FX money management

In the first of two articles adapted from his new book, *Technical Analysis of the Currency Market*, Boris Schlossberg addresses money-management myths and looks at ways to manage trades and capture profits in the real world.

BY BORIS SCHLOSSBERG

Just as in trading there are really only two decisions to make — trend or fade — so, too, in money management there are only two strategies to follow: You can either suffer numerous small losses and hope that an occasional large win will more than offset the drawdowns in your account, or you can harvest many small profits and suffer an occasional large loss that you hope doesn't overwhelm the profit cushion you have built.

Of course, novice traders rarely face these two choices; they simply lose money. Some lose money in small increments over a long period of time, while others lose money in shockingly huge chunks and are out of the game before they even have a chance to learn how to properly use their trading software.

Why do novices inevitably lose? Because they trade in a random fashion. They rarely practice consistency in their setups. They rarely understand the dynamics of price flow, and even when they learn it, they frequently misunderstand the nature of technical analysis.

Trading randomly is one of the quickest ways to lose money in FX. Many threads on many Internet bulletin boards have been started using the random entry "coin flip" approach and some basic form of money management, such as risking $1 for every $2 of profit; within a matter of weeks or months, the originators of those threads have found themselves either in deep drawdown or completely broke.

Ironically enough, the practitioners of the random entry method inadvertently prove that market action is not random. If it were random, then they presumably should perform no worse than skilled traders. But alas, like a lucky idiot who sinks a half-court shot during a contest but could never win a one-on-one game against a professional basketball player, so, too, these novice traders will fall by the wayside when competing against professional technical traders over any reasonable length of time.

The notion that technical analysis doesn't matter — it's just money management that matters — is, like so many trading myths, complete nonsense. Money management alone will not make you a successful trader. It is, however, a vital complement to any intelligent technical setup.

Money-management strategies are as unique as each trader, and one of the most pernicious myths perpetrated on the gullible public is that money-management strategies are sacrosanct and thus all traders must follow the same money-management rules in order to achieve success.

That is utter nonsense. In fact, the longer the traders trade, the more flexible, the more complex, the more creative their money-management skills become. Because FX offers retail traders unprecedented liquidity and limitless customization, money-management strategies in FX are truly variable.

The myth of 2:1

Let's start the most classic money-management technique preached by every trading book ever printed: In every trade your reward-risk ratio must be at least 2 to 1 — that is, you must try to obtain 2 points of gains for 1 point of risk. This way the trader needs be correct only 40 percent of the time and will still have a positive expectancy to his trades.

On the surface this idea sounds eminently logical and practical. In real life, however, it's quite difficult to squeeze out 2 points of profit for 1 point of risk. Try it and see. First look at the price action on the smallest time frame and see how hard it is to risk 1 point in order to capture 2 points.

On the smallest level the FX trader faces the overwhelming barriers of the spread. Even in the most liquid financial instrument in the world, the EUR/USD, the spread is 3 points wide, so in effect the trader must make 5 points in order to earn 2, thus forcing him to generate an improbable ratio of 5:1 in order to simply meet this goal.

Moving on to a 10-point increment, a 10-point risk for a

One of the most pernicious myths perpetrated on the trading public is that money-management strategies are sacrosanct and all traders must follow the same money-management rules to achieve success.

20-point profit still requires a 23-point gain and allows for only a 7-point risk of loss in the tightest spread pairs like EUR/USD and USD/JPY; in effect, this means a trader must generate 3 points of profit for 1 point of risk just to meet the 2:1 reward/risk ratio.

Expanding the time line to longer time frames, a 100-point risk with a 200-point profit target provides much better odds. Here the spread plays a minuscule part as it requires only 203 points of profit and allows for 97 points of risk, generating very close to a 2:1 ratio.

But let's step back a second. What if you were simply not predisposed to patiently stay in the trade for the time necessary to see it to fruition? If you were impatient, wouldn't it be much more probable that you would try to take your profits far sooner, perhaps at 100 points in the money or even 50 points in the money, turning what in effect was supposed to be a 2:1 trade into a 1:1 or 1:2 reward-to-risk setup? You will do what every trading book preaches not to — you will cut your profits short by not letting them run. But given your personality, can you really be expected to do it any differently?

But let's suppose you are different. You possess the patience of a saint, you have the discipline to follow this rule inviolably. Imagine the following scenario: You place a trade in EUR/USD. Let's say you decide to short the pair at 1.2500 with a 1.2600 stop and a target of 1.2300. The trade is going well. The price moves your way. EUR/USD first drops to 1.2400, then to 1.2350, and slowly makes its way toward 1.2300.

At 1.2335 the price action pauses and the pair starts to inch back up, first trading through 1.2350, then 1.2375. You, however, are patient. You have nerves of steel. You hold on, looking for your 2:1 reward-to-risk. The price starts to move back down and you are starting to feel vindicated. Back to 1.2350, 1.2325; slowly but surely you see the target in sight. 1.2320, 1.2310, 1.2305. Your take-profit order sits on the platform waiting to be filled. The price ticks a few more pips down, reaching all the way to 1.2301 — but then it bounces back, first slightly, then violently, until in a matter of seconds it's at 1.2350, then 1.2370.

You remain calm. The price nearly touched your target. It's bound to test that level again. You won't make the same mistake others make of cutting your profits short. You will stay in the trade and follow the classic money-management rules.

Of course, the price never does see 1.2300. Instead the pair "verticalizes" and soon reaches 1.2600, easily taking out your stop. You are now faced with the idea that you had a 199-point profit and allowed it to become a 100-point loss. Welcome to real trading.

Modifying the approach

How many episodes like that do you think a novice trader can experience before abandoning all sense of discipline and proper money management? This is the reason why the 2:1 reward-to-risk strategy is mostly a fantasy, an ideal. In practice most traders will modify the strategy in one of two ways.

First, once price moves in the direction of the trade by the amount of points risked, professional traders will move their stop-loss to the breakeven point to assure themselves that a winning trade will not become a losing trade. So in the case of our EUR/USD trade the trader would move the stop to 1.2500 once the price breached the 1.2400 level.

This, however, still presents a dilemma for most traders. Suppose the price retraced all the way back to 1.2500, stopping the trader out. There would be no losses, but also no gains. The trade would be a scratch. In trading there is nothing more frustrating and psychologically unnerving than to be right on direction and walk away with no profit. It's the equivalent of working very hard all day long at your job and then losing that day's pay through a hole in your pocket.

For this reason many traders practice a scale-out approach. Typically traders will let go of half of their position once the gains match their risk value. In our EUR/USD example the trader would sell half at 1.2400 and then move the stop to the break-even point, assuring himself of harvesting at least some profit out of the trade.

This approach allows the trader to remain in the trade for as long as necessary because it satisfies the most basic desire of trading — the need to get paid. By selling half of the position at 1.2400 and half at 1.2300, the trader is able to harvest only a 1.5:1 reward-to-risk ratio, which of course is mathematically inferior to 2:1. However, trading is not a game of mathematics but one of psychology, and frequently what is mathematically optimal is psychologically disastrous.

Professional traders recognize this fact. They also understand that market dynamics are fluid and will rarely conform to rigid reward/risk ratios. By constantly monitoring their positions and adjusting their risk parameters to the reality of the markets, professional traders are able to not only generate positive reward/risk ratios, but also produce more profitable trades.

For information on the author see p. 6.

Next month: More money-management strategies from the book Technical Analysis of the Currency Market.

Related reading

Technical Analysis of the Currency Market: Classic Techniques for Profiting from Market Swings and Trader Sentiment by Boris Schlossberg (2006, John Wiley & Sons).

***Other articles by Boris Schlossberg*:**

"Progressive entry technique," *Currency Trader*, July 2005.
A staggered trade-entry approach allows you to be more flexible and structure your trade depending on market developments.

"Forex options," *Currency Trader*, June 2005.
Forex options are a breed apart. Traders accustomed to standard calls and puts need to familiarize themselves with some new concepts and terminology before trading these "exotic" instruments.

You can purchase and download past articles at www.activetradermag.com/purchase_articles.htm.