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Does Size Matter?

Futures trading attracts people thinking it will be easy to turn a small account into a large account. Reality is quite different – this is very difficult. Don Dawson discusses the traps of trading a small account and how to successfully trade a small account.

One of the big attractions to futures trading for many people is the low start-up cost involved in funding their accounts to day trade. Unlike equities, where you have to come up with about $30K to open a day trading account, you can open a futures account with about $5K and control futures contracts worth hundreds of thousands of dollars.

Many futures brokers will let you day trade with margins, good faith money you deposit per contract to trade, for as little as $500. This also attracts people to these markets thinking that it will be easy to turn their small accounts into very large accounts almost overnight. They look at the day trading margin of $500 per contract and figure out the maximum number of contracts they can trade with their $5K account. Almost immediately, they are over-leveraged and lose all or in some cases more than their initial $5K deposit. Very few people survive when they start with this type of account and these dreams.

Trading a small account requires extreme discipline and risk management to guard against unexpected and large losses. Simply put, there is no cushion for big mistakes at this level.

Another drawback to a small account is that you are limited to the type of trading strategy you can use and the number of contracts you can trade, unlike a larger account without these restrictions. For example, if you wanted to buy three contracts and scale out of them, and take profits at different levels as the price moved your way, you would be restricted in doing this with a small account.

The most important part of trading a small account is the added psychological stress that is endured. As if trading is not mentally challenging enough, try trading with a small account knowing you "have" to win just so you can trade again after a few inevitable small losses. Once most traders get to this level, their mindset is that they will just try and take a tick or two out of the market to build their account back up.

First off, this is not part of their usual trading plan and they are trading by the seat of their pants trying to get their money back. In this situation, most traders will have upside down risk/reward ratios trying to accomplish this task. Their target is 1 or 2 ticks but they are letting losses run for 6 or 7 ticks against them because now their ego will not let them take a loss, but the ego will be the first voice you hear when you have that small profit saying, "Get out now, it's a profit. You can't go broke taking a profit," etc. The ego has many voices that can play in your head and they are usually all wrong. If you are lucky and string a handful of these 1 or 2 tick profits together, you start feeling pretty good about yourself. Then, that one trade comes and a whole week's worth of profit is gone with one trade because of the upside down risk/reward you are trading with.

Obviously, we would all like to have unlimited funds to trade with. Unfortunately for most of us, we have a finite amount of funds we can trade before we have to stop trading if it is lost. Then the real challenge comes when we have to go get a "JOB" to replenish our account if we desire to continue trading at a later date. Let's discuss some ways of helping you build your small account and not lose all your money too fast.

While teaching classes, I try to tell students that a good, general rule of thumb for trading futures is one contract for every $10k in your account. Now, I know some of you are saying that is too much money and not enough contracts. If you treat your trading like a business, and I hope you are, then you should try to think of what other business you could possibly start for less than $10K and be successful?

Once you have been trading and your account has increased to say $19K or more, start trading 2 contracts if you are comfortable with that. Let's say you have that $5K account and the day trading margin is $500 per contract – that does not mean you have to trade 10 contracts. Only increase trading size when mentally and financially ready to do so. Some of the best traders trade with small contract size because they have tried to increase their position size but their minds are only comfortable with so much risk.

You will find out one day the maximum contract size that your mind can handle. Remember, the brain is a muscle and just like you are lifting weights at the gym, you must gradually increase the weight (risk) so the muscle will adapt to this change and not become injured. Keep in mind that professional traders do not make their living hitting home runs. If you ask any one of them, you will find they have been doing this for a long period of time and have ground out slow consistent profits to make it as a professional trader.

Money management with any account size cannot be emphasized enough, much less a small account. Here are a couple of ideas to help you with this area of trading:

- Maximum dollar loss for the day
- No more than 1-2% of account size should be risked on any one trade

In my trading plan and taped to one of my monitors is my maximum dollar loss I will allow per day before I will halt trading and leave the office. This rule has saved me so many times and has allowed me to continue trading for almost 22 years. To be honest, I did not implement this part of my plan until about 11 years ago. I can tell the difference in my equity swings now that I have this "written" in my plan.

I used to trade in the mornings and if I lost a good chunk of change, I would get upset and tell myself I would make it all back after lunch that day. Nine times out of ten, if I lost $2,500 in the morning and came back after lunch or tried to trade through lunch (lunch trading after a large morning loss is revenge trading at its worst, at this point you have not left your screen and cleared your head yet), I would end up losing even more in the afternoon. I am too embarrassed to tell you how much was lost at times. By the way, have I told you that I am not perfect? I am a human and make mistakes, too. The difference is learning from the mistakes and being able to reduce the losses the next time they happen. This is not a business for a perfectionist; you will never make it in trading if you continue trying to be perfect.

By setting a fixed dollar or percentage of your account (small accounts, I would not risk more than 2-3% per day) as a maximum loss for the day, you will be around for a long time trading.

Here are just a few reasons why the maximum loss rule could save you some money and possibly your account:

1. Your losses may be attributable to a mental state you are in that day. Odds are good that if you were not clear headed in the morning, then the afternoon will not be much better.
2. Your strategy may not be conducive to the markets that particular day, if you are a trend follower and the markets are in a trading range, for example.

After establishing this maximum loss for the day, an added safeguard could be to call your broker and ask him to shutdown your platform after you have hit your maximum loss for the day. Perhaps put yourself on a simulator, if possible, but no real time trading for the rest of the day. I have found it much more beneficial to actually leave the office than to just sit there and watch the screens the rest of the day. By staying at your screen, you are only going to get more upset with yourself and end up carrying the negative thoughts into the next trading day. Just accept your maximum loss and walk away understanding that this is part of the trading business. You will be surprised how quickly you can recover your maximum loss another day rather than trying to recover a possible week's loss from one day.

Keep in mind that trading is a probability business. Make sure you do not lose more than 1% or 2% of your account on any one trade, especially when you are starting out. By using these percentages, you would have to be wrong approximately 50 to 100 times in a row to wipe out your account. With each trade, you will learn something that can help you in the future. That is the advantage of using this type of risk management; it allows you to be around to enjoy trading after you have learned a few things that will help you be profitable. The goal is to keep your money long enough to enjoy trading after you have had some screen time and learned more about making profits in the markets.

Even if this 2% - 3% per day loss allows you to only have two trades, so be it. Until you have capital in your account, this should act as your circuit breaker to protect you from the dangers of self-destruction.

Here is an advantage of having a small account. When traders first start out, they are very methodical and careful to do their homework before each trade. They patiently sit and wait for their setups, then pounce on the opportunity when it arrives. After a few trades, they have some extra money in their accounts and start getting careless. They do less market study, the trades seem to take too long to appear so they force trades that are not there, they think because they won three times in a row that they are now qualified to trade multiple contacts and then they get bit by Mr. Leverage or they start tweaking their strategy trying to make more money faster – all of this because their account size has grown a little.

Do not feel bad if this is you or you have done this; trust me, we all have. As you trade for a while and your account does start to grow, figure out how much you actually need in your account to trade the size and volume you are comfortable with. Then each month, take out any money you have that is over that amount and put it somewhere safe and accessible. This way, you will not start getting sloppy with your trade selection because you have "extra" cash in your account. This happens more than you know in the trading world. With smaller accounts, we are much more selective with our orders and are willing to wait for the high probability setups.

One point on setting daily profit goals – be careful not to have a maximum dollar loss of $750 with a profit objective for the day of only $200. Think about this in terms of risk/reward.

Trading small accounts can be done with the right risk management and discipline. Remember, even the biggest fish in the sea were once small. Small accounts can be more difficult to trade successfully, but it can be done. You have to be on top of your psychological game, too. Even with small accounts, we do not trade for the money but what the markets are telling us. Do not focus on growing your account, just follow your trading plan and the profits will follow.

Good luck with your trading and I leave you with this thought when things become a challenge:

"Today I will do what others won't, so tomorrow I can accomplish what others can't."

Don Dawson is the Online Trading Academy Commodity Futures Instructor.