Money Management (Pt. I):Controlling Risk and Capturing Profits

By Dave Landry

Money management is the process of analyzing trades for risk and potential profits, determining how much risk, if any, is acceptable and managing a trade position (if taken) to control risk and maximize profitability.

Many traders pay lip service to money management while spending the bulk of their time and energy trying to find the perfect (read: imaginary) trading system or entry method. But traders ignore money management at their own peril.

The story of three not-so-wise men

I know of one gentleman who invested about $5,000 on options on a hot stock. Each time the stock rose and the options neared expiration, he would pyramid his position, plowing his profits back into more options. His stake continued to grow so large that he quit his day job.

As he approached the million-dollar mark, I asked him, "Why don't you diversify to protect some of that capital?" He answered that he was going to keep pyramiding his money into the same stock options until he reached three to four million dollars, at which point he would retire and buy a sailboat.

I recently met a second gentleman at a dinner party. He told me that six months ago he began day trading hot stocks. It was so profitable, he said, that he quit a flourishing law practice to trade full time. Amazed at his success, I asked him, "How much do you risk per trade, a half point, one point?" He replied, "Oh no, I don't like to take a loss."

A third gentleman was making his fortune buying the hottest stock(s) on the momentum list(s). He, too, was on the verge of quitting a successful business. When asked about his exit strategy, he replied "I just wait for them to go up." When asked, "What if they go down?" his reply was, "Oh, they always come back."

What ever happened to these "traders?" Gentleman number one is now homeless, and the other two are about to be. They are on the verge of financial devastation and the emotional devastation that goes along with it. This is the cold, hard reality of ignoring risk. How do we avoid following in the footsteps of these foolhardy traders? Three things will prevent this from happening: 1) money management, 2) money management, and 3) money management.

The importance of money management can best be shown through drawdown analysis.

Drawdown

Drawdown is simply the amount of money you lose trading, expressed as a percentage of your total trading equity. If all your trades were profitable, you would never experience a drawdown. Drawdown does not measure overall performance, only the money lost while achieving that performance. Its

calculation begins only with a losing trade and continues as long as the account hits new equity lows.

Suppose you begin with an account of $10,000 and lose $2,000. Your drawdown would be 20%. On the $8,000 that remains, if you subsequently make $1,000, then lose $2,000, you now have a drawdown of 30% ($8,000 + $1,000 - $2,000 = $7,000, a 30% loss on the original equity stake of $10,000). But, if you made $4,000 after the initial $2,000 loss (increasing your account equity to $12,000), then lost another $3,000, your drawdown would be 25% ($12,000 - $3,000 = $9,000, a 25% drop from the new equity high of $12,000).

Maximum drawdown is the largest percentage drop in your account between equity peaks. In other words, it's how much money you lose until you get back to breakeven. If you began with $10,000 and lost $4,000 before getting back to breakeven, your maximum drawdown would be 40%. Keep in mind that no matter how much you are up in your account at any given time--100%, 200%, 300%--a 100% drawdown will wipe out your trading account. This leads us to our next topic: the difficulty of recovering from drawdowns.

Drawdown recovery The best illustration of the importance of money management is the percent gain necessary to recover from a drawdown. Many think that if you lose 10% of your money all you have to do is make a 10% gain to recoup your loss. Unfortunately, this is not true.

Suppose you start with $10,000 and lose 10% ($1,000), which leaves you with $9,000. To get back to breakeven, you would need to make a return of 11.11% on this new account balance, not 10% (10% of $9,000 is only $900--you have to make 11.11% on the $9,000 to recoup the $1,000 lost).

Even worse is that as the drawdowns deepen, the recovery percentage begins to grow geometrically. For example, a 50% loss requires a 100% return just to get back to break even (see Table 1 and Figure 1 for details).

Professional traders and money mangers are well aware of how difficult it is to recover from drawdowns. Those who succeed long term have the utmost respect for risk. They get on top and stay on top, not by being gunslingers and taking huge risks, but by controlling risk through proper money management. Sure, we all like to read about famous traders who parlay small sums into fortunes, but what these stories fail to mention is that many such traders, through lack of respect for risk, are eventually wiped out.

% Loss of Capital	% of Gain Required to Recoup Loss
10%	11.11%
20%	25.00%
30%	42.85%
40%	66.66%
50%	100%
60%	150%
70%	233%
80%	400%
90%	900%
100%	broke

Table 1. Notice that as losses (drawdown) increase, the percent gain necessary to recover to breakeven increases at a much faster rate.

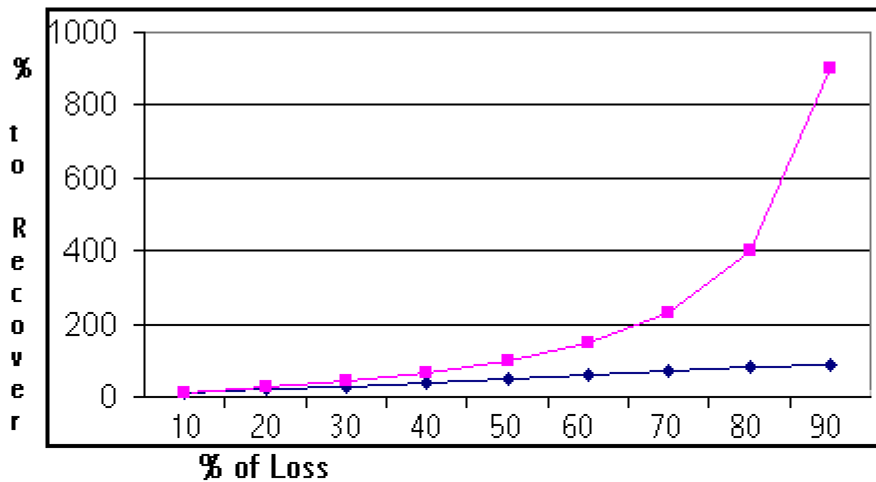

Figure 1. Percent loss (drawdown) vs. percent to recover. Notice that the percent to recover (top line) grows at a geometric rate as the percent loss increases. This illustrates the difficulty of recovering from a loss and why money management is so important.

Summary

Money management involves analyzing the risk/reward of trades on an individual and portfolio basis. Drawdown refers to how much money you've lost between hitting new equity peaks in your account. As drawdowns increase in size, it becomes increasingly difficult, if not impossible, to recover the equity. Traders may have phenomenal short-term success by taking undue risk, but sooner or later these risks will catch up with them and destroy their accounts. Professional traders with long-term track records fully understand this and control risk through proper money management.

In the next installment: Money management ranges from simple, commonsense approaches to complex portfolio theory formulas. The good news is that it does not have to be rocket science. A simple, straightforward approach should be sufficient for most traders. In the next installment of this series (May 15), we will look at general money management guidelines that should help keep you out of trouble and help ensure your long-term success.

Money Management (Pt. II): Rules Of The Road

By Dave Landry

In the first installment of this series we stressed the importance of money management, illustrated through drawdown and percent to recover analysis. We mentioned that money management ranges from simple, commonsense approaches to complex portfolio theory.

The good news is that for most traders money management *can* be a matter of common sense rather than rocket science. Below are some general guidelines that should help your long-term trading success.

1. Risk only a small percentage of total equity on each trade, preferably no more than 2% of your portfolio value. I know of two traders who have been actively trading for over 15 years, both of whom have amassed small fortunes during this time. In fact, both have paid for their dream homes with cash out of their trading accounts. I was amazed to find out that one rarely trades over 1,000 shares of stock and the other rarely trades more than two or three futures contracts at a time. Both use extremely tight stops and risk less than 1% per trade.

Use real stop orders—"mental stop" don't work

2. Limit your total portfolio risk to 20%. In other words, if you were stopped out on every open position in your account at the same time, you would still retain 80% of your original trading capital.

3. Keep your reward-to-risk ratio at a minimum of 2:1, and preferably 3:1 or higher. In other words, if you are risking 1 point on each trade, you should be making, on average, at least 2 points. An S&P futures system I recently saw did just the opposite: It risked 3 points to make only 1. That is, for every losing trade, it took 3 winners make up for it. The first drawdown (string of losses) would wipe out all of the trader's money.

4. Be realistic about the amount of risk required to properly trade a given market. For instance, don't kid yourself by thinking you are only risking a small amount if you are position trading (holding overnight) in a high-flying technology stock or a highly leveraged and volatile market like the S&P futures.

5. Understand the volatility of the market you are trading and adjust position size accordingly. That is, take smaller positions in more volatile stocks and futures. Also, be aware that volatility is constantly changing as markets heat up and cool off.

Never add to or "average down" a losing position

6. Understand position correlation. If you are long heating oil, crude oil and unleaded gas, in reality you do not have three positions. Because these markets are so highly correlated (meaning their price moves are very similar), you really have one position in energy with three times the risk of a single position. It would essentially be the same as trading three crude, three heating oil, or three unleaded gas contracts.

7. Lock in at least a portion of windfall profits. If you are fortunate enough to catch a substantial move in a short amount of time, liquidate at least part of your position. This is especially true for short-term trading, for which large gains are few and far between.

8. The more active a trader you are, the less you should risk per trade. Obviously, if you are making dozens of trades a day you can't afford to risk even 2% per trade--one really bad day could virtually wipe you out. Longer-term traders who may make three to four trades per year could risk more, say 3-5% per trade. Regardless of how active you are, just limit total portfolio risk to 20% (rule #2).

9. Make sure you are adequately capitalized. There is no "Holy Grail" in trading. However, if there was one, I think it would be having enough money to trade and taking small risks. These principles help you survive long enough to prosper. I know of many successful traders who wiped out small accounts early in their careers. It was only until they became adequately capitalized and took reasonable risks that they survived as long term traders.

This point can best be illustrated by analyzing mechanical systems (computer-generated signals that are 100% objective). Suppose the system has a historical drawdown of $10,000. You save up the bare minimum and begin trading the system. Almost immediately you encounter a string of losses that wipes out your account. The system then starts working again as you watch in frustration on the sidelines. You then save up the bare minimum and begin trading the system again. It then goes through another drawdown and once again wipes out your account.

Your "failure" had nothing to do with you or your system. It was solely the result of not being adequately capitalized. In reality, you should prepare for a "real-life" drawdown at least twice the size indicated in historical testing (and profits to be about half the amount indicated in testing). In the example above, you would want to have at least $20,000 in your trading account, and most likely more. If you would have started with three to five times the historical drawdown, ($30,000 to $50,000) you would have been able to weather the drawdowns and actually make money.

10. Never add to or "average down" a losing position. If you are wrong, admit it and get out. Two wrongs do not make a right.

11. Avoid pyramiding altogether or only pyramid properly. By "properly," I mean only adding to profitable positions and establishing the largest position first. In other words the position should look like an actual pyramid. For example, if your typical total position size in a stock is 1000 shares then you might initially buy 600 shares, add 300 (if the initial position is profitable), then 100 more as the position moves in your direction. In addition, if you do pyramid, make sure the total position risk is within the guidelines outlined earlier (i.e., 2% on the entire position, total portfolio risk no more that 20%, etc.).

12. Always have an actual stop in the market. "Mental stops" do not work.

Strive to keep maximum drawdowns between 20-25%

13. Be willing to take money off the table as a position moves in your favor; "2-for-1 money management1" is a good start. Essentially, once your profits exceed your initial risk, exit half of your position and move your stop to breakeven on the remainder of your position. This way, barring overnight gaps, you are ensured, at worst, a breakeven trade, and you still have the potential for gains on the remainder of the position.

14. Understand the market you are trading. This is especially true in derivative trading (i.e. options, futures). I know a trader who was making quite a bit of money by selling put options until someone exercised their options and "put" the shares to him. He lost thousands of dollars a day and wasn't even aware this was happening until he received a margin call from his broker.

15. Strive to keep maximum drawdowns between 20 and 25%. Once drawdowns exceed this amount it becomes increasingly difficult, if not impossible, to completely recover. The importance of keeping drawdowns within reason was illustrated in the first installment of this series.

16. Be willing to stop trading and re-evaluate the markets and your methodology when you encounter a string of losses. The markets will always be there. Gann said it best in his book, *How to Make Profits in Commodities*, published over 50 years ago: "When you make one to three trades that show losses, whether they be large or small, something is wrong with you and not the market. Your trend may have changed. My rule is to get out and wait. Study the reason for your losses. Remember, you will never lose any money by being out of the market."

17. Consider the psychological impact of losing money. Unlike most of the other techniques discussed here, this one can't be quantified. Obviously, no one likes to lose money. However, each individual reacts differently. You must honestly ask yourself, What would happen if I lose X%? Would it have a material effect on my lifestyle, my family or my mental well being? You should be willing to accept the consequences of being stopped out on any or all of your trades. Emotionally, you should be completely comfortable with the risks you are taking.

The main point is that money management doesn't have to be rocket science. It all boils down to understanding the risk of the investment, risking only a small percentage on any one trade (or trading approach) and keeping total exposure within reason. While the list above is not exhaustive, I believe it will help keep you out of the majority of trouble spots. Those who survive to become successful traders not only study methodologies for trading, but they also study the risks associated with them. I strongly urge you to do the same.

In the final installment of this series, we will question successful traders about their insights on proper money management.

Additional reading on money management:

Mark Boucher: *The Hedge Fund Edge: Maximum Profit/Minimum Risk Global Trend Trading Strategies* (1999, John Wiley & Sons, New York).

Mark has the utmost respect for risk, one of the reasons he is consistently one of the top hedge fund managers in the world. This book does a great job of expanding on many of the concepts mentioned in this article.

The TradingMarkets.com Guide to Conquering the Markets, Mark Etzkorn, Editor (with Kevin Haggerty, Jeff Cooper, Mark Boucher, Dave Landry, Larry Connors, Manuel Ochoa, and Bob Pisani). 1999, M. Gordon Publishing, Los Angeles, Calif.

- Contains many strategies that discuss the importance of risk control. Also, contains an excellent chapter on money management written by Mark Boucher.

Larry Connors and Linda Raschke: *Street Smarts* (1995, M. Gordon Publishing, Los Angeles).

- In addition to low-risk strategies, there are four rules for short term traders in the money management chapter that should help keep you out of trouble.

Robert Rottela: *Elements of Successful Trading* (1992, New York Institute of Finance, New York.)

- This book clearly defines money management concepts and provides concise explanations of general money management formulas. It also has some excellent chapters on trader psychology that go hand-in-hand with proper money management.

Money Management (Pt. III): Insights From The Pros
By Dave Landry

What separates the pros from the would-be pros? Money management. Read on and find out why.

Manuel Ochoa, who chronicles his trades in *Financial Futures Insight*, has enjoyed a great deal of success as a trader and hedge fund manager, but he learned some very valuable lessons about money management early on in his career--the hard way.

As the following discussion will detail, after being wiped out in just one night, Manuel quickly realized that if he was to survive long term as a trader he would not only have to study the markets but the risk associated with them. What impressed me about Manuel is that he not only considers the chance of extraordinary events occurring that will cut into his equity, he actually plans for them and expects them to happen sooner or later.

Dave Landry (DL): Manuel, you seem to be known for your money management techniques. Did you always use strict money management or was this learned through experience?

Manuel Ochoa (MO): It was learned experience.

DL: At what point did you realize the importance of money management?

MO: In 1989, I was in college and had a personal account of $20,000. I had a large position in currencies. One night, while I slept, there was a big news development involving Britain's Prime Minister. At 4:00 a.m. I get a call from a clearing broker notifying me that my account had a balance of -$2,000.

DL: That must have been a pretty humbling experience.

MO: Yes. Up until that point, I only thought about how much money I could make--I never thought about how much money I could lose.

DL: When you started trading again, did you immediately implement risk controls to keep this from happing again?

MO: I began to control risk more carefully but I noticed my equity swings were as much as 10% in one day. I knew I had to reduce risk even further or it was only a matter of time before a string of losses would wipe me out again.

I think stop placement is the number one misconception when it comes to trading.

So, I continued to increase my focus on money management.

DL: How do you define money management?

MO: I think it's half art, half science--but mostly common sense.

DL: Let's talk about the science of it.

MO: It's a matter of stop-loss level placement, what size position you trade, how much risk, how much leverage (i.e., dollars controlled vs. account size). You have to know all of this ahead of time. You don't want to be making decisions while you're attempting to pull the trigger on a trade. It's like swinging a bat: Half way though your swing, you can't think, am I going to hit it high or low, to right field or left.

DL: Let's break down these concepts. People seem to be first and foremost interested in where to place their stop-loss. *(Note: Manuel can best be described as a swing trader; he normally holds positions for several days. This discussion on stops assumes the positions are held overnight).*

MO: I think stop placement is the number one common misconception when it comes to trading. People think that the tighter the stop the less they are risking when in reality they often guarantee themselves a loss.

DL: For instance?

MO: People try to trade a high-flying stock like eBay with a $2 price stop. The stock trades in a range of over $30 in one day alone. People are kidding themselves if they think they can trade a stock like this with such a tight stop. In a case like this they will almost always be guaranteed a loss. The same applies to other markets.

Let's say that someone is trading S&P futures and using very tight stops. In all likelihood, they'll get stopped out hundreds of times in one year. I'd bet in many cases, at the end of the year, when you add up all those hundreds of small losses from tight stops, it comes to much more than a few large losses through somewhat looser stops.

Now, this is not to say that you should take excessive risk. You should have your stop far enough away that random noise won't take you out. Suppose someone decides to dump a position or a sell program kicks off, this has absolutely nothing to do with the overall market or the reason you are in the trade in the first place.

No professional money manager that I know risks more than 5% per-trade;most keep it much lower than that

Don't get me wrong, I'm not saying use "loose" stops as a general rule. What I am saying is learn to place your stops wisely so the random price action or noise won't take you out.

DL: Obviously, you can't pace a stop too far away.

MO: True. In order to avoid being stopped out, you should have a stop that allows for the volatility of the past three to four days and make sure your stop is outside those levels. Otherwise you're almost guaranteed a loss. You have to use the volatility of the market or you will almost surely get shaken out of good positions.

DL: How do you define the volatility?

MO: I have various techniques that I use but it can be defined with something as simple as the average range for the past three to four days. Again, the key is to make sure your stops are outside of that level.

DL: How much do you risk per trade?

MO: No professional money manager that I know risks more than 5% per trade; most keep it much lower that that. I think more important than how much you risk is how much you can lose above and beyond that risk. At least once a year, some extraordinary event will create a price shock and you'll lose at least twice what you thought your max loss per trade was. Therefore, I never risk more than 2.5% on any given trade. That way, the worst that can happen to me on anyone trade is probably twice that amount (a 5% loss).

DL: So you not only consider your calculated risk but the possibility of an extraordinary event occurring?

MO: Exactly.

DL: Although you use a lot of discretion in your trading, you're known as an expert on systems (computer generated signals). Can you elaborate on using systems testing when studying risks?

MO: System testing is great, or least it appears that way on the surface. People forget that these are just stats, historical estimates if you will, but they accept them as if they were fact. They fail to realize that they are only historical estimates.

DL: For instance?

MO: They look at worse loss on a single trade or the drawdown (string of losses) and think that's as bad as it gets.

Controlling risk is much more important than the system itself.

What missing is the hidden features or phenomena of a historically based system. One phenomena that doesn't show up in the stats is that longer you trade the system the bigger the largest losing trade will be as well as the maximum drawdown.

DL: Is this from increased exposure to the markets?

MO: Yes, every decade and often much less, something really "bad" will occur: someone will get assassinated, a war will break out, or some sort of financial meltdown will take place. The system can never adjust for this. These things do and will happen. For instance, the crash in 1987 took out many professional option sellers in just one day.

The bottom line is that everyone is searching for a method or system that will generate enormous profits. What they fail to realize is that controlling risk is much more important than the system itself. No matter how good the system, without risk control it will surely blow up.

Dr. Paul Ruggieri, who writes TradingMarkets.com's *Medical Technology Insight* column, is a surgeon who also has enjoyed great success investing in medical and biotech stocks. Paul strikes me as a man who really does his homework and has found his trading niche--he truly has a passion for medicine, research and investing in medical stocks.

Paul's perspective is especially interesting because he approaches the market from a more traditional, non-technical vantage point. Although he doesn't follow strict money management rules like many technicians, he does consciously avoid excessive risk through other means.

First, even though he's willing to buy companies that have under-performed the market, he takes reasonably sized positions and does not buy stocks because they are "cheap." He'll only "bottom fish" in well-diversified companies that show promise. Second, in riskier, single-focus companies, he realizes it's all or nothing. Accordingly, he takes a only very small positions and accepts the fact there is a high likelihood the stock will go to zero. Third, although he classifies himself as a long-term investor, he's willing to take profits as approval for drugs nears versus holding out for top dollar.

Dave Landry (DL): What's your basic approach to the markets?

Dr. Paul Ruggieri (PR): I trade stocks but I'm not a "trader" per se. I use fundamentals to select my stocks and consider myself more of an "investor."

DL: So how you select stocks?

PR: For pharmaceutical companies, I look for drugs in the pipeline. I carefully study these drugs and their potential for success, the demand and size of the market for these drugs, and of course, the possible side effects.

DL: Being a technician who only keys off price action, I have to bring up the classic technical vs. fundamental argument. If a stock looks good to you at $100, wouldn't it look even better at $75? Suppose it kept dropping: Is there a point where you just give up? For instance, a while back you liked Pfizer; the stock has recently dropped from 150 all the way to 110.

PR: On a stock like Pfizer, I feel that they have a strong pipeline of drugs. Although the stock has been dropping as of late, nothing has changed on a fundamental basis.

I never take a position so large that it will have a material effect on my lifestyle.

So, in this case, yes, I view it as a buying opportunity, and as long as the fundamentals stay sound, I'm willing to buy more at lower prices.

This is not to say that I buy something just because it is "cheap." Merck , for instance, has made a similar move down like Pfizer. However, Merck has patents on drugs that will be expiring over the next few years and I don't feel like they have enough currently in the pipeline to make up for it.

DL: Doesn't this approach require you take a very long-term outlook?

PR: Yes, many times these drugs are years away from getting approval. I'm willing to wait.

DL: What about losses while waiting?

PR: I never take a position so large that it will have a material effect on my lifestyle. Also, by diversifying and holding positions in many medical companies, some of the drugs will get approval and some won't, some sooner, some later.

DL: How do you know when to take profits?

PR: Clinical trials are based on a limited number of people. Even if the drug shows tremendous promise, once it hits the masses, there will likely be unforeseen side effects. This only stands to reason as the statistical base increases. Take Viagra, a huge drug for Pfizer.

If I buy a very risky company, I know there's a good chance it will go to zero. Therefore, I would only take a small position.

Once it hit the masses, there were cases of people dying due to heart attacks. Many of these people may have died regardless, but it did have a negative impact on the company. Therefore, I'll often take profits in a medical company as approval nears because I know there will likely be unforeseen side effects once it hits the market.

DL: I was fascinated by your article on cloning technology. Genetically cloned goats that produce blood-clotting drugs, keeping cells alive forever. It's pretty amazing.

PR: I have to admit I myself was amazed while doing the research. It's almost scary--science fiction in nature.

DL: In the case of companies like these, with just one drug or process in the pipeline, isn't it all or nothing?

PR: Absolutely.

DL: So, how to you trade these stocks?

PR: Take a company like Geron. They are a single-focus company concentrating only on developing a technology that will keep cells alive forever--a fountain of youth, if you will. They're years away from perfecting the technology, let alone getting any type of approval. I think if anyone has a shot at succeeding, they do. However, I'm not going to bet the farm on the company. If I buy shares, I think there's a very good chance that they will go to zero--and I'm willing to live with that. Therefore, I would only take a small position. I think the risk to reward is tremendous. I'm not looking for a small gain in these small, single-focus companies--I'm looking for a homerun.

DL: Do you ever think of becoming more active as a trader?

PR: Every chance I get, I follow the markets. However, I work out of two hospitals, I'm writing a book on surgery and spend many nights researching

medical technology for TRADEHARD and my own personal investments. I know that due to time constraints, it's not feasible for me to be an active trader. Therefore, I take long-term positions based on sound fundamental research. This approach has worked quite well for me.

Money Management (Pt. IV): Pro Traders Share Their Lessons

By Dave Landry

Jeff Cooper, the professional short-term stock trader who writes TradingMarkets.com's "Momentum Stocks Insight" and "Weekend Stock Market Outlook" commentaries, has had more than his share of market experiences--both good and bad. Jeff's family was devastated by his father's stock market losses in the in the early 1960s. You would have thought Jeff learned from those mistakes, but it wasn't until he nearly went broke himself years later that he began to implement a strict money management plan.

Most traders view money management as an afterthought--something they add to their methodology as a finishing touch. Jeff on the other hand, doesn't distinguish money management from his methodology--it's in integral part of it. In addition, he recognizes that markets are dynamic and he constantly adjusts his money management style to current market conditions.

Dave Landry (DL): Maybe we should fill readers in about some of your history. In your first book, "Hit and run Trading," you write that your father built and sold a very successful textile business and retired to Beverly Hills. Based on his brokers advice, he began investing in stocks. Not only did they sell him on the buy and hold mantra, but they also introduced him to buying stocks on margin to increase his fortune through leverage.

Unfortunately, the first bear swing in the market wiped out your father's account. To add insult to injury, the brokers who originally had convinced your father to part with his money were now liquidating his portfolios on the day your mother was being operated on for cancer. Now forced into bankruptcy, your family had no choice but to move back east. If this wasn't enough pain and suffering, the moving van caught fire in route destroying what few possessions that were left.

Your father, started yet another textile business from scratch and within five years sold it for millions and retired. Instead of enjoying the good life he decided once again to return to the markets. This time however, it was on his terms. He began investing in IPOs, but on a short-term basis. Not only did he make back all of his original stake, but he made millions on top of that.

Did you automatically become a short-term and risk-averse trader based on your family's painful experience with buy and hold?

Jeff Cooper (JC): No. I fell into the footsteps of my father's initial tragedy. I was nearly wiped out in the late 1980s making the same mistakes that he made over 20 years earlier.

DL: Why is it that you didn't learn from your father's initial tragedy?

JC: I suppose it's the Cooper family nature. We're hardheaded. Look at my father. After being devastated in the markets, he started another textile business from scratch and made back enough money to retire. Instead of living the good live in retirement, he returned to the markets. Now, with those genetics, I couldn't help but to go out and do it *my* way. I suppose as human beings it's not enough to experience other's pain. You have to feel it for yourself.

The lessons that stick are ones that are learned first hand. And those have to be learned and re-learned often. That's just the way most of us are built. Bernard Baruch, one of the great investor/traders, went broke five or six times, I believe, before asking his mother for some more of the family's funds. At this point he was told that this is the last of it. He was able to make that his grubstake, and turn it to his fortune.

Bernard Baruch was humbled by the markets before he was able to master them. And I would have to say that this is one common thread that runs through almost every great trader that I have ever met. They have all been humbled by the market early on in their careers. This creates a definite respect for Mr. Market. Until one has this respect, indelibly engraved in their makeup, the concept of money management and discipline will never be treated seriously.

DL: So you were trading longer-term and taking excessive risk?

JC: Yes.

DL: Why?

JC: The market has a way of soft-peddling risk, making the masses happy and comfortable. When that belief system is universal, that is when it (the market) is to be feared the most. Hello! *(referring to the masses who are currently plunging into the market)* Does this give anyone the idea I'm more of a day trader as opposed to a position trader?

DL: Why do you think people hold on to stocks and refuse to sell?

JC: It's very easy to buy a story on a company you hear about at a cocktail party. In addition, many people are paid to promote stocks. Furthermore, people are generally hopeful and optimist--dreamers by nature.

DL: Recently, I was approached by a friend at a cocktail party. The guy is a brilliant organic chemist, probably the most intelligent person I know. He took out a stack of charts and began asking me for trading advice. On many of the charts it was the same story: "I've doubled my money on this one but now it's selling off. I'm still up 50% but it keeps dropping." When asked, so why not take a 50% profit? His reply was that he can't do that because at one point he was up 100%. He felt like a failure. Yet, here's guy who had made some nice profits in the market--profits I envied.

JC: Many people think the object is to get out close to the top. They buy Amazon at 150 and ride it up to 280 points. It then sells off to 240 and they think they've made a bad decision. They forget that the real object is to make money.

The hardest thing though, whether its investing or short-term trading is to learn how to extricate oneself from a situation, whether it be positive or negative.

DL: Yes. It seems like each stock had a story behind it as to why it should go back up.

JC: It's human nature to be optimistic. Any fool can enter, it takes talent to exit consistently and profitably.

DL: What do you think is the secret of your success?

JC: I look to take money out of the market, to create income and build wealth. I do this by consistently hitting singles not home runs. I never try to capture a huge move and I never do.

DL: How do you view money management?

JC: Regardless of what we think we know and should happen the reality is that a lot of stock action is random. Therefore, money management is crucial if you want to be successful as a trader. To me, it's the cornerstone of both making a living at trading and building wealth.

DL: What percentage of equity do you generally risk per trade?

JC: I risk very little. I don't really think of it in terms of percentages. I suppose if I did, I'm probably not risking more than ¼ to ½% per trade. In addition, I haven't changed my trading size in years. Nor do I intend to. Therefore, by keeping my position sizes relatively small, my risk continues to decrease as my capital base grows.

DL: Why not keep your risk consistent to the amount of your equity to strive for even larger returns?

JC: I see things on a monetary basis. For instance, I think $1,000-$2,000 is a lot of money to lose on an individual trade. Think about it. Not many people make $1,000 an hour, yet an active day trader can loose that in a matter of minutes.

I suppose at some point in time, I might consider managed funds. At that point, I'd be forced to adjust risk to equity. However, as long as its my personal account, I'm comfortable knowing that as my equity grows, my risk continues to decrease.

DL: Would you share with us your techniques for money management and dealing with risk?

JC: Sure. Depending on the situation, I use price stops, time stops, pivot stops and size stops.

DL: Of the four, price stops seems obvious--is that points risked per trade?

JC: Yes. As a rule of thumb I never permit a stock to go more than one point against me. I've learned that your first loss is the best and it only gets worse from there. Almost all big losses start with small losses.

DL: Is your one-point rule rigid?

JC: No. Markets are constantly changing. Also, obviously on a carry-over trade, there's no way to prevent a gap from making it worse. However, in those cases I reduce the risk by not taking the entire position home.

DL: What about thinner stocks, higher-priced stocks, or those that are more volatile?

JC: On those I'm willing to go to 1 ½ points or so. However, I reduce my position size accordingly.

DL: What are pivot stops?

JC: When I see a stock break out of an intraday congestion or consolidation as a momentum player, I'm looking for immediate continuation. That's the normal expectation. My many years in the market have taught me to be cynical: Stocks don't move, they *are* moved. Often stocks don't go up, they are *put* up. So typically, I will place a stop immediately below a consolidation. If the stock simply is stutter-stepping after the breakout, that is, if the stock goes one to three bars (on a 5-minute chart) and then has a shallow pullback, then, OK. However, if a stock comes in below the breakout point, I'm usually gone. Most traders wait for a base to be violated. I won't wait that long. If the stock reasserts itself, then I'll re-enter. That's the way I like to trade.

DL: What about time stops?

JC: As a momentum/short-term player there's an opportunity cost to be in a stock. Especially with today's volatility.

DL: So by being in a stock that's not moving you miss opportunities in other stocks?

JC: Yes. Depending on the stock, I find it difficult to manage five to six positions at one time, and if we are talking about Internet stocks, managing more than two or three on an intraday basis can be a real feat. So if I enter a stock based on momentum, I expect continuation. If the stock just sits, I may simply scratch the trade and look for greener pastures.

DL: And size stops?

JC: I use size stops with my Stepping In Front of Size Methodology (SIFOS). *Note: The SIFOS methodology essentially involves buying stocks at the market when a large trader persistently bids for the stock. You are "stepping in front of size."* With this, I'm buying at the market and my stop goes right below the large bid. This can often turn out to be much less than one point away.

DL: What about exiting?

JC: It all depends on the market. I recognize that markets are constantly changing and require different approaches at different times. Although this may should sound patently obvious on the surface, it's been a real to a key to my profit-making potential.

Let's say that the overall stock market or a sector is in a solid monolithic move. I'm pretty comfortable with a one-point stop rule. I'm also more prone to let things ride a bit. When markets are choppy, I'm going to be less forgiving, both with my stops and in taking profits. I'm much more apt to take a piece off as a soon as a stock runs up a point or so and bring my stop up to breakeven on the remaining piece. I don't overstay my welcome in choppy markets.

DL: Are there any times when you take larger positions or pyramid?

You can take the same two people and sit them at a blackjack table in Las Vegas. The cards are coming out randomly but it's the player who bets properly and uses a disciplined approach and knows how to recognize a streak when it occurs and go for the throat who will live to survive and play another day.

The market is very similar. There are few times where the market has a strong run and you want to do the same with your positions. This may happen as often as a few times a month or as seldom as a few times a year. The key is to recognize when this is occurring and bend the rules and press a bit.

DL: Any closing thoughts?

JC: Yes. Many people think they want to pursue one particular form of trading. For me, its day trading and short-term momentum trading. This is not to say it's for everyone. It all depends on your makeup. I admire traders like Mark Boucher who occasionally catch much larger moves. Also, you have to be willing to change. At some point in time, I might be willing to commit a small portion of my capital to trading this style. However, for now, I know my niche and stick to it.

Kevin Haggerty

Kevin Haggerty's long career in the institutional side of the trading business has given him a unique perspective from which to pursue short-term stock trading. If you've read Kevin's "View's From The Trading Desk Commentary," you know he keeps risk on a short leash.

DL: Do you always wait for your stop to be hit, or will you get out of a trade for other reasons?

KH: When you take your initial position, assume you are wrong until the market proves your position correct. You don't have to wait until your stop is hit to get out. If the dynamics of your specific trade change, just exit the trade and immediately you will save some money that can be applied to other trades. You can always re-enter the trade again if it sets up.

DL: How tight do you keep your stops?

KH: Intraday trading requires tight stops to be profitable. You are limited by the clock and the daily range of your selected stock. Remember, a pure day trader goes home flat everyday.

With tight stops of 1/4 to 3/8 of a point and accuracy of 50%, a trader that can lose 1/4 and make 1/2 can be very successful. With tight stops accuracy is lower so you must learn to manage the trades to make multi point gains.

For example, on a 1,000-share position, a day trader is not going to risk more than 1/4 to 3/8 of a point, including commissions. If you decide to adjust for volatility and take a 500-share position in a stock with an implied volatility of 80 versus one with 40, then you could risk, say, ¾ of a point, or $375.

With tight stops of ¼ to 3/8 you are often stopped out by normal market noise, such as programs and news blurbs. You can't let this bother your emotionally. Every trade you make is a probe and you will soon catch a multi-point move. However, you can't make up multi-point loss in a day.

Another key point is that beginning traders are better off trading smaller size with wider stops especially, if they are not connected by direct access execution and have to rely on a standard ISP hookup and possible phone call. I highly suggest you don't attempt to day trade with an online brokerage firm where you don't have direct communication.

I have seen traders correct on 40% of their trades and stopped out on 60% of them who are among the most profitable in the firm because they are excellent at managing their profitable trades and adamant about taking only small losses.

DL: Can you expand on this in practical terms?

KH: Consider catching a one-point move, and losing ¼ point on three trades. Suppose your commissions are $25 per round trip and you are trading 1,000 shares. If you lose a quarter point plus commissions (-$250 - $25 = -$275) three times in a row (-$275*3 = -$825), then make 1 point ($1,000 - $25 = $975), your net result is a profit of $150 even though you were wrong 75% of the time--because you managed the winners properly.

But traders who lose ¼ and take a profit of ¼ and pay commissions go out of business. Learn to manage your winners and keep tight stops. Pyramiding positions in stocks for a day trade is difficult at best, and should not be attempted by novice traders. It is probably better for all traders to put on their maximum positions initially--that's your best entry, assuming you have enough daily range to provide you ample profit opportunity.

Summary

In the first part of the series on money management, we looked at drawdown and why it's so important to keep it within reason. We showed that the percentage to recover from a drawdown increased at a geometric rate as the drawdown increases. For instance, a 60% loss of capital requires a 150% return on the remaining capital just to get back to breakeven; a 70% loss requires a return of 233%, and so forth.

In the second part of the series we looked at 17 general guidelines that should help to protect capital and ensure profits as a trader. These included risk control techniques such as use of stops, keeping drawdowns within reason, portfolio correlation, judging risk-to-reward, volatility of markets, understanding the instrument being traded (i.e., derivatives), percent per trade risk and overall portfolio risk.

We looked at techniques to help ensure long-term survival and capturing profits such as being adequately capitalized, 2-for-1 money management and taking windfall profits. And finally, we touched upon the psychological impact of losses.

In Parts 3 and 4 of the series we interviewed professional traders and money managers. Although their approaches to the markets varied greatly, they all had the utmost respect for risk and clear and practical methods to control it.