Trading Plan and Risk Management

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Why use a trading plan?

Your emotions influence your actions. **Confidence** in your trading plan helps to overcome your emotions which cause you to become indecisive and break trading rules.

KEY DECISIONS

There are three key decisions you need to make when trading and your trading plan should answer each question:

1. Under what circumstances will you enter a trade?
2. How much money will you commit to the trade?
3. Under what circumstances will you close the trade?

BUILDING A GOOD TRADING PLAN

A trading plan is a simple plan you develop that takes into account your trading mindset, your trading method, and your money management.

- **Trading mindset** – your psychology is what will make or break you as a trader. A trading plan will help you overcome your emotions.
- **Trading method** – requirements for trade selection, initiation, and liquidation.
- **Money management** – Risk capital for trading and your discipline for risk management.

What are the components of a good trading plan?

PERSONAL ASSESSMENT

- Are you **ready to trade**?
- Have you **tested your system** by paper trading or back testing it?
- Do you have **confidence** that your system works?
- Can you follow your signals **without hesitation** and second guessing?
- Have you chosen a **good broker** who has the services you need?

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SET GOALS

- Before you enter a trade, set **realistic profit targets** and **risk/reward ratios**.
- What is the **minimum risk/reward you will accept**?
- Many traders will not make a trade unless the potential profit is at least **three times greater than the risk**.

For example, if your risk is $500 then your goal should be a $1500 profit. Set weekly, monthly and annual profit goals in dollars or as a percentage of your portfolio, and re-assess them regularly.

How much of your portfolio should you risk on any one trade?

It can range anywhere from around 1% to as much as 5% of your account on a given trade. That means if you lose on that trade, you get out and wait for the next signal.

DO YOUR HOMEWORK

- Before the markets open, what is **going on** around the world?
- What has been the **recent trends** in the markets you are monitoring?
- Over night trading is a good way of **gauging** market mood before the markets open.
- What reports are **due out** and when?
- Good traders trade based on **probabilities**. They don't gamble.

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SET EXIT RULES

Before you enter a trade, you should know where your exits are to be placed.

1. What is your stop if the trade goes against you? It must be placed as a working order. Mental stops do not liquidate a position.
2. Each trade should have a profit target.

Good traders lose more trades than they win, but by managing their money and limiting losses, they still continue to trade.

SET ENTRY RULES

This comes after Exit Rules for a reason.
Exits are harder to determine than entries.

Your system should be complicated enough to be effective, but simple enough to facilitate quick decisions.

DOCUMENT YOUR TRADES

Good traders keep good records.

Traders want to know why they profited on a trade and more importantly, if they lose what mistake was made.

Remember this is a business and not a lottery.

RISK MANAGEMENT

- Many **successful traders** regard this as the single most important aspect of trading.
- The lack of a discipline in **money management** is a major cause of failure among new traders.
- A **trading plan** should define risk per trade and maximum losses per a month and for the trading year.
- Using **strict risk management rules** helps the new trader overcome the emotional aspect of trading.

GUIDELINES FOR MONEY MANAGEMENT

There is an old investing adage about cutting ones losses and letting profits run.

Before a trader enters a trade, the first thing they should ask themselves is how much money they are willing to risk and can their account afford to lose it?

Keeping the **risk small and constant** is absolutely critical.

RISK MANAGEMENT EXAMPLE

There is a so-called "rule of thumb" in the trading world which states that a trades risk shouldn't be more than 2% of the total trading capital on any one trade.

For example, if a trader buys 1 contract of May corn at $6.00 with a 6 cent risk, your risk is defined as 6 cents x $50 = $300. A trader needs to have an account value of at least $15,000 to follow the 2% rule.

Need help developing or trading your current plan?

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