

**Uploaded 2001 March 02**

## **Don't Bet the Farm**

**(c)1998-2001, Teresa Lo, [www.IntelligentSpeculator.com](http://www.IntelligentSpeculator.com). All rights reserved.**

### **Preservation of Capital**

At the beginning of a trader's career, he has many handicaps working against him.

- The first is simply not having enough knowledge.
- The second is lack of experience in the application of the knowledge that he should have.
- The third is the lack of experience in managing one's own emotions.
- The fourth is the lack of risk and money management techniques.

Several of these handicaps can be improved by paper trading and/or using back-testing methods. Managing one's emotions when cash is on the line must be learned on the job. It is easier if the trader has made adequate preparation and has confidence gained from successful testing of his trading method. However, in reality, most people never test their methods and simply plunge into the market unprepared. If a trader takes this route at the beginning of his career, only one thing can help him survive until he proves out his method - Risk and Money Management. Before superior performance can be obtained, a trader needs to learn how to stay in the game.

### **The Adventures of Trader John Doe**

We will assume Trader Doe is new to the market and has a simple idea. He likes America Online and has decided to buy a breakout of the previous day's high. He has not tested this idea to statistically verify that this is a profitable technique. He believes in momentum. Trader Doe does not want to sell short. He only wishes to buy. Prior to making his first trade, Trader Doe phones a friend, a professional trader, who gave him two pieces of sage advice.

1. Implement Risk and Money Management rules prior to trading. They are outlined below.
2. Know that the trend is your friend, but eventually ends when it bends. This is why stop loss orders are necessary. A copy of the technique is available [here](#).

### **Determine Equity Risk**

A trader first needs to determine the dollar risk per trade according to his account size that brings his risk of ruin to an acceptably low level. Trader Doe follows his friend's advice and determines his equity risk first. He has allocated \$50,000 of risk capital to his trading account, and is willing to take a moderately conservative risk per trade of 2% equity. He will therefore risk \$1,000 on his first trade. Once this has been done, Trader Doe proceeds to determine the time frame that this dollar risk will allow him to trade.

### **Determine Time Frame and Position Size**

Trader Doe has determined that he can risk \$1,000 on his first trade. Now he must settle upon a time frame that is suitable for both his wallet and his personality.

The first step is to find the approximate range of a bar over several time frames. This is the average distance between the high and the low for a certain number of bars. The reason for doing so is that his stop loss must be at least one average bar away from the entry point, according to the stop loss technique that his friend showed him. A quick method to determine the length of an average bar over a recent time period is to put two moving averages on a chart, one of the highs and one of the lows.



In the chart above, the red line is the 40-period simple moving average of the highs and the blue line is the 40-period simple moving average of the lows. On this 30-minute chart, the average bar length over the past 40 bars is the difference between the red line and the blue line, approximately \$1.40. So if Trader Doe decides to trade AOL on a 30-minute chart, he takes his trade risk of \$1,000 and divides it by \$1.40 to produce the maximum number of shares that he can trade intraday within his predetermined parameters. His maximum position is approximately 700 shares and he must close out his trade at the end of each day since he is "day trading" using an intraday time frame.



If he decides that he does not want to trade on an intraday basis, and instead uses the daily chart, he takes the difference between the red and blue lines on the daily chart, which is approximately \$7.25 to produce a maximum position of approximately 135 shares. This is in contrast to the average trader, with margin maxed out, who trades 800 shares to hold overnight.

### The Results

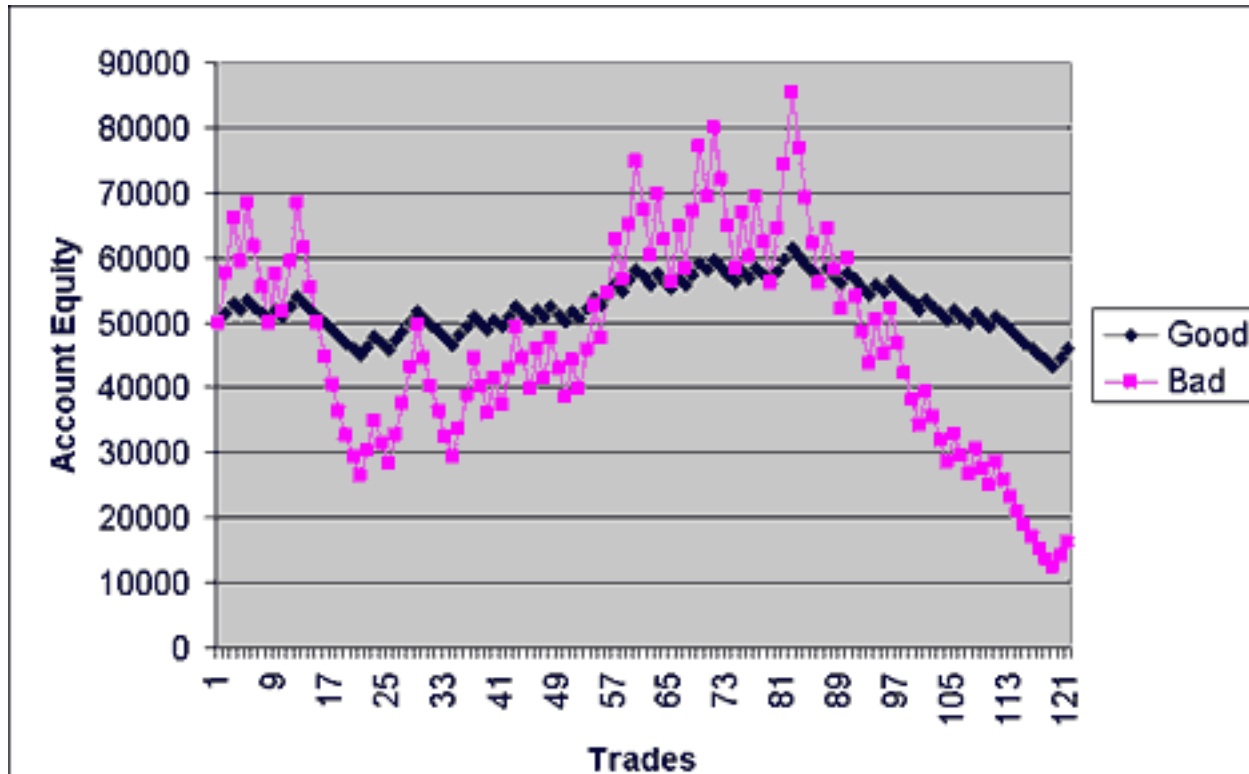
Suppose Trader Doe does not yet know how to trade very well since he is new to the world of trading. He only follows his professional trader friend's two pieces of advice. He implements risk & money management by setting a per trade risk of 2% of his account. He enters stop loss orders as instructed. After a series of over 100 trades, Trader Doe has obtained a statistic of 35% winning trades. When his trades are profitable, he wins 3% on his account. When he loses, he has the discipline to stick to his 2% loss before he admits defeat.

As Trader Doe is using a daily chart for signals, these 120 trades have been made over a period of approximately a year. At the end of the year, he has learned many things about the market and himself, AND he still has preserved most of his capital. In the graph below, we have plotted Trader Doe's progress by simulating his trading using the parameters outlined above. His progress is charted on the blue line marked "Good".

### Keeping up with The Jones' -The Adventures of Neighbor Bob

At the same time Trader Doe decided to try his hand at the market, his neighbor, Bob, who also has \$50,000 to play with, decided to go in with Trader Doe and use his strategy of buying breakouts. In contrast to Trader Doe, Neighbor Bob was impatient because the market was "hot" and he was a gambler at heart. Instead of only risking 2% of the money in his account per trade, Neighbor risked 10% per trade. He thought that he could never lose, because, even if he was wrong, in the

end "the market always goes up" and somehow the bull market would "fix" his mistakes. He would only have to hold onto the trade a little longer than planned.



### He Who Fights and Runs Away...

During the course of the year, Neighbor Bob, whose performance is plotted by the pink line on the chart marked "Bad", would look over the fence and gloat on occasion. At one point he was way ahead of Trader Doe. Neighbor Bob could not understand why Trader Doe was being so conservative when making money was so easy.

### ...Lives to Fight Another Day

Unfortunately, the odds caught up to Neighbor Bob in the end when the market stopped going straight up. With \$15,000 left in his account, his wife told him "enough is enough - the market's nothing but a gamble" and forced him to stop trading altogether. Meanwhile, Trader Doe, having taken exactly the same trading signals as Neighbor Bob, still had his capital intact. Over that one-year period, he gleaned a lot of insight into the market, read a few good books, and refined his technique with the help of his friend the professional trader. In the following year, knowing much more than he did before about both the market and himself, he was able to increase his batting average to 50 per cent. The progress of his account in the second year is charted below.



Trader Doe never looked over the fence to gloat back at Neighbor Bob because he knew that his performance was the result of his respect for money and the market. He knew that it was risk and money management, and not brains or luck, that kept him in the game until he learned enough to increase his batting average. He remains vigilant and humble because he also knows that he will never be a perfect trader, and so long as he wins more than he loses, he'll be around to play.