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The 10 Commandments of Risk Management for Traders

There are few maxims in trading held at all times and for all traders, but at least one concept will always be relevant to every trader. That concept is risk management. From a seasoned veteran to a brand-new beginner, every trader needs to know about and practice risk management if they don't want to see their trading account get vaporized. The concept of risk management can be broken into smaller parts, and we want to do that today. Essentially, we want to help any trader walk away with a better understanding of what risk management is, why they need to apply it to their trading, and how it can transform their trading philosophy and skills.

01

Only Trade Money You Can Afford to Lose

It is very tempting for new traders to dive into the world of trading as soon as they hear about it. They may expect that they can outthink the market and make profits no matter what. It is a great fallacy that many traders allow themselves to fall victim to. Sadly, when traders get out too far ahead of themselves and start trading with money that they cannot honestly afford to lose, things can get terrible quickly. The problem is that when someone trades with money they cannot afford to lose, their trading psychology changes. They become highly worried about losing money, and they don't make wise trading choices.

People who trade money they cannot afford to lose often end up thinking about trading like gambling. They feel a huge surge of happiness when they win some wagers, but that happiness turns to anger and frustration when things turn against them. The swings in one's psychology can really impact how they trade in general, and things can get terrible for them in a hurry. Thus, it is necessary to consider all of the implications of your choices when you choose to trade beyond your means.

02

Always Use Stop-Loss and Limit Orders

When you place an order as a trader, you send the broker instructions to place a trade on your behalf. They will follow instructions and attempt to place the order at the best possible price, but you might not get the price you see quoted or even the price that you genuinely want if you don't set the order up as a stop-loss or limit order.

What stop-loss and limit orders do for you is set pre-defined limits for how much you will gain or lose on a particular trade. You want to set these up before you place the order, so you don't change your mind in the middle of the trade. If a trade made sense at a certain price when you were thinking about it with a level head, then it shouldn't change as the price movement comes into play. You will be much happier with your results if you stick to a pre-defined system that doesn't deviate as the markets move around. Remember, there are a lot of bad things that can happen if you start to try to outguess the market.

03

Avoid Break-Even Stops and Fixed Stop Distances

Break-even stops and fixed stop distances seem like good trades to place on paper, but that is rarely the case. A moving stop-loss order will shake you out of a trade more often than it will create the conditions for a winning trade. Thus, they should be avoided as much as possible. You are simply taking on too much risk with too little reward when you place this type of order. Tradeceity.com explains why many traders get taken out by the pros when they try to place these break-even stops:

Moving the stop loss to the point of the entry and so creating a "no risk" trade is a very dangerous and often unprofitable maneuver. Whereas it's good and advisable to protect your position, the break-even strategy often leads to a variety of problems.

Especially if you are trading based on common technical analysis (support/resistance, chart patterns, highs and lows, or moving averages), your point of entry is usually very obvious, and many traders will have a very similar entry. Of course, the pros know that, and you can often see that price retraces back and squeezes the amateurs at the very obvious price levels, just before price then turns back into the original direction.

The world of trading can be cruel, and people will take advantage if they see that there is easy money just waiting to be plucked. Don't make your money the easy money that they come after!

Additionally, you do not want to use fixed stop distances in your trading either. Fixed stop distances take away the critical thinking that is such a vital part of trading. They promise to simplify trading, but what they really do is take a lot of the dynamic elements out of it. You are making assumptions about the market that are less than likely to pan out, and you are doing it all in a very simplistic manner. Do not allow yourself to get sucked into thinking that fixed stops are the way to go. You are likely only costing yourself in terms of how powerful your trading really could be.

04

Setting Your Risk-Reward Ratio

It is reasonable and a good idea to set up a risk to reward ratio for each trade that you enter. Knowing ahead of time how much you stand to gain versus how much you stand to lose is something that could serve you very well when you start trading more frequently.

A risk/reward ratio of at least 1:2 is recommended for all trades. This means that you stand to gain two dollars for every dollar you put at risk. This two-to-one payout is ideal because you want to make sure your winners more than take care of your losing trades. Some people hike their risk/reward ratio even higher to make sure they gain as much as possible when they trade correctly. Even at a 1:2 ratio you would only need to be right 33.33% of the time to theoretically break even. That is a nice place to be as a trader. You can be wrong more often than you are right and still come out on top if you just get your trading ratios lined up properly.

Focus on your win rate and how often you believe is reasonable for you to be on the winning side of trades. If you feel that your rate is lower than you would like, then you might want to set up a risk/reward ratio that allows you to win at a lower rate and still come out ahead. Just be prepared for the fact that doing so means that fewer of your trades will turn up as winners. You need to be prepared to embrace the harsh reality of this from a psychological point of view. You cannot afford to get too down about losing many trades in a row if you set them up this way.

05

Always Compare Win-Rate and Risk-Reward Together

Diving a little deeper into your win-rate and the reward:risk ratio that you have set up, you should try to think about the two factors together. They go together because your win rate and the amount of risk versus reward that you set up with each trade will ultimately determine if you are a profitable trader or not.

Breaking this down into some examples may prove useful.

Trader A

- Trader A sets up a risk/reward ratio of 1:2
- Trader A has a win rate of 40% over 100 trades
- Trader A risks $100 per trade
- Trader A profits $2,000 over the course of those trades ($8,000 in winning trades minus $6,000 in losing trades)

Trader B

- Trader B sets up a risk/reward ratio of 1:3
- Trader B has a win rate of 20% over 100 trades
- Trader B risks $100 per trade
- Trader B loses $2,000 over the course of those trades ($6,000 in winning trades minus $8,000 in losing trades

The win rate made all the difference in this example. Trader B scores bigger winners when his trades are correct, but he suffered more losses overall because his win rate was lower. It is a danger that can happen to anyone. If you find yourself on the end of a losing streak, you might give up trading entirely, and that is the ultimate negative outcome that could occur. Be mindful of risk/reward and win rates and how they interact with one another.

06

How to Do Position Sizing Like a Pro

Getting position sizing just right is a little tricky. It will probably be something that you spend the most time on as far as the learning curve for trading goes. It would help if you focused a lot of time and energy on it because sizing your trades the right way is the only chance you have of continuing to show profits into the future. You don't want to get in too heavy on trades that don't provide a lot of rewards, and you certainly don't want to risk too little when you do have something worth making some money on.

A mistake that many traders make is keeping all their positions exactly the same size. That is to say that they choose to always risk between one and three percent of their bankroll on a given trade. It might seem smart to do so at first blush, but there is a good chance that traders who do this are missing out on some of the best money-making opportunities out there. The problem with keeping the size of every trade the same is that not every trade is truly identical. There are some opportunities that really are much more appealing than others.

The ideal setup for how you risk your bankroll on given trades looks like this:

- **High win rate/low volatility:** Large position
- **Low win rate/average volatility:** Moderate position
- **High win rate/high volatility:** Moderate position
- **Low win rate/high volatility:** Small position

You simply cannot afford to push it all in on outcomes that are either low win rates or have a lot of volatility attached to them. You are going to lose too many of those trades to make it worth your while, and you just don't want to put yourself in that position. Instead, try to even out your position sizing based on your likelihood of winning.

07

Using the Risk-Reward Ratio and R-Multiple Together

You can look at reward/risk ratios all day long and still not know how you ought to trade because you are not also looking at the performance of your trades. If you consider the outcome of various trades that you have made, then it is a little easier to see how you should position your next move. In other words, you ought to use the R-multiple to figure out where you need to deploy the majority of your positions in the future.

In other words, you are looking both at how you have set up trades in the past and also how those trades have ultimately panned out. This helps you to incorporate real-world data into your calculations for the future. After all, you need to know how you did in the past if you are ever going to figure out how to position yourself for the future. This is the best way to face the reality of the trades that you have made and how they actually panned out. You need to take this seriously, and you need to make sure you give proper attention to the real outcomes instead of just how you hoped things would turn out.

08

Control Your Risk per Trade and Keep Your Risk Consistent

Managing risks is just as important as looking for profitable trades. After all, a penny saved is a penny earned, and risks are such a big part of trading. You need to control the amount you risk per trade, and you need to keep that risk consistent. It doesn't matter if you have a good feeling about the trade, you are about to enter or if you are "just sure it is going to be a winner", you need to keep everything on a stable and steady course if you want to be profitable.

Mytradingskills.com explains that controlling your risks is a great way to produce steady and stable outcomes:

You also need to consider your risk per trade as a percentage of your trading capital and set it at a conservative level, this is especially important when you're new to trading and are likely to make more mistakes than someone with experience.

You should only risk a small portion of your trading capital per trade: a good starting point would be to not risk more than 1% of your available capital per trade. If you're applying sound RRR then that means risking 1% to potentially return 3%.

As mentioned above, there will be some variation to how much you risk on a trade based on its likelihood of success, but that risk should still remain within the confines of a steady number (such as 1%). You can control the swings in your portfolio much better if you are only putting a certain amount at stake with any given trade. Thus, you should always try to keep things as consistent as possible.

Try to keep your own psychology out of it. If you are on a winning streak, don't assume that it will just continue forever. Therefore, you can risk more money. That may not be true. Instead, take the time to appreciate that you have been winning and try to keep that streak going. If you are on a losing slide, don't become risk-averse and start putting less on each trade. If you do that, even when the tide begins to turn your way, it will take a very long time to get out of the hole.

09

Understand and Control Leverage

Leverage allows you to trade more money than what you have deposited into your account. This is useful for helping traders who have smaller accounts be able to trade with sums that are truly significant. However, leverage can also eat you alive if you are not diligent about managing the risks around it. You should try to always be extremely careful about how much risk you take with every trade and understand that leverage can make your losses stack up even more quickly than they otherwise would.

The broker will happily lend you the money you need to trade as leverage, but you need to make sure you can handle this. Only use the amount of leverage that makes sense to you and try not to get too carried away with things. People can sometimes see the leverage power that they have as a great tool to generate a nice profit very quickly, but they neglect to recognize that leverage can also be stabbing and take away those profits that they have worked so hard to earn. The bottom line is that everyone should try to respect leverage for what it is.

10

Take Currency Correlations into Consideration

Forex traders need to pay particular attention to how various currency pairs correlate with one another. For example, the AUD/USD and the NZD/USD often trade nearly in tandem. They are similar pairings, and the movements that they make are often similar to one another. It is wise to keep a running tally of the various pairs that are correlated like this so that you may trade them in a way that makes sense. You don't want to trade one pair a certain way and the other pair the opposite way when they are correlated.

Conclusion

All traders should consider various risk factors and how their trades can be impacted by those factors. It is a good idea to start with the basics such as risk management, but it is important to move on to the various other topics covered here in order to more fully understand how to manage risks and how to create situations where you can trade more profitably and to the best of your abilities.

If you are uncertain about certain aspects of risk management or how to be a better trader, just know that you are not alone. A lot of people out there are still working on figuring things out. Just makes sure you are willing to do your homework before you hop right back in. There is much that you can learn, and you deserve to give yourself a fighting chance as you venture out into the markets.

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