MONEY MANAGEMENT

EBOOK 04

GFtrade Inc

Money Management in Forex

Money management is something that everyone does, but some people just do it better than others. Strict money management and risk control are essential to achieving long-term success in the Fx market. When people try trading and in particular forex for the first time, the first thing they tend to look for is the fanciest trading system they can get their hands on. People just think that if they can find the latest and the greatest system, all their dreams will come true.

Whilst solid trading method is needed to make money trading, if the trader doesn't use a profitable money management technique to fit that system or method, then even the best system in the world won't do any good. Expert traders could give a trader all their tips, but if the trader fails to make use of money management, then they are still likely to fail. This is about how important money management is and it is something that is constantly overlooked at.

What is Money Management in Forex?

Money management is the most crucial and significant aspect of trading. Many successful traders place money management technique as the highest contributing factor to their overall success. Because knowing money management is such a critical factor, it became important to know exactly what it is and is not. Money management is the quite self-explanatory term. It is how you manage your money when you trade. Many of the times when discussing money management in Forex, traders are referring to how much they are risking of their account. Thus this technique should be carried out with consistency.

Why is it important?

Because it can ensure that you can remain in the market long enough to become profitable. It is a non-negotiable success factor for any active traders. It is vital determining just how successful of an investor you will become. It's really all about asset protection. Which means you need to apply few more factors such as using stop losses to limit the damage and knowing how much you should risk per trade. Learning to apply wise money management tech nique is vital to trading success. Protecting your equity should be your priority as a trader because without equity, you will not be able to continue trading unless you are willing to constantly restock your account balance. For this reason, you should learn how to apply the concept of money management effectively and develop a policy which a strategy enabling you to maximize your profit potential at minimum risk.

Now you know what money management is and how much of an important factor it is in trading, now you need to know methods of applying it to your trading routine.

How? What to do?

Have a trading plan

Have a Forex trading plan and stick to it in all situations. Your plan should include your money management strategies. A trading plan will assist you to keep your emotions in shape and also prevent you from over trading.

Just 2%, Even less

As part of your trading plan, which should never be violated, traders should know and decide how much they are going to risk per trade. Traders need to know that there is a risk element in every trade and need to accept the fact that it is possible to lose on any given moment. You should not be carried away with your potential profits and should be more aware of the potential risks.

Risk only a small percentage of total equity on each trade, preferably no more than 2% of your account balance on an individual trade. Many experienced traders suggest that even 2% risk is too high, particularly for new traders and that risk should be set at between 0.5%~1% even. You should be risking less if you are more active than average traders. Obviously, risking 2% may even be considered to be high if you are making dozens of trades in a day. One bad day could possibly kill your balance. Long-term traders who may make only few trades per year could risk more.

Theoretically if you risked 5% per trade and say you suffered 5 full losses in series, this means you would have lost 25% of your account. You would then be required to win over 6 trades at 5% risk to just recover the damage you have taken. To clarify this damage more clearly, if your account contains $100,000, in this situation you lost $25,000. It is definitely not an uncommon situation losing 5 trades in series. Now if you had only risked 0.5% for example, you would have only lost 2.5% of your total account. (Given that we are discussing it with the same figures).

You would feel a lot more confident trading the next day having 97.5% of your balance intact (provided that you had 2.5% loss) rather than having a 25% loss of your balance. Perhaps you may have lost less if you have used stops.

New comers of trades become far too concentrated on the possible gains as opposed to the potential losses. Now to look at another essential aspect of your money management technique to control your losses.

Stops

Use stop-loss orders

Stop loss is an order placed with your broker to sell a security when it reaches a specified price. It is designed to mitigate an investor's loss. Stop-loss order helps eliminating emotions that can impact trading decisions. This can be especially handy when one is not able to watch the position.

Using stop-losses for trade position you initiate is a good money management habit. Stop-loss order protects your investment from unexpected turn in the market. Set your stop-loss order not to exceed more than 2% of your trading balance to prevent the possibility of a big loss.

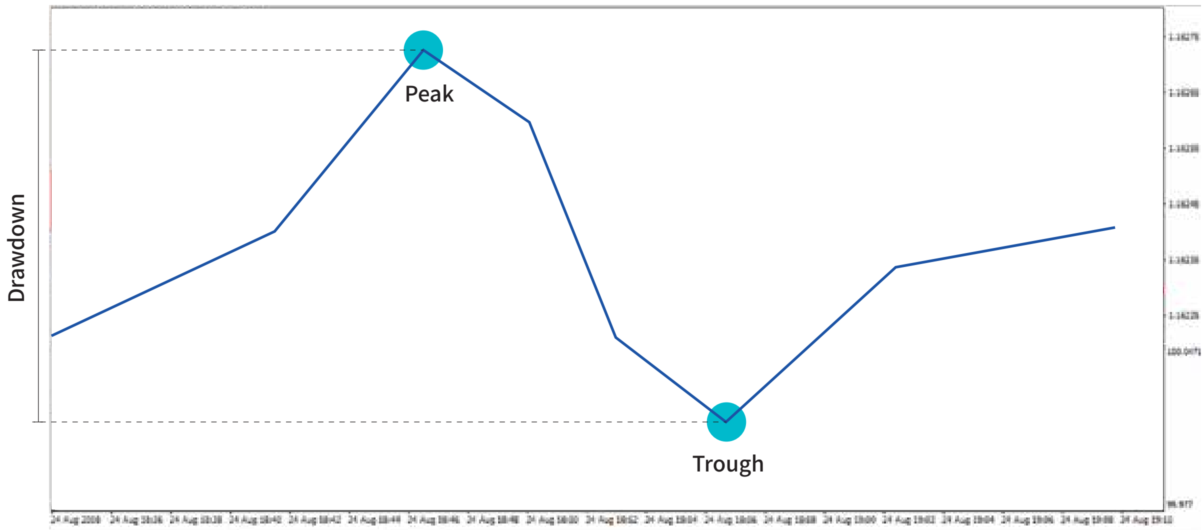
Forex trading is all about achieving more profits than losses. However, no traders out there can say that they have never experienced losses. You need to reduce your losses with a stop-loss order. You should never wait for the trade to change direction to your favor and try to reduce the loss. Be confident to face the loss if it is triggered and analyze what happened and continue trading.

Use leverage wisely

Your broker may give you leverage on your account to enable you to trade for bigger profits. However, you must be careful when using this facility. For example, a leverage of 1:200 on a $400 account means you can place trade up for $80,000. Your level of exposure to risk is higher with a higher leverage.
If you are a beginner, you should avoid high leverage. Use leverage only when you have a clear mindset about the potential loss. Therefore, you will not suffer major losses in terms of your portfolio, and you can avoid being on the wrong side of the market. Leverage is one of the key advantages of the Forex market. It will assist you to achieve more, but it can also work against you.

Drawdown? Maximum drawdown?

Drawdown is simply the reduction/difference of trading capital measured from peak to trough. A drawdown is calculated by getting the difference between a relative peak in capital minus a relative trough. Most traders like to avoid drawdowns of 20% or higher before cutting their losses.



As mentioned before, to be able to be on the road of success at trading, you will need a complete trading plan that is suitable to you. A complete trading plan will tell you when to enter, when to exit, which currency to pair to trade and most importantly, how to manage your money. Below are few more money management tips to use while Forex trading.

Money Management Tips

1. Avoid trading too aggressively

Trading too aggressively is the biggest mistake newly entered traders make. Only by small number of trade losses would be enough to empty your risk capital, it is suggesting that you are risking too much.

2. Be realistic

The reasons that new traders are aggressive is because of their expectations. They think aggressive trading will help them with making profit quicker. However, experts are steadier. Let yourself know how to set realistic goals and maintain that thought.

3. Prepare for the worst

We can't see the future, but we have evidence of the past. What has happened before may not happen again, but it will show what is possible. Thus, it's important to observe the history and recent flow of the currency pair you are trading.

4. Use stops

Using a form of stop can assist you with reducing losses and can be helpful when you can't physically monitor the market.

5. Swift decisions

Basics of trading is to make profit and cur your losses. It is crucial to make your exit swiftly when you have realized that you made a bad trade. Most people try to turn a bad situation around, but in this case, closing the trade and just letting it go may be more beneficial for you.