Money Management

If you have not figured it out by now, money management is the most critical part of the successful traders trading plan. It will determine whether you are ultimately making money or losing money. There have been studies done that conclude that if 100 traders use a trading system that is correct 60% of the time, only about 5 of them will be profitable. The other 95% will lose money because they do not understand or do not follow proper risk and money management.

Money management is a separate issue from knowing when to enter and exit a trade. Money management represents the amount of money you are going to put into one trade and the risk you're going to accept for that trade. Your entry and exit rules are simply your triggers that tell you when to put that amount of money into the trade.

There are multiple types of money management strategies. The ultimate goal is to help you preserve your balance from high risk exposure. Remember, protecting what you have is more important than worrying about what you don't YET have.

Here are three components of Risk Management you should become familiar with:

1. **Core Equity (CE) = Available Margin.**

The first concept that you should understand is that of "Core" equity. Core equity is simply the amount of money available to trade. The formula looks like this:

For example, if you have a Starting Balance of $5,000 and $1,000 of it is used as margin already your CE is $4,000.

2. **Single Trade Risk = Amount of risk in a single trade**

Your single trade risk should fall somewhere between 0.5-5% of your Core Equity. As you get started, you are better to use a smaller percent risk. A good starting point would be less than 1%. As you gain confidence and understanding of your trading system you can adjust this amount as needed.

Example:

1% risk of a $100,000 account = $1,000

You should adjust your position size so that you never lose more than $1,000 per single trade.

If you are a short term trader and you place your stop loss 50 pips below/above your entry point and each pip is worth $10 you should be able to calculate how many open positions you should buy or sell.

The formula looks like this:

Single Trade Risk amount/(Pip value x Stop loss) = # Lots

For example:

$1,000 Single Trade Risk/ ($10 pip value x 50 pip stop loss) = # Lots

1,000/ (10 x 50) = # Lots

1,000/500 = 2 Lots

3. **Total Portfolio Risk = The overall amount of risk in your total portfolio**

This is the combined amount of risk you are taking between all the open trades you currently have. Depending upon the type of trading you are doing or the strategies you are using you may have a total risk between 10-20%.

For example:

5 trades at 1% risk = 5% total portfolio risk

Take some time to review your risk rules for the trading you are doing. Make sure you understand how to calculate the risk you will be taking.