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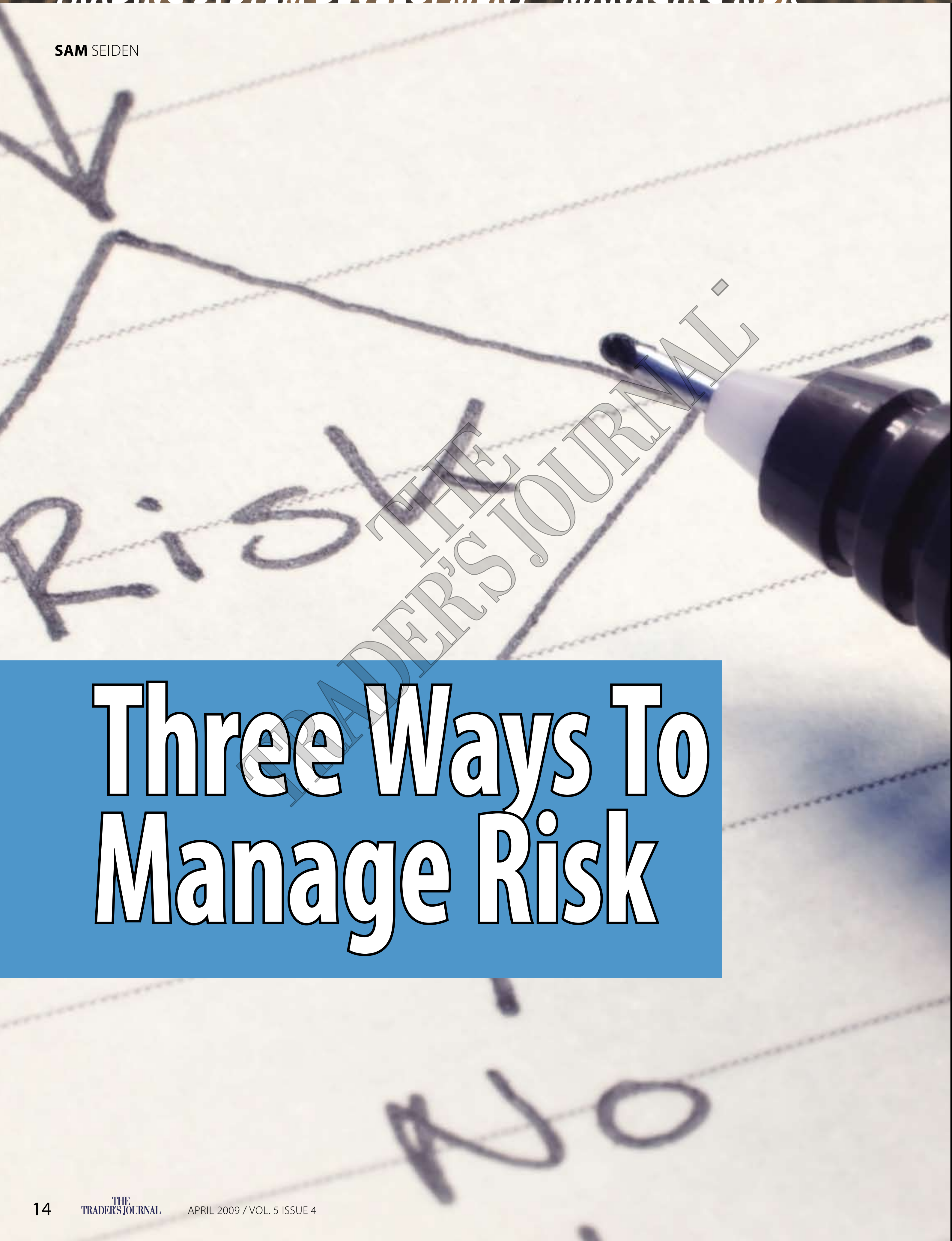

Three Ways To Manage Risk

One certainty in trading is that losses will occur. Sam Seiden looks at effective ways to manage the risk in trading to enjoy a long and successful career.

One thing that is certain in anyone's trading career is losses. Even the best traders lose money from time to time. However, what the best traders have in common is that they are very professional losers. Knowing how to lose properly is a must in a long and prosperous trading career. The first thing to

Figure 1

know is the proper use of protective stop orders, the second is proper position sizing and the last, but maybe most important tool, is to keep losses small.

Protective Stop Orders

Protective stop orders to a trader are as important as the oxygen tank is to the astronaut in outer space. Without them and their proper use, you are in big trouble. Protective stop orders in trading are meant to help limit your potential losses. There is more than one type of protective stop order and it is very important that you understand the difference between them.

Stop Market Orders – This is an order to buy or sell once price touches a particular point. Once price touches a pre-defined price, the order becomes a market order. This type of order can be used to enter or exit positions. Typically, this type of order is used for protection. While execution of this order is typically guaranteed, the price of the order execution is not guaranteed because the order being triggered is a market order. The benefit is that if price touches your stop price, the market order will take you out of the position. The negative is that if the market is moving fast, you may see some slippage and not get filled at your order price. This certainly is the ideal order however if your goal is to protect yourself. As a trader, I always use this type of order for protection.

Stop Limit Orders – This type of order combines the features of a stop order with the features of a limit order. Once a pre-defined stop price is reached, the stop limit order becomes a limit order to buy or sell at the limit price or better. The benefit of this type

Figure 2

of order is that the trader has control over the price the order will be executed at because it is "limited" to the stop price. The negative factor with this type of order is that it does not in any way provide guaranteed protection, which is what most traders/investors want in a stop order. For example, if you bought a stock at $41 and have a sell stop limit at $40.50 and price reached $40.50 but there are no buyers, the price will keep declining and your loss will grow with no protection. In short, if you are looking for more guaranteed protection, the stop market order is a much better choice. As a trader, I NEVER use a stop limit order for protection.

Where to place protective stop orders?

Figure 1 shows a shorting opportunity that we identified in the hourly S&P chart. On this day, the market opened and rallied to our pre-determined supply (resistance) level where it was sold short. To protect the short position if we are wrong, we use a "buy stop market" order. The initial protective buy stop order was placed just above the black resistance (supply) line. The purple line is exactly where the buy stop market order should be placed. We place the stop at that price because it is just above where all the sellers are according to the chart. We know this is where all the sellers are because price could not go to that level, there was too much supply. This was our "initial" buy stop.

Figure 2 shows the 10-minute timeframe chart of our S&P short trade. We go to the smaller timeframe to identify where to place our "trailing stop." A trailing stop is simply the act of moving a buy stop down with

Figure 3

price during a short position or moving a sell stop up with price during a long position. The benefit of a trailing stop is to capture the majority of an intended move in price so as to not "give back" profits.

While there are a number of different types of trailing stops, I will focus on one of the more objective ways we handle trailing stops. As price is falling and we are in our short position, we want to bring our protective buy stop down as price falls to protect our profit. The circled candles on the chart represent strong declines in price. Once price declines from a price level, the origin of that decline becomes new resistance (supply).

Therefore, we can move our buy stop down to just above the new resistance area. We are protecting our short position with these new resistance levels. If the market is in fact weak, price should not rally above these resistance levels and should continue to decline, which is what we want for our short position. The circled candles drop as they do because supply is greater than demand at the origin of the decline. This again is one of the more objective ways we use real time supply and demand analysis to trail stop our positions.

Position Sizing

Proper position sizing is another key component to managing risk properly. In Figure 3, we show a pivot low support (demand) level and then a decline in price to that level for a low risk buying opportunity. If we buy at the top of the support zone and place our protective sell stop below the support zone, we can do some simple math to ensure we are not going to lose more money than we are comfortable losing by using proper position size.

In this example, let's assume that we have a $100,000 account and decide that our maximum risk is going to be 1% of the account ($1,000). If this trading opportunity requires a $0.40 stop and we do the math, we see that we can buy 2,500 shares. This means that if the trade does not work out, we will only lose the amount of money we are comfortable losing, the $1,000. Having a position-sizing grid like the one you see here when trading any asset class also helps your trading become more mechanical. The key is that you do not want to be "thinking" much when the markets are moving. You simply want to follow a logical rule-based plan based at its core on the laws of supply and demand.

Keeping Losses Small

Knowing how to minimize risk is the most important element of trading. There are really only four possible outcomes for a trade or investment – a big win, a small win, a small loss or a big loss. As long as we ELIMINATE the big loss, we can live very comfortably with the other three. Let me share an email from one of my members with you. He is somewhat new to trading and the education path. In the last two months, he has only had profitable trades about 30% of the time. The other 70% of the trades were losing trades.

However, by keeping the losses small and holding on to the profitable trades to the pre-planned targets, his account is up around 50% in the first two months of this year. While we will certainly work with him to increase his winning percentage, his results are fine with the winning percentage he has now. The key for him is following the risk management rules we focus on.

Sent: Friday, March 20, 2009 6:57 AM

To: Sam Seiden

Subject: Re: Futures

Sam,

I wanted to share some stats with you. This is since the beginning of the year. Roth IRA Performance

Stat	Value
Ticks	952
Profit	$13,185.73
Wins	7
Losses	17
Avg. Win	$2,528.29
Avg. Loss	($265.43)
Biggest Winner	$4,369.30
Biggest Loser	-$925.50
Win %	29.17%
P / L Ratio	9.53
Max % Risk	2%
Max $ Risk	$827.35
Start Capital:	$28,182.00
End Capital:	$41,367.73
Net Gain %:	46.79%

As humans, we always want to be right and we hate being wrong. You cannot think this way in the world of trading and investing because the truth is, you will have losses. Embrace those losses as a part of your trading and keep them small. I have losing trades sometimes, but I really do not care. On the emotional side of trading, I do not feel any different about a winning trade or a losing trade. Perhaps the fact that I have been doing this so long is a factor but the reality is, I am simply executing a profitable plan over and over and over. The casinos in Las Vegas sustain huge losses every day but they do not care. In fact, they are perfectly comfortable with them because they know the losses are small compared to the winners and this is all just a part of a very profitable plan that does not allow for big losses.

Sam Seiden brings over 15 years experience of equities, Forex, options, and futures trading that began when he was on the floor of the Chicago Mercantile Exchange. He has traded equities, futures, interest rate markets, Forex, options, and commodities for his personal interests for years and has educated hundreds of traders and investors through seminars and daily advisory services both domestically and internationally. Sam has been involved in the markets since 1991 both on and off the floor of the Chicago Mercantile Exchange. He has served as the Director of Technical Research for two trading firms and regularly contributes articles to industry publications. Sam is known for his trading, technical research, and educational guidance.