Risk Management & Position Sizing

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All Materials presented are for training purposes only. Traders should paper trade any new method prior to risk of personal capital.

Risk Management & Position Sizing

Risk Management and Position Sizing is a critical part of every solid trading system!

1. Establishes protective rules before taking any action to trade—no second guessing

2. Risk Management is our insurance policy—Capital to trade another day

3. It makes up part of Pillars 3 & 5 (When to get out & What to Expect)

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The basics

1. Define your trading capital
2. Define how you will divide your trading capital
3. Define how much you will risk on each trade or position
4. Stick with what you've decided

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Guidelines

1. Beginning Account will usually allocate more to trading

2. You decide how to divide your capital. Approx. IBD's guidelines:
   - $1 Mil or more: 5-7 positions
   - $100K: 4-5 positions
   - $20K: 2-4 positions
   - $10K: 2 positions

3. Define how much of your trading capital to risk on every trade. Some use 1% and some use 2%

4. Establish a Reward/Risk Number (2 or 3 is typical—I will risk $1 to make $2 or $3)

5. Let these decisions determine how to buy

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Example - $1 Mil or more

1. Do you really want to actively trade 100% of your capital

2. Specify an amount like 10% - 50%
   - Once defined: Find a longer term trading entity for the balance

3. Split the trading funds into 5-7 equal amounts

4. Use a formula on every trade to determine number of shares & exact stops

The next Example will use $100K to demonstrate the formula

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Example - $100K

1. Trade up to 5 entities: $20K per position
2. Max Loss = 7% = $1400 per trade or 1.4% of trading capital
3. Trade Size: (Per Trade Capital)/ Price of Stock then round
4. Stop Loss Level: Entry Price - (Max Loss / Number of shares)

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Example - $100K -- Stock XXX Price $60

1. Trade Size: $20000/$60 = 333.33 (round to 300* or 330 shares)

2. Max Stop Loss: $60 – ($1400/300) = $60 – $4.67 = $55.33

3. Now with the stop loss level established go to the chart

   - Where is support?
   - Is support below or above the stop?
   - What would you do if support was at $55.10?
   - What would you do if support was at $57.50?

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Example - $10K -- Stock XXX Price $60

1. Trade Size: $5000/$60 = 83.33 (round to 80 shares)

2. Max Stop Loss: $60 – ($350/80) = $60 – $4.38 = $55.62
   - This would be a 7% loss which if hit would equal a 3.5% loss of capital is this too much?

3. Now with the stop loss level established go to the chart

   - Where is support?
   - Is support below or above the stop?
   - What would you do if support was at $55.10?
   - What would you do if support was at $57.50?

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Options:

1. A similar formula can be used for trading options, but it is a bit more complex

2. As a rule of thumb I do my calculation to determine the number of shares I would buy and then see what that equates to in an ATM option with a delta of approximately 0.5

3. I then use a 30% stop loss and this keeps me close to what a stop on the stock would have been (APPROXIMATELY)

4. I use 30% & 50% as my initial profit targets

I will put together either a Mid-Week Training or Training Video on Options in the near future.

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