



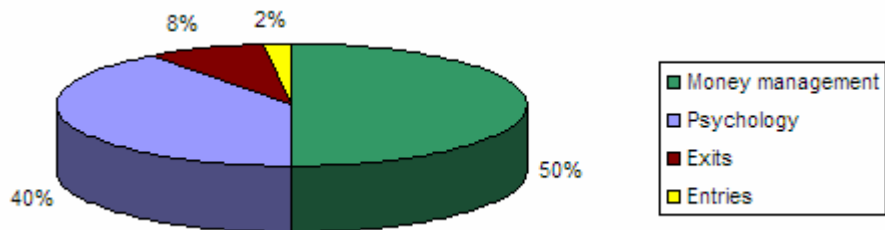
Lesson 10

Money Management and Building Your System

The final, and by far one of the most important factors to your success is *money management* (sometimes also referred to as *position-sizing*). To illustrate just how important it is to your final results, there has actually been a mathematical study which confirms that even completely random entries, based upon a coin toss and yielding only a 35% “win” ratio, can produce steady profits when combined with proper money management formulas.

As a matter of fact, to break it down by level of importance and influence, it can be said that money management accounts for up to 50% of the final result. Approximately 40% can be attributed to psychology, 8% to exits (including targets, stops, and position management), which leaves 2% for entries – at best.

And, yet, when most people believe they have a system, what they really mean is they have a set of signals for entry.



The Components of a Good System

Every system should include the following components:

- Criteria for entering trades
- Indicators to confirm entry signals
- Criteria for exiting trades (or staying in them)

- Rules for setting stops
- Rules for setting targets
- A method to size positions relative to risk
- A way to look back and evaluate trades

A Simple Money Management Formula

A good rule of thumb for sizing positions is to risk no more than 2% of your account equity in any one position. That's 2% assuming worst-case scenario of a stop loss being triggered. Therefore it should be easy to calculate how much is being risked based upon the total size of the account, and the distance in pips to the stop you have in mind for any given position.

If you are trading a strategy which requires you to use wider stops in order to be effective, then you will have to consider using smaller lots. Conversely, if you find yourself trading with smaller amounts than you like, you will have to seek out a strategy which uses tighter stops (and therefore closer targets and perhaps smaller timeframes).

It is far better to make small, yet consistent profits than it is to have one or two big wins, followed by an equally big loss which creates irreparable damage to your account. By far the biggest mistakes made by new traders are over-trading (due to greed and fear – see lesson 9) and trading with positions too large relative to their account size. Keep in mind larger positions are also more uncomfortable to hold if the market is moving against you, making it that much more likely that you will exit early, not giving the markets enough time to move in your favor.

It should be noted also that 2% is the *maximum*... for positions you feel really strongly about. It is also quite acceptable (and recommended) to use less. Additionally, there should never be more than 6% of your account balance exposed at any one time as a sum of *all* open positions.

Risk vs. Reward

The other critical factor is a healthy risk-to-reward ratio. Simply put, what is the distance from your entry price to your stop vs. the distance to your target? Trades with a ratio of 1:1 should be avoided – you should strive for a minimum ratio of 1:2 (that is, your target distance is twice as big as your stop). This does not mean arbitrarily tightening stops or widening targets – the rules of your strategy must still be obeyed – it just means passing on trades which do not satisfy this requirement.



Of course, once you become good at identifying trades with risk-to-reward ratios of 1:3, 1:5 or even better, you will see your overall percentage gain improve dramatically. When combined with proper money management, these two keys become the final pillar of your trading system.