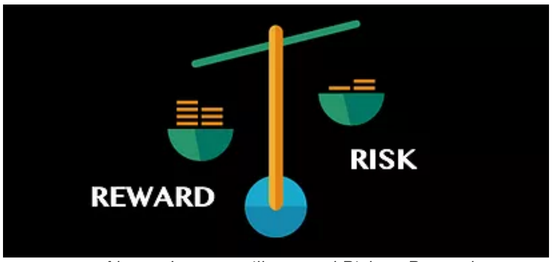
Risk Management

What is Risk Management?

Risk Management is all about capital preservation and ensuring longevity in the FOREX market. Naturally, when engaging in live trades you may focus more on and put more emphasis on the potential upside of a trade without fully considering the possible downside of the trade. It's all about balancing Risk vs Reward and how you can maximise your reward and minimise your risk exposure to the market all at the same time.



Above: Image to illustrated Risk vs Reward

As you can see from the image above, you *always* want to have a heavier reward than your risk exposure in the market. I cannot express the fundamental importance of running a Risk to Reward ratio where the reward always outweighs your risk. To help you manage your risk in the market I am going to teach you some powerful tools to give you the best possible chance of achieving longevity in this market. As the classic saying goes, 90% of trades lose 90% (or more) or of their account balance in the first 90 days. I hope by following these next few steps that you do not fall into this statistic.

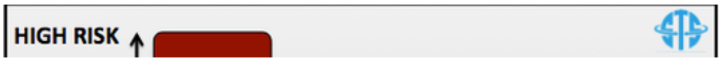
Risk Percentage

This refers to the overall risk you are prepared to expose yourself to the market on any given trade. Given we are on the topic of risk management and reducing our risk at all times, my personal criterion to manage my risk levels it to enact a 2% risk per trade.

Now, what does 2% risk mean? Well it means that I am prepared to risk a maximum of 2% of my account balance on any given trade. In other words, this means that i need to *lose* 50 trades in a row to blow my account. YES, 50 TRADES! Different people have a different tolerance to risk. I recommend a 2% risk per trade, however anything between 1-3% is still acceptable depending on the style of trader you are and your risk tolerance. Now this isn't to say you cant risk 10% of your account on a single trade, but if you do, you only need a losing streak of 10 to blow your account. Give yourself every possible chance of success, that usually comes with long term consistency rather than short term over leveraging.

Risk Spectrum

Whilst we are on the subject of risk, I just want to bring to your awareness where engaging in FX trading sits on the risk spectrum in your overall investment portfolio. The risk spectrum is something I have put together to help demonstrate where FX sits in comparison to other means of investment. Let's have a look at this spectrum before we dig into it a little deeper and link this back into why risk management is so important.



Above: Risk Spectrum of Cash Savings, Investments and Speculative Investments.

So as seen above, let's take a look at the risk spectrum of cash savings, investments and speculation by breaking down what each of these are and how much they are exposed to risk. Please note, as with any information provided in this course this is not financial advice and is used for informative and educational purposes only.

1. Cash Buffer / Low Risk
Cash, the typical pot of money which people store in current accounts and savings accounts in government backed banks here in the UK. I say government backed banks because of **XYZ regulation** states if a bank is to fail and go out of business, the first £85,000 of any cash savings you have is protected and will be re-imbursed. As we have seen in the 2008 financial crisis, despite the fundamental difficulties the banks faced due to irresponsible levels of lending and being in critical levels of debt the government still bailed them out. For these reasons you can expect a minimum that at least the first £85,000 of any cash savings is fairly well protected against any macroeconomic event.

2. Investment / Medium Risk
Now the term investment is a very broad category, and I wont be going into too much detail on this as this is an FX course not an investment course. However generally speaking there are typically 6 types of investment products; property, bonds, shares, commodities, funds or insurance products. All of these investments are exposed to the volatility associated with macroeconomic conditions in any given market. This is why whilst they can be hugely financially rewarding especially over the long term, you do have to be aware of the risks associated with holding investments such as those above. Let me give you a few examples of when the market hurt investors.

3. Speculation / High Risk
You may be asking well what is the difference between investing and speculation, isn't it just the same thing? Well speculation is a type of high risk investing which proposes a high risk of loss which could exceed your initial outlay. In contrast you also have the potential to make significant gains engaging in speculative activity. FX is a zero sum game, this means that in order for you to win a trade there must be a loser on the other end. Your ability to make consistent profits will depend on your ability to develop an edge to increase the probability of making a positive ROI. FX is not for all investors, it certainly will depend on your appetite for risk, despite this it can accelerate wealth if you are able to trade consistently and profitably over a long period of time.

PIP Size Calculation

To ensure we are trading within our risk management criteria I will show you the calculations I use in order to determine the size of my trade per pip given a 2% risk per trade. The lot size you use will potentially differ depending on the trade, for example if your stop loss is 20PIPs on one trade, but 50 PIPS on another trade, if you traded the same lot sizes for both trades you would have more than twice the exposure to the market on the 50PIP stop loss trade as the 20PIP stop loss trade. This means that a trade you originally wanted to risk 2% on now has 5% at risk. So in order to ensure we are differentiating between trading setups and maintaining our 2% risk criteria below I will show you how to calculate the value of a pip per trade.

2% RISK EXAMPLE:
Risk %: 2 divided by 100 = 0.02 (2%)
Risk: Multiply 0.02 by account balance
PIP Value: Divide the risk by the stop loss.

Real Life Example on a £5,000 Trading Account:
2 divided by 100 = 0.02 x £5,000 = £100 risk per trade.
Divide £100 by 40PIP stop loss = £2.50 per pip.

Now, you have an awareness of how to calculate your risk, let me show to you what Risk : Reward is and how this will effect you trading returns.

Risk : Reward

Risk to Reward is defined as the amount you are willing to lose in exchange for the amount you are willing to gain. Due to this you always want to have a bigger reward available than your risk exposure on any given trade. If you are risking more than your reward you are destined for disaster. Let me give you an couple of example of Risk:Reward (R:R) in live trading examples:

Above: Demonstration of Risk/Reward Ratio on a Live Trading Chart

To begin with, don't worry about why this trade was executed, why my stop loss is placed where it is and why my target profit is placed where it is because we will discuss that in greater depths in a different section of this course. So, Risk:Reward, as you can see on this given trade our risk to reward was 2.2. This means that our reward was 2.2x the size of our risk. Let me break the numbers down for you using our £5,000 account example:

2 divided by 100 = 0.02 (2%) x £5,000 = £100 risk per trade.
Divide £100 by my 64.2PIP stop loss = £1.55 per pip.

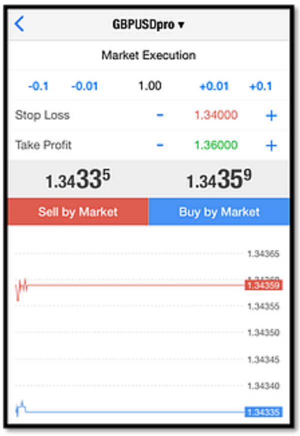
MAXIMUM Potential Loss = £1.55 x 64.2PIPs = £100 OR 2%
MAXIMUM Potential Gain = £1.55 x 141.5PIP target = £220 OR 4.4%

This may seem very simplistic but it bewilders me at how over-leveraged some traders a
don't stick around for too long. Focus on your R:R, you always want to be looking for a pc

suggest a lower risk:reward than 1:1.

Stop Loss

We have spoken about risk and what pound/dollar/euro amount you are prepared to risk in relation to the pips you are prepared to lose for the pips you are prepared to gain. You may be asking well at the point of execution, how can i ensure that if i lose a trade, that I am taken out the position where i pre-defined my risk levels. Well this is the purpose of a stop loss! It prompts the broker to take you out of a position at a pre-specified price level. For example, if market price on GBP/USD for a long position, you buy at 1.3435 and you have a 35 pip stop loss, you put your stop loss in at 1.3400 and your broker will take you out the position at this level, ensuring you only lose a maximum of 2%, or whatever risk parameters you decide to use.



Above: Executing a Stop Loss

Above shows a visual representation of the MT4 app of the above example of setting a 35 pip stop loss at 1.3400. You manually input your 'Stop Loss' and then execute your 'Buy by Market' position. The use of this stop loss will mean that you will not make any additional loss than your pre-defined criteria that you have already worked out in line with your risk tolerance.

Trade Management

Trade management refers to every action a trader completes after executing the trade to help minimise risk but maximise reward. Managing a trade can be a critical aspect of trading as your emotions will come into play and staying completely grounded and clear in your decisions can be a huge difficulty for some traders. This is where trade management comes in to try and help mitigate the difficulties of trading. There are four main techniques that can be used to help manage your trades, so lets get into it...

Trailing Stop Loss

A trailing stop loss can be used to remove risk from a trade. There are a various techniques traders use and it all depends on your style as a trader. I will explain generically what it is and then use an explicit example to describe the trailing stop loss. Now this strategy isn't for all traders, I personally don't take this approach but it is an option to help manage your trades. So what is a trailing stop loss? Removing risk from a trade can sound kind of appealing, so lets get into it. A trailing stop loss is a stop loss that gets adjusted as price begins to move in the directional bias of your trade. Some traders may take the approach of a 25 pip trailing stop or a 50 pip trailing stop or whatever variation they see fit. This means that for every time price moves 25 pips further towards your take profit target, you adjust your stop loss by another 25 pips to begin to start locking in profit. You keep doing this until price reaches either your target profit or reverses and hits your stop loss. Let me show you what this looks like on a chart...

Above: Example of a Trailing Stop Loss

As you can see above, we execute the trade with our standard stop loss and take profit targets. However once price moves 25 pips in profit at 1.1800 we move our stop loss to break even. Then when price moves up again by another 25 pips to 1.1825 we then push our stop loss up to 1.1800. We keep doing this until our take profit target has been reached. Now whilst this strategy can looking appealing, do make a conscious effort to understand that the market will not always move this strongly in one direction in the duration of a trade. You may find that price could pullback much further than 25 pips and stop you out, and then you end up missing the rest of the move. This is not my preferred choice of trade management, however it is an option that many traders do use and can be highly effective to minimise risk exposure.

Profit Lock

Profit lock is an approach I do find to be highly effective in minimising risk exposure whils
is a technique whereby you allow the market to move into your profit target, then allow p
does pullback). Let's say for example you are long on EUR/USD price has pulled back to

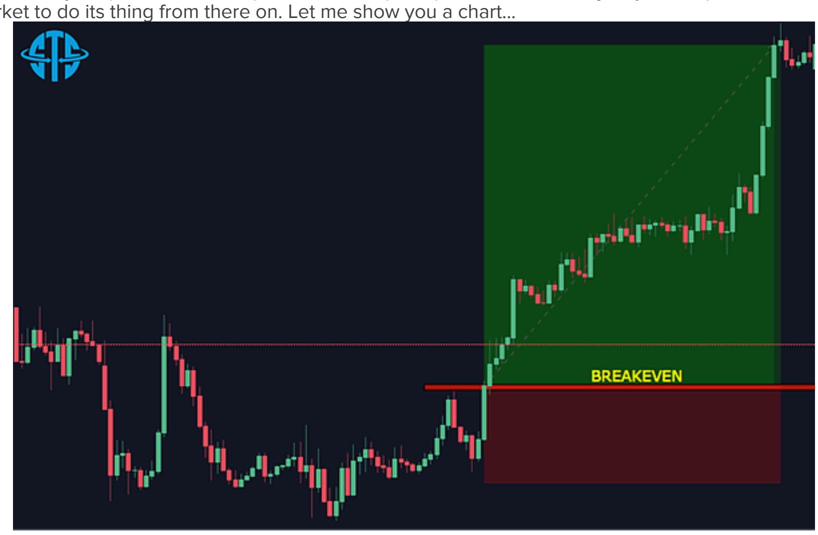
a nice rejection and another a new leg to the upside begins to form a new higher high. At the point price makes the new higher low, you set your stop loss just below this level. Lets show you this on a chart...

Above: Example of a Profit Lock Strategy

So as you can see above, this approach to trade management allows the market to breath. You wait for price to move to the upside before it pulls back. At the point at which price pullbacks back and continues to move in the direction of your trade again you place your stop loss just below the previous low of the pullback. You keep doing this every time the market makes a higher low (or lower high if you're short), this will both protect your capital and minimise your risk. However, the key thing here is that if price makes a pullback, but fails to make a new high and price subsequently falls below the previous higher low to make a new lower low, price would then hit your stop loss. Now on many occasions this is probably a good position to be in because if price breaks lower again, if you are long then it shows that market sentiment has changed and turned bearish. This means that you'll more than likely have taken a small amount of profit with this profit locking approach as opposed to taking a full loss on the position.

Risk Free

This technique is also a sound methodology to use to help manage a trade. Not only does it allow the market to breath more but it also will help manage any emotional volatility that may creep in during a trade. It is a method of trading that I use quite regularly as it allows me to let the position run and the market run its course with absolutely zero risk on the table. So, how do you enact a risk free approach? You simply adjust your stop loss to break even. Now what you don't want to do is adjust your stop loss to break even instantly as price moves into your profit area. You want to wait for the market to move into your profit area, then pullback, once price pulls back, then adjust your stop loss to break even and allow the market to do its thing from there on. Let me show you a chart...



Above: Example of a Risk Free Strategy

As you can see, price has pushed higher into our profit area, as soon as price moves comfortably enough into your profit area then a pullback occurs, you can then put your stop loss to breakeven. You are then risk free. The reason for this is that you can no longer lose this trade. So best case scenario you hit your take profit and make a few % gain. Or your stop loss gets hit and you neither gain or lose anything, a breakeven trade.

No Trade Management

Your initial instinct may be to think, no trade management? What kind of poor trading practise is this? Well what you will find is this is a technique used by many traders. No trade management means once you execute the trade you only receive one of two outcomes; a win or a loss. The reason people enact no trade management is that they are comfortable with and accept the risk of the trade prior to execution. When you are truly engaging in strict risk management a 2% loss doesn't seem all that significant...

Above: Example of a No Trade Management

Further to this, letting the market breath once you have executed a trade is extremely important. You may not often see a trade run straight into profit and straight to your target after the point of execution without any drawdown. Many traders, including myself have been caught out in the past by putting my stop loss to breakeven, price coming to re-test my entry to stop me out for a breakeven trade, just for price to then run to my target shortly after. Don't allow yourself to sacrifice winning trades by trying to eliminate risk to fast as this will prove costly in the long run. I hope that these 4 techniques discussed provide you with a little more clarity on trade management and that you find a technique that best suits your style as a trader.

What Risk SHOULD NOT Look Like

To be brutally honest, I thought this section was pretty common sense. However after speaking to a follow on Instagram and getting sent screenshots of their trades I was shocked to see how the individual was actually risking far more than their potential reward. Let me just show you what I mean by this and then explain why this is completely the wrong way to go about trading...

Above: How Not To Trade!

If you cannot see why this is totally wrong already, let me explain the math behind it. So, let's say you have a fairly strong success rate when you are trading. Let's say for every 10 trades you take, 6 of them are winners and 4 of them are losers. So in other words you have a 60% success rate, pretty respectable right. However, let's say that for every trade your Risk : Reward ratio is 0.5 : 1. This means that for every trade you take, you are prepared to risk twice as much as you are prepared to gain. So let's say you have a £5,000 account balance and risk 2% which is pretty good risk management, right? Well over the course of 10 trades with a 60% win rate, this is what your account balance will look like...

WIN/LOSE	AMOUNT	ACCOUNT BALANCE £5,000	RETURN
WIN 1	£50	£5,050	1%
WIN 2	£50	£5,100	2%
WIN 3	£50	£5,150	3%
WIN 4	£50	£5,200	4%
LOSE 1	£100	£5,100	2%
LOSE 2	£100	£5,000	0%
WIN 5	£300	£5,050	1%
WIN 6	£300	£5,100	2%
LOSE 3	£100	£5,000	0%
LOSE 4	£300	£4,900	-2%

Above: 60% Win Rate / 2% Risk / 0.5:1 R:R

As you can see above, with a 60% win rate, risking 2% of your account balance, if you R:R ratio is 0.5 : 1, you are destined to lose. With the criteria above, over the course of 10 trades you would actually be down 2% on your account. Please understand that when you are trading you need your risk to outweigh your reward on every single trade you take. Ask yourself this. If someone said to you if you loan me £50,000 of your own money to start a business, I might give you £25,000 back in return or you might lose the £50,000 if the business fails? Anyone in the right mind would turn that investment opportunity down because its not a positive ROI investment. With this in mind, let me explain a little bit more about how to engage with risk management and a positive risk reward ratio.

Losing Streak

Let me be real with you, 100% winning streaks in FX trading are pretty much unheard of. You must accept that losing is part of the game, however you need to maintain the same mental strength and consistency when losing streaks occur. This will allow you to maintain longevity when trading, let me show you some comparative differences between engaging in different levels of risk.

2% Risk Losing Streak on a £5,000 Account Example:

LOSSES	AMOUNT	ACCOUNT BALANCE £5,000	2% RISK
1	£100	£4,900	2%
2	£100	£4,800	4%
3	£100	£4,700	6%
4	£100	£4,600	8%
5	£100	£4,500	10%

Above: 10 Losses with 2% Risk

In other words, after 10 CONSECUTIVE LOSSES by enacting a 2% risk per trade, you are still left with 80% of your account balance!

10% Risk Losing Streak on a £5,000 Account Example:

LOSSES	AMOUNT	ACCOUNT BALANCE	10% RISK
1	£500	£4,500	10%
2	£500	£4,000	20%
3	£500	£3,500	30%
4	£500	£3,000	40%
5	£500	£2,500	50%
6	£500	£2,000	60%
7	£500	£1,500	70%
8	£500	£1,000	80%
9	£500	£500	90%
10	£500	£0	100%

Above: 10 Losses with 10% Risk

Now, by enacting a 10% risk per trade, after 10 CONSECUTIVE LOSES you now have 0% of your account! This is not the aim of trading FX, hence why we put some much emphasis on risk management. Over-risk and over-leverage yourself and a blown account like the one above is the end result. Plus thats only on 10 losing trades in a row, which is far from unheard of.

20% Risk Losing Streak on a £5,000 Account Example:

LOSSES	AMOUNT	ACCOUNT BALANCE	20% RISK
1	£1,000	£4,000	20%
2	£1,000	£3,000	40%
3	£1,000	£2,000	60%
4	£1,000	£1,000	80%
5	£1,000	£0	100%

Above: 5 Losses with 20% Risk

Just to emphasise my point even more, this is what you account looks like after 5 losing trades risking 20% of your account per trade. Just 5 POORLY MANAGED TRADES and you after out the game, account blown and £5,000 worse off. If there is just one thing you take from this whole course, please get your head around the risk management side of trading, failure to do so will be a recipe for disaster.

Winning Streaks

Whilst it's always important to understand the possible downsides from trading, we also need to pay attention to the possible upside which is why i'm guessing most of you are here. So let's balance out some of the risk we're trading into a more balanced portfolio of trades with a Risk:Reward ratio of 1:3. On a £5,000 account, operating with a 2% risk this means you are risking £100 per trade. However with a 3:1 risk reward, with 2% risk this means your potential reward is 6% (2% x 3). So in monetary terms your potential reward is £300 per trade. So in other words, if you lose the trade, you lose £100, but if you win the trade, you profit £300.

2% Risk Management with a £5,000 Account Balance operating 70% Win Rate Example:

WIN/LOSE	AMOUNT	ACCOUNT BALANCE £5,000	RETURN
WIN 1	£300	£5,300	6%
WIN 2	£300	£5,600	12%
WIN 3	£300	£5,900	18%
WIN 4	£300	£6,200	24%
LOSE 1	£100	£6,100	22%
LOSE 2	£100	£6,000	20%
WIN 5	£300	£6,300	26%
WIN 6	£300	£6,600	32%
LOSE 3	£100	£6,500	30%
WIN 7	£300	£6,800	36%

Above: 10 Trades, 70% Win Rate, 2% Risk, 3:1 Risk:Reward

WIN (7/10)
70% STRIKE RATE
36% RETURN

THE POWER OF RISK TO REWARD!!!

Compounded Returns

So you know what a 70% win rate looks like operating with a 2% risk with a 3:! risk reward ratio and you can see over the process of 10 trades you can have a whopping return of 36%. When the bank are paying you only 1% interest if you're lucky (as of writing this in 2017) a return of 30% plus is quite staggering.

Now baring this in mind, ask yourself, what are you trading for? Are you trading for retirem
enhance your own lifestyle? Are you trading to accelerate your goal of financial freedom?
5 and be your own boss? Or are you just looking at adding a little bit of additional income

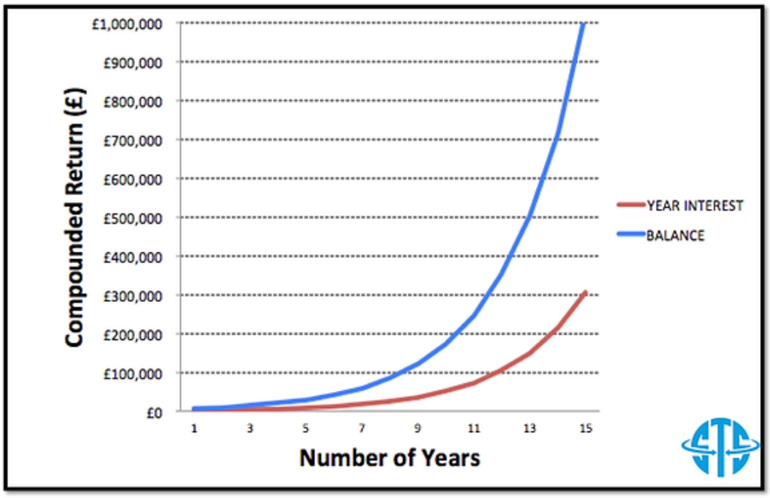
Whatever the reason behind trading the FX market, let me express the power of compounded returns over a long period of time. As I have explained previously, trading is a long term game; its not a get rich quick scheme and will not make you a millionaire overnight. So with that in mind, let me run you through what compounded returns look like over the course of 15 years. As stated by Albert Einstein 'compound interest is the eighth wonder of the world'.

Now i'm not here to sell you a dream, nor do I want to give you unrealistic expectation of whats achievable in the FX market. Some traders can hit 100%+ ROI in one year as seen in book 'The Way of the Turtle' whereby two traders in Chicago had a bet that one of them could teach a group of individuals to trade the markets profitably in one week with no past expereince as the other trader believed this was impossible. Well, the outcome was out of the selected group of traders they achieved an average return of 80% per annum. With one 19 year old trader turning $2,000,000 into $31,000,000 in just 5 years thanks to the power of compounding. Despite this scenario being very real, other traders may not ever achieve a positive return, ever. However, I do believe consistency is certainly achievable and obtaining healthy returns of 3%+ per month. 3% per month is 36% return per year. Whilst this may not sound as sexy as the 1000% returns you may see on IG, I hope the angle that i'm taking on this will give you a grounded and honest approach to realistic returns when trading.

YEAR	YEAR INTEREST	TOTAL INTEREST	BALANCE
1	£2,128.80	£2,128.80	£7,128.80
2	£3,035.17	£5,163.97	£10,163.97
3	£4,327.42	£9,491.39	£14,491.39
4	£6,169.87	£15,661.26	£20,661.26
5	£8,796.76	£24,458.02	£29,458.02
6	£12,542.07	£37,000.09	£42,000.09
7	£17,881.99	£54,882.08	£59,882.08
8	£25,495.45	£80,377.53	£85,377.53
9	£36,350.41	£116,727.94	£121,727.94
10	£51,827.00	£168,554.94	£173,554.94
11	£73,892.90	£242,447.84	£247,447.84
12	£105,353.61	£347,801.45	£352,801.45
13	£150,209.06	£498,010.51	£503,010.51
14	£214,162.20	£712,172.71	£717,172.71
15	£305,344.09	£1,017,516.80	£1,022,516.80

Above: £5,000 Account after 15 Years at 36% Annual Return

So as you can see, if you can consistently return 3% per month for 15 years, a £5,000 account balance with compounding will end up just over £1,000,000. It is unlikely you will consistently deliver 3% every single month, as your returns trading FX will more than likely be slightly more sporadic. Some months you may see a 12% return, other months you may see a 9% loss. However, I hope you can see the point that with some level of consistent returns off a relatively small amount of capital, if you can see this out for the long run it can be hugely profitable and allow you to build significant amounts of wealth.



Above: Graphical Representation of £5,000 Account after 15 Years at 36% Annual Return

Now forgive me for being repetitive but I cannot stress the importance of being disciplined when your trading and prevent your mind from shifting to the 'go big or go home' mindset. For some, it'll pay off and they will obtain rapid wealth. For the majority your account will blow up in your face quicker than you think. As you can see above, you will see very little momentum or significant wealth building until at the first 7-9 years. After this point your returns will grow exponentially and accelerate as time goes on. In the first 10 years your compounded account balance is £173,554, however just 5 years later your account balance is £1,022,516. This is the power of compounded growth. If you truly understand this phenomenon you will benefit hugely over the long term. And after all this if you're still not convinced, lets take a look at the track record of one of the best investors of all time; Warren Buffets net worth over the course of his lifetime and extremely successful career...

Let's Chat!

Above: Warren Buffets Compounded Returns Over His Investing Career

By this point, if you still are not sold on the fact that wealth comes with consistent returns compounded exponentially over a long period of time then you'll probably never truly believe in this vital concept to wealth building. Even if you just take a visual analysis of both Warren Buffets Net Worth and a £5,000 account balance compounded over 15 years, you will see huge similarities in the gradient and momentum of wealth generation. Not much happens in the early stages, then the compound effect kicks in and before you know it you are sitting on real good chunk of capital. Now I know Warren Buffet wasn't known for FX trading but more for his investments in equities such as Coca-Cola and IBM but the concept still remains the same despite what area of investment you are engaging in.

Understanding Losses

If you cant see why risk management is a key factor to success in the markets, I hope this will emphasise it far more than any other section. So understanding your losses and the consequences of 'losing'. The best way to conceptualise this is with numbers as essentially that's what we're talking about here. We're talking about the figures that result in losses. So a loss, a loss is when your trade hits your stop loss or you make a negative amount of money from your account after a trade. So how does that effect you and why is risk management so important to understanding a loss. Well, a trader, I can pretty much guarantee will experience some degree of drawdown in their trading career, or even just a spell of a couple of trades that went against them. Let's categorise a drawdown as anything more than 20% of your trading account balance when operating a 1-3% risk. So if you're doing an average of 2% risk that is the equivalent of 10 losing trades in a row which is perfectly acceptable, but how does this affect you? Let me show you the math.

If you lose 10 trades in a row, on a £5,000 account balance, risking 2% per trade, you have lost £1,000 or 20% of your account. Now this is this important bit so make sure you understand this. You've lost £1,000, do you know what percentage return you now need to get back up to the original amount of £5,000? 20% you say? Wrong. You now need a 25% ROI to get your account balance back up to where it was before. How you ask?

£5,000 x 0.2 (20%) = £1,000 (LOSS) = £4,000 Account Balance Left.

£4,000 x 0.25 (25%) = £1,000.
£1,000 + £4,000 = £5,000 Account Balance Regained

From the countless books and studying I have done prior to writing out any kind of knowledge, the individual that brought this to my attention was the man above, Warren Buffet. The math is very simple and understanding the power of a loss really will make you think twice about your risk management as it can have catastrophic effects on your long term performance.

For arguments sake let's say your risk management is poor (or non-existent) and you experience a 50% drawdown on your account balance. You go from £5,000 to £2,500. You now need a 100% ROI to get your £2,500 back up to £5,000. Acknowledging how losses can so badly effect your longer term performance I hope will make you think twice about your risk management and risk:reward when you are trading. Never lose sight of the end goal but never get carried away, the market will burn you, trust me.

Summary

So you are now risk management specialists, equipped with the knowledge on how to calculate your risk and hopefully have an understanding of how to approach trading the Foreign Exchange Market. The power of Risk:Reward and Compound Growth are tools that you can use to leverage your advantages in the market. Don't try to strike big fast, slow, small and consistent profits will leave you in a far more profitably position over the long run. Remember the average time to achieve mastery is 10 years, enter the industry with this mindset and see it out for the long term and hopefully you won't go far wrong.

NEXT LESSON!