



Trade management:

Risk, reward, and the 10-percent solution

In the second of two articles adapted from his new book, *Technical Analysis of the Currency Market*, Boris Schlossberg looks at aggressive money management, scale-in techniques, and a trade-management approach designed to balance high-risk and conservative approaches.

BY BORIS SCHLOSSBERG

Editor's note: In last month's article, "FX money management," the author addressed the "myth" of 2-to-1 money management and looked at practical ways to manage risk in the forex market. This installment focuses on three different approaches to managing positions.

Do you have the killer instinct? Can you press the trade? Then the following trade-management technique may be for you. If you ever want to hit home runs, if you ever want to make a huge score in trading, then this is the only way for you to trade and FX is the single best market to effect this strategy.

Let's review the EUR/USD trade discussed in last month's article. Again, assume you get short at 1.2500 but this time your strategy is different. If the pair trades up to 1.2550, you cut your loss quickly and await the next opportunity.

For traders who are more than willing to suffer a long series of losses and empty trades for a chance to score big, FX offers the best opportunity to do so of any financial market in the world.

If, however, the trade moves your way, you do not automatically take half the position out of the market. Rather, you wait patiently and watch the price action. Imagine the price has now moved to 1.2200, fully 300 points in the money. Instead of taking profits, you add another unit to the trade. If the price begins to retrace all the way back to 1.2350, you cover the whole position for a scratch. You haven't lost anything on the trade, but you haven't made a profit, either.

However, if the price retraces only slightly but then resumes direction, you stay in the position and again mon-

itor price action carefully. The price has now reached 1.2000 and you sell another unit at that price. You now have sold a total of three units at an average price of 1.2230. As long as the price remains below this level, you stay in the trade.

Your patience pays off and the price collapses to 1.1700, at which point you finally cover the whole position. Let's review the total profits from the trade:

- 1 unit at 1.2500 covered at 1.1700 results in a profit of +800 points.
- 1 unit at 1.2200 covered at 1.1700: +500 points.
- 1 unit at 1.2000 covered at 1.1700: +300 points.
- Total profit: 1,600 points.
- Total risk: 50 points.

For those traders who can implement this strategy, this is clearly the best way to trade. Dennis Gartman (the famous investment newsletter writer), an old pit trader himself, calls this method "doing more of what is working and less

of what is not." It is no doubt deceptively simple and seductive.

In fact, here is a description (taken from the Elite Trader bulletin board) of another famous pit trader, Richard Dennis, employing just such a strategy in the bonds.

As someone who has seen the likes of Rich Dennis and Tudor Jones operate, those "5 percent" winning trades involve add-on after add-on. Case in point is Dennis in the 1985-86 bull market in bond futures. He would start with

continued on p. 28



his normal unit of 500 contracts and get chopped for days. Buy the day's high, put 'em back out on a new swing low, etc. Every once in awhile he'd wind up with 500 that worked. Then he'd start the process higher, all over again. Work 'em in, work 'em out.

After maybe a couple of months the market has rallied 10 points from where he started and he has 2,000 on (meaning 2 million a point). Now the market is short and ready to pop on any size buying and he's there supplying the noose. Bidding for 500 on every uptick, he finally gets to a point where for the last month of the move he has 5,000 on. T-bonds rally 20 points in just over a month and he's up \$100,000,000 on a trade that started out with him just testing the waters, losing \$100,000 a few times before he could establish a position worth doubling up on.

Wouldn't we all want to own that trade? One trade, \$100 million in profit. But let's remember what's required to get there:

- Accurate directional entry into trend.
- An intense, multi-hundred-point trend with little or virtually no retracement along the way.

What are the chances this type of strategy succeeds? Minimal at best. Note that the writer described these as "5 percent" trades, meaning they occurred only 5 percent of the time. In fact, the perfect confluence of events to gener-

are more than willing to suffer a long series of losses and empty trades for a chance to score big, FX offers the best opportunity to do so of any financial market in the world. Why? Leverage and liquidity.

Using leverage and liquidity

Here is how this strategy would work. Assume that you have \$10,000 of trading capital. Deposit only \$2,000 of capital with your FX dealer. Keep the rest in your bank account. With 100:1 leverage, which is standard in the FX market, you will have 100 points of leeway before you get a margin call in EUR/USD. (Trading other pairs the margin requirements might be different, so consult with your dealer before attempting this idea on other currencies.)

If the trade moves against you, an automatic margin call will instantly take you out of the market. Dealers will not call you in advance and warn you of an impending margin call like they may do in exchange-based futures markets. Rather, the dealer's software program will automatically liquidate your position. This may seem a bit brusque, but the upside of such an arrangement is that your account should never experience negative equity and your total risk should be limited to the amount you've deposited. The margin call will then act as a de facto stop on your account.

If a margin call is triggered, your account should have approximately \$1,000 of equity left: \$2,000 initial deposit – \$1,000 loss on trade ($\10×100 points at 100:1 leverage) = \$1,000.

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ate such profits probably happens less than that.

Far more than the fortuitous market conditions necessary to produce such windfall profits is the unbelievable psychological pressure such trading will generate. The term "pressing the trade" is most apropos to describe this dynamic. Not only is the trader pressing the market by adding more and more units as they go deep into the money, but he is also pressed by the market as his profits pile up.

Put yourself in Richard Dennis' place. Would you be able to stay in the trade once it hit \$1 million? How about \$10 million? \$50 million? At each level the intensity is enormous, and for most people the pressure of winning can be far worse than the fear of losing.

Forget Richard Dennis and just think how you would have felt if after selling the third unit at 1.2000 you had to cover at 1.2233 as prices retraced, and you had to watch a certain profit of 700 points evaporate.

For those unconcerned with such issues, for traders who

Deposit another \$1,000 from your bank and trade again once your setup is triggered. You can repeat this process up to nine times before you run out of your trading capital. Will you lose most of your money? Perhaps. Remember, this is a very low-probability trade. But at least by subdividing your capital into 10 equal pieces you've given yourself the best opportunity to succeed. This strategy is basically a more intelligent variation on the old trader saying, "Have a hunch, bet a bunch."

Let's imagine, however, that on one of the trades you were successful and caught the large directional move. If that's the case, you could employ the trade management strategy discussed before and continuously add to your position as prices move your way. In the best of all possible scenarios the trader could eventually build up a large position, perhaps 10 lots or more (with notional value of \$1 million), that could be 1,000 points in the money. In that case the profit on the trade would grow to \$100,000. Not bad for

\$1,000 of initial risk.

As I've already noted, this strategy is not for the faint of heart. This is a very high-risk, (potential) high-reward strategy that requires a unique mindset and proper trade management techniques to succeed. For those inclined toward a more steady approach, here is a completely different trade methodology and one that I employ myself.

Take a nibble, not a bite: Scaling into trades

Never add to a loser. Never double down. These old trading maxims are treated as sacrosanct truths by most traders.

What a bunch of nonsense. I add to losers all the time, and so do some of the most successful traders I know. Why? Because what most books never tell you is that almost all trades start out as losers. It is extremely difficult to time the entry so well that it immediately begins to move in the direction of your trade. Sometimes trades will move only a few points against the position but occasionally prices may retrace several hundred points away from initial entry only to eventually turn around and become profitable.

Trading is the art of accurately forecasting direction and timing. Between the two, timing is far harder to handicap, especially if prices seesaw back and forth for a while before ultimately moving in the right direction. Traders who trade

2. Trade in very small increments.

To understand just how destructive this strategy can be, let's examine what happens if the trader uses this method employing the standard allocation of 2 percent of capital per trade. Imagine that the trader with a trading account of \$10,000 initiates the first trade in the EUR/USD currency using two mini lots (worth \$1,000 each). Prices move against his entry by 100 points and he now doubles his allocation to four mini lots. Again prices continue to move against him by another 100 points and he doubles his position yet again to eight mini lots.

Prices continue to follow this adverse pattern and move against him by 100 points more. Finally, the trader gives up and covers his position in dismay. What is his total loss? A whopping 22 percent of his total capital!

- \$600 on two mini lots (prices moved 300 points away from entry).
- \$800 on four mini lots (prices moved 200 points away from entry).
- \$800 on eight mini lots (prices moved 100 points away from entry).

Like a mother who feeds her baby medicine in tiny little portions in order to make it more palatable, this technique forces the trader to do what is best for his account with minimal psychological damage.

highly leveraged positions with tight stops will be eviscerated in such an environment, as they will continuously get stopped out. Far worse than the hit to equity is the psychological pain of "death by a thousand stops."

That is why traders who do not like frequent stop-outs prefer the scale-in approach to price entry. This strategy is almost diametrically opposite to the strategy discussed in the preceding section. Using the scale-in approach assumes that the first entry will almost never be the best entry; as a result, the approach requires very low leverage in order for the strategy to withstand the adverse price moves.

In this strategy, the trader continuously adds more units as prices move against him, trying to achieve a blended price that remains near the current price. If prices do eventually turn, the constant averaging of price levels will make the position profitable much faster than if he expended all of his trading capital on the first price entry. While this can be a successful trading strategy, it can also be highly dangerous if the trader does not follow two key rules:

1. Set a hard stop for the whole position.

The irony of the matter is that after an uninterrupted 300-point move against the position, chances are quite high that the trade may turn around and could quickly become profitable. But by overleveraging the position the trader is unable to withstand the drawdown.

Imagine the same scenario but instead of using mini lots with the value of \$1 per point, the trader uses micro lots with each point having a value of only 1 dime (\$1,000). In FX, where many dealers offer such small lot sizes, this strategy is eminently possible. In that case the drawdown would be a far more manageable 2.2 percent of capital and the price would need to move back only 150 points instead of the full 300 points in order for the trade to become profitable.

This type of scaling where the trader doubles the size of the position at every interval is called "geometric scaling." Unlike regular average-in scaling that cuts the break-even point by 50 percent, geometric scaling requires that prices retrace by only 33 percent to reach the break-even point.

While this can be a very effective way to quickly make a

continued on p. 30


TABLE 1 — GEOMETRIC vs. ARITHMETIC SCALING

		Arithmetic	Notional value	Geometric	Notional value
Long every 50 pips down	1.2500	100	\$125	100	\$125
	1.2450	200	\$249	200	\$249
Starting account \$5,000	1.2400	300	\$372	400	\$496
	1.2350	400	\$494	800	\$988
Unit — 100	1.2300	500	\$615	1,600	\$1,968
	1.2250	600	\$735	3,200	\$3,920
Pip value — 1 cent	1.2200	700	\$854	6,400	\$7,808
	1.2150	800	\$972	12,800	\$15,552
	1.2100	900	\$1,089	25,600	\$30,976
	1.2050	1,000	\$1,205	51,200	\$61,696
	1.2000	1,100	\$1,320	102,400	\$122,880
		6,600	\$8,030	204,800	\$246,658
Hard stop	1.1950				
Break-even value		1.2166			1.2049
Maximum loss in pips		-143			-2,041.5
Maximum loss in dollars		-143			-2,041.5

losing trade profitable, the strategy can also spiral out of control. A better compromise between the straight average-in method and the geometric scale-in is the arithmetic scale strategy. Instead of doubling up the position at every interval, the arithmetic scale calls for an increase of the position by a fixed amount. Table 1 shows the key differences between the geometric and arithmetic approaches using a hypothetical scale-in strategy in EUR/USD starting with entry at 1.2500 and a hard stop at 1.1950.

Note that in the worst-case scenario the geometric strategy loses more than \$2,000 on a \$5,000 account while the arithmetic strategy loses only \$143. At the same time the break-even point on the arithmetic strategy is 1.2166, only slightly higher than the 1.2049 break-even on the geometric approach. The data clearly shows that for multiple-interval scale-in approaches the arithmetic strategy is the best bet.

The 10 percent solution

An interesting trade-management compromise between the low-probability, (potential) high-reward method of scaling up into a position and the high-probability, low-reward technique of scaling down into a trade is something I call the 10-percent solution, which I picked up from a trader on one of the FX trading bulletin boards.

Let's suppose once again we would like to short the EUR/USD pair at 1.2500. For simplicity's sake, we are willing to risk 100 points and seek a 100-point target on the trade. In other words, our stop is at 1.2600 and our target is at 1.2400.

Let's further imagine we will trade 10 mini-lot contracts with total notional value of 100,000 units. We place our short at 1.2500. However, here is the rub. Instead of stopping out at 1.2600 with the whole position, we place stops at 10-point intervals for 10 percent of the position. So, if the

trade moves against us by 10 points we would sell one mini lot, leaving us with nine mini lots (90,000 units) in the trade.

If the trade moves 20 points counter to our entry we would sell one more mini lot, leaving us with 80,000 units — and so on, until the price reached our ultimate stop-out value of 1.2600, at which point we would only have to liquidate one mini lot left in our inventory. On the opposite side we would maintain our target of 100-point profit regardless of how many lots we had left, so if we got stopped out on three mini lots but prices then turned in our favor we would harvest a 100-point profit on the remaining seven lots.

Think about the implications of this strategy for a moment. In the original trade we risked 100 points on 10 mini lots or a total of 1,000 points ($100 \times 10 = 1,000$). Using this compromise stop-out approach we were able to winnow down the total loss from 1,000 points to only 550 points if the trade became a complete bust.

However, if the trade turned in our favor at any time before reaching the eighth stop-out, we would still have been able to bank a gain. The attractiveness of this approach is twofold. It automatically reduces risk if the trade moves against you, but it allows the trader to partially remain in the trade up to the very last moment. Not only is this a good practice of risk management but it is also a very clever way to get the trader to actually accept his stops. Just like a mother who feeds her baby medicine in tiny little portions in order to make it more palatable, this technique forces the trader to do what is best for his account with minimal psychological damage.

Steve Cohen, probably the greatest trader in the world today — so good that he is able to charge 50 percent of gross profits in his multibillion-dollar hedge fund STC Capital — once said in an interview with Jack Schwager in *Stock Market Wizards* (Harper-Collins, 2001), "What happens when you are short a stock that is moving against you, and there is no imminent catalyst? I always tell my traders, 'If you think you're wrong, or if the market is moving against you and you don't know why, take in half. You can always put it on again.'"

When I first read that comment it went in one ear and out the other. But upon further reflection, I realized Steve Cohen was practicing just this type of risk control methodology for all of his trading.

The 10-percent solution strategy is only a template. We need not scale out at every 10 percent of the distance to the ultimate stop. We could use 20 percent, 25 percent, 33 per-

cent, or any other type of ratio that makes sense. The strategy can also be refined further to enhance the probability of success, though at a cost to profitability.

For example, instead of keeping the profit target at a static 100 points from original entry, we could adjust the target in response to price action. If the price moved 10 points against our position we could reduce the profit target by 10 points, so that instead of 1.2400, we would decrease the profit target for our short to 1.2410; if the price moved 20 points we would decrease the profit target to 1.2420. Table 2 shows what happens when the system is adjusted in such manner.

Note that while the profitability of each trade is somewhat reduced, the probability of the success for each trade is likely to be better as it needs to travel less and less distance in order to reach the profit target.

Conclusion

Whenever I teach new sales traders at my firm about proper trade management in the currency market, I often start out with the example of Richard Dennis and the method of pressing the trade. Before I even have a chance to finish, some overeager rookie will inevitably jump up and confidently proclaim, "Yes! That's the only way to trade!" However, in trading there is no "only" way of doing anything, especially money management.

One of the great strengths of trading is that it is an art, not a science — and there is a highly flexible discipline that allows for numerous individual modifications.

Are you comfortable with the classic 1:2 risk-reward approach? If so, it can be quite profitable, especially if you modify it as most traders do by scaling out of half of the position at profit distance equal to risk and trail the rest with a break-even stop.

Do you have a killer instinct? Can you easily give up small to medium-sized gains in quest of one huge win? Then pressing the trade by constantly adding to a winning position may be the best strategy for you.

What if you like taking small, frequent gains and can accept an occasional large loss? Then arithmetic scaling may be just the right approach for you to succeed.

Finally, what if you are a true moderate, neither seeking remarkable gains nor afraid to absorb a series of small losses? Then the 10-percent solution may be just the "solution" for you.

As you can see, risk-management trading is truly contingent on the trader's personal preferences. The currency market makes the task immeasurably easier by allowing retail traders to

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:


"FX money management," *Currency Trader*, May 2006.
Cracking open the "myth" of 2-to-1 money management and exploring practical money-management techniques.

"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.

customize the size of their positions without incurring any marginal costs. Whether the trader wants to deal 1 million units of EUR/USD contract or only 100 units, the transaction cost among most of the reputable dealers will almost never exceed 0.03 percent. This allows even the smallest traders to implement any of these sophisticated risk-management techniques on the exact same terms as the biggest interbank FX traders.

However, the one inviolable truth that no trader, big or small, should ever forget is this: Everybody loses in trading at some time in their career. The difference between those who survive and those who do not is that winners honor their stops while losers make excuses. 

For information on the author see p. 6.

TABLE 2 — TEN PERCENT SOLUTION STRATEGY

Number of profitable lots (out of 10 total)	Total points at 10 percent	Total points at 10 percent with adjustable targets
10	1,000	1,000
9	890	810
8	770	610
7	640	430
6	500	260
5	350	100
4	190	-50
3	20	-170
2	-160	-300
1	-350	-420
0	-550	-550