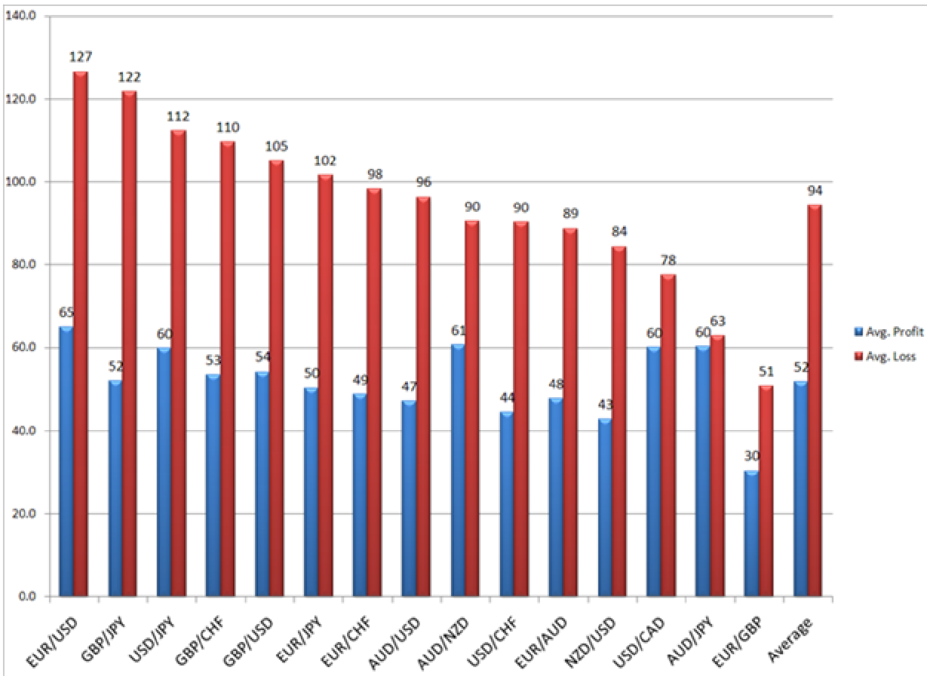


[From The Number One Mistake FX Traders Make](#) *by David Rodriguez*

For most of the observed currency pairs, traders were profitable far more than half-of-the-time (the exception on the above graphic in which traders in AUDJPY were right only 49% of the time). So, one might expect that these traders, with their hearty winning percentages were doing well?

Unfortunately not: Despite the fact that traders were winning on as many as 71% of trades, traders still lost money as a whole. Want to venture a guess as to why?

Well, here it is:



[From The Number One Mistake FX Traders Make](#) *by David Rodriguez*

The average win is in blue, and the average loss is in red, and as you can see – ***every pair*** shows that traders took larger losses when they were wrong than the amount that they made when they were right.

And despite the fact that traders were winning *much more* in the previous graphic, the fact that they lose so much more when they are wrong brings many unwanted consequences.

In [The Number One Mistake Forex Traders Make](#), Quantitative Strategist David Rodriguez found that this was the most common pitfall for traders in the FX market; and this can be rectified by using risk management to your advantage.

Using Risk Management

So, if a trader wants to properly institute risk management into their strategies, how can they do it?

There are two primary areas that traders want to investigate whilst building their approach.

The first we looked at above, and that pertains to the risk-reward ratio used on each trade that is taken; in effort to avoid [The Number One Mistake Forex Traders Make](#).

In the article, David suggests that 'traders should use stops and limits to enforce a risk/reward ratio of 1:1 or higher.' This can be instituted by placing a stop and a limit on each trade, ensuring that the limit is *at least* as far away from current market price as your stop.

We can even take this concept a step further by looking for larger profits when right, but risking smaller amounts so that when losses are smaller; this can be done with a 1-to-2 risk-to-reward ratio (risking 1 dollar for every 2 dollars sought).

A visual representation of a 1-to-2 risk-to-reward ratio is illustrated in the picture below:

The reasons for such a risk-reward setup are numerous, as future prices can be difficult to forecast and impossible to predict. But when a trader is on the right side of the trade, this type of risk-reward ratio can maximize their gain and limit their losses in the instances in which they are wrong.

As a matter of fact, let's say that a trader isn't even right half-of-the time. Let's assume a trader is only winning in 40% of their trades. By using a 1-to-2 risk-to-reward ratio, they can still attain a net profit.

Risk-Reward	1-to-1	1-to-2
Total Trades	10	10
Total wins (40%)	4	4
Profit Target	100 pips	200 pips
Stop Loss	100 pips	100 pips
Pips Won	400 pips	800 pips
Pips Lost	600 Pips	400 pips
Net gain	(-200 pips)	200 pips

As you can see, the risk-reward ratio completely changed the strategy. If the trader was only looking for one dollar in reward for every one dollar risked, the strategy would have *lost* 200 pips. But by adjusting this to a 1-to-2 risk-to-reward ratio, the trader tilts the odds back in their favor (even if only being right 40% of the time).

But what if our strategy is only successful 30% of the time (as we had mentioned above)?

We can simply look to be more aggressive, seeking a higher reward for the fewer times that we are right. The table below looks at 3 different risk-to-reward ratios with a 30% winning ratio:

Risk-Reward	1-to-1	1-to-2	1-to-3
Total wins (30%)	3	3	3
Total Trades	10	10	10
Stop Loss	100 pips	100 pips	100 pips
Profit Target	100 pips	200 pips	300 pips
Pips Lost	700	700	700
Pips Won	300	600	900
Net gain (loss)	-400	-100	200

Leverage

Taking the discussion of risk management a step further, we can begin to focus on the leverage being utilized. After all, it doesn't matter how strong our risk-to-reward ratios are if we face a margin call within our first couple of trades of executing the strategy.

This topic was investigated in much more depth in the article '[How Much Capital Should I Trade Forex With](),' by Jeremy Wagner.

While researching how traders fared based on the amount of trading capital being used, Jeremy made a fascinating observation. Traders with smaller balances in their accounts, in general, carried much higher leverage than traders with larger balances.

The traders using less leverage saw far better results than the smaller-balance traders using levels over 20-to-1. Larger-balance traders (using average leverage of 5-to-1) were profitable over 80% more often than smaller-balance traders (using average leverage of 26-to-1).

The table below was taken directly from '[How Much Capital Should I Trade Forex With](),' and illustrates in more detail this massive deviation between these groups of traders.

Taken from '[How Much Capital Should I Trade Forex With?](#)' by Jeremy Wagner

From the article, Jeremy states that 'traders should look to use an effective leverage of 10-to-1 or less.' Doing so will enable traders to mitigate the damage posed by losses; and if this is combined with strong risk-to-reward ratios (looking for more of a reward than the amount risked as mentioned above), traders can begin looking to put the concept of risk management to work in their favor.

--- Written by James B. Stanley

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