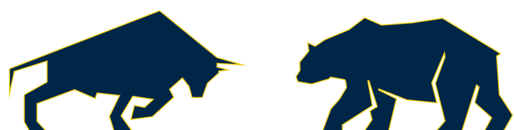

TRADING ACADEMY

LEVEL-1: COMPLETE GUIDE TO TRADING FOREX & CFDs

MODULE-1
MECHANICS OF TRADING

SECTION-12
RISK MANAGEMENT

TRADING ACADEMY LIMITED

MODULE-1: SETUP PHASE / THE MECHANICS OF TRADING

SECTION-12: RISK MANAGEMENT

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PREVIEW

ABOUT THIS SECTION

This section will cover the vital component of risk management and the crucial role it plays in a trader's overall journey. Risk management requires attention to detail and continued focus throughout one's trading life and must be considered at all times when entering and exiting the markets as well as with monitoring and maintaining trades both as pending and live positions.

Various aspects to risk management will be considered throughout this section and these aspects are important ingredients that otherwise only present their lessons with time, experience and multiple exposures to failure, as a result paying attention to these key principles now will potentially save you from some expensive and pain staking experiences later.

SECTION OBJECTIVES

At the end of this section you should:

- Have an idea of your risk profile and what you can afford to trade with
- Understand the necessity of stop losses and their use
- Explain the purpose of trade management and the role it plays
- Understand risk / reward ratio and how to put profit-loss rules into practice
- Be able to explain the purpose of capital protection and describe ways to implement its use
- Understand the basic parameters around trade plans and the components they comprise
- Be able to explain the dangers of over trading
- Have an understanding of risk management and the purpose it serves for longevity
- Be able to communicate the idea of mindfulness and awareness when trading

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12. OVERVIEW OF RISK MANAGEMENT

12.1: RISK PROFILE

Very important to know is your risk profile and risk appetite. This is made up of firstly, how much you can afford to trade with and ultimately, although this is not the goal, how much you can afford to lose. The conclusion of how you arrive at this amount is also comprised of a few factors that are personal in nature according to your risk appetite and financial capacity. If you do not have an idea of your comfort zone in this arena then it is advisable to seek independent financial advice to ensure you are investing or trading within your capability.

Once you have arrived at the conclusion of how much you can afford to trade with, seasoned traders typically look to the investment pyramid that suggests committing 10% of your workable capital to high risk investment options such trading on the financial markets with forex or equities.

With this trading capital you would then look to your risk component you are prepared to work with on each individual trade, and in the interest of a compounding mechanism such as trading that can both contract and expand as trades result in profit or loss, traditionally this risk component as a percentage would be small in comparison to your account balance and maintain the same percentage sustained for long periods of time to compensate for the buffer of profit and loss.

Traditionally a wise risk management approach is to start with 1% risk of your account balance per trade and with good trade plans that 1% would be split over a few positions comprising the one trade as covered in **Section-10** for **Trade Entry Plans**. 1% of your account balance to start is a safe mode of trading as only small amounts of your account are exposed at any one time and this protects your trading account from being wiped out and potentially facing a margin call on account of a poor turn of events. This concept will be elaborated on in greater detail throughout **Module-2** in Learning the Markets.

Only after extensive experience has developed and you are trading with ease of understanding the vital elements for managing your positions and using stop losses in conjunction with risk management strategies should you consider upping the anti on your risk profile and moving up to 2% of your account value per trade. Changing from 1% to 2% should only be implemented once no mistakes are being made with making entries and managing your positions.

- Commence with an initial risk profile of 1% risk per trade of your account balance per trade
- After extensive experience you may consider increasing your risk profile to 2%

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12.2: THE USE OF STOP LOSSES

As considered in **Section-8** on **'Stop Losses'** they are an absolutely necessary ingredient to good trade practice and managing your trades. They also play a vital role in protecting your losses, managing your risk as well as protecting profits and trading capital. Essentially stop losses should be used at all times.

Whilst with long term trading you may consider the benefit of not using stop losses in order to compensate for downturns before favourable outcomes result, this style of trading should be reserved for experienced trader investors only that have the capacity to deposit more funds should they require and have a sound understanding of fundamental influences on the markets affecting trading conditions. Essentially trading without stop losses is dangerous and can be detrimental to your trading capital.

Stop losses are used as an exit strategy on the back end of sound analysis and judgement, so they are placed accordingly to compensate for volatility and potential slippage, protecting your trading capital should the market turn against your analysis and move in the opposite direction. Therefore the stop loss will protect you from further losses in the event of an unfavourable outcome.

Stop losses can also be used to exit trades early in an attempt to break even after the position has been under pressure for some time. Whilst manually monitoring trades stop losses can be used to protect profits as the trade advances and can be used as an automatic feature with a trailing stop loss to lag behind the market price collecting and protecting profit as the trade advances further. *(Fig 12.1)*

- Stop losses are an essential element of trading and key to risk management and good trade plans
- Stop losses are a safety net exit strategy to protect you from further losses already exposed
- Stop losses can be manually moved or automated
- Trailing stops move with the price lagging behind
- Hard stops on the MT4 server are secure but there is an operational risk of using scripted Expert Advisors (EA's) on your platform for automated stops if the trading platform goes offline

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FIG 12.1: STOP LOSS - BASIC OVERVIEW

12.3: TRADE MANAGEMENT

Using stop losses in the above manner, in combination with good trade practice to avoid weekend gaps and compensate for slippage as well as closely monitoring changes in conditions in the markets, looking out for impactful events and manipulating take profit values to provide greater potential or close out early are all components of positive trade management.

Basically once positions go live or pending orders are in line to go live then you need to monitor these positions and potential positions with diligence and take into consideration the ever-changing landscape of the markets to ensure you are not caught out with an unsuspecting surprise move. The more you engage, the more experience you'll obtain and the more confident you'll become with trading in general.

If you have an open position and it has moved either favourably or unfavourably and has stalled at a specific price for some time representing indecision in the market, you might want to refer to calendar of events such as; www.forexfactory.com/calendar.php or another generic one as offered by your broker or trading platform to keep an eye on upcoming events that could have a potentially drastic impact on your positions.

Ensure you close out positions heading into weekends or ahead of bank holiday periods to protect yourself from any potential gaps that could take place over the weekend or during these periods.

The trading environment is in a continual state of flux and forever changing and therefore may require stop losses and take profit values to be modified to compensate for these changes. By monitoring your charts from time to time you'll be attentive to what is going on with the markets and be more open to finding positions that present potential tradable opportunities.

- www.forexfactory.com/calendar.php is a good site to use for news and events
- Reuters and Bloomberg also have calendar based events for trading purposes

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12.4: RISK / REWARD RATIO

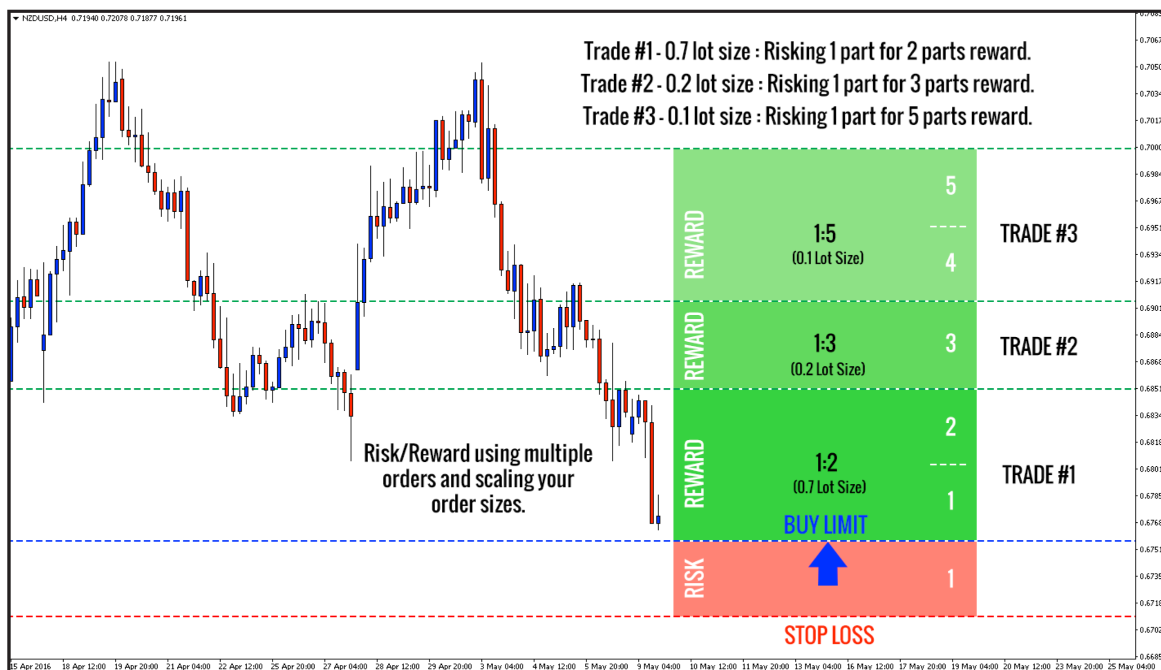
To be considered before each and every trade is actioned is the risk:reward ratio of the trade. Traditionally, experienced traders will employ an approximate set of rules around their method of risk:reward as part of a suitable trade plan taking into consideration an overall value of success rate of trades.

Typically for a risk:reward strategy to be true and geared toward obtaining potential long terms profits the ratio would not want to fall below 1:1 (1 part risk to 1 part reward) eg, $50 risk to achieve a $50 reward. As covered in Section-10, common practice for traders is to scale in to trades and then scale out of trades providing an opportunity to manage ones risk and profit potential. In this instance the risk/reward ratio would fluctuate accordingly without ever intentionally falling under 1:1 in the onset of the trade.

The risk component can be spread across multiple trades and the profit take values can be set across successive levels to increase the risk:reward ratio objective from approximately 1:1 or more in one position, 1:2 or more in another and 1:3 or more in another trade. In this way subtle tweaks and tactics are employed to help capture a favourable return for potential short-term and long-term growth. *(Fig 12.2)*

- Risk:Reward ratio needs to be greater than 1:1
- Trades can be split and tiered with varying take profit levels striving for 1:1, 1:2 and 1:3 or greater respectively

FIG 12.2: RISK/REWARD - TRADE SAMPLE



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12.5: CAPITAL PROTECTION

You've no doubt worked hard to acquire the capital you have throughout your working life, or perhaps you've inherited a set amount of capital, which most likely comes with a certain level of emotional attachment, or maybe through a strike of good fortune you've won the lottery and have had a bumper crop windfall to your advantage. Regardless of how you have arrived at the financial position you are currently in, most investors value their keep and want to look after it carefully whilst hopefully expanding on it to some measure.

Trading capital should therefore be looked after studiously and protected carefully throughout your trading journey. Stop losses should be employed carefully to protect the extensive loss of trading capital and take profit values should be placed considerately to capture what profit is available at various stages throughout the life of exposed positions.

Throughout the various modules to follow, emphasis will be placed on capital protection and the aspects that make the topic up so you will obtain a sound understanding of what it takes to meticulously protect both your risk and profits that essentially combine to protect your overall trading capital.

A structured approach to the markets means to stay true to the lessons learned throughout this course and to not stray from those lessons. You have hopefully not arrived at the subject of trading with the mindset of a punter-gambler, but rather with the prospect in mind of embarking on a journey to exercise a well thought out trading strategy for the purpose of becoming an advanced seasoned trader.

- Stop losses can be used to protect you from further loss
- Stop losses can be used to minimize your loss
- Stop losses can be used to break even on a trade
- Stop losses can be used to protect profit and capture more as the trade progresses

12.6: TRADE PLANS

Perhaps the most important and repetitive lesson delivered throughout Level-1 of the Complete Guide to Trading Forex & CFDs of the Trading Academy. Trade Plans encompass all of the required facets to placing a trade on the markets.

We have set about to repeat this over and over throughout the entire course so you can see trading in action, and whilst it should not be expected that all trades will result in profit, this is the very reason why each aspect of the entry, stop and take profit values should be carefully considered. From there you would investigate what type of entry, stop or take profit would be carried out to obtain the desired outcome of the trade idea or trade plan. *(Fig 12.3)*

When analyzing the markets and looking for a potential trade there are many methods to employ using technical analysis and these many methods will be explained in greater detail throughout Modules 2, 3 and 4.

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- The first conclusion to draw is if there is overall strength or weakness in the market and this can be examined over various time frame charts in conjunction with fundamental inputs and sentiment to determine this outcome.

- The next conclusion is to see if the charts are revealing an overall plan that can be deciphered into a trade idea of where you think or feel the market is likely to go.

- Through the use of technical analysis you would implement a variety of functions to find confirmation of multiple points of confluence affirming a possible outcome aligned with what is being revealed on the charts.

- Taking into consideration a possible entry price, the stop loss component to the trade is the first aspect of the actual trade values to consider. Through using a variety of inputs to confirm that given the likelihood of the trade resulting in the way you expect, where would a safe level be to place the stop loss to avoid recent tests at that level and accommodate the pairs natural volatility.

- Based on the assessed positioning of the stop loss, you could now look at determining an entry price for the trade in conjunction with points of confluence that are suggestive of a price level test, resulting in a potential entry point.

- The next component to consider is a likely or probable points of exit for your first take profit value and then suitable successive take profit values venturing for further gains.

- What are the risk/reward ratios reflected in the trade plan now? Are they set at a minimum of 1:1 for the first take profit value and then 1:2 for the second take profit value and 1:3 for the third? If not are there subtle tweaks that can be made in accordance with what the charts are saying to capture these ratios or strive for more?

- A good trade plan should be able to express the trade idea behind why the trade plan has been implemented in the first instance, what information led to the idea and the desire to execute this trade, along with the reasoning behind why and how the entry and exit points were determined.

PLAN YOUR TRADE AND THEN TRADE YOUR PLAN, IF YOU FAIL TO PLAN THEN YOU PLAN TO FAIL!

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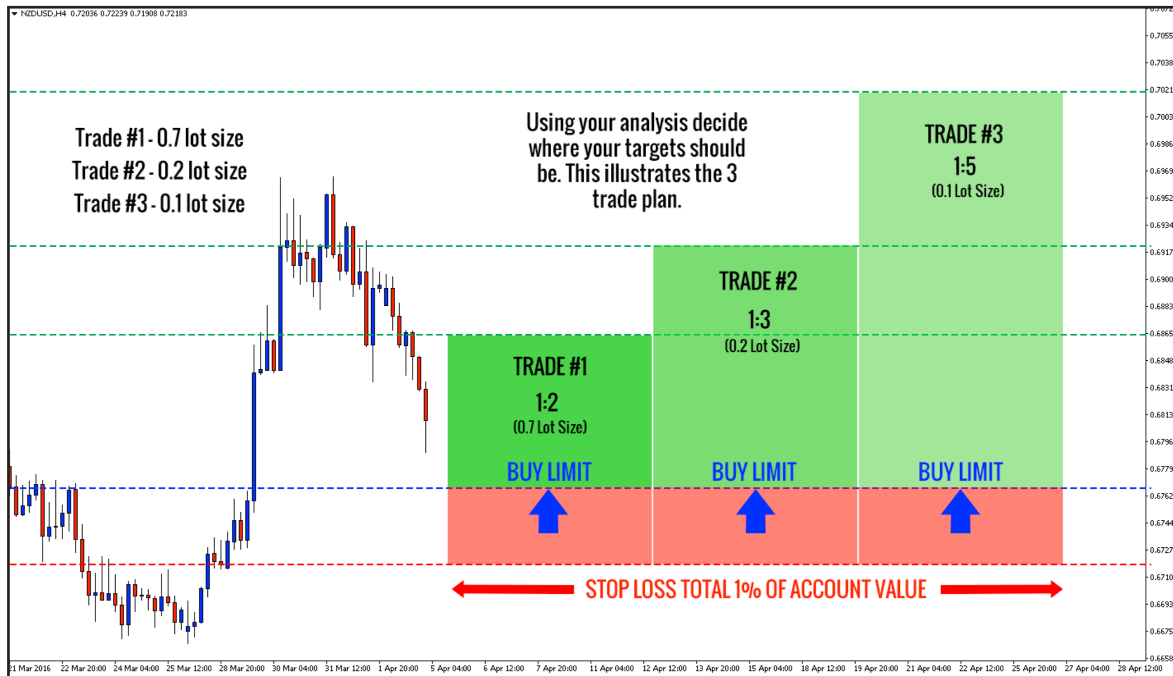
FIG 12.3: TRADE PLANS - EXAMPLE OF THREE TRADE SETUP



12.7: OVER TRADING

As a discretionary trader this is a reality that you want to either avoid or have the awareness to recognize when you have fallen victim to the lure of wanting to become a high frequency scalper of the markets entering and exiting at every potential and possible opportunity that either presents itself or that you at least think has.

The computer works so much faster than the human mind and whilst the computer can't necessarily recognize patterns and rhythms that the mind can see and respond to in an intuitive nature, the computer certainly works infinitely faster than the human mind can and therefore the exercise of zooming in to close time frame charts in order to scalp the markets and become a high frequency trader as every pattern signals a potential move is futile!

Algorithms by way of Expert Advisors (EA's) and scripts are scouring the markets across all financial instruments at every second over every time frame and these systems are continually running taking advantage of the markets. Systems and automated trading will be advanced on in great detail throughout Level-3 of the Trading Academy, but for now this type of trading cannot be competed with by the human mind and therefore should be avoided by the discretional trader.

Another type of over trading is feeling the impulse to continually enter the markets even if trade setups are not particularly apparent, like a self-feeding addiction to ensure trades are executed and positions are placed on the markets. It is naturally going to be more beneficial to place less position on the market ensuring the analysis is sound rather than haphazardly entering the markets for the sake of it.

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When you feel you are over trading, and your results take a dive or your joy of trading has diminished it is best to step away completely for a while and have a breather or perhaps resort back to sound analysis and strategy rather than feeling compelled to execute trades. Take the time to tweak your charts and rebuild your confidence.

- High frequency trading and over monitoring can be fatiguing and counter-productive
- Discretional trading cannot compete with the quantity and frequency of systematic trading
- High frequency trading is expensive on brokerage and fees
- High frequency scalping can lead to burnout and account wipeout

12.8: RISK MANAGEMENT

Touched on and reiterated throughout this module and particularly this section and will continue to be covered throughout future modules of Level-1 for the Complete Guide to Trading Forex & CFDs, implementing good-practice risk management strategies throughout your trading endeavours is imperative for long-term progress as a trader.

As outlined above, one should consider the risk component of a trade before contemplating the other elements and executing a live trade. Incorporating risk management strategies is essential for a safer low-risk, strategic and progressive trading experience when immersed in a high-risk and volatile environment.

It is very important when trading on the Financial Markets to have a highly calculated, educated and risk assessed strategy in place to ensure losses are both minimized and protected and your profits are in pursuit of maximum potential gain, relative to what's available based on the implemented analysis.

Executing sound strategies with a progressive approach will help in your quest to secure long-term gains and benefits on the markets. Commence trading with a risk/reward ratio as a suggested guide for operating a low-exposure account with a lower-risk trading profile of only 1% of your account balance per trade, seeking returns of 1.5% - 3% on successful trades will help offset unsuccessful trades. Of course every trade will be different and each trade must be executed on its own analysis and merits.

- The risk component is the first element in a trade plan to consider
- The trade reward should outweigh the risk value e.g., 1% risk for a 3% gain
- Trade using a methodology you have tested and have confidence in
- Trade in accordance with your trade plan including risk management and capital management

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12.9: MINDFULNESS

Mindfulness and traders awareness should not be overlooked when trading. Even though you are doing the same thing over and over utilizing various strategies and tactics to achieve a variety of results, the monotonous and mechanical nature of trading can be quite repetitive and whilst this helps to instil habitual patterns and behaviour, you do not want to overlook the menial tasks.

Some actions to be aware of throughout your trading progression are:

- Ensure stops, entries and take profits are well-analyzed according to the available knowledge you have at hand.
- Monitor and manage trades diligently throughout their life until expiry to ensure you have control over what you can while the trade is taking place.
- Close trades before the weekends or any bank holidays to avoid weekend gaps.
- Be mindful of upcoming events to avoid unfavourable news spikes.
- Remove any pending positions that have not yet triggered and the market price has drifted away from entry.
- If trades have stalled midway in profit and indecision seems to have entered the market, consider closing the trade or moving your stop loss to a satisfactory level to secure the available profit.
- Although stop losses are in place to protect trades from incurring any more losses, if the market's movements have appeared to change and it is apparent the strength of the momentum is going to collect your stop, then consider closing the trade out early.

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REVIEW

SUMMARY

This section examined risk management and its properties to outline the importance of careful consideration and scrutiny when placing and managing trades. The subject of stop losses and their use in relation to trade management and capital protection was also analyzed.

The topics of over trading and mindfulness were also covered and the roles they play to assist in a sound trading strategy. We looked at trade plans and the components a trade plan embodies as well as the importance of deliberating over the basic entry and exit features as well as exploring the finer details that greatly aid in the traders quest.

QUESTIONS

1. What is your risk profile in relation to trading and what is one way to determine what your risk profile is when trading?
2. What is a stop loss and what is the purpose of their use?
3. What is trade management and what role does it play?
4. What is risk reward ratio and what is a good-practice strategy to implement?
5. What is the purpose of capital protection and what methods can you employ to take advantage of it?
6. What is a trade plan and what does a trade plan embody?
7. What is over trading?
8. What is the importance of risk management?
9. What role does mindfulness play when trading?

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ANSWERS

1. Risk profile relates to the individual financial appetite or amount of trading capital that the trader is able to trade with in accordance with his or her capital availability. Risk profile also relates to the risk appetite of the trader. The investment pyramid suggests 10% of ones investment worth could be used for high-risk investment options such as trading on the financial markets with forex.

2. A stop loss is an automated function of an order ticket acting as an exit strategy to stop the trader enduring any further losses than are exposed in the stop loss component of the trade. A stop loss can also be used to free the risk of the trade, break even or be moved into the profit region of the trade to protect profits as the trade advances forward.

3. Trade management refers to managing ones trades with the use of stop losses and the variety of functions they represent, as well as monitoring and managing the trades as they progress along. This may incorporate modifying the trade or closing the trades out before weekends to avoid any unfavourable weekend gaps.

4. Risk:reward ratio refers to the level of risk exposed in relation to the level of reward being sought by the trade as a potential outcome. A good strategy to implement is not entering any position with less than a 1:1 profit to loss ratio. When trades are spread across multiple parts the risk:reward ratio would be set to tier higher as the trade progresses. E.g., the first part of the trade would venture for 1:1 or more, the second part of the trade would venture for 1:2 or more and the third or more parts would venture for 1:3 and beyond.

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5. Capital protection means to look after the capital you have and to protect the capital you earn through trading. This can be done by well-analyzed trade plans before execution and through the use of stop losses to secure available profits should the trades turn against the initial analysis as well as using take profit values in realistic places.

6. A trade plan embodies all of the necessary components to entering and exiting a trade, such as entry prices and order types, stop losses and the type of stop loss used, take profit values, risk management, risk:reward ratio and the trade idea that instigated the trade plan in the first instance.

7. Over trading is trading beyond ones comfort of frequency resulting in a downturn of performance. High frequency trading or scalping the markets can be an exhausting and expensive experience that leads to diminishing account balances and burnout or fatigue.

8. Risk management is a vital element to ensure trades are not thoughtlessly and haphazardly executed with too much account exposure on any one trade. Good risk management practice ensures trades are well thought out and considered with the correct position sizing implemented in accordance with account balances.

9. Mindfulness and awareness are key elements to ensure you maintain an edge while trading, remaining aware of the potential variables at play that could affect you negatively and being prepared for those changes. Being conscious of your open and pending positions will enable you to make the required modifications without being caught unaware and vulnerable.

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CHECKLIST

Below is a checklist of the main points covered in this introduction section of Module-1, Section-12: Risk Management.

- ☐ Discover what level of capital you can afford to trade with in accordance with the investment pyramid or on account of seeking independent financial advice.

- ☐ Choose a level of risk to trade with per trade that you are comfortable with and stick to it. If you are comfortable with trading 1% of your account balance then trade with this and maintain this level.

- ☐ Stop losses are there to protect further loss than the initial risk exposed and can be used to break even on a trade once the trade progresses and also used to secure and protect profits as the trade advances further.

- ☐ All trades should be monitored and managed from time to time until they expire by way of stopping out, taking profit, reaching a time based exit or being closed out manually.

- ☐ The risk:reward ratio needs to be considered for every trade and should be carried out with the benefit in mind of an overall positive trading experience.

- ☐ It is important to protect trading capital as the trade ventures into profit, essentially protecting what’s available and what’s on the table.

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- [ ] Trade plans encompass many ingredients and all of these aspects need to be carefully considered and utilized to ensure a well thought out and executed trade idea takes place.

- [ ] It is important not to over trade and compete with automated trading systems. High frequency trading is not necessarily beneficial to your trading account balance and can lead to burnout and fatigue.

- [ ] Carefully assessed risk management strategies will have a long-term positive effect on your trading aptitude and trade experience.

- [ ] Being mindful is key to having an overall awareness of what is taking place in the marketplace and within your trade account in relation to your open and pending positions.

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RECAP OF MODULE-1

This section concludes the initial setup phase and the mechanics of trading for Module-1.

In this section we have covered the various steps required for setting up your trading account with your broker and going through some of the vital components to the trading environment in order to get you started along your journey experiencing the markets firsthand.

The following sections have been covered in detail:

- Section-1 Setup Phase Introduction
- Section-2 Glossary of Terms
- Section-3 Broker and Trading Platform
- Section-4 MT4 Setup
- Section-5 Position Size – Lot Size
- Section-6 PIPs and Points
- Section-7 Forex Order Types
- Section-8 Stop Losses
- Section-9 Adjusted Prices – Buffer Zone
- Section-10 Trade Entry Plans
- Section-11 Trade Journal
- Section-12 Risk Management

The topics covered in Module-1 will be elaborated on again in further detail throughout the following modules with more topics being added along the way to build a comprehensive step by step learning syllabus designed to progress you from a beginner trader through to an advanced seasoned trader able to turn trade ideas into trade plans through the use of a variety of means of technical analysis and fundamental event trading strategies.

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INTRODUCTION TO MODULE-2

Module-2 titled 'Learning the Markets' will explore the scenery and landscape of the financial markets with an emphasis on forex trading delving deeper into the use of technical analysis (TA) and fundamental factors governing the markets. Looking at how to recognize opportunities as they are presented through the use of TA, how to formulate trade ideas from these potential setups, and then how to create trade plans from these ideas with a systematic approach to acquiring the required points of confirmation for exercising the trade plans into trade executions.

The following topics will be covered in great detail throughout Module-2:

- Section-1 Introduction to Module-2
- Section-2 Introduction to the Financial Markets
- Section-3 What is Price Action
- Section-4 Trading Mechanics
- Section-5 Brief overview of Fundamental Analysis
- Section-6 Technical Analysis
- Section-7 Entry and Exit points to the markets
- Section-8 Trading Patterns and Indicators
- Section-9 Retail Trading
- Section-10 Trading like a market maker
- Section-11 Risk Management
- Section-12 Protecting Profit and Trading Capital
- Section-13 Trading Psychology
- Section-14 Types of Forex

The Learning the Markets module provides a comprehensive overview of the markets, taking a look at the basic of economics and the supply/demand continuum, breaking down the analysis required to derive your own entry and exit points to the markets, exploring trade plans and their execution based on traditionally used methodology.

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NOTES

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Trading foreign exchange on margin carries a high level of risk, and may not be suitable for all investors. Before deciding to trade in foreign exchange, you should consider your investment objectives, level of experience, and risk appetite. There are no guarantees or assurances about the returns you will make. The possibility exists that you can sustain losses; therefore, you should not invest money you cannot afford to lose. You should be aware of the associated risks with trading foreign exchange.