

Five Risk Management Strategies

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Introduction

Minimizing risk is a priority for many investors and traders. Even if your risk tolerance is high, you'll still weigh the risk of your investments versus the payoff. However, there's more to risk management than simply choosing less risky trades or investments. A comprehensive toolset of risk management strategies is available, many suitable for beginners too.

What is Risk Management?

Risk management entails predicting and identifying financial risks involved with your investments to minimize them. Investors then employ risk management strategies to help them manage their portfolio's risk exposure. A critical first step is assessing your current exposure to risks and then building your strategies and plans around them.

Strategy 1: The 1% Rule

The 1% rule is a simple risk management strategy that entails not risking more than 1% of your total capital on an investment or trade. If you have \$10,000 to invest and want to adhere to the 1% rule, there are a few ways to do so. One would be to purchase \$10,000 worth of Bitcoin and set a stop-loss order to sell at \$9,900. Here, you would cut your losses at 1% of your total investment capital. You could also purchase \$100 of Ether without setting a stop-loss order, as you would only lose a maximum of 1% of your total capital if the price of ETH were to drop to zero.

Strategy 2: Stop-Loss and Take-Profit Orders

Stop-loss and take-profit orders help you manage your risk in two ways. First, they can be set up in advance and will be executed automatically. There's no need to be available 24/7, and your pre-set orders will be triggered if prices are particularly volatile. This also allows you to set realistic limits for the losses and profits you can take. It's better to set these limits in advance rather than in the heat of the moment. While it can be strange to think of take-profit orders as part of risk management, you shouldn't forget that the longer you wait to take profit, the higher the risk the market could fall again.

Strategy 3: Diversifying Your Portfolio

Diversifying your portfolio is one of the most popular and fundamental tools to reduce your overall investment risk. A diversified portfolio won't be too heavily invested in any asset or asset class, minimizing the risk of heavy losses from one particular asset or asset class. For example, you might hold a selection of different coins and tokens. But you could take it even further and invest in different types of assets or industries. The idea is that if one part of your portfolio incurs losses, the rest of your portfolio remains unaffected or even makes gains.

Strategy 4: Set a Plan and Stick to It

Creating a trading plan is essential for successful trading. This should include your entry and exit targets, as well as how much you're willing to invest or trade per position. Once you've created a plan, you should stick with it. Emotional trading can lead to irrational decisions that may result in significant losses. Your trading plan should also include time limits. For example, you might decide only to trade on specific days of the week or always close your positions before the weekend.

Strategy 5: Consider the Risk/Reward Ratio

Another helpful way to manage your risk is by determining the risk/reward ratio for each of your trades. Simply put, the risk/reward ratio compares your potential profit (reward) to your potential loss (risk) for each trade. To calculate it, divide your maximum risk by your net target profit. A lower risk/reward ratio means your potential profits are greater than your potential losses, which is generally what you want. For example, a 1:3 risk/reward ratio means you're willing to risk \$1 to potentially make \$3.

Best Practices

With the five risk management strategies outlined, you'll have an effective toolkit to help reduce your portfolio's risk. Even employing simple methods that cover most areas will help you invest more responsibly. It's important to combine these strategies rather than relying on just one. Consider using stop-loss orders together with the 1% rule, diversifying your portfolio across different assets, and always maintaining a trading plan that includes realistic risk/reward assessments.

Conclusion

With crypto moving rapidly, it's imperative to employ sound risk management practices and strategies to reduce your exposure to potential risks. This is also an essential step to becoming a successful and responsible trader. By implementing these five fundamental strategies, you can protect your capital while still positioning yourself for potential gains in the volatile cryptocurrency market.

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