LONDON ACADEMY OF TRADING

MONEY MANAGEMENT

A LONDON ACADEMY OF TRADING GUIDE BY PADDY OSBORN BSC (HONS), MSTA, CFTE

MONEY MANAGEMENT IS THE PROCESS OF MANAGING THE POTENTIAL RISK WITHIN YOUR OVERALL PORTFOLIO.

Of course you need to analyse and manage the potential risk and reward of each individual trade you enter, but you also need to keep in mind the overall risk within your whole portfolio – and your potential worst case scenario **(Maximum Drawdown).**

Many traders focus all their time and effort trying to find the (very elusive) Holy Grail of trading strategies, but they pay little or no attention to their money management – this is a major mistake!

All traders must understand about potential drawdown and maximum drawdown, and keep these rules in mind at all times.

DRAWDOWN

Drawdown is simply the amount of money lost from your trading account, expressed as a percentage of your maximum trading equity (also known as your “high water mark”).

If you have never made a loss, of course, then your Maximum Drawdown would be zero. To illustrate how drawdown is calculated, if you begin with an account of **£50,000** and **lose £5,000**, your drawdown is **10%.**

On the **£45,000** that remains, if you then **lose a further £5,000,** then your overall **loss is £10,000** and your drawdown increases to **20%.**

However, if you first made **£10,000 profit** (to bring your account up to **£60,000**), and then made a **£10,000 loss,** then (even though the actual loss amount is the **same £10,000** as in the example above), this would mean a drawdown of just **16.6%** (as opposed to the **earlier 20%** drawdown above).

MAXIMUM DRAWDOWNS

Of course all traders experience drawdowns. The key is to control the size of any drawdowns, keeping them within what's known as your **Maximum Drawdown** limit.

This is the largest percentage drop you should allow yourself within your account from any historical equity value peak. Therefore, as your account grows, you will be "allowed" to lose a greater number of pounds, but your maximum drawdown percentage should always remain the same. You should set daily, weekly and monthly limits on your maximum drawdown (as well as risk limits on individual trades). For example:

1%	**Risk per trade**	**4%**	**Maximum drawdown per week**
2%	**Maximum drawdown per day**	**8%**	**Maximum drawdown per month**

If you hit your maximum drawdown for any period, then you stop trading for that day/week/month and go back to analysing where you went wrong.

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RECOVERY FROM DRAWDOWN

To illustrate how important it is to control your maximum drawdown, the table below illustrates the percent gains required (after a drawdown) to recover your equity value back up to its previous peak. As you can see, the percentage profit required to recover your losses grows exponentially as your maximum drawdown increases.

% loss/ drawdown from an equity peak	5%	10%	25%	50%	100%
% gain required to return to previous peak	5.26%	11.11%	33.33%	100%	You're bust!

Professional traders and money managers know just how difficult it is to recover from a significant drawdown, so the best traders always maintain processes within their trading strategies to manage their maximum drawdowns.

Everyone has heard (apocryphal) stories of traders who have turned £1,000 account into £1,000,000, but what these stories fail to mention is that the vast majority of these traders ultimately wipe out their account through lack of money management and lack of respect for risk.

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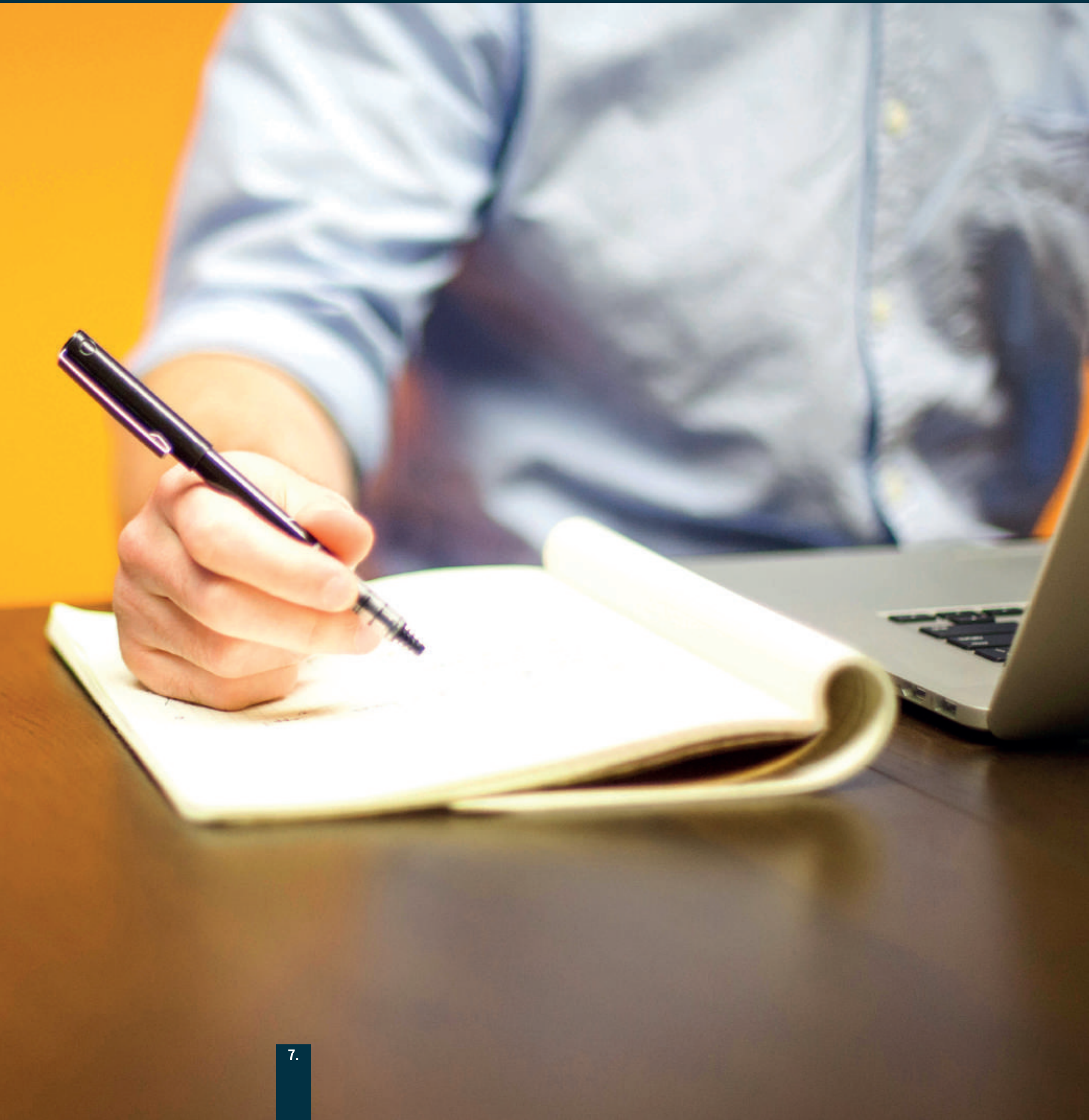
IN SUMMARY, MONEY MANAGEMENT INVOLVES ANALYSING THE RISK/REWARD OF ALL OF YOUR TRADES INDIVIDUALLY, BUT ALSO ON A PORTFOLIO BASIS.

Many traders achieve amazing short-term success by taking uncontrolled risks, but if you can double your account in a short period of time, then you can lose it all in the same amount of time. This lack of respect for risk management will surely catch up with every such trader in the end… usually sooner rather than later!



MONEY MANAGEMENT TIPS

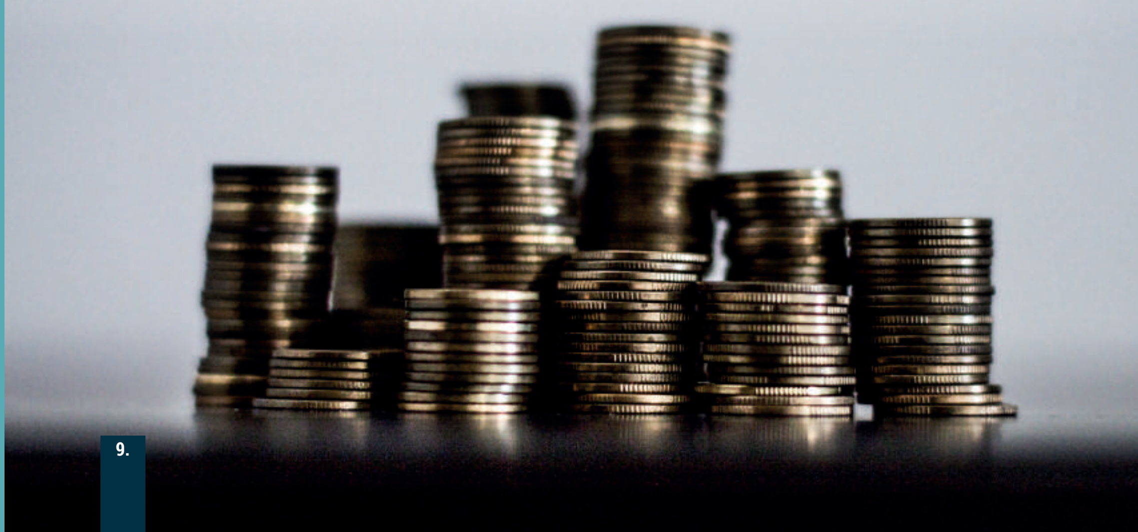
Good money management is really just common sense, but in the highly-charged emotional activity of trading, these rules can quickly go out of the window. Keep your money management rules objective, mathematical and easy to follow, and avoid rules (or guidelines) that are emotional and subjective.

Here are a few simple rules that should help you achieve long term trading success:

- Risk only 1–2% of your equity on each trade
- Limit your overall outstanding risk to 2–4%. (i.e. If all your open positions are stopped out for losses, you would still have 96–98% of your trading capital remaining)
- **Always** place stop loss orders for **every** trade as you enter each new position, making sure your individual trade risk and overall risk remain within your chosen limits
- For each trade, aim for a reward-to-risk ratio (RRR) of at least 2–to–1 and preferably 3–to–1 for trend-following trades.
- Never "average down". (i.e. Never add to a losing position) ..."Only losers add to losers"

MORE MANAGEMENT TIPS...

- Recognise when your positions are correlated For example, if you are long of USD–JPY and short of GBP–USD and EUR–USD, then you're taking the same (bullish) view on USD on all three trades. If USD falls, then all three positions will fail
- Aim to lock in some profits as you progress towards your ultimate target. By closing out, say 20–50% of your position as your profit reaches your initial risk level, and then trailing your stop loss towards the current price, your trade management becomes psychologically much less stressful (once you can lock into a break-even trade)
- Be prepared to stop trading for a while and reevaluate your trade plan when things are going badly. Even consider returning to a demo account while you regain your confidence



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WHO WE ARE

The London Academy of Trading (LAT) provides accredited, vocational programmes with a focus on fundamental and technical analysis, trading psychology and risk management.

LAT attracts focused and ambitious students who are looking to become the next generation of financial markets traders.

Visit us at Sceptre Court,
5th floor, 40 Tower Hill, London,
EC3N 4DX, United Kingdom

Call +44 (0)20 3435 4629
Email info@lat.london