



Stock Pick Service Information for Success

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3.1 RISK MANAGEMENT THEORY

To be consistently profitable in trading, it is essential that you control losses. Without Risk Management, you could be having a great, profitable year and one bad trade, with uncontrolled loss, could not only take away all of your hard earned profit, but put you in the red. A couple of losing trades, with uncontrolled loss, could very well reduce your trading account so much that it would take months or years to earn it back, or worse yet, leave you without enough capital to continue trading.

You've probably seen warnings like this, when you sign up for a brokerage account or advisory service (including FollowMeTrades.com.)

“Investing involves a great deal of risk, including the loss of all or a portion of your investment.”

You see these warnings a lot because they are true! Many, many traders and investors have found out just how true the potential for loss really is. We absolutely can MANAGE risk, but we cannot ELIMINATE risk. This section will deal with how to manage risk effectively.

FollowMeTrades.com uses strict Risk Management rules to minimize exposure to losses – at all times.

- **It is inevitable that some trades will lose.** The key to profitability is keeping the losses small and the wins big.
- We base our Risk Management on the **“Risk of Ruin”** tables developed by Prof. Nauzer Balsara¹ and the implementation strategies developed by Bennett McDowell, President/CEO of TradersCoach.com²
- We control **“Trade Risk”** (the amount of potential loss on each trade) by using the guidelines for Position Size (the amount of shares to buy).
- We always have **Stop Loss** levels identified and almost always have Stop Loss Orders in place (the exceptions are on some options trades, where the Stop Loss level then triggers an option trade exit.)
- We cannot always control **“Market Risk.”** It is possible for news or some other event to cause the market or an individual stock to move dramatically – well beyond our carefully chosen Stop Loss level - and to incur more loss than we had planned for. It is also possible for a dramatic market event to cause many or all of our positions to hit or exceed their stops simultaneously resulting in a large loss in our trading account.
 - The only way to protect ourselves against “Market Risk” is to only trade the amount of money that we can afford to lose. It is not a good idea to trade our entire net worth. Each individual needs to assess what percent of their net worth is appropriate to trade with.
 - This type of risk is not limited to the type of trading that Follow Me Trades is engaged in. Nearly all Equity Mutual Funds and other instruments have this same risk.

¹ Prof. Nauzer Balsara, Money Management Strategies For Traders, John Wiley & Sons, 1992.

² Bennett McDowell, A Trader's Money Management System: How to Ensure Profit and Avoid the Risk of Ruin, John Wiley & Sons, 2010.

We never, ever move out stops for a bigger loss after taking the trade.

3.2 RISK OF RUIN

The **Two Key Statistics** that we measure are:

- **Win-Ratio:** How many trades do you win vs. how many trades do you lose?
 - E.g. 10 trades, 6 winners, 4 losers = $6/10 = 60\%$ Win-Ratio
- **Pay-Off Ratio:** How many dollars do you make for every dollar you lose?
 - E.g. 10 trades, average profit = \$2000, average loss = \$1000
 - $\$2000/\$1000 = \text{Pay-Off Ratio of } 2:1$

See Figure 3.2.1

Risk of Ruin Table using 2% Risk / Trade

| | Payoff Ratio 1:1 | PR 2:1 | PR 3:1 | PR 4:1 | PR 5:1 |
|---------------|------------------|--------|--------|--------|--------|
| Win Ratio 10% | 100 | 100 | 100 | 100 | 100 |
| Win Ratio 15% | 100 | 100 | 100 | 100 | 100 |
| Win Ratio 20% | 100 | 100 | 100 | 100 | 22% |
| Win Ratio 25% | 100 | 100 | 100 | 27% | 0 |
| Win Ratio 30% | 100 | 100 | 16% | 0 | 0 |
| Win Ratio 35% | 100 | 84% | 0 | 0 | 0 |
| Win Ratio 40% | 100 | 0 | 0 | 0 | 0 |
| Win Ratio 45% | 100 | 0 | 0 | 0 | 0 |
| Win Ratio 50% | 100 | 0 | 0 | 0 | 0 |
| Win Ratio 55% | 0 | 0 | 0 | 0 | 0 |
| Win Ratio 60% | 0 | 0 | 0 | 0 | 0 |
| Win Ratio 65% | 0 | 0 | 0 | 0 | 0 |
| Win Ratio 70% | 0 | 0 | 0 | 0 | 0 |
| Win Ratio 75% | 0 | 0 | 0 | 0 | 0 |
| Win Ratio 80% | 0 | 0 | 0 | 0 | 0 |
| Win Ratio 85% | 0 | 0 | 0 | 0 | 0 |
| Win Ratio 90% | 0 | 0 | 0 | 0 | 0 |

Figure 3.2.1

Source: Prof. Nauzer Balsara, Money Management Strategies For Traders, John Wiley & Sons, 1992

Figure 3.2.1 is a Risk of Ruin table for a risk size of 2% per trade. The risk size of 2% means that you have selected a position size and stop loss level such that the most you will lose on the trade, the “Trade Risk” is 2% of your trading account.

*This is the amount of the “Trade Risk.” Remember, “Market Risk” can be larger.

For example, a Win Ratio of 50% and a Payoff Ratio of 1:1 have a table value of 100%. Notice that 100% is in red. This is saying that with these performance statistics, you have a 100% chance of “Ruin,” of drawing down your account, unacceptably, over time. Not good...

Also notice that with the same Win Ratio of 50% and improving your Payoff Ratio to 2:1 results in a table value of 0%, meaning you have 0% chance of “Ruin.” That is good! The 0% chance of ruin also implies profitability.

Obviously, the deeper you are into the green area of the chart, the higher your profitability will be.

Risk of Ruin and Profitability are more sensitive to Payoff Ratio than they are to Win Ratio. Both statistics matter, but Payoff Ratio matters more.

Simply stated, a high Payoff Ratio means that your winning trades are bigger than your losing trades. That is what we want! We want to “keep our losers small and our winners big!”

There are two primary ways that we work to keep the winners as big as possible;

1. By only taking trades that have a high Reward/Risk Ratio
2. By staying with the trends as long as possible

We keep the losers small by following our trade size guidelines

We recommend a risk size of 2% per trade as a starting point. You can find more guidelines in a book like Prof. Nauzer Balsaras’ *Money Management Strategies For Traders*, John Wiley & Sons, 1992. Software like *The Traders Assistant*, from www.traderscoach.com can also calculate a recommend trade risk size, based on your actual trading statistics.

In order to trade with a higher risk size, you have to have really good trading statistics. See Figure 3.2.2

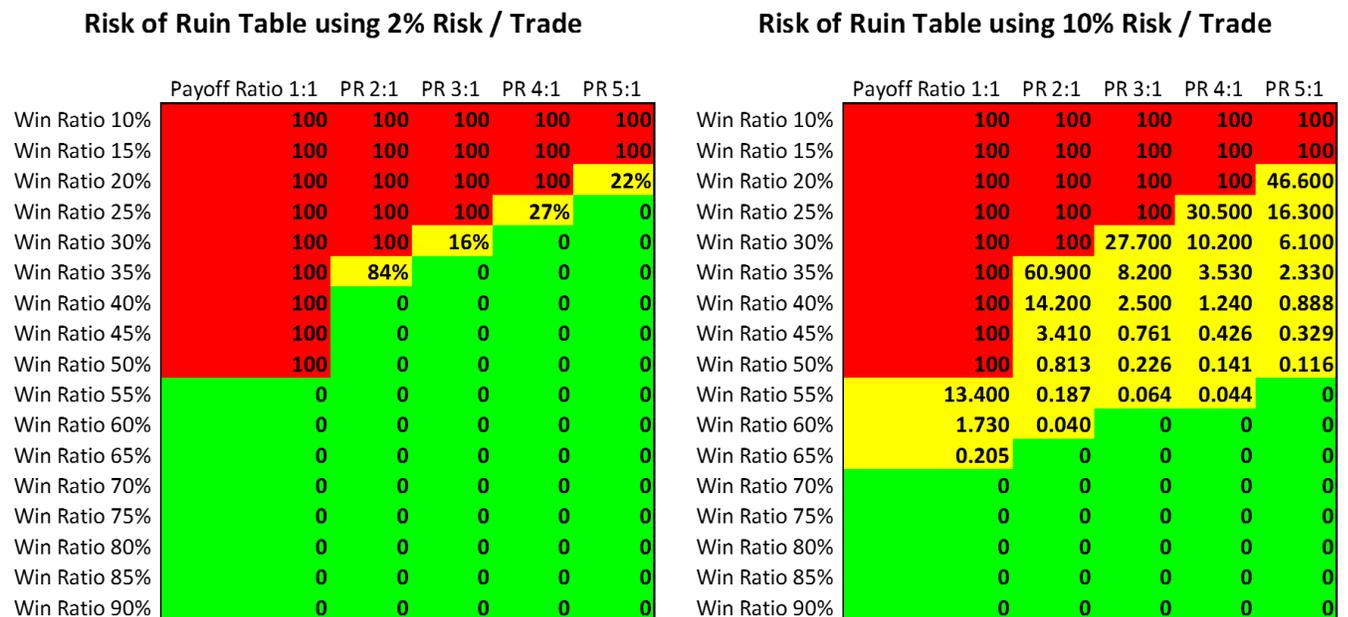


Figure 3.2.2

Source: Prof. Nauzer Balsara, *Money Management Strategies For Traders*, John Wiley & Sons, 1992

Figure 3.2.2 shows the 2% risk table alongside the 10% risk table. Notice how much better your trading statistics need to be in order to be in the “green.”

3.3 TRADE SIZE CALCULATION

The math behind Trade Size Calculation is very simple. Here is how it works.

Trade Size Formula

STEP ONE: Calculate Your Dollar "Risk Amount"

$$\text{Account Size (\$)} \times \text{Risk\%} = \text{Risk Amount (\$)*}$$

$$\text{Example: } \$50,000 \times 2\% = \$1,000^*$$

* Dollar Amount you can afford to lose on this trade if you get stopped out.

STEP TWO: Calculate Your "Trade Size"

$$\text{Risk Amount(\$)} / \text{Difference Between Entry and Stop(\$)} = \text{Trade Size (Shares or Contracts)}$$

| | |
|--|------------|
| Guidelines: | |
| *Account Size | \$ 100,000 |
| Maximum Risk % | 2% |
| Maximum Risk \$ | \$ 2,000 |
| The Math: | |
| Entry Price - Stop Price = \$Risk Per Share | |
| Maximum \$ Risk / \$Risk Per Share = Number of Shares to Buy | |

Figure 3.3.1

Figure 3.3.1 summarizes the formula for Trade Size Calculation.

*\$100,000 Account Size is used for illustration purposes. These guidelines apply to any account size.

See Figure 3.3.2 for an example.

| Example Trade: | |
|------------------------------------|--|
| Entry Price | \$ 4.99 |
| Initial Stop Loss Price | \$ 3.99 |
| \$ Risk Per Share | \$ 1.00 (\$4.99 - \$3.99) |
| Maximum Risk \$ | \$ 2,000 (From Guidelines) |
| Number of Shares to Buy | 2000 (Maximum Risk \$ / \$ Risk Per Share) |
| Max \$ Loss if Initial Stop is hit | \$ 2,000 |

Figure 3.3.2

Figure 3.3.2 is an example of an actual stock trade, with the Entry Price, Stop Loss Price and Account Size. The calculations are based on a 2% risk level.

In this example, you would buy 2000 shares. The cost of the position would be \$9980, the risk amount is \$2000, meaning if the trade fails and hits the stop, you will lose a controlled amount of \$2000.

If your trading performance statistics are good and you are in the green on the Risk of Ruin Table, you can take this loss in stride, knowing that some trades lose and that your system produces profits over time.

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