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Trading Secrets Revealed

AUDIO TRANSCRIPTION

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Professional Trader, Author & Coach

www.meta-formula.com

Money Management Secrets Revealed

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I wish to thank all of you, the readers of this powerful money management manual. My purpose in writing it was to make these proven strategies for success available to you, the private trader, whether you're a beginner or trading veteran.

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INTRODUCTION

" The best investment you make is the investment in yourself"

David Jenyns - Trader, Author & Coach

Welcome to Money Management Secrets Revealed, proudly brought to you by www.meta-formula.com. My name's David Jenyns, and before we begin, I'd just like to congratulate you on making a wise investment decision. You've made the best investment you can make, which an investment in yourself. What were going to discover in this audio program is going to save you thousands and thousands of dollars when you come to the market. The truth of the matter is there really are a lot of ways to make money in the market. There are tons of seminars that you can pay for that will tell you how they made a million dollars in the stock market, and of course there's those books that will tell you how to double your money every hour, and sure some of these books have some fantastic material in them, and there are patterns that might work sometimes and others that won't work. However, at the core of any successful trading system is the same critical component, and that is excellent money management. You need to have systems in place to make sure that you're not losing too much.

Realistically, a system is not going to be correct one hundred percent of the time, that's why money management is so important because we need to make sure that we don't lose too much because if we lose all our money today, we'll have absolutely no money to keep trading tomorrow.

Now, I'm not the only one to believe that money management is the Holy Grail when it comes to trading. In fact, many other successful traders all site money management as a core principle of their success in the market. For this reason, it's not my job here to reinvent the wheel. My goal of this audio package is to bring the best of the best of money management all together in one concise package that can then be applied to any trading system.

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So, some of these concepts may not necessarily be new to you, however, I would like to put forward the idea if you're not successful in the market, or you're not achieving the success that you would like to achieve, one of the major reasons is because you may not be using correct money management. It's one thing to know these rules. It's another to actually apply them, and remember everyone is at a different point in their trading journey.So, some people who listen to this audio it will be a new idea a minute. For others who are familiar with money management, you may pick up only a few finer distinctions.The point I would like to make here is if you can just pick up and learn one new thing from this program, your time and money was well spent. All it takes is one new idea, one finer distinction, and you can watch your trading profits soar.

Also, due to the fact that everyone is at a different point in their trading journey, I've tried to avoid the use of confusing financial stock market jargon that you might commonly find in books and tapes and in seminars. My personal feelings about these terms are that they're not well understood by the public and make the world of stock investing seem like some sort of alchemy.The emphasis here is on keeping it simple. This will not be the most complicated or scholarly course that you ever invested in, but it may be one of the most simple and most practical courses. Simplicity is best and especially simplicity works best. Why complicate things unnecessarily?

We're going to answer the most pertinent questions when it comes to money management. What is money management? Why is it so important? And the most critical component is how do we implement excellent money management? We can break that down into the broader topics. We'll cover your trading float. Also, I'll look at setting your maximum loss. By doing this, you're going to know your worse case scenario if the stock doesn't go in your desired direction, and you're going to know this before you even enter a trade. This is how we manage your risk.

No money management course would be complete without a discussion of stop losses, what they are, how they're implemented, and a few different suggestions on how you might go about setting your stop loss. Just as the name suggests, a stop loss does just that. It stops your loss. Effectively, it's a predefined point at which you'll sell if the share or stock doesn't go in your desired direction.

We're also going to discuss how you should determine how many stocks to buy. Also known as trade size, we'll go through a formula that will allow you to plug in some values so you can calculate how many stocks you buy without ever exceeding your maximum loss.

With this package, you would have also received a money management calculator that will calculate all these formulas for you. However, I want to make sure that you understand the method behind the madness.

The next component we'll discuss is trailing stop losses. By implementing a good trailing stop loss, you'll give the share price enough room to move, while also making sure you stay with the trend as long as possible. That way, you make maximum profit while also reducing your risk.

Of course, that's only a brief outline of what we're going to cover. We're going to go into these topics and many more in much greater detail. Money management doesn't have to be a complicated area of your trading system. In fact, it's best to have that simple system in place. I'm going to take away the smoke and the mirrors, and you're going to be left with the nuts and bolts, step by step plan that you can follow to ensure you have the most critical component of trading success in place.

I want you to understand what you're doing and why you're doing it. Once you have a good system in place, you won't need to follow market gurus, full-service brokers, newsletters, advisers, or anything like that. I want you to be able to avoid the most common mistakes and fallacies that most investors fall prey to.

I want you to have the confidence of knowing that once you enter into a trade, you'll have your exit strategy already predefined. By doing this, this is going to enable even the most busy person to manage an aggressive portfolio of stock with only five minutes per day with the peace of mind that comes with having a plan, and most importantly, you'll be able to sleep at night because your risks will be tailored to fit your level of risk tolerance and confidence level. Let me assure you all these goals and more can be achieved by setting excellent money management.

WHAT IS MONEY MANAGEMENT?

"Study and research into the state-of-the-art in money management will pay enormous dividends."
Richard Dennis - Co-Founder of the Turtle Traders

I suppose the first question to answer is, "What is money management?" Money management is simply a set of rules and guidelines that keep your risk at a level at which you're comfortable with. Now, these rules and guidelines need to be determined before we even enter a stock. That way, we don't get emotionally involved in the stock and make poor trading decisions.

The key to not going broke is to respect risk. We need to take small positions that won't to allow our capital to blow out. You must always keep in your mind that when you're trading you're simply playing the odds.

It's funny. I once thought I had a fool-proof way of making money on roulette. You see, I'd bet on red and black. I'd sit at the table, and after the ball had landed on black or red five times in a row, I would start betting on the opposite color.

So, let's say I had five reds in a row. I would start to bet on black. Then, if I was wrong, I would go ahead and double down, meaning that if I started my bet at one dollar, the next time I would be able to bet two dollars, then four dollars, then eight, then 16. With this system, eventually I'd win and I'd come out with one dollar ahead.

So, here I am, 18 and I've got a computer program where I tested my theory and I made a ridiculous amount of money. I really thought I had the Holy Grail here. If it's so easy for an 18 year old to figure it out, why is it that all the casinos are not out of business and we're millionaires? Simply, it doesn't work that way. You see, if we're flipping a coin, heads has a 50 percent chance of turning up on each flip of the coin and so does tails, but each flip is independent of the last. The last coin toss has nothing to do with the one before it. It's a random event. Each time a coin is flipped, that debunks to billions of times that a coin has already been flipped. What I'm trying to illustrate here is that it's possible to get a hundred heads in a row if you do it long enough, and believe it or not,

that's what happened to me when I first played Roulette at Crown Casino, and I saw a string of 23 blacks in a row, and of course I went home defeated.

Trading is the same. We have a certain percentage of our trades that will not work out. A certain percentage will not go in our favored direction, but our next trade has nothing to do with the last one. So, even if you have the world's most accurate method, over time you will go broke if you don't practice good money management.

The truth of the matter is you're going to have a system that sometimes wins and sometimes loses. In fact, many successful speculators have success rates of between 30 to 50 percent. They're not successful because they predict prices well. The reason they're successful is because their profitable trades far exceed their losses.

Psychologically, this type of system can be difficult to follow, and that's why successful market professionals achieve success by controlling risk, but unfortunately controlling risk goes against our natural tendencies. To apply the rules we're going to go through, you must have tremendous internal control. With this control, you'll be able to adhere to two cardinal rules of trading - you'll be able to let your profits run and you'll be able to cut your losses short.

More importantly, by having the rules in place, your system can be set on autopilot. You won't need to think on the fly and decide, "Should I be holding this stock?" or "Shouldn't be holding that type of stock?" It's that type of indecision that most people are confronted with when they don't have money management rules in place. The result is that those small losses end up being big losses.

What's worse is when you string a few of these big losses together, it has a detrimental affect on your trading capital, and we all know it's much more difficult to trade to try and gain back money you have lost then it is to trade with profit that we have in the hand, and that the absolute extreme if you wipe out your entire trading float like many traders do when they first get started, obviously you're not going to be able to continue to trade.

It's funny though, despite the proven fact that money management is so important, many of my clients, when they first come to me, the majority of them focus their time looking for the perfect entry. It's that search for the Holy Grail. They

want a perfect indicator. It's going to be the indicator for them that slays the market. Not only is this indicator going to get them in right at the bottom of the trend, but it's also going to tell them at the exact point at the top of the trend when to get out, and here's the good part about this indicator. Apparently, it can guarantee success and it's never, ever wrong.

Unfortunately, even though I don't like to disappoint my clients, I need to let them know two things when they come to me. Firstly, there is no Holy Grail. There is no perfect indicator. And, secondly, I need to let them know hypothetically - let's say they did find the perfect indicator that got them in at the exact bottom and got them out at the very top – even if they did find that, it's not when you buy the stock or when you sell the stock that determines how much money you make. It's how much you actually put into the trade.

For example, let's say that I had a system that gave me a buy signal for a particular stock, let's call it "XYZ", and I received a buy signal at one dollar. After following this trade, I got a second signal to exit the trade, and I exited at two dollars.

Now, if I bought at one dollar and then sold at two dollars, I've made one dollar or 100 percent profit, haven't I? But, what determines how much money I actually make on this particular trade? Sure, I've made a dollar profit, however, what determines how much money I make is how much money goes into the stock.

Now, of course, we're just talking about the long side in this example, however, the same goes for losing stocks. If I entered into a losing trade, it's not actually when I purchased the stock or when I sold the stock that determines how much money I make, what determines how much money I make is how much money I actually put into the trade.

It sounds rather elementary, doesn't it? However, why do you think most traders spend their time focusing on entry rather than the money management which is so much more important? It relates to a psychological trait that all humans have, and that's the belief that we get some sort of increased confidence when we have some way of being involved in this stock selection. It's as if we have the ability to manipulate the data in a somehow meaningful fashion that gives us control over the market. People believe that by finding the perfect entry what they're doing is controlling the market.

In a fantastic book called "Trade Your Way to Financial Freedom" by Dr. Van Tharp, Dr. Tharp relates this to what's known as the Lotto Bias, and it's the perfect illustration of the way control works. Just simply look at a Lotto game. When people play Lotto, they get to pick numbers, usually six or seven of them, and if all of them happen to be hit, you become an instant millionaire. People really like to play the Lotto games, even logical people who understand the odds. Why? Because the prize is so big, and the risk is so small.

Dr. Tharp goes on to talk about the Lotto Bias being an illusion of control. People get an illusion of control when they play the game. You see, people think that because they get to pick the numbers that their odds of success are somehow improved. Therefore, some people might suspect that if they pick the numbers of their birthday or from their anniversary, it might improve their chances of winning.

The truth of the matter is each number that you choose is just as likely to win as any other number. Similarly, many people get a sense of control when entry signals are used because the points at which they choose to enter the market is the point at which the market is doing exactly what they want it to do. As a result, they feel like there's some sort of control not over the entry, but over the market, and unfortunately once you're in a position in the market, the market is going to do whatever it wants to do. The only component you have control over is your money management and your own psychology.

Probably, if you ask anybody who's studied trading for any period of time, they'll tell you that psychology is the most important component to a successful trader. In short, this is true because if I gave you the perfect system with the perfect money management in place, the only thing that stands between you and success is your own psychology.

You need to have the discipline to be able to follow your system, and this is what's going to determine if you're successful in the market. However, if you're disciplined, the next major component of a successful trader is what this course is all about – constructing good money management. It's the only thing that you have control over when trading.

DEFINE YOUR TRADING FLOAT

"Rule number one of investing is never lose money. Rule number two is never forget rule number 1"

Warren Buffet

The first step you will take in setting your money management rules is to define your trading float, and by trading float I mean the amount of capital that you have to trade with. In fact, one of the most commonly asked questions that I receive is “How much do I need to actually start trading and make a full-time income from it?” But, before you mortgage your house and car and sell your wife and kids, realize that when you first begin trading you’re going to have to pay your share of tuition.

There’s a learning curve involved in learning the markets. Don’t try and skip this, just make sure you prepare for it in advance. The solution is to simply treat your trading as a business. Any business including trading requires start-up capital.

Unless you’re trading from an office, computers, data-feeds and software are all a part of start-up costs. Of course, the start-up costs for a trader don’t end there.

You also have draw downs which are just part of doing business. There are going to be times when you lose money for a long period of time, count on it and make sure you also plan for it. Additionally, just like traditional business, would you expect to purchase a business for five thousand dollars, and see it turn over one million dollars in the next financial year? Yes, this is achievable; however, especially when you’re first starting out, it’s not very likely. The same can be said with trading.

Don’t come to the market with five thousand dollars and expect to turn it over to one million dollars by the end of the year. That said, what sort of return you do achieve really does depend on what products you decide to trade.

If you are trading leverage products, sure you’ll have a greater chance for reward, however, there’s also more risk involved with trading these types of instruments.

And, although there is no perfect amount of capital to start trading with it's no secret that the bigger the trading float you do begin with, the easier it is to trade. The reason for this is because there are fixed costs involved with trading.

The major fixed cost I'm referring to here is brokerage. Depending on which broker you go for, many brokers charge a flat fee, and it's no secret with brokers who charge a flat fee, that traders with the larger fund size have it a little bit easier. For example, if we had two traders, and the first trader was looking at opening a position valued at 1,000 dollars, and our second trader was looking at opening a position valued at 10,000 dollars. If both of these traders have fixed brokerage costs, obviously the trader with the larger account size has the advantage because if both traders were paying 100 dollars on their brokerage, our first trader who's trading 1,000 dollars would have to make back ten percent before he would even reach break even. Whereas, if we compare that to trader two, he only needs to increase his capital one percent before he reaches break even.

Now, I'm not saying that you can't start trading with a smaller trading float; however, those who do start with a smaller trading float are slightly disadvantaged. An additional point I'd like to make in regards to your trading float size is that your trading float size is going to determine what type of system you're going to trade. If you have a very small trading float, it's recommended that you look at trading a system that is more long-term system, and the reason is because with a longer term system, you'll be incurring a lot less brokerage. However, if you have a small trading float and you were trading a short term system, you would receive lots of buy signals, lots of sell signals, and your trading float would be chewed up very quickly just with the cost of brokerage.

That's why if you're looking at trading very short term systems such as day-trading systems, they're best suited to larger trading sizes. I actually recommend that when you first begin trading that you look at trading a longer term trading system. You can actually manage a very successful long term trading system while still working full-time.

Once you're successful with this time frame, you might look at shortening your time frame, and focusing more time on trading itself.

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Talking about getting started, having the money is only one part of the equation. Where to actually get that money is the other part of the equation.

Maybe you've been planning for a while and you've amassed a wad of money. That's good planning. Or, maybe you're borrowing it. This is a bad idea in most cases. I know of guys who've maxed out their credit cards to get started in the trading business. While, yes, this is a quick and easy way to get in cash, the effects from it can be potentially devastating.

Worrying about trading profits is hard enough without having to worry about debt service on your credit card as well. In this case, you're not concerned with good trading, rather you're concerned about making payments. Don Miller talks about this in "Trading Markets World Meet the Traders" when he tells new traders to worry about trading well, not making money.

Quitting your day gig to day trade is a bad idea unless you've got a pile of money to keep you afloat with no worries for two years. It's like the old joke, "How do you make a million dollars in the stock market?" The answer is to start with two million dollars.

A fantastic way to learn is to begin trading on a part time basis. That way you've still got an income stream while you're honing your skills. The advantage here is that you're not trading your rent money. As a trader you need to realize the risk you're taking on by simply putting your money in the market.

Now, I know with good money management, you'll be able to limit you risk. However, you need to appreciate what's known as "market risk", and that's the risk that the market might not be there tomorrow. You might put your money in the market and just by doing that you're putting it at risk. So, make sure you only trade with money you're willing to lose.

Now, again, I'm not saying that you're going to lose all your capital, however, the point I'm trying to make here is that you need to focus on trading well, not trading to make money.

In summary, how much capital you start with will depend on how much money you've got, your level of risk tolerance, the instruments you're looking to trade, and what timeframe of system you're planning to trade. There is no perfect amount of capital to begin trading with. The key here is to simply define how much capital you're trading with and have

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it set up as a separate business. That way you're not drawing on the profits all the time and losing your focus. Remember, your trading is a business now.

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SETTING A MAXIMUM LOSS

"Never risk more than 1% of your total equity in any one trade. By risking 1%, I am indifferent to any individual trade. Keeping your risk small and constant is absolutely critical."

Larry Hite.

After defining your trading float, the next thing that you need to do in setting excellent money management is to define what your maximum loss is. The maximum loss is quite simply the maximum amount of capital that I'm happy to lose on any one trade. The reason for defining this upfront before we even open a trading position is to make sure that we can stick to one of the cardinal rules of trading and that is to keep our losses small. We want to make sure that we set what our maximum loss is and make sure that's a small percentage of our trading float so it won't have a detrimental affect if we have a string of losses.

If 95 percent of traders end up losing money, the primary reason for this is because they haven't applied good money management. Let's look at an example. If I had a trading float of only one thousand dollars, and I began trading risking 100 dollars, with most trading systems, it could be very reasonable to experience three losses in a row. If I was risking 100 dollars, obviously my trading capital would have now reduced to 700 dollars. Now, what do you think those 95 percent of traders say to themselves at this point in time? They go, "Well, I've already had three losses in a row. So, I'm really due for a win now." And, that's when they decide they're going to bet 300 dollars on the next trade because they think they have a higher chance of winning. This just isn't the case and I suppose we could draw parallels back to the story before when I was talking about going down to Crown Casino and I was waiting for a string of blacks in a row and then I would bet on red.

Effectively, this type of trader that I've just described is doing the same thing. Assuming that person did bet 300 dollars on the next trade because they thought they were going to win. If they lost this time, now their capital would be reduced to only 400 dollars. The chances of making money

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now are very, very slim. They'll need to make 150 percent just to break even.

Similarly, here's another example and a perfect illustration why most people lose money in the market. If we again, start out trading with 1,000 dollars and we begin betting with 250 dollars, then after only having three losses in a row, we've now lost 750 dollars, and our capital has been reduced to 250. Effectively, we must make 300 percent return and that's just to break even.

In either one of these cases, the reason for failure was because the person risked too much. Remember, the goal here is to keep our losses as small as possible while also making sure that we open a large enough position so we can capitalize on profits as well.

So, the question remains, what is a small loss? Well, they're usually represented as a percentage of your trading float, and studies that have been done that suggest you should never risk more than two percent on any trade. However, many pros will tell you that this is way too much. They'll risk one percent to even as little as a quarter of a percent on any trade. The idea here though is that no one trade is really going to affect you either way.

I really believe a lot of people don't actually appreciate how powerful this rule is. To be honest, by simply changing the amount of capital you risk, you can turn a system from returning 10 percent to a 100 percent per annum by simply altering this one variable.

Ultimately, by increasing the risk, yes you increase your chance for reward, however, you also end up increasing your draw down as well, and although I recommend you never exceed two percent risk, I do recommend that you do a little bit of testing to understand the importance and the power of changing this one variable.

But, let's look at an example of the two percent rule in action. If we had a trading float that was 20,000 dollars, by setting the two percent rule, we set our maximum loss to be 400 dollars on any one trade. The beauty of having made losses so small by using the two percent rule, is that we need a huge string of losses before our entire trading float is eroded. If we had a 20,000 dollar trading float and our maximum loss was 400 dollars, we could have a string of 50 losses in a row before we had no more capital left to trade

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with. Most trading systems the chances of getting 50 losses in a row is very, very slim. However, the chances of going broke are even smaller than that because when you implement the two percent rule correctly, that two percent is actually calculated on the current float size.

So, initially two percent of 20,000 dollars is 400 dollars. However, if we experienced a loss first off, our trading float would now be worth 19,600 dollars. We calculate two percent of this new value of our trading float, and set this as our maximum loss for our next position.

Two percent of 19,600 dollars would be 392. So, you can see the effect each time our maximum loss would shrink. As our portfolio increases in size, we're happy to take on more risk as well.

I thought I'd play around with a few of the figures just to see what would happen if we had a string of six losses in a row. Our trading float after receiving six losses in a row, would have decreased to only 17,717. That's after six successive losses, and we've only lost 2,283 dollars. Now, that's managing your risk.

Being such a small component of our trading float makes it much easier to gain back those losses. In this example, we've lost a little bit more than ten percent. To gain back a ten percent loss, we'll need to make 11.1 percent gain to get our trading float just back to break even.

Now, imagine if we didn't have good money management in place and we had a draw down of over 50 percent. If we have a draw down of 50 percent, we need to make 100 percent return on our remaining capital just to reach break even. So, you can begin to see the bigger the draw down the more difficult it is to pull yourself out of that.

Remember, novices risk more than two percent. Now, you know better. Also, if you're starting out with a small trading float, that's no excuse for practicing poor money management. Your goal in trading should be trading to survive. If you can survive in trading, the profits will come. What you need to do is position yourself so that you can endure long strings of losses so when the market does turn around, you're already in the market positioned to capitalize on those moves, and that's what setting the maximum loss is all about.

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SETTING STOP LOSSES

"You're protective stop is like a red light. You can go through it, but doing so is not very wise!"

Richard Harding

The next area that we need to discuss is now how to calculate our stop loss. The stop loss very simply is a predefined point at which we exit a stock. This exit point is determined before we even enter the trade. You see anytime that we enter a position, we don't know at what point we're actually entering into the trend. We might be entering into a stock just before the trend changes. So, what we need to do is set a stop loss. Effectively, it's like drawing a line in the sand underneath the share price, and we say, "If the share price falls below this line, then the stock hasn't done what we thought it was going to do, therefore we'll exit the position."

This allows us to cut our losses short and we all know how important that is. Psychologically humans are hard wired into believing that they must be right. When 95 percent of traders enter into a position, they're expecting to profit from this trade. If, however, the share price goes against them, they feel they need to justify why they bought this stock by holding onto it until it turns a profit. However, you might have heard before the idea that all big losses once started as small losses. This just illustrates the need to have a stop loss in place. It's almost like we have an ejector seat that tells us when to abort mission.

One of the most common question I receive when traders first become introduced to a stop loss is "How wide should I actually set my stop?" Or in other words, how much room should I give the stock to move? Unfortunately, there really are no definitive answers here because it depends on what time frame you're trading. If you're a shorter term trader, you're going to have a stop loss that's actually set closer to the share price. Whereas, if you're a longer term trader, you'll actually give the share price a little bit more room to move by setting your stop loss lower.

Once you've identified what time frame you're looking at trading, the next step is to be able to remove the normal market noise in that particular time frame. You don't want to

have to close out of a position just because a share price moved a little bit while part of its normal trading volatility.

In fact, by setting tight stops, there are some serious drawbacks. Firstly, by having tight stops you'll decrease the reliability of your system because you get stopped out more often. Secondly, and probably a little bit more importantly, by setting tight stops, you dramatically increase your transaction costs. Transaction costs, when trading, make up a major proportion of doing business. To give yourself a fighting chance, you want to at least trade a system that doesn't excessively chew through brokerage. Consequently, this is one of the major reasons I steer my clients into trading systems over a slightly longer time frame.

With that in mind, the question still remains, how can you go about setting stop losses? Although there are many ways to do this, the one real key here is just to have one in place. Some of the different methods available are things such as your percentage retracement where you allow share prices to retrace a certain percentage of the entry price before you exit.

Other stops consult indicators to identify where the stop loss is going to be set. You could also use support and resistance stops to set the level at which you'd exit. Although, personally, I find this a little bit subjective, and I like to have a mechanical way of calculating my stop losses. The way I go about setting my stops is by using a volatility based stop.

The reason I use this type of stop is because I believe that volatility usually represents market noise. Consequently, if I have a way of measuring volatility, and I take a multiple of that value and subtract it from my entry price, I'm probably going to have set my stop loss beyond the immediate noise of the market. I personally find this most effective. So, let me show you how I go about calculating it.

The way in which I measure volatility is by using the average true range. Now, you can get the value of the average true range out of most charting packages. Very simply, though, the average true range is a measure of volatility. It indicates how much a stock will move on average over a certain period.

So, if you had a one dollar stock that moved five cents on average over the last 20 days, that doesn't tell us whether the stock is going to move up or down. It just tells us on

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average how much the particular stock moves. The average true range really is a fantastic tool and can be utilized in your trading for more than just setting stops. So, if you're not familiar with it, I recommend you do a little bit of research because it can be a great tool.

So, how can we use this indicator in calculating our stop loss? All you do is subtract a multiple of the ATR from the entry price. I might take two times the ATR and subtract it from my entry price.

Now, what that means is if we look at the example I just touched on before, if we had a one dollar stock and its ATR value was five cents, I would simply take a multiple of the ATR which I said we'll use two in this example, and we'd subtract it from our entry price. So, two times our ATR is ten cents, subtracted from our entry price gives us a stop loss value of 90 cents.

Now, by adhering to this pre-defined point at which I sell, I know if the share price doesn't move in my favored direction, and actually moves against me, I already know the point at which I'm going to sell. My emotions are removed from the equation, and I just simply follow what my stop loss says. This is how most successful traders limit their losses. They know when they're going to sell and they have this pre-defined before they even begin trading. Although their methods of calculating this stop loss may be different, the one common element here is that they have a stop loss in place.

Here's a little extra finesse point that you might look at including in your trading plan. I sometimes introduce a time stop depending on the type of system I'm trading. This type of stop simply takes you out of a position after a fixed amount of time if I haven't made enough profit. To successfully implement this type of stop, you're going to have to do some sort of back testing, to find out if it's appropriate for the particular instrument you're trading. I just thought I'd throw that in there to make sure you have all your bases covered.

When you first begin outlining your stop losses, just keep in mind what Tom Baldwin, the successful trader said. He said the best traders have no ego. You have to swallow your pride and get out of your losses. He's simply referring to having a stop loss set, and more importantly, having the discipline to stick to it.

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CALCULATING TRADE SIZE

"If you have an approach that makes money, then money management can make the difference between success and failure... ... I try to be conservative in my risk management. I want to make sure I'll be around to play tomorrow. Risk control is essential."

Monroe Trout

We have now reached the point where we need to discuss the most important aspect of money management – position sizing. When we talk about position sizing, we're asking the question, "How much are we going to put into any one trade?" Fortunately, by adopting the two percent rule we talked about earlier, we're using a strategy that decreases the size of our losses during losing streaks. When experiencing a winning streak, our position sizes will actually grow. What's more, by simply changing the amount of capital we're wishing to risk, we're going to change the characteristics to our risk to reward ratio.

Many people believe though, they're doing an adequate job of position sizing by simply having a stop loss in place. Sure, this will tell us when to get out and by setting our maximum loss, we'll also know how much capital we're risking, however, it doesn't answer the question of how much or how many units we can buy.

Again, since we've already calculated our maximum loss and our stop loss, we can simply take these values, plug them into a formula and calculate how many shares we purchase without ever exceeding our maximum loss.

Although very simple, the formula I'm about to give you is extremely powerful. The formula goes like this – the number of shares is equal to our maximum loss divided by our stop loss size. You're already familiar with what our maximum loss is; I just need to define what a stop loss size is. It's the difference between our entry price and our stop loss value. So, if we go back to our example earlier where we were talking about entering a stock at one dollar and setting our stop loss at 90 cents, the stop loss value is the difference between our entry price and our stock price or ten cents.

It’s just a matter of plugging the values into the formula, and it will calculate how many shares you should buy so you never risk more than your maximum loss. Now, for those of you who don’t like math, you don’t need to worry because I’ve made this as easy as possible for you. Included in this package, you would have also received a money management calculator. So, now all you need to do is plug in the values into this calculator and you’ll have set excellent money management every time.

Let’s now look at how this formula works in practice. If our trading float was 20,000 dollars, and we were risking two percent, our maximum loss would be 400 dollars. If our entry price was one dollar, our stop loss value was 90 cents, our stop size would be ten cents. Now, to use the formula, the number of shares is equal to our maximum loss divided by our stop size. We calculate that we can purchase 4,000 shares. If this stock reaches our stop loss, and we have to exit the trade, we know we’re not going to risk or lose more than two percent of our float, which is 400 dollars.

This formula is extremely simple, but also extremely powerful. Another little finesse point that some of my clients like to include is to class brokerage as part of the maximum loss. So, how would you go about doing that? Well, if brokerage was 40 dollars for our return trip, we’d subtract 40 dollars from our maximum loss.

So, instead of entering our maximum loss as 400 dollars into the formula, we’d now enter 360. Once this is computed out, we can determine how many shares we’d buy, and we know that we’re including brokerage as part of our maximum loss. There’s one small caveat that you need to be aware of when using this formula to calculate how many shares you are going to buy. The astute listener may have realized how many shares we can purchase is determined by our maximum loss and also the size of our stop. So, by increasing our risk, we can also increase the dollar value of the position we open, or by simply shrinking our stop size, that is setting a tighter stop loss, we can increase the dollar value of the position we open.

So, to avoid this situation where we open excessively large positions that might put our trading float at risk, you may also introduce an extra rule that limits the dollar value of a position to be no more than a set percentage of your entire trading float.

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For example, you might say you'll never open a position that has a dollar value of more than 25 percent of your entire trading float. This rule would only ever get executed if after calculating the formula that determines how many shares you buy, you find the dollar value of that position would be an excessively large position and greater than 25 percent of your trading float. If this was the case, all you would do is simply scale down the position to make sure it never exceeds that 25 percent.

Now, the percentage value that you decide to choose will depend on the type of system you're trading, the size of your float, and also your personal tolerance for risk. As a guide though, smaller trading floats might use 25 percent, whereas larger trading floats might use as little as 10 percent or even five percent.

There are no definitive answers and it will depend on your personal circumstances. This leads on to my next point that your study of money management shouldn't stop with just listening to this course. You need to take the principles that you learn in this course, realize that I've simply set up the goal posts for you to shoot between. You need to test your system to find out which of the variables best suit you, and remember position sizing is the most significant part of any system design. It is the central theme of money management. Be sure to take what you've learned here and apply it in your system.

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TRAILING STOP LOSSES

"You've got to know when to hold 'em; know when to fold'em; know when to walk away; and know when to run."

Kenny Rogers

Next, after defining your trading float, setting your maximum loss, calculating your stop losses, and also calculating your position sizing – we now need to discuss how do we take profits. Traditionally what an inexperienced trader will do is once they see a little bit of a profit in their trading account. They want to crystallize that profit straight away. The psychological reason for this is because they don't like to lose, and they falsely believe that those profits are their profits, and they don't want to give them back to the market.

The reason this strategy is doomed to failure is the fact that you're not adhering to one of the cardinal rules of trading and that is to let your profits run. The astute listener may have realized that we're starting to implement rules that adhere to these cardinal rules of trading. For example, by setting our initial stop loss, we're cutting our losses short, and now we need to introduce a rule that allows us to let our profits run. By simply setting these rules, we're going to be able to control two important variables - whether or not we make a profit, and how much profit we're actually going to make.

Now, of the two types of exits, hopefully it's the ones we're about to discuss now that you'll get to implement more often because these are the ones that are implemented once we're in a profitable situation. They have the potential to help us gain large profits, but before we go any further, let me warn you that they will also give some of our profits back to the market. When people first hear this, they're usually taken aback. However, you're starting to realize that we're never going to be able to peak the top of the trend. I know and you know that it's much better to stay with the trend as it develops so we can let our profits run, and as the share price turns, we'll exit.

A simple example can illustrate the importance of a trailing stop loss. If we received a buy signal and we purchased XYZ stock, and set our initial stop loss, because

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the stop loss doesn't move up, that is our initial stop does not move – if after purchasing XYZ, the stock runs up a few hundred percent. Unless we have a way to lock in the profit and then the stock reverts all the way back down to our stop loss, and obviously we'd be kicked out of the trade. The result would be that we ended up losing money even though there's some potential for some fantastic gains.

Obviously, we need a way to circumvent this ever happening, and that's exactly what a trailing stop does. This form of stop is simply adjusted on a periodic basis according to some sort of mathematical algorithm. For example, depending on the trailing stop we use, after the first day of trading if the price moves in our favor or even if volatility shrinks then the trailing stop is moved in our favor. If the market then moves against us enough for our stop to be triggered, we would still take a loss, but it would not be as large as our initial stop loss.

The key to the trailing stop loss is that you need to continually make adjustments to make sure that the stop is moved in our favor. The way in which a trailing stop loss is calculated is very similar to the way in which we calculated our initial stop loss. The only difference being rather than calculating our trailing stop loss from the entry price, we're calculating our stop loss from the highest price since entry. The method that you just can vary dramatically, however if we use the ATR method that we used to calculate our initial stop as our trailing stop loss, we'll have the ability to lock in the profit as the share price increases.

For example, if we bought a share at one dollar, and our initial stop is set at 90 cents, if our initial stop is equal to our trailing stop, our trailing stop would also have a value of 90 cents. If after the first day, the share price moves in our favor and moves to $1.10, the next step would be to grab the value of the ATR and subtract two times this from our highest price of $1.10. For the ease of this example, let's say that our stop size hasn't changed, so our stop is still ten cents wide. When we calculate our trailing stop loss, our new trailing stop loss would be set at one dollar. So, let's take a stock take. Our initial stop was at 90 cents, our trailing stop loss is now a dollar, and the share price is at 1.10. Since our trailing stop loss is higher than our initial stop, the initial stop becomes obsolete, and our trailing stop loss now becomes our active exit.

Now, my question for the astute listener is to ask, "How much profit have we made on this trade?" The share price is at 1.10 and we entered at one dollar. If you thought, "No, we haven't made any money", then you'd be right on track because remember our stop loss strategy gives the share price a little bit of room to move. We're not going to exit this position until the share price reverts to one dollar. So, here's an important point to note, when valuing any open position, always value that position based on its stop loss value because if we were to exit this share, we would wait until that price point was breached.

Let's go back to the example. Now, what happens if the share price begins to fall? Let's say that the share price falls from 1.10 down to 1.05. What does our trailing stop loss do? Would it move down also? Here's another important point to note. A stop loss will never ever move down. A trailing stop loss can only ever move up. In this way, we'll lock in profit and we'll also get out of shares once they start to turn. A trailing stop loss is always calculated from the highest price since entry, so the highest price is still $1.10. It's not until the share price makes a new high since entry that the trailing stop loss would begin to move in our favor again.

If we're using the ATR method, there's another way for our trailing stop to move up. This alternative method would occur when the volatility of a stock begins to shrink. So, if a share price begins to move sideways, the affect would be that the ATR value would begin to drop off. This would also obviously mean that the trailing stop would begin to move up as the share price came less volatile.

The best way to get a grasp on what I'm saying is to print out a chart with ATR value along the bottom. Then on a chart, identify the point where you would have received an entry signal. Then on the chart mark your initial stop loss and also your trailing stop loss. As the trade progresses make sure that you revalue the value of your stop so you can begin to get a feel for the way this method of calculating a stop loss works.

Also, in this type of testing, you may wish to test the effects of having a wider trailing stop loss then an initial stop. This is one of those finesse points that you could add to your system that may squeeze a little bit more profitability out of it. For example, what you might look at doing is setting a two ATR stop loss for your initial stop, whereas you might set your trailing stop loss as three ATR.

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Now, the method behind this madness is that you're allowing a stock, once it's in profit, a little bit more room to move. Sure you're limiting your risk at the beginning of the trade by keeping a tighter stop loss; however you're going to become risk seeking in a profitable situation. That is to say you'll have more risk once you're already in profit.

Personally, I think this is one way of taking it a step further than most people do when adhering to those two cardinal rules of trading. That is let your profits run and cut your losses short because you're keeping the losses small but you're letting the profits run by taking on more risk when you're already in profit.

With this strategy, I also mix and match my stop loss methods. For example, for one of my trend following systems, I set a two and a half ATR initial stop loss, and my trailing stop loss is calculated using a completely different method. I use what's known as the lowest low stop. The way this stop loss works is I simply find the lowest low in the last X number of periods.

Now, for that trend following system, I actually find the lowest low in the last 40 days. I then position my stop one cent below this low. Where I find this stop effective, is it's almost as though it's consulting the price action itself, and by identifying where the lowest low is. Many times my stop is set one cent below a support line.

So, when in action, the way this trailing stop loss works is as a new trading day is added to the chart, one of the old days drop off. I then find the lowest low in the last 40 days, and reposition my stop at that point. I find this stop to be fantastically effective and it may be a stop loss that you look at testing.

But, before you go looking for that perfect trailing stop loss, realize that it's very much like the initial stop. There is no perfect stop that's going to get you out and save you the most profit. Sometimes it'll work for you. Other times it won't. in fact, the real key and the real secret of having a stop loss and an initial stop in place is that it's not how you calculate it, rather it's just having one in place.You need to find an initial and trailing stop loss that you're comfortable with. You understand how it works and it makes sense to you. So, how do you find a stop that you're comfortable with? Really simply, you picked out a whole lot of charts of stocks that you've been looking to trade, marking where you would receive and entry signal, and

then marking various initial stops and trialing stop losses, progress through the trade, revaluing your trailing stop loss and seeing which one works the best and makes most sense to you.

What I find works best at this point in time is to design a system with simple concepts. Simplicity seems to work best because it's based upon the understanding rather than optimization. If you can come up with a generalized, simple concept, that will be able to be applied across a number of markets in trading instruments. The truth of the matter is when designing any system all components should apply to this same principle. You want to keep things as simple as possible, that way it's robust and can be applied to any market. As long as you follow this underlying principle, you'll be on the right track.

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THE WORST TRADING STRATEGY

"I'm more concerned about controlling the downside. Learn to take the losses. The most important thing about making money is not to let your losses get out of hand."

Marty Schwartz

However, there is one trading technique that I'd like to warn you about. It's quite possibly the worst trading strategy I've ever seen. You may be wondering, "Why would I want to learn about the worst trading strategy around?" Here's why – because once you know the worse possible strategy, one that is destined to maximize your losses over the long run, then you can reverse those ideas to craft a strategy which does the exact opposite. That is to create a strategy that's designed to produce some tremendous long term gains. The worse strategy I'm referring to is known as averaging down. This is the process of buying more shares of a stock that you had previously acquired. Now, the price has dropped and you buy more. The motivation behind this type of strategy is people you believe that they can reduce their initial entry price by continuing to buy more as the stock's share price falls away. Only bad investors average down by buying shares of a sinking stock to decrease their average price per share that they've paid. This strategy is like throwing good money after bad. It's hardly ever effective. In addition, you'll magnify your losses if the stock keeps dropping.

Remember, when you look at a cheap share price, just because it's cheap now doesn't mean it's not going to get any cheaper. The way this devastating strategy works is let's say you bought one thousand shares at 40 dollars. The novice investor may not have a stop loss in place, and the share price now fell to 30 dollars. Here comes the stupidity of this strategy – to average down the novice trader might by another thousand shares at 30 dollars to lower the average cost per share that he'd already purchased. So, his average cost per share would now be 35 dollars. It gets worse though. The share price may fall even further, and the novice trader will again buy more shares to reduce the initial average cost per

share. The effect is such that they buy more and more into a stock that's losing their money. Now, imagine this strategy being applied to a portfolio of stocks. What will end up happening is all the capital is automatically allocated to the worse performing stocks in the portfolio while the best performing stocks are sold off. The result is at best a disastrous underperformance versus the market.

If a trader uses averaging down and uses margin, then you can only imagine this would magnify those losses even further. The biggest problem with this strategy is that a trader's gains are cut short, and the losers are left to run. So, hear me know, never average down.

The process of buying a stock, watching it fall, and then throwing more money at it in the hopes that you'll either get back to break even or make a bigger killing is one of the most misguided pieces of advice on Wall Street. Never be faced with a situation where you'll ask yourself, “Should I risk even more than I originally intended in a desperate attempt to lower my cost and save my butt?”

Now, that we know this, let's turn this strategy on its head and see how we can utilize this idea and an extremely profitable way. One point to note though, this strategy is fantastic, however, it lends itself best to a trend following or longer term system – a system where you allow the trend to develop over a longer period of time. The way this strategy works is by simply doing the opposite of averaging down. You do what's known as averaging up or pyramiding. In other words, we add an equal dollar amount to our stock positions as the share price moves up instead of when it moves down.

Without going into too much detail because it's just a little bit outside of the scope of this audio. However, the way pyramiding works is if we already received an entry signal in a stock, and that position is already starting to show us some profit, if our system gives us another buy signal by utilizing pyramiding, we enter the stock again.

Some people think our position size is the same size as when they first entered. Others use a percentage of their initial position. The common element here is they're simply adding extra dollars to a position that's already making them money. I like the think of this as applying to that cardinal rule of trading, “Let your profits run” to the next step because in effect you're becoming risk seeking when you're in a profitable situation. This method can be a fantastic addition to any trading system.

Personally, I find this strategy effective if I pyramid twice after the initial entry. Any pyramid you receive past that are I usually find to be ineffective. Although this strategy does have its benefits, also let me tell you the major drawback of using this method in trading.

When you introduce pyramiding, nine times out of ten, you also increase the draw down of your system. How do I know this? Because I've tested it.

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BACK TESTING

***"If You Haven't Back Tested Your System...
You Might As Well Trade With Your Eyes Closed"***

This leads to my next major topic the importance of fact testing. Sure within this audio, I've set up goal posts for you to shoot between, and if you stick between those goal posts, you'll at least be heading in the right direction, however, your next step is to take this a step further, and back test the system.

Back testing a system involves applying the rules and conditions of a trading system to historical data. To do this, it's only possible if you're trading a system that is entirely mechanical and does not require any discretion to trade. How can you know whether or not your system is completely mechanical? I'll ask you this question. Could you take down your trading plan, your set of rules and guidelines that you follow, and can you hand that over to someone and they could trade the same system and receive the same results if they follow the system? If the answer is yes, you have a mechanical system. If the answer is no, my personal opinion is that you should look at implementing a completely mechanical system, and here's why.

Back testing does not give you 100 percent accuracy as to the profitability of the system once you start trading it. The reason for this is price movements are never going to be exactly the same. That said, price is driven by supply and demand. Supply and demand is a direct result of decisions made by humans. For this reason, you can assume that price movements in the history may mimic and have similar attributes over time.

With this in mind, back testing a system can give you confidence in your system. Perhaps one of the hardest parts in trading any system is to have the confidence to stick with your system. In fact, a mechanical system almost forces you to make decisions that are in direct conflict with what your gut feeling might tell you what to do. Remember, our gut feeling tells us we should hold on to losing stocks to wait until they get to break even, and our gut feeling would tell us to sell shares as soon as we're a little bit in profit.

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Obviously, a mechanical system goes against this grain and this is one of the reasons that it's psychologically difficult to trade. However, by back testing your system, you can quantify the probability of your system with reasonable certainty. As long as you make sure you back test your system over different market conditions, it can be reasonable to draw parallels as to the performance of your system historically to trading it in real time.

There are two ways that you can back test a system. You can do it manually, which can be time intensive and a very laborious process, or you can do it with the aide of some software packages. I recommend when you first start out, you do it by hand. The reason is you'll get a much better feel for your system if you understand the way it works and its intricacies. Once you understand this, you may look at finding a software package that does it for you.

Let me again draw some parallels between running a business and trading. Most successful businesses keep statistics on everything from their conversion rate to their average dollar sale to the amount of people that come in the door. The reason a successful business will do this is because they understand you must first take score before you can begin to improve on that score. Trading is exactly the same.

Now that you're looking to trade as a business, you need to learn some valuable statistics about your system so you can improve its performance. How could you ever expect to improve something unless you knew what it was you were looking to improve?

Let me now cover a few of the definitions and major statistics that you need to know about your system. Firstly, you must understand the principle of R multiples. R stands for risk, the risk you take on any trade when you enter the market. The R multiple of a trade is the ratio of the profit and loss compared to the amount of money risked to make the profit or loss.

Hence, if you risk 200 dollars in your initial stock, and you make a profit of 1,000 dollars, then you have made five times the amount you risked in the trade. In other words, you have an R multiple of five. Ultimately, you're just wanting to get a good idea of your relative size of profits to your losses by simply taking our average size of our winning trade and comparing them with the average size of our losing trades.

Next you want to calculate your win to loss ratio. That is how many times you get a winning trade to how many times you get a losing trade. For example, if you had ten trades and four of those trades were winners, and six were losers, your win to loss ratio is simply four to six. This is just your hit rate. In other words, you get 40 percent of your trades correct.

Can you believe that this simple two statistics that I've now gone over, you can calculate the average size of your winnings and the average size of your losers, multiple these figures with our win to loss ratio, and you'll be able to calculate on average how much money you make with every dollar you risk?

Another vital statistic you need to know about is your draw down. What is the maximum historical draw down that your system has received? What you'll tend to find is systems that have a very high rate of return will also have massive draw downs. Is that draw down something that you can live with?

I'm starting to introduce a few high level concepts to whet your appetite and encourage you to read more about back testing a system. To go into these in detail is a little bit outside the scope of this audio program.However, if you want to take your back testing knowledge to the next step, I recommend you get a fantastic book called "Trade Your Way to Financial Freedom" written by Dr. Van Tharp. He goes into these and many more concepts in much more detail. For those of you who think this sounds like a little bit too much work, let me put forward a scenario that will illustrate the importance of back testing your system.

Imagine yourself trading a system that you knew had a win to loss ratio of 60/40. You made profit on every six trades and lost on every four. How do you think you would feel and where would your confidence level be if you after you traded the system for a little while, you had received a string of 11 losses in a row? Now, you knew that this system had a win to loss ratio of six to four. Would you have the confidence to open another trade if your system brought up another buy signal after getting 11 trades wrong?

Unless you've back tested your system, I would highly doubt it. That trading system may have been a fantastically profitable system, however, since you hadn't back tested it, you didn't know that historically, this system had received up

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to 13 losses in a row, and even with 13 losses in a row it was still a profitable system.

Here's another point you may not have picked up unless you have done the correct back testing. Once you've employed excellent money management and you begin to trade, be ready to experience a string of losses as soon as you begin trading. Countless times I've had clients who get disheartened by this fact because they don't understand the nature of setting good management. If you're adhering to the rules of cutting our losses short and letting our profits run, obviously because we're cutting our losses short, those trades are going to last for a shorter amount of time.

This means once you begin trading, the odds of getting losses early in the pace, are much higher than getting a winning trade especially when you consider many successful trading systems run on a 40/60 win to loss ratio. The point I'm trying to illustrate here is you will not know the intricacies of your system unless you back test it.

You need to begin to get an understanding of what works and what doesn't. You shouldn't believe everything I've told you. Instead, you need to prove it to yourself and this is done through back testing.

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CONCLUSION

"To be a money master, you must first be a self-master."

J.P. Morgan

We've now covered the most important components in setting excellent money management, however what I'd like to do now is take a few moments just to tie up some lose ends and put the entire money management picture into perspective.

So far, we talked about what is money management and why is it so important. The core principle here is to realize that it doesn't matter when you buy a stock and it doesn't matter so much when you sell a stock because what determines how much money you make is actually how much money you put into the trade. On the flip side, obviously, how much we put into the trade is also going to determine how much we lose.

We then moved on to the trading float. We defined what is our trading float and how much capital should you begin trading with. I then outlined a few of the major components that you need to consider before deciding how much you'll trade with.

Next, we covered setting a maximum loss. By doing this, you'll now know your worse case scenario before you even open a trade. You'll know how much you stand to lose if the particular stock doesn't go in your favored direction.

We then went on to discuss initial stops. By utilizing these, we'll limit the amount of capital we lose on any one trade. We'll have a predefined point at which we'll sell. This is extremely powerful in the fact that it allows us to remove the emotion previously involved in trading.

Next, we looked at the formula I use to calculate my position size. I've set it up so all you need to do is take your maximum loss and divide it by your stop size, and you know if you stick to your initial stop, you'll never exceed your maximum loss.

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We then went on to discuss trailing stop losses. I showed you how you can lock in profit as the share price goes up. We then took this a step further and discussed how we can best have our initial stop and trailing stop work together.

Finally, we talked about the worse trading system in history. I then showed you how to turn it on its head and turn it into a fantastically profitable method.

We then finished with a discussion on back testing your system and how it can give you confidence in trading. Back testing is imperative to anyone who's contemplating risking any capital in the markets.

Sure we've covered a tremendous amount of material, however what's left for you now is to actually go out and test these strategies. It never ceases to amaze me the amount of people that go out and willingly trade their hard earned capital on a system they may have not tested.

It's true that historical results don't provide an indication as to what's going to happen in the future, however it should be part of your due diligence to at least know a few characteristics about your system.

Here's the good news though. You've begun to take the first steps to achieving your success. By simply listening to this audio, you've put yourself ahead of the pack, and identified yourself as someone who's not going to settle for mediocre returns.

This is just the beginning of the journey though. Included with this package, you've also received many other bonuses that are going to help you along your trading journey.

To trade successfully is not something that you're going to learn in one day. It's just like any other profession, it takes time. You now have a wealth of information at your fingertips. Make sure that you listen to this audio until you apply every one of these principles in your system.

Once you've done this and listened to the other audios and worked your way through all the material added bonuses that you got in this package, you'll be well on your way to be successful in the market. You're going to be one of the minority.

I truly hope you enjoyed this presentation as much as I've enjoyed passing on the information. I'm not the originator

of these secrets. I'm just a custodian of the knowledge. It's my goal to bring this information to as many people as possible.

So, if you've enjoyed this program, please make sure to tell others about it. My name's David Jenyns, and this audio is proudly being brought to you by www.meta-formula.com.