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Money Management for Traders

A disciplined approach to risk

By Michael Sincere

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In the heat of battle, many traders lose sight of one of the most important but underestimated aspects of trading: money management. "Without proper money management there is a higher probability you will lose money," cautions Dr. Alexander Elder, psychiatrist and bestselling author, of *Sell and Sell Short* (Wiley, 2008). "It's like trying to run a race by hopping on one foot."

Steve Nison, president of Candlecharts.com and author of the bestselling *Japanese Candlestick Charting Techniques* (Prentice Hall, 2001), put it another way: "To use a Japanese proverb, trading without money management is like leaning a ladder against the clouds. It is dangerous to use candlesticks or technical analysis without money management. Otherwise you are relying more on luck than skill."

What is money management?

In a nutshell, money management is based on the old trader's saying "Cut your losses short and let your winners run." The idea is to keep your losing trades as small as possible while letting your winning trades grow as large as possible.

Elder says, "Every trader has to establish in advance what the maximum amount he or she will risk on any given trade." In other words, money management tells you how much you can afford to lose on the trade.

The advantage of proper money management is that it takes the emotion out of decisions. "When I enter a trade," says Deron Wagner, founder of Morpheus Trading Group and author of *Trading ETFs* (Bloomberg Press, 2008). "I am comfortable that the stock might stop out and I will lose that much money. That's one way you can have sound risk management at the same time that you have proper money management."

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When you don't manage your money

If you ignore money management, you do so at your own risk. Bennett McDowell, president of Traderscoach.com and author of *A Trader's Money Management System* (Wiley, 2008), put it this way. "Without proper money management, traders will expose themselves to obscene risk. Although not as sexy as entries and exits, money management is a key element in being a successful trader."

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McDowell says that new traders sometimes don't use money management at all.

They are focused on the excitement of entries and exits and the software that will supposedly do everything for them." Over time, new traders eventually learn that money management is just as important as trading tools, psychology, and entries and exits. McDowell adds that traders should think of trading as a career that takes time to master, and money management is an integral part of that development.

The 2% rule

Elder has written extensively about the 2% rule, which is one of the key techniques of money management. "This rule simply means that traders cannot risk more than 2% of their money on any given trade," he says. Elder points out that you don't have to risk as much as 2%; in fact, many pros use even lower percentages, perhaps only a half percent.

McDowell explains the calculations: "If you have a \$25,000 account, 2% of \$25,000 is \$500. This means that \$500 is the maximum you will lose if that trade fails and you get stopped out. It does not mean you are only buying \$500 worth of stock."

Both Elder and McDowell caution that some people get confused about the 2% rule. The rule does not limit how much stock you can buy, but only helps you determine the total amount you will allow yourself to lose on the trade.

The secret: calculating trade size

Although traders have been cautioned against listening to secrets, one of the secrets of money management is trade size. Calculating trade size is one of the easiest but least utilized aspects of money management.

If you ask many traders what trade size they use, they often tell you they trade the same number of shares all the time, such as 1,000 shares or 500 shares. Fortunately, there is a much more professional way of calculating share size.

With the proper share size, you will run your trading like a business," says McDowell. "Perhaps you won't get the excitement of making a killing with a large size, but you'll be more consistent in the long run."

After you have calculated 2% of your total portfolio, you are ready to determine the proper share size.

McDowell explains, "We have a very specific formula that takes into account the trader's account size, percent risk on each and every trade, entries and exits, and potential commissions. From this, we can determine the proper trade size."

Trade size formula

Risk amount – commission ÷ difference between entry and exit = trade size.

"For example," says McDowell. "Let's say you have an entry of \$60 a share. Our initial stop loss is \$58.50. So we enter the trade at \$60, and as soon as it's filled, we put in the stop loss at \$58.50." The risk to the trade is now 1.5 points. After subtracting commissions, you divide by 1.5 and end up with the maximum trade size. It will look something like this: $\$500 - \$80 \div 1.5 = 280$ shares. Using this example, you should limit yourself to only 280 shares.

Put another way, not including commissions, if you have a \$25,000 account, you don't want to risk more than \$500 per trade, or 2%. Therefore, if you have a one-point stop on the trade, you shouldn't trade more than 500 shares. If you have a two-point stop, you shouldn't trade more than 250 shares.

Wagner warns that if you want to stay in the trading business you must calculate trade size. "It often takes a disaster for people to understand how important it is." He, like other pros, reduces risk by calculating trade size using lower percentages.

The 6% rule

The 6% rule is another important money management technique. According to Elder, "The maximum risk that you will take to your entire account is 6%. If you are trading a \$100,000 account and are risking \$1,000 on each trade, you may not have more than six trades open at any one time.

By limiting the amount of risk to your portfolio to 6%, even in a worst-case scenario, you reduce the chance that your account will take a game-changing hit.

Using another example, McDowell says that by keeping your total active trading account risk under 6%, you can have three live trades simultaneously, each allowing 2% risk per trade.

In conjunction with the 6% rule, McDowell says traders should be careful not to have all their trades in one sector. "Traders should have trades spread across different sectors so they are diversifying," says McDowell. "This protects them against unexpected and dramatic events in the market that can cause gaps in prices or big, quick moves." These moves, called market risk, can sometimes move past your stop-loss exit.

John J. Murphy, chief technical analyst at Stockcharts.com and author of *The Visual Investor* (Wiley, 2009), says that he discovered early in his career the importance of asset allocation. "No matter whether you use fundamental or technical analysis," he says, "money management is not only about how much you are willing to risk at one time, but also how much you should allocate to each position. It's an extremely important part of any trading plan." He suggests having trades spread across different sectors.

Trade with discipline

Obviously, none of these formulas work unless you have the proper discipline to make it happen. Discipline, as Elder cautions, can be somewhat challenging. "To practice proper money management, you need the elusive characteristic of discipline," he says. "Discipline is a wonderful topic to discuss when the market is closed. But when the market is open, it often goes out the window."

Toni Turner, bestselling author of *A Beginner's Guide to Short-Term Trading* (Adams Media, 2008), put it this way: "I'm a nice person and not highly emotional, but I have learned to be a cold-hearted trader. You need to apply your rules to the market or the market will grab you by the throat and you'll be in trouble."

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(Tell us what you think about this article. E-mail your comments to [Active Trader](#).)

*Michael Sincere is a freelance writer and the author of five books on investing and trading, including *Understanding Stocks* (McGraw-Hill, 2003) and *Understanding Options* (McGraw-Hill, 2006).*