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CHAPTER 2. RISK MANAGEMENT

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Today you will Learn

- Choosing Strong Stocks vs Managing Risk
- Profit Loss Ratios
- Target Percentage of Success
- Breakout or Bailout
- 9 Types of Risk
- Reasons why traders fail
- Gambling Mentality
- Fear of Missing Out
- Revenge Trading

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Why Is This Important?

Risk management is critical to long term success as a day trader. Without it, you will not succeed.

An inability to manage risk is the leading cause of failure as a Day Trader.

If you fail to plan, plan to fail.

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Risk Management is #1

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Traders think about Risk

Traders think about Risk, but Gamblers think only about profits.

We have to always ask how much we're risking?

Do you have a mental stop?

How much are you risking in this trade?

If you're going to take 17k shares and you're risking 10 cents ($1,700), you better make sure you stand to make at least 20 cents ($3,400).

Whether you take 17k shares or 170 shares, the profit loss ratios need to be sustainable.

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9 Types of Risk

1. Exposure Risk
2. Float and Volatility
3. Distance from Stop x Share size versus your profit target.
4. Halt Risk (explained in more detail in next slides)
5. Allowing Fear to prevent you from following your plan
6. The impulse to double down
7. The impulse to try to get revenge after a loss (Snowball Days)
8. Following people on Social Media, Chat Rooms, etc
9. Improper Position Sizing

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1. Exposure Risk

Exposure risk is really simple. This is calculated by the amount of money you have in a trade, multiplied by the amount of time you're in a trade.

The good news is that as day traders, we are able to mitigate exposure risk by holding stocks for very short periods of time.

This completely changes the way we look at, and evaluate a potential trade. Imagine, if you were going to hold a stock for days, weeks, or months, you would apply a very different standard than a 15min long trade.

I generally keep my exposure risk to under 30min of total hold time.

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2. Float and Volatility

As short term traders, we crave volatility. We don't make money when stocks are going sideways, or going up a mere 1-2%. We need to find stocks moving 20-30% in a single day.

These stocks will have lower floats of under 100mil shares, and sometimes as low as 1-10mil shares.

While these stocks offer the volatility we want, that also means they have increased amounts of risk. If we buy a stock up 50% in a single day, we're buying it at an extreme premium versus the previous day's close.

This means we have to be particularly mindful of our max loss.

Imagine Rock Climbing, and starting half way up the cliff. You REALLY want to make sure you have your rope secured. It is the same with trading.

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3. Distance from Max Loss vs. Profit Target

What does it mean to have a "secured climbing rope" as a trader?

This is an understanding of your MAX LOSS on a trade.

Success is not about being right 100% of the time. In reality, it's about learning to **cut your losses when you are wrong**….In other words.

CAP YOUR LOSSES

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Cap Your Losses

Imagine if all your losses were only $10, but your winners were $90.00. You wouldn't need to be right that often to cover your losses. In fact, if you were right just 10% of the time you'd break even before commissions.

Trading is like Skiing. When you ski, you know you are going to fall, falling is inevitable. You have to learn to fall in a controlled way, so you don't get hurt. This is like trading, understanding loss is part of trading, but if we learn to control losses, we can have a great career as traders.

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Always Know What You Stand to Lose

If you don't know how much you are risking in a trade, you are asking for trouble.

Always know your potential risk, it's how to establish the value of taking a trade.

A trade is not a trade until you know your max loss and your potential profit target. Until you know these things, you aren't trading, you're gambling.

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Profit Loss Ratios

As we work through this course we'll be talking about Profit/Loss Ratios a lot. So what does it mean?

2.00 average winner : 1.00 average loser is a 2:1 profit loss ratio.

Successful Day Traders have a MIN profit loss ratio of 1:1, and aim for 2:1. This means our losses are smaller than our winners, or at worst, equal in size. The profit loss ratio you trade with directly relates to the percentage of success required to be profitable.

A high profit loss ratio means you can be wrong a lot, and still make money.

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Profit Loss Ratio Stats

2:1 Profit Loss Ratio = 33% is Breakeven

1:1 Profit Loss ratio = 50% is Breakeven

1:2 Profit Loss ratio = 66% is Breakeven

Over the course my of years trading and after reviewing tens of thousands of trades, I've always aimed for a 2:1 profit loss ratio, but I typically see a 1:1 profit loss ratio. I aim high, but come in slightly below my targets. This means I need a 50% success rate to breakeven. I trade between 68-72% success rate, which makes me a profitable trader with a 1:1 ratio.

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Put Statistics in your Favor

KNOW YOUR STATS

Know your Average Winners and Losers

Aim to always Improve this Ratio

Small Adjustments can amount to Big $

I know if I can make my losses just a few cents smaller on average, and my winners a few cents bigger, over the course of 1000 trades that can be the difference between breaking even and being profitable.

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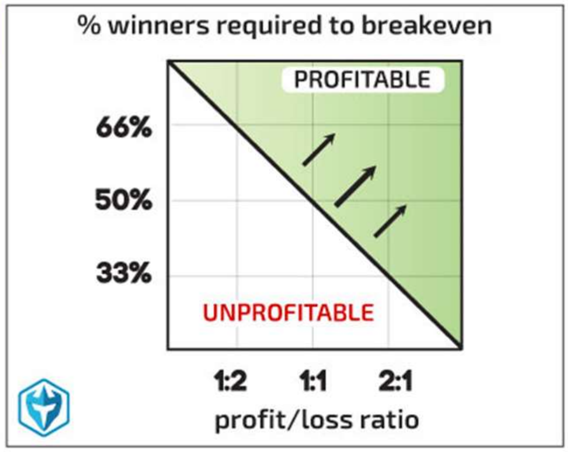
Target P/L Ratio

REWARD	RISK	BREAKEVEN WIN RATE %
1	50	98%
1	10	91%
1	5	83%
1	3	75%
1	2	67%
1	1	50%
2	1	33%
3	1	25%
5	1	17%
10	1	9%
50	1	2%



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2:1 = The Golden Ratio

I rarely take a trade the doesn't give me the chance to double my risk, having said that, I don't have a 2:1 ratio because many trades don't end up hitting the ultimate profit target and I take profits sooner before it turns into a loser.

One of the reasons I don't like trading stocks under $1.50, is because getting even 10-15 cents of profit is difficult, and it's hard to keep stops as tight as 5-7 cents (which you would need for a 2:1 profit / loss ratio.

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Risk $100 to make $200

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Be GOOD at being WRONG

I'm Wrong 30% of the time and Make Money.

Learn to be GOOD at being Wrong

Take lots of small losses

Always get your stops as tight as possible

As soon as a setup doesn't feel right I bail out.

Sometimes this means I sell for a small loss and then end up seeing the stock run, but other times I sell for a small loss and then the stock ends up tanking.

I have these rules because they keep my account SAFE and help me reduce risk.

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Breakout or Bailout

As part of my short term trading strategy, I look for almost immediate resolution on my trades. **On my best trades I'm profitable immediately and never go red**. So if I get into a trade and I'm not in the profit in the first 2min, I bail out. It's either a breakout or a bailout situation.

This strategy doesn't work as well for longer term day traders because they often sit with small losses for a while before a setup starts to work.

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Breakout or Bailout

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Determining Profit Targets

Right now we're talking primarily about setting HARD mental stops. This means if we see our max loss, we bail out of the trade.

We haven't talked about how to determine a profit target. For right now, profit targets are simply going to be 2x the risk. You can look at the chart and decide if you feel the profit target is realistic.

As we begin to look at charts and support/resistance levels you will learn more about how to understand realistic profit targets.

We will cover this in more depth in the coming classes.

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4. Stock Trading Halts

Stock Trading Halts: Stocks can be halted and paused from trading for several reasons. During halts traders cannot trade the stock in any way. Halts can last from 5min to hours or days.

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Halt Types

Code: T1 – News Pending:

Code: T12 – SEC has suspended trading in this stock

Code: LUDP – (Limit Up/Limit Down Pause) Volatility Trading Pause.

Stocks under $3.00 have different circuit breaker rules, and S&P 500 stocks and Indices also have different rules.

Circuit breaker thresholds are doubled between 9:30-9:45 because that is when peak volatility exists.

When a stock is halted, you cannot trade it, you have to wait.

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Securities	Time Period	Price Band Percentage
Tier 1 and Tier 2 NMS Securities Reference Price > $3.00	Market Hours, excluding Open/Close (9:45 AM -to 3:35 PM)	5% (Tier 1) & 10% (Tier 2)
Tier 1 and Tier 2 NMS Securities Reference Price equal to $0.75 to and including $3.00	Market Hours, excluding Open/Close (9:45 AM -to 3:35 PM)	20%
Tier 1 & 2 NMS Securities Reference Price Less than $0.75	Market Hours, excluding Open/Close (9:45 AM -to 3:35 PM)	The lesser of $0.15 or 75%
Tier 1 and Tier 2 NMS Securities Reference Price > $3.00	During Market Open/Close 9:30 a.m. and 9:45 a.m. ET 3:35 p.m. and 4:00 p.m. ET	10% & 20% Note: Band % is doubled during these times.
Tier 1 and Tier 2 NMS Securities Reference Price equal to $0.75 to and including $3.00	During Market Open/Close 9:30 a.m. and 9:45 a.m. ET 3:35 p.m. and 4:00 p.m. ET	40% Note: Band % is doubled during these times.
Tier 1 and Tier 2 NMS Securities Reference Price less than $0.75	During Market Open/Close 9:30 a.m. and 9:45 a.m. ET 3:35 p.m. and 4:00 p.m. ET	Lesser of $0.30 or 150% (upper band only) Note: Band % is doubled during these times

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When will this stock resume?

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Black Monday

Black Monday (round 2) with 1200 circuit breaker halts

On August 24th 2015, Black Monday Round 2, there were over 1200 circuit breaker halts when the market opened. It was the most extreme amount of volatility across the entire market I'd ever seen as a trader.

In March 2020 the market dropped 3,000 points in 1 day. The largest point drop I'd ever seen as a trader.

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5. Allowing Fear to prevent you from following your Plan

This is very important. If you intended to breakout trade, don't turn it into a 5hr hold.

If you intended a short term day trade, don't turn it into a swing trade.

Don't average down

Don't add to a bad Chart Pattern

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6. The Impulse to Double Down

7 Figure account traders can buy anywhere, add more, and make their way out of a trade with profit.

This isn't MOST traders

This is not a good way to trade for MOST traders.

If you see somebody on twitter or hear of a trader who hit a huge winner, just remember to keep it in perspective.

Be the best trader YOU can be, don't worry about how much other people are making.

You aren't stronger than the market. Accept defeat with humility.

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Add to Winners not to Losers

In contrast to adding to losing trades, I add to winning trades.

Many traders practice a strategy of averaging into positions. This means they take a starter with the expectation that they may lose and add more shares at a lower price.

I personally avoid Averaging Down

I add to Winning Trades and Scale out of Losing Trades

If a Trade isn't working, I can Sell half, and Buy back if the pattern shapes up again!

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7. Revenge Trading & Snowball Days

The second cause of failure is more concerning for me. It's called revenge trading, and snowball days. This is when a trader goes into the red and instead of walking away with a small loss, they average down, or get extremely aggressive trying to make up for the losses.

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Fear of Loss

Fear of Loss and Fear of Missing out, are two big emotional motivators. These fears can cause you to trade in order to alleviate the fear. If you are afraid of losing, you may hold a loser too long, if you are afraid of missing, you may end up chasing a stock and paying a price that is too high.

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Fear of Missing Out

Anytime I see a big mover and I missed a good entry I start to feel that itch to jump in and chase it. I have the fear of missing out on the move. It's really important to develop a sense of self awareness regarding these emotions. It's easy to see a stock run up and think I can jump in here and it will keep going, but a bad entry is never worth it. Every trade must have a good risk reward ratio and a safe 1min or 5min chart setup.

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Learn to capitalize on FOMO instead of fall victim to it!

When markets are really hot emotions will run strong! This is when there is a lot of FOMO. If you can anticipate the FOMO, you can capitalize on it by trading momentum stocks early in the run, knowing that stocks have been irrationally strong due to FOMO.

Falling victim to FOMO is when you buy a stock too high, and end up giving back profits.

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8. Twitter Traders never lose

Remember that on social media people typically put out the image of themselves they want people to see. That means selective posting of trades. Only posting the best trades, and quietly sweeping the losers under the carpet.

Even worse, there are people out there who will simply lie about trades to get attention.

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9. Improper Position Sizing

I have developed a strategy where I'm as aggressive as I possibly can be, but I only trade A Quality Setups. On my A Quality setup, I sometimes take very large size.

If I adopt a strategy of only trading A quality setups, and I find that during a period of a few days or a few weeks that A quality setups are working extremely well, then I will be more aggressive. This means making the strategic decision to use larger size in order to capitalize on the strong markets.

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Capitalize on Opportunities "The Sugar Shack"

Being from Vermont I grew up around the maple syrup industry. The tricky thing about sugaring is that you have a very small window in the spring where you can collect and boil down the sap. Once that window is gone, you have to wait till next year.

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Building a Cushion

The most important part of each day is building your daily profit cushion. If my first three trades put me in the red should I triple down and try to get out of the loss? No. By doing that I risk tripling my loss on the day.

I usually get aggressive pretty quickly out of the gates. I look for immediate resolution to take small winners to work my way up to a small daily cushion.

Once I have a cushion I get aggressive until I hit my daily goal. Once I've hit my goal, I ease back and start reducing my risk so I don't worry about giving back the easy profits.

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P/L Ratios reflect your personal trading style

Your profit loss ratios will often be a reflection of your personal risk preferences.

I have a trade management strategy that involves selling ½ my position as soon as I've made the amount of money I was risking on the trade. If I'm up $100 and I was risking $100, I sell ½, which gives me a $50 profit cushion.

As soon as I've sold ½, I adjust my stop on the remaining shares to breakeven. Because of this strategy, I have TONS of small $50 winners which draws down my average winner statistic. However, it increases my percentage of success.

This trade management strategy will be discussed in detail later in the class, but for right now we will look at it as a reflection of my personality.

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Sometimes the Best Trade is NO TRADE

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Mitigate Risk by Trading Strong Stocks

I want everyone trading strong stocks but we know we can make money with a horrible percentage of success as long as we use proper risk management.

This means we must focus our foundation as traders on risk analysis first, and stock selection second.

When we apply the fundamentals of risk management to proper stock selection and chart patterns, we greatly improve our odds of success.

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My $100k Challenge

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Steps you can take today

These are steps you can take today to get better at managing risk.

1) Enter a position then set a live STOP loss order on the trade (I use mental stops, but live stops are good because you delegate responsibility to your broker). I would usually use a max loss of 10-20 cents on each trade.

2) Never take a trade that doesn't have 2:1 profit loss potential.

3) Focus on 1-3 trades/day. Goal is to put together as many consecutive green days as possible. Get green then walk away!

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Live Trading: Breakout or Bailout

Bailout at break even when it doesn't breakout as expected.

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note-taking

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