Money Management Techniques

Aspiring traders, after getting frustrated with wasting time and money, typically go through a process of realizing the need for money management, apart from controlling risk.

If you risk too little on each trade, the returns will be too low to overcome transaction costs: small losses and trading will lead to a loss of capital.

Risk more and the returns will increase, but also the potential Drawdown.

Money management is like a thermostat — a control system for risk that keeps your trading within the comfort zone. It is about scaling up or down your position size - by adding and reducing position size to the trades. If you do it based on the account equity or balance, the aim is always to maximize a run-up in equity and reduce the effects of a Drawdown.

Before we further explore the power of money management, it is important to clarify that not just any money management should be applied to trading, but a proper money management. Some of the money management methods outlined in this chapter address the growth potential while others address the risk - so **it's important to adopt a technique accordingly to the trading system you use.**

Pyramiding (Averaging Up)

Pyramiding means when you increase the size of an already winning position. You may add for instance one lot each time a position moves favorably by a certain number of pips. Depending on if you calculate your sizes based on the Total Equity, you may be using unrealized profits to add to the position, meaning each add-on will have a higher size.

It can be considered a money management formula or just a technique, depending if its rules are based on the available capital or simply on the market conditions. Usually, when the available capital (account balance or equity) are taken into account, we speak of a money management model.

Pros:

- **This strategy is meant to exploit trends and to increase profitability.** You have to have enough trading capital to go through a series of averaging ups, and by doing so you can stay in the market longer riding whipsaws.
- Averaging up can work wonders for a trading portfolio when done properly. The goal in trading is to enhance the profit factor having small losers and gigantic winners. By being able to successfully average up, you have more equity derived from the winning trades to add to your overall position. Therefore, the math is in your favor that the winners will naturally be substantially larger than the losers.
- In the case of a random process - such as coin tosses - strings of heads or tails do occur, since it would be quite improbable to have a regular alternation of heads and tails. There is, however, no way to exploit this phenomenon which is random in itself. But in non-random like processes, such as trends in market prices, pyramiding and other trend-trading techniques may be effective.

Cons:

- Life is grand as long as a position continues to increase in value. But as it is very difficult to identify the point at which you should add to your position, if you do it and the price falls back, you may move from a total winning position to one of a loss.

Imagine you have added to a winning trade and the price retraces 50% - half way to your entry point. If both trades have the same size, you are now break-even. But if you had not added to the position, you would still be up in profit. This is where averaging up gets tricky.

- While this technique might be useful as a way for a trader to pyramid up to his/her optimal position, pyramiding on top of an already-optimal position is to invite the disasters of over-trading.

A safer way to average up is to stack many smaller position additions over time, this will make a pull back of a few points more tolerable.

You can also set different sizes for each pyramid layer- starting by using a bigger size and ending with smaller sizes- different from using always the same size. This way, if price reverses at the 2nd or 3rd position you can sustain a positive overall position despite of as 50% retracement.

By stacking trades in a veritable pyramid -since the lower layer have a bigger size, as in a real pyramidal architecture -even a sharp retracement back would not knock you out of the game.

Averaging Down (Cost Averaging)

It's sometimes popularly called "throwing good money after bad". As the name suggests, it's the inverse method of averaging up and it consists of increasing the size of the position when it is in negative territory.

Again, its more of a technique than a model as market conditions determine whether it's viable or not.

A variant of this technique, called “Dollar Cost Averaging” or “Constant Dollar Plan”, simply refers to a systematic investment method, in which the investor continuously buys a fixed amount of a certain financial instrument. As a matter of fact, many mutual fund managers use this technique exclusively and don't even look at charts!

The basic idea of these averaging techniques is to profit from long-term performances of certain markets irrespective of short-term market ups and downs.

In practical terms, Cost Averaging would mean to enter long positions periodically spending the same amount of money in each one. As the pip value changes depending on the exchange rate (see Chapter A03), the constant dollar value may result in a slightly different position size.

More currency units are bought when the value of the purchased currency is relatively low, and fewer units are bought when its relative value is high. The whole purpose is that once the positions are liquidated, and you have your positionsconverted to your account currency, there is a profit in the account balance.

Pros:

- The raging nature of the currency markets may also be exploited using the Averaging Down technique, reducing the losses by riding the retracement waves.
- One of the advantages of the Dollar Cost Averaging variant is the independence of market timings other than the closing of the positions. In general, these strategies protect you from market up and downs. You'll end up buying more quantity of a currency when its relative value is low and less quantity when its value is at a peak. This means that if the average cost is less than the average price, you will be in a good position to get a good return.

Cons:

- An under capitalized or an over leveraged trader may be unable to do this during an equity Drawdown, even in cases where it might be preferable from a system performance perspective to increase the position size as prices move away from the entry point. In this situation the trader would be unable to derive the potential benefits of the strategy.
- **This technique can also get a little tricky because it is somewhat of an art to determine at what levels to enter the market.** This is precisely why it is imperative to have stringent risk control guidelines. Since it is a technique more common to stock markets, when trading currencies it gets more complicated because you have to take into account not only the exchange rate of the pair being hold but also the account currency.
- This technique does not ensure good profits when the market trends strong against the direction of the position. In those cases, using a traditional stop loss when you're applying Cost Averaging is counter intuitive, because it defeats the entire purpose. Nevertheless, positions have to be monitored by measuring equity Drawdowns.

Suppose you entered a long position worth 1000 USD on the EUR/NZD on the 22/May/2008 at 2,0000 and another one at the 19/Nov/2209 at the same exchange rate, but the EUR/USD was traded at 1,5750 in the first entry and at 1,4900 at the second, would you have made a profit in US Dollars if the trade closed at the 19/Nov/2009 with the EUR/NZD at 1,0400 and the EUR/USD at 1,4850?