

Forex Money Management

A New Approach

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Forex Money Management

Have you come across a trader who reported a large amount of profit from a relatively small account? Such stories are wide spread and often attract inexperienced trader's attention. In this 5 part article we will explore into traders mind and psychology plus look into ways of managing money the right way.

Was it a Fluke? Perhaps just a stroke of luck. Anyone claiming outstanding gains overnight is probably exposing his trading account to enormous risk by trade large number of lots. It is only matter of time before huge losses would wipe out gains and beyond, leaving trader feel devastated financially and emotionally. Trust me, I know that from personal experience. Money management in Forex Trading is a combination of specialized techniques and your trading judgment. Lets look further into it.

Calculating Right Trade Size / Lot:

Overexposing or underexposing your account can change the end result drastically and hence the first thing we need to do is to come up with the right size for our trades. Also remember that this is not a one time process, in fact it is an ongoing process because variables like account size, stop loss and pip value keep changing with time.

Before we can even look into the formula for successfully calculating the right trade size we need to agree one very important thing, Risk. So what should be the ideal risk per trade? Answer to this question would depend on the trader however most successful traders would recommend 2-3%. In my personal opinion you should not risk more than 3% per Pair Category. You can read up further on Trade Category here: [Risk Management](#)

Once you have made up your mind about the Risk % then calculate Risk in Dollars by multiplying the account size by Risk %. For Example if you have \$10,000 account and willing to risk 3% then total risk in dollars is \$300 $(\{10,000 \times 3\} / 100)$.

Next step is to determine the Stop Loss. Whatever trading system you are using, you would know by now what is your Stop Loss. Lets say for the sake of this exercise your Stop Loss is 100 pips. The next important factor is to determine Pip Value of the pair your are about to trade. The easiest way to find out is to look at your brokers trading platform. MBT represents Pip Value/Lot for a Mini Lot under their Watchlist or Position window and FXCM calls it Pip Cost under Simple Trading Rates window represented for a Standard Lot.

Trade Size Formula:

$$\frac{\text{Risk Amount}}{\text{Stop Loss} \times \text{Pip Value}} = \text{Trade Size}$$

$$\frac{\$300}{100 \times 1} = 3 \text{ Mini Lots}$$

In the example I've used MBT Pip Value as 1 resulting in Trade Size in Mini Lots. If you use FXCM Pip Value then the result would be in Standard Lots. Also keep in mind that resulting Trade Size may not come out as whole number and may be a fraction. In that case always go down to whole number and never go up. For Example, If the resulting Trade Size is 2.32 Mini Lots then make it 2 Mini Lots and not 3. Some broker may let you trade fractional lot sizes and in that case you won't need to worry about it

Symbol	Last	Ask	Bid	Change	High	Low	Pip Value/Lot	Volume
EUR/GBP	0.79945	0.80007	0.79945	+0.0067	0.80251	0.79365	1.5663	0
AUD/JPY	57.23	57.36	57.23	-0.98	58.81	56.267	1.06963	0
EUR/JPY	117.13	117.23	117.13	-1.76	119.37	115.30	1.06963	0
GBP/JPY	146.40	146.64	146.40	-3.43	149.77	138.30	1.06963	0
USD/JPY	93.49	93.51	93.49	-0.84	94.467	91.886	1.06963	0
AUD/USD	0.6125	0.6131	0.6125	-0.0008	0.62432	0.6063	1.00	0
EUR/USD	1.2520	1.2531	1.2520	-0.0091	1.2683	1.2510	1.00	0
GBP/USD	1.5663	1.5685	1.5663	-0.0239	1.5876	1.5600	1.00	0
USD/CHF	1.16272	1.1638	1.16272	+0.01612	1.17013	1.1562	0.86005	0
USD/CAD	1.2819	1.2832	1.2819	+0.0066	1.2825	1.26988	0.78009	0

You Win Some You Lose Some

As you saw previously that calculating right trade size is a relatively simple process. Even so most traders don't bother doing it until they suffer large losses and then decide to learn more about money management. New traders concentrate on the result or the outcome of the trade, on the other hand professional traders ask themselves "how much can I afford to lose on this trade?" The sooner you realize that outcome of every trade is different and beyond your control the sooner you would acknowledge the importance of sound Money Management.

Let me tell you a secret. A winning system is usually not more than 60% successful. Even though you find one with 80-90% successful system on the paper, when you trade it usually come down 60%. In fact I think it is a blessing in disguise. What it means is that we don't have to wait for Holy Grail to come along before we can start making profit. There are several systems available which works superbly if traded with right Money Management.

So if we are losing at 40% of the time it is essential that we control risk. Every time we lose we need make sure we don't let it run and cut the loss when we reach the risk identified earlier. Trading with improper trade size and variable risk every time would result in account wipe out sooner than you would think. The ability to come back next day and trade more is what creates a successful trader in long run.

Do You Have A Trader's Mindset?

As a trader I need to keep in mind that even the most successful system will have series of losses. This is called Drawdown and it is part of life. I am mentally prepared that this is going to happen sooner or later, it helps me prepare and control my risk.

When I look at my equity curve and it points up steadily over the period of time, I know that I've been disciplined and successful in controlling risk. This gives the confidence boost beyond imagination. Getting into the zone and acquiring trader's mindset will take time, here are tips that may help:

- Try to be calm when trading. If your mind is occupied with some other concern than try to avoid trading until things settle down and you believe that you can trade calmly.
- Develop ability to focus on present reality and not how you would like reality to be. No one can see the future, so try not to predict it.
- Understand that making money is not the only point. I personally don't look at dollars when trading, I look at pips and keep a log in pips made or lost.
- There is always room to learn more. Never stop your self from reading more, keep your updated with news at all times.
- Being open minded, keep opinions to a minimum. Don't let others opinion affect you before you make a trading decision.
- Avoid anger at all cost.
- Learn to enjoy the process and make trading as your passion.
- Only trade one system or method at a time. What hurts the novice traders the most is the impatience when testing a system. Stick to one system at one point of time.
- Understand that we can control or conquer the market. Market is so big that no one can really control who wins and who lose.
- Stop feeling that brokers or market has taken you for a ride. There is no conspiracy, there is hidden agenda. Stop feeling that you are being cheated by the market.
- When it goes bad, take responsibility of the results. Don't blame market, broker or some one else for your losses. Accept your losses and move on.

The points above helped me a lot to get where I am today. However you may disagree with some of the points, feel free to comment.

3% Risk Rule - Who Cares?

Ask yourself these questions: Are you trading Forex to make a living? Or Are you hoping to trade Forex Full Time? Or Do you want to learn how to trade like a professional Forex trader? If the answer of any of the above question is Yes, then **You Should Care**.

You must have come across Brokers advertising that their Mini account competition winner made 500% in one month. If you got excited reading such advertisement then I've a bad news for you. The winner of such competitions usually have multiple accounts with rather small equity in each account. They bet all or nothing and try to gamble their way to win the prize money. Anyone who want to last long in the markets and serious about trading then he should seriously consider 3% risk rule.

So what is this rule all about?

The 3% Risk rule basically says the every time you place a trade you don't risk more than 3% of your total equity. So in case you lose then your losses should not go beyond 3% of total account equity. Look at the image on the right to see how it is calculated.

Another important thing to note here is Risk to Reward ratio (R/R). Ideally traders look for 1:2 Risk/Reward per trade, which means that for every dollar risk your wins should be two dollars or better. So if you take example from the image then your risk is \$300 and your expected reward should be \$600 or better. Now as long as your trading system gives you a Win to Loss ratio of 50% or better you would end up in profit.

3% Risk Rule Formula:			
Total Equity x 3%	=	Risk Amount	
10,000 x 3%	=	\$300	

3% Risk Per Pair Type:

Anyone who has been in market long enough would realize that some currency pairs move in synchronization. From my personal experience I've noticed two major Pair Types:

1. EUR/USD, GBP/USD, AUD/USD and NZD/USD (USD/CHF and USD/CAD in reverse direction)
2. USD/JPY, EUR/JPY, AUD/JPY, NZD/JPY, CHF/JPY

What this tells me that when I am looking at opening multiple trades then I would not risk more than 3% in one set of currency pairs. For example if I want to go long EUR/USD and AUD/USD then I would risk 1.5% of total equity on both pairs at one given time. However if the pairs are in the different set then I would risk 3% per trade never exceeding a total of 6% risk at any given time.

Commissions and Slippage:

When trading with mini lots you may not want to worry about commissions or slippage. However if you start trading anything more than 5 standard lots I would recommend to consider commission and slippage to your calculations. Commission depends on the broker you use and usually large brokers charge commission in order to provide tighter spreads. Slippage would happen when try to execute a large order and price move before complete order is filled. It would also depend on the time you trade and liquidity provided by your broker.

Risk Warning

The risk disclaimer is meant to inform the user of the potential financial risks of engaging in foreign exchange trading. The transaction of such financial instruments known as forex, fx, or currency, and dealt on a valued basis known as 'spot' or 'forward', 'day trading' and 'option', can contain a substantial degree of risk.

Before deciding to undertake such transactions with any other firm offering similar services, a user should carefully evaluate whether his/her financial situation is appropriate for such transactions. Trading foreign exchange may result in a substantial or complete loss of funds and therefore should only be undertaken with risk capital.

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