Risk Management Basics

By @CryptoCred

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General Remarks

- Risk management is the most important yet least popular topic in trading
- I mean it when I say this is lesson covers the “basics”
    - Hedging, expectancy, laddering etc. are not covered
- This lesson is aimed at traders
- Lots of variables come down to personal preference and good journaling/record-keeping
    - How much to risk per trade
    - When/if to risk more than usual on certain setups
    - Whether to increase/decrease risk when trading is going well/poorly
    - High R lower strike rate versus lower R higher strike rate
    - And more
- There’s no point drawing nice lines on candlestick charts if you get wiped out trading - manage risk and stay in the game!

Stop Losses

- Definition - *an order to close a position at a certain price point/percentage to limit one's losses*
  - I personally always use a stop loss, and I always use a market stop
- The primary purpose of a stop loss is to <u>protect a trader's account balance</u> when they are wrong on a trade
  - By limiting the amount a trader loses if they are wrong, they are able to continue trading and be profitable without having to win every time
- My 2 key principles of stop loss placement:
  - A trader's stop loss must be <u>based on technical analysis</u> - do not use fixed percentages, R calculations, etc.
  - A trader's stop loss must be placed at the <u>invalidation level</u> - that is to say, the point at which the trader's idea for entering the trade has been invalidated/disproved by the market
    - When entering a trade, a trader (hopefully) has a thesis for taking it. The stop loss goes where the trader knows that their reasons for entering have been disproved.
      - This is unique depending on the setup!

Risk Per Trade & Position Size I

- Definition of risk per trade: *what percentage of total equity a trader stands to lose per trade*
- Definition of position size: *the number of units of an instrument a trader purchases*
- Risk per trade:
  - Largely down to preference, but most traders are comfortable in the range of 1-5% of equity per trade
  - I use 3% as a baseline (and reduce it if I start getting slapped around)
  - <u>Calculating risk per trade</u>: total equity x risk %
    - E.g. if a trader's equity is $10,000 and they wish to risk 3% - $10,000 x 0.03 = $300
  - Crucially, this does NOT mean a trader buys units worth $300
  - Risking $300 means <u>if the trader gets stopped out</u>, they will lose $300

Risk Per Trade and Position Size II

- Position Size:
  - The two key pieces of information a trader needs to know to establish position size are:
    - Risk per trade
    - Distance to stop loss from entry in percentage (%) terms
  - Calculating position size: (total equity x risk %) ➗ distance to stop loss from entry
    - BitMEX example: if a trader has a $50,000 account and wants to risk 3% of their account and their stop loss is 5% away from their entry, the calculation would be performed thus:
    - (50,000 x 0.03) ➗ 0.05 = 30,000 contracts
  - Thus, risk per trade and position size are quite distinct: a trader can trade with a $50,000 account can have a $30,000 position size while only risking $1500 (3% of $50,000)
  - For effective trading, it helps if the trader has their risk per trade and stop loss determined in advance so that they trade the appropriate size
  - Worth bearing in mind that most platforms, exchanges, and so on have calculators

R & Win Rate I

- Definition of R: *number which reflects the amount of risk undertaken relative to the reward of a trade*
  - In other words, R reflects how much risk a trader is taking on a trade to reach a certain reward
    - Also commonly known as risk:reward ratio
  - Calculating R: reward ➗ risk
    - BitMEX example: if a trader enters a long position with a stop loss (risk) $50 below entry and a target (reward) $200 above entry, the calculation would be performed thus:
    - 200/50 = 4R
    - Once again, most platforms and plenty of websites will calculate this for you e.g. TradingView long/short position tools
  - Lots of gurus will pontificate about a minimum R/gold standard R - they're wrong
  - As with stop placement, targets should be based on technical analysis - randomly picking numbers to suit a specific R is pointless; the market doesn't care!
    - This also means that targets for a trade should be realistic - there is no point in choosing overly ambitious targets which inflate R unless there are good reasons to believe the target will be reached

R & Win Rate II

- Definition of win rate: *percentage which reflects how many of a trader's total trades are winning trades over a given period of time*
- Calculating win rate: (winning trades ÷ total trades) x 100
  - E.g. a trader has made 20 total trades in the month of May, 11 of which have been winners. The trader's win rate for May is calculated thus:
  - (11 ÷ 20) x 100 = 55% win rate
- Traders often split into two camps:
  - Higher R lower win rate setups
  - Lower R higher win rate setups (most of the setups I trade fall into this category)
- By knowing their average R, a trader can calculate the minimum win rate they must meet in order to be profitable: 1 ÷ (1 + R) x 100
  - E.g. if a trader's setups usually have an R of 3, the win rate to be profitable would be calculated thus:
  - 1 ÷ (1 + 3) x 100 = 25%

Evolving R

- Concept I picked up from @Trader_Dante
- Premise: *the R of a trade is static upon entry, but as price moves away from entry, the R of the trade evolves*
- The point is to <u>manage the trade such that during its course the R remains reasonable</u>
  - Many traders will routinely move their stop loss to break even as soon as possible and leave their targets as they were
    - This is almost a form of laziness
    - Where it is possible to do so, traders ought to be <u>reactive</u> and respond to the price action as it develops
  - Example: trade travels towards target, misses it by 1-2 points, and comes back to take out the trader for a breakeven → that retracement from nearly target back to breakeven is money that the trader effectively gave back to the market
- No such thing as a free trade - do not let winning trades turn into breakevens/losers

Handling Drawdown

- The idea that the market will, at some point, hand your ass to you is just about the only certainty in trading
  - In fact, this is what risk management is premised on: if a trader manages risk well, they can take a beating and stay in the game
- Recovering losses is psychologically difficult and becomes progressively more difficult to do if you continue losing - see table (source: BabyPips)
- Potential drawdown mitigation checklist:
  - Can your win rate and R take a losing streak on the chin? See table 2.
  - Do you have trading rules/some sort of system for taking trades? Or are you gambling?
  - Have you been following your trading rules?
  - What links your losing trades? What links your winning trades?
  - Do you simply need a break? Are you punting FOMO/revenge trades?
  - Have you considered reducing your risk and increasing the quality of setups you take?
- Focus on survival

Margin

- Definition: *borrowing capital from your broker to open a position larger than one would otherwise be able to*
- With margin trading come liquidations: the price at which your losses are such that the exchange will forcibly close your position
    - Usually stated very clearly on the exchange
    - E.g. using 25x leverage, a trader's position will be liquidated if losses exceed 4%
- Cross or isolated margin
    - Cross = your entire available balance will be used to avoid liquidation
        - Liquidation = your entire account gets nuked
    - Isolated = fixed margin for a certain position (which can usually be amended)
        - Liquidation = the balance used to open the position gets nuked
- The position size calculation <u>does not change</u>
    - Your risk must still be the same; margin simply allows you to open positions at a fraction of the cost/without using your entire account balance
- Margin trading is very risky and can accelerate your losses - do plenty of research before trying it with live funds

Conclusion

- I cannot stress enough the importance of risk management - it is the backbone of any good trading strategy and what separates traders from gamblers
- Focus on survival
- One of the best things you can do for risk management is keep a trading record/journal
  - By building a trading record/journal you can look back and see what risk % works best, which setups are the best, what links your best/worst trades, et cetera
- This is a basic lesson on risk management - this area of trading warrants further and continued study
- Exercise utmost caution when margin trading - hone the testnet/demo environment first

Thanks for watching!

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