MONEY MANAGEMENT

As you sit looking at the monitor, eyes transfixed on the screen, you keep going over in your head all the analysis that led to the decision to buy. Your heart begins to pound as you reach for the mouse. You pause for one last look at the chart before committing to the trade. With a push of the button you are in, and then suddenly it hits you, the one thing you forgot. How could you have overlooked it? Money management and an analysis of your individual direction, discipline, risk, and leverage equation: the DDRL©.

AN IMPORTANT COMPONENT

Money management addresses the preservation of existing and accumulated capital. Without the implementation and strict adherence to money management principles, even the best trading strategy may not succeed. Money management is a critical element of a successful trading plan. It is a long held belief by many professional traders that "it's not how much money you make; it's how much you don't lose" that

A NEW APPROACH

BY ROBERT DEEL

ultimately determines success. This article is not about the traditional application of money management, such as how much total capital should be risked or how much should be risked in any one individual trade. Your screening selection, risk management, and the proportion of leverage can be ascertained from your DDRL score. Understanding this simple but powerful equation is, in my opinion, the key to all aspects of money management and skill.

Under no circumstances are you to allow a profit turn to a loss.

WHAT IS DDRL?

Direction, discipline, risk, and leverage (DDRL) are the components of an equation that examines your ability, trading methodology, and ultimately your skill. Solving the equation answers the questions of how good you really are and focuses on your individual problem areas. It pinpoints in which phase of the trading process you are deficient: Trading vehicle selection, timing, direction, risk management or money management. Are you risking more than your trading skill allows and using too much leverage? Your DDRL score will reveal all of this to you. The basic DDRL equation has three segments, that tell you a great deal of information about your trading. View the equation as three columns, with each column giving you different information. See ***Table 1***.

The three segments of the equation are buy, sell, and leverage. Each phase of the trading decision can be analyzed based on your individual score and total score. Let's examine what each part of the equation can tell you. Please refer to *Table 1* as each segment is explained. This will help you understand better what buying, selling and leverage tell you. Let's examine how this could work for you.

BUY

When you make a decision to buy, you are selecting the direction or trend of a trading vehicle stock, index, ETF or commodity. You are taking a position, either long or short, based on your analysis of the direction. When analyzing your buy decision, you will be able to tell if you were correct or incorrect in your assumptions of the direction. The buy side of the equation also reveals the effectiveness of your individual screening selection. No matter which selection methodology you use — technical, fundamental, or both — the result is revealed when those individual vehicles make or lose money. If you have a large number of losses, examine your selection methodology.

You can be correct on the direction and selection and still lose money because your timing (entry) was wrong. When you buy, timing is of the utmost importance because you are trying to capture gains in the shortest amount of time possible. This limits risk and it makes little sense to tie up capital in a position that goes sideways or down. An examination of your timing or entry point can be very helpful. Again, if you have a large number of losses, timing might be a factor. If it is, reassess your entry criteria. As the old saying goes, "Timing is everything."

The amount of capital risked and how much should be risked in any single trade is critical to success. If you are using poor money management principles, your trading plan will not be successful. The buy side of the equation will reveal whether you are risking too much capital or not enough. The buy side reveals information on direction, selection screens, timing and money management.

SELL

The sell segment of the equation examines your self-discipline, trading psychology and risk management. If your score is a good one, it indicates that you are able to cut a loss quickly and you don't hold on to losing positions. It also indicates that you are able to take profits and move on to the next opportunity. By keeping your losses small relative to your trading account, you will greatly reduce the likelihood of a margin call. You should also consider the use of leverage. Your analysis may reveal that you are selling too soon. If this is the case, examine your stop placement strategy and risk-to-reward projections. In most cases it is better to sell too soon and take a profit than to hold out for the last dime only to have a large drawdown. Under no circumstances allow a profit to turn to a loss.

LEVERAGE

The leverage segment is a factor of both the buy and sell sides of the equation. The leverage side tells you just how good you actually are (competence level). This is a true reflection of your abilities, and one that can't be exaggerated, because it's based on your performance up to that point. If you don't achieve a score of +1, leverage is not justified. Ignoring your true abilities and using leverage when your skill doesn't indicate competency will result in disaster. A score of +1.2 to +2 means leverage is justified. A score of over +2.4 indicates margin, options and futures may be used as well. This part of the equation not only tells you your competency level but it also addresses the leverage justification.

As your skill improves, you can use more leverage. For this reason, you should use leverage on a sliding scale. If using margin, start with 20 - 30 percent of available buying power and increase it as your DDRL score, skill, trends and risk projections dictate. Also, remember that margin is more cost efficient than paying an option premium and margin has no time restriction—so use margin first as a choice of leverage. See ***Table 2***.

Once you start using DDRL it will go on through time as long as you trade. This brings up an important point about the score. Don't acknowledge the DDRL score until you have a minimum of 20 trades. This will reflect a more realistic picture of the score. When you begin, your scores will be artificially high. As the number of wins and losses take place the DDRL will fall into a tighter zone between one and four.

TABLE 1: Direction Discipline Risk Leverage Equation

Wins / Losses X	Total Average $ Gains / Total Average $ Losses	Gains / Losses = DDRL Score
BUY	**SELL**	**LEVERAGE**
Direction	Self-discipline	Competence
Selection and Screening	Risk Management	Leverage Factor
Timing		
Money Management		Under +1 no leverage or skill
		+1.2 to +1.4 Small Leverage
		+1.5 to +2.0 33-45 % Margin
		+2.4 to +4.0 Full Leverage
		Margin, Option, Futures

Source: Robert Deel

TABLE 2: DDRL Leverage Score

0 to 1	= 0 leverage and skill
+ 1.2 to +1.4	= 20 – 30 % of available Leverage margin
+ 1.5 to +2.0	= 33- 45 % of available Leverage margin
+ 2.4 to +4.0	= Full leverage Margin, Options, Futures

Risk and money management should be scalable based on your skill level. The DDRL Equation helps you identify your problem area. Is it on the buy, sell, or leverage?

Source: Robert Deel

PUTTING IT INTO ACTION

Let's take a look at how to use the DDRL equation in the following example:

1. Trader X has 10 wins and 6 losses.
2. Trader X average dollar gain was $900.
3. Trader X average dollar loss was $400.
4. Trader X gains were $9,000.
5. Trader X losses were $2,400.

Plugging these figures into the equation gives us the following:

10 Wins	x	$900 Average Gain	$9,000 Gain	= 3.75 DDRL SCORE
6 Losses	x	$400 Average Loss	$2,400 Losses	

In most cases an excellent DDRL score will be from +2 to +2.5. A score greater than +2.5 reveals a high degree of skill. Over time a score greater than 3.00 will be a rare occurrence. You should strive to achieve a score of at least +1.4 to +2.0

RUN THE NUMBERS MONTHLY

Run a DDRL score every month. This will give you a better picture of your performance over time and under different market conditions. Everyone can have one or two good or bad months. By taking an average of your score you have a more precise idea of your true ability under real market conditions and psychological stress. What you find may be very interesting and useful to you.

THE BOTTOM LINE

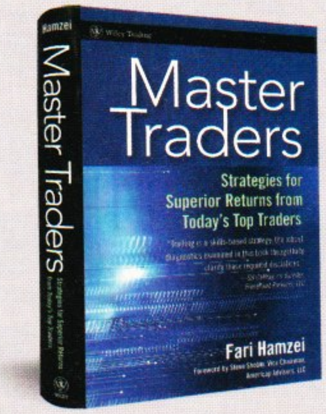
Wins and Losses: If the ratio is unfavorable and the number of losses becomes even with or greater than the number of wins, begin your search for the problem on the buy side. Remember, the buy segment of the equation will give you information about direction, selection and screening, timing, and money management. For example, you might discover you are placing too much capital in the trade and your direction and timing are off.

Average Dollar Gains and Average Dollar Loss: This segment of the equation identifies problems in self-discipline, risk management and trading psychology. The sell side identifies things such as the inability to cut a loss or holding on to a losing trade too long. Average dollar losses have a dramatic effect on average dollar gains.

Gains and Losses: This segment of the equation identifies your competence level, how good you really are, and the degree of leverage justification. In other words, it tells you how much leverage you can use based on your true skill and ability by giving you a DDRL score. Ultimately, risk and money management benefit from applying the application of the DDRL equation and answering the questions it causes the trader to ask. ■

Robert Deel is an author, trading strategist and CEO of www.tradingschool.com. His school trains traders and money managers from all over the world. Deel created the DDRL Equation© and has used it for over 20 years. For more information visit www.tradingschool.com.

Book
REVIEW



MASTER TRADERS STRATEGIES FOR SUPERIOR RETURNS FROM TODAY'S TOP TRADERS
BY: Fari Hamzei
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BUY THIS BOOK FOR $64.95 ON SFOMAG.COM

There's little substitute for the experience, fruitful and painful, that comes from rolling up your sleeves and just trading.

Any book that promises advice from the masters — whether discussing golf, bridge, Zen philosophy, or trading — summons high expectations from readers. Or, at least, it should. In *Master Traders*, a range of veteran voices, timely but classic investing topics, and an in-the-trenches perspective bring to readers decades of market experience and know-how that would be difficult for even seasoned investors to achieve over a lifetime. Here, it's in a rather compact 300 pages.

Fari Hamzei, a nationally ranked market timer and analyst, has assembled 14 masters, including himself. Each chapter is credited to a different author, and hedge fund managers and technicians share pages with investment advisers, floor traders and newsletter editors.

Master Traders offers a humble introduction, conceding, for starters, that there are scores of successful and revered market players who won't be found in its pages. Proven success, wealth, and recognition from their peers and the financial media earn its contributors the subjective label "master," at least for the purposes of this compilation.

But perhaps most important, its authors are careful to bow ever slightly to the true master – the markets themselves. As hedge fund veteran Greg Collins writes in the introduction: "None of them claims to have figured out the stock market in its entirety. What they have managed to find is a system that works for them."

"For some, mastery is less about conquering the most complex technical aspects of trading and more about taking control of the human elements — the emotional side of trading, unavoidable no matter how sophisticated the methodology used. Much of what leads to trading mastery can't be taught in a how-to book," says Collins. "Setting realistic goals, finding humility, effectively using focus and the ability to think for yourself with a need to sometimes scrap a viewpoint and adapt to changes."

Thus, mastery here isn't broad. Where the book covers much ground with relatively little ink is in each contributor's success with a specific area of investing or a particular technique, and their willingness to share some of those secrets.

In his chapter, Hamzei reveals what he considers the "Secret Messages of Equity and Options Markets." He uses real-time put/call ratios to get ahead of the herd and calculates the best point of entry and profit target with his own twist on support, pivot and resistance levels.

With its range of approaches, *Master Traders* can be read cover-to-cover or browsed through by topic. Global examples and domestic markets are both covered. The book offers commentary relevant to both novice and experienced investors. Where appropriate, the book is brimming with charts and mathematical equations to support its theories.

Readers are privy to a view of stock, futures and options markets through a wide-angled lens; one chapter, for instance, is dedicated to options market volatility, another to the blend of technical and fundamental analysis. Readers also get a microscopic view; one author covers seasonality, a middle chapter is divided neatly into five rules and three themes for biotech investing, with an emphasis on second-tier industry players.

There's little substitute for the experience, fruitful and painful, that comes from rolling up your sleeves and just trading. Many may be satisfied just to turn a profit, but it takes finely honed skills on top of tested theories, good instincts, and typically, plenty of experience, to join the ranks of the masters. That's an achievement that many, perhaps even most of the contributors to this book, would argue is never fully realized. What a privilege to join them in their pursuit.

Book review by Rachel Koning Beals