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Risk and Money Management

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In an age where it has become fashionable to manage one's own investments, every investor needs to apply professional risk and money management strategies.

Preservation of capital is the foundation of *long-term* success in today's volatile markets.

One common adage on this subject that is completely wrongheaded is: You can't go broke taking profits. That's precisely how many traders do go broke. While amateurs go broke by taking large losses, professionals go broke by taking small profits. The problem in a nutshell is that human nature does not operate to maximize gain but rather to maximize the chance of a gain. The desire to maximize the number of winning trades (or minimize the number of losing trades) works against the trader. The success rate of trades is the least important performance statistic and may even be inversely related to performance. ...The market does behave very much like a tutor who is trying to instill poor trading techniques. Most people learn this lesson only too well...Since most small to moderate profits tend to vanish, the market teaches you to cash them in before they get away. Since the market spends more time in consolidations than in trends, it teaches you to buy dips and sell rallies. Since the market trades through the same prices again and again and seems, if only you wait long enough, to return to prices it has visited before, it teaches you to hold on to bad trades. The market likes to lull you into the false security of high success rate techniques, which often lose disastrously in the long run. The general idea is that what works most of the time is nearly the opposite of what works in the long run.

*William Eckhardt,
interviewed in "[The New Market Wizards:
Conversations With America's Top Traders](#)",
Schwager (1994)*

When asked about **risk and money management**, we often hear the same two phrases from investors: "I'm diversified" or "I have a balanced portfolio". But are they really? And does this have anything to do with risk and money management?

We all know the oldest clichés in the world of investing:

- Buy low.
- Sell high.
- Take losses quickly.
- Let profits run.

This is easier said than done. Some investors devote countless hours to stock

picking by spending their time doing research, using either fundamental or technical analysis. Others visit chat rooms, message boards or get tips from neighbors. Many approach investing as if it were a gamble, without knowing the risk reward equation. In the never-ending quest to find the next momentum stock to buy, the most important factor in long-term profitability is overlooked - ***the exit strategy***.

*He said, son I've made a life out of reading people's faces
And knowing what the cards were, by the way they held their eyes
So if you don't mind my sayin', I can see you're out of aces
For a taste of your whiskey, I'll give you some advice*

*You got to know when to hold 'em, know when to fold 'em
Know when to walk away and know when to run
You never count your money, when you're sittin' at the table
There'll be time enough for countin', when the dealin's done*

*Every gambler knows that the secret to survivin'
Is knowing what to throw away, and knowing what to keep
'Cos every hand's a winner and every hand's a loser
And the best that you can hope for is to die in your sleep*

*And when he finished speakin', he turned back for the window
Crushed out the cigarette, faded off to sleep
And somewhere in the darkness, the gambler he broke even
But in his final words I found an ace that I could keep*

*Select Lyrics, "The Gambler",
by Kenny Rogers, (c) 1978*

The lyrics in this song are applicable to investing in many ways. Nowhere in the song does "The Gambler" say when to *join* the game, for entry is by far the simplest part. One only needs the inclination and a stake. It's easy to find a game. The hand dealt to a poker player is by chance, but the *skill is in knowing what to do with it*. And so it is with the market, except it's harder in the market because people have to choose their initial hand. Often what instinctively looks and feels good is actually very bad and vice versa.

Once a position has been taken, the investor cannot control the day to day actions of buyers and sellers. We can only apply rules of risk and money management to ensure our "stake" is not wiped out should the market subsequently deal us bad cards later in the game. Like The Gambler, we can "read people's faces" by studying the interaction of buyers and sellers in any given marketplace. We can directly observe their transactions in terms of price and volume in order to obtain clues as to what may come to gain an edge over other players.

After carefully reading the market, the trader takes a position. The first thing he does is set a stop loss order so that a series of bad trades will not end his time at the table, for once a player has no more money, he must leave the game. Since no one

can predict the market with 100% certainty, every hand is a winner and every hand's a loser if one does not know how to manage a position. In the world of trading, we are interested in tossing out the losers the moment the market lets us know that we are wrong, and giving the winners a little rope, so they may go as far as they can.

The reason most people lose money in the market is because of the fact they have not learned how to trade and/or they have not proved on paper that their ideas are profitable by testing them rigorously. Even if they know how to trade, they will not be around the market for very long unless they know the rules of professional risk and money management and their proper application. Basically, most traders begin their trading career very undercapitalized and they bet far too large an amount for their account size. The argument from clients was if they already had lots of capital, they wouldn't be "gambling in the market". My reply was that gamblers always lose. One would not go into business without expertise, a sound business plan and adequate capital, and trading is no different.