# TRADING INSIGHTS

**SWI Continuing Education** **Volume 4**

## Trading Risk
## Why Percentages Don't Matter

**A look at why the conventional method of risking a fixed percentage of your account equity per trade is a misdirected approach to proper risk management**

It goes without saying that as traders our primary goal is to grow the equity in our trading account. Therefore, no matter the extra curricular endeavors we have in the world of trading, it all comes second to being consistently profitable. Steve Clark, world renowned trader, said it best in Jack Schwager's book, *Hedge Fund Market Wizards*. "Your job as a trader is to make the equity line go from bottom left to top right. That's it. If the line goes down too much, you were wrong."

This is of course an oversimplified way of looking at it, but the point is that our goal as traders really is that straight forward. However, any experienced trader knows that while the end goal may be straight forward, the journey is far from it.

### A Misdirected Approach

There are many facets of a successful trader, one of the most important, and possibly most controversial, is the question of how much capital to risk per trade. The conventional method that is heavily promoted on the Internet is to risk no more than 2% of your account balance on any one trade. While you are better off using this method than no method at all,

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it is a misdirected approach as it does not help to mitigate against one of the most common and destructive mistakes a trader can make, trading on emotion.

To illustrate this, let's assume that you have a $5,000 account and as part of your trading plan you have defined your risk per trade as 2% of your total portfolio.

Let's up the stakes. Assume you have a $50,000 account and are maintaining your 2% rule. So you are now risking $1,000 on your first trade. Once more the market moves against you for a full loss of $1,000; a little harder to swallow. While any trader can easily do the math to figure out that 2% of $50,000 is $1,000, and you may tell yourself this before putting on the trade, the question remains, have you *fully* accepted the risk?

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To find the answer to this question, close your eyes and create the scenario in your mind. Ask these questions and answer with complete honesty. Imagine you are in a trade and are seeing drawdown reach $600 which quickly becomes $800, does this make you anxious? Will you pull the trade early? What if your stop loss is hit and you lose $1,000? How does that make you feel? If you're squirming just thinking about losing $1,000 then you're risking too much and need mount.

## Emotions Are a Trader's Worst Enemy

If you pull a trade early due to fear of loss, you have just made one of the most common, and most destructive, mistakes in trading. You have made an emotional decision in a market that does not cater to feelings. The market doesn't know where you entered the trade, how much you win or lose, nor does it care.

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To clarify, there may be times when the market moves against you in a way that justifies pulling a trade early, but make sure you know *why* you are pulling the trade and make sure it isn't because you have a paper loss..

Pulling a trade due to drawdown is *never* a valid reason to liquidate your position. If this occurs your first step should be to immediately reassess your position sizing and scale back on future trades to a dollar amount that fits your comfort level. More on this later

Once you begin trading on emotion you stop trading what you see and start trading what you feel. Your emotions have removed you from the market, not only disrupting your current trade but also making it harder to realize future opportunities. This is why proper risk management is paramount to controlling emotions and ultimately finding success as a trader.

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**So What is the Solution?**

Forget about percentages. The problem with thinking about risk in terms of percentages is that when you are  in a drawdown situation, your emotions don't get the best of you because you're thinking about losing 2%, they get the best of you because you're thinking about losing $1,000. So why determine risk based on the concept of fixed percentage, when we know it will do nothing to help curb our emotions while in a trade? The answer is simply that this is what we have been told to do by other so-called traders and it sounds logical, at least on the surface.

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One reason the fixed percentage method is heavily encouraged is due to the powerful effects of compounding. I'm sure you have seen the marketing ploys that show a chart of an account starting with $100 which blows up to an obscene amount through the use of compounding in a rather short period of time. Let me be clear, I am in no way dismissing the qualities that compounding returns can have on a trading account, but there is a point to be made here with respect to how you define risk.

Going back to the example of risking 2% of $50,000 or $1,000 per trade. If you are blindly following the 2% rule, or any arbitrary rule you are not reacting dynamically to a dynamic market.

By developing a method of risking a dollar amount that you feel comfortable losing, you are allowing your mind to be free from the fear of loss and can focus on trading the market and not your balance.

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Naturally as your account grows, so too will the dollar amount you feel comfortable risking. So in the end the power of compounding is still on your side, only now you are controlling it to fit your comfort level which will, in the end, have a positive effect on your bottom line.

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**Bringing It All Together**

If you like the idea of risking a fixed percentage, because you feel it gives structure to your trading, but also like the alternative method discussed here, why not develop a hybrid method? This would allow you to have a rule in place to cap the maximum amount of risk per trade but also give you the freedom to modify the dollar amount to a level you feel comfortable with. For example, if you have a $50,000 account you may have a rule that caps your maximum risk per trade at 2%, so $1,000 in this case. However your comfort level may be capped at $700, risking any more than this may lead you to trade on emotion. Now you have a strict rule in place to protect your capital but also have the opportunity to scale back your position size to remove the fear of loss from your trading.

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In closing, the amount risked per trade is an inherently personal decision that depends on several factors. These factors range from account balance, risk tolerance and even the trader's edge in the market. This gives further credence to the idea that defining trading risk based dollar amount is much more effective than a fixed percentage, which gives no consideration to these factors.

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