1. *Price forecasting* indicates which way a market is expected to trend. It is the crucial first step in the trading decision. The forecasting process determines whether the trader is bullish or bearish. It provides the answer to the basic question of whether to enter the market from the long or short side. If the price forecast is wrong, nothing else that follows will work.
2. *Trading tactics,* or timing, determines specific entry and exit points. Timing is especially crucial in futures trading. Because of the low margin requirements and the resulting high leverage, there isn't much room for error. It's quite possible to be correct on the direction of the market, but still lose money on a trade if the timing is off. Timing is almost entirely technical in nature. Therefore, even if the trader is fundamentally oriented, technical tools must be employed at this point to determine specific entry and exit points.
3. *Money management* covers the allocation of funds. It includes such areas as portfolio makeup, diversification, how much money to invest or risk in any one market, the use of stops, reward-to-risk ratios, what to do after periods of success or adversity, and whether to trade conservatively or aggressively.

The simplest way to summarize the three different elements is that price forecasting tells the trader *what* to do (buy or sell), timing helps decide *when* to do it, and money management determines *how much* to commit to the trade. The subject of price forecasting has been covered in the previous chapters. We'll deal with the other two aspects here. We'll discuss money management first because that subject should be taken into consideration when deciding on the appropriate trading tactics.

MONEY MANAGEMENT

After having spent many years in the research department of a major brokerage firm, I made the inevitable switch to managing money. I quickly discovered the major difference between recommending trading strategies to others and implementing them myself. What surprised me was that the most difficult part of the transition had little to do with market strategies. The way I went about analyzing the markets and determining entry and exit points didn't change much. What did change was my perception of the importance of money management. I was amazed at the impact such things as the size of the account, the portfolio mix, and the amount of money committed to each trade could have on the final results.

Needless to say, I am a believer in the importance of money management. The industry is full of advisors and advisory services telling clients *what* to buy or sell and *when* to do it. Very little is said about *how much* of one's capital to commit to each trade.

Some traders believe that money management is the most important ingredient in a trading program, even more crucial than the trading approach itself. I'm not sure I'd go that far, but I don't think it's possible to survive for long without it. Money management deals with the question of survival. It tells the trader how to handle his or her money. Any good trader should win in the long run. Money management increases the odds that the trader will survive to reach the long run.

Some General Money Management Guidelines

Admittedly, the question of portfolio management can get very complicated, requiring the use of advanced statistical measures. We'll approach it here on a relatively simple level. The following are some general guidelines that can be helpful in allocating one's funds and in determining the size of one's trading commitments. These guidelines refer primarily to futures trading.

1. *Total invested funds should be limited to 50% of total capital.* The balance is placed in Treasury Bills. This means that at any one time, no more than half of the trader's capital should be committed to the markets. The other half acts as a reserve during periods of adversity and drawdown. If, for example, the size of the account is $100,000, only $50,000 would be available for trading purposes.

2. *Total commitment in any one market should be limited to 10-15% of total equity.* Therefore, in a $100,000 account, only $10,000 to $15,000 would be available for margin deposit in any one market. This should prevent the trader from placing too much capital in any one trade.
3. *The total amount risked in any one market should be limited to 5% of total equity.* This 5% refers to how much the trader is willing to lose if the trade doesn't work. This is an important consideration in deciding how many contracts to trade and how far away a protective stop should be placed. A $100,000 account, therefore, should not risk more than $5,000 on a single trade.
4. *Total margin in any market group should be limited to 20-25% of total equity.* The purpose of this criteria is to protect against getting too heavily involved in any one market group. Markets within groups tend to move together. Gold and silver are part of the precious metals group and usually trend in the same direction. Putting on full positions in each market in the same group would frustrate the principle of diversification. Market commitments in the same group should be controlled.

These guidelines are fairly standard in the futures industry, but can be modified to the trader's needs. Some traders are more aggressive than others and take bigger positions. Others are more conservative. The important consideration is that some form of diversification be employed that allows for preservation of capital and some measure of protection during losing periods. (Although these guidelines relate to futures trading, the general principles of money management and asset allocation can be applied to all forms of investing.)

Diversification Versus Concentration

While diversification is one way to limit risk exposure, it can be overdone. If a trader has trading commitments in too many markets at the same time, a few profitable trades may be diluted by a larger number of losing trades. A tradeoff exists and the proper balance must be found. Some successful traders concentrate their trading in a handful of markets. That's fine as long as those markets are the ones that are trending at that time. The more negative correlation between the markets, the more diversification is achieved. Holding long positions in four foreign currency markets at the same time would not be a good example of diversification, since foreign currencies usually trend in the same direction against the U.S. dollar.

Using Protective Stops

I strongly recommend the use of protective stops. Stop placement, however, is an art. The trader must combine technical factors on the price chart with money management considerations. We'll show how this is done later in the chapter in the section on tactics. The trader must consider the volatility of the market. The more volatile the market is, the looser the stop that must be employed. Here again, a tradeoff exists. The trader wants the protective stop to be close enough so that losing trades are as small as possible. Protective stops placed too close, however, may result in unwanted liquidation on short term market swings (or "noise"). Protective stops placed too far away may avoid the noise factor, but will result in larger losses. The trick is to find the right middle ground.

REWARD TO RISK RATIOS

The best futures traders make money on only 40% of their trades. That's right. Most trades wind up being losers. How then do traders make money if they're wrong most of the time? Because futures contracts require so little margin, even a slight move in the wrong direction results in forced liquidation. Therefore, it may be necessary for a trader to probe a market several times before catching the move he or she is looking for.

This brings us to the question of reward-to-risk ratios. Because most trades are losers, the only way to come out ahead is to ensure that the dollar amount of the winning trades is greater than that of the losing trades. To accomplish this, most traders use a reward-to-risk ratio. For each potential trade, a profit objective is determined. That profit objective (the reward) is then balanced against the potential loss if the trade goes wrong (the risk). A commonly used yardstick is a 3 to 1 reward-to-risk ratio. The profit potential must be at least three times the possible loss if a trade is to be considered.

"Letting profits run and cutting losses short" is one of the oldest maxims of trading. Large profits in trading are achieved by staying with persistent trends. Because only a relative handful of trades during the course of a year will generate large profits, it's necessary to maximize those few big winners. Letting profits run is the way that is done. The other side of the coin is to keep losing trades as small as possible. You'd be surprised how many traders do just the opposite.

TRADING MULTIPLE POSITIONS: TRENDING VERSUS TRADING UNITS

Letting profits run isn't as easy as it sounds. Picture a situation where a market starts to trend, producing large profits in a relatively short period of time. Suddenly, the trend stalls, the oscillators show an overbought situation and there's some resistance visible on the chart. What to do? You believe the market has much higher potential, but you're worried about losing your paper profits if the market should fail. Do you take profits or ride out a possible correction?

One way to resolve that problem is to always trade in multiple units. Those units can be divided into *trading* and *trending* positions. The trending portion of the position is held for the long pull. Loose protective stops are employed and the market is given plenty of room to consolidate or correct itself. These are the positions that produce the largest profits in the long run.

The trading portion of the portfolio is earmarked for shorter term in-and-out trading. If the market reaches a first objective, is near resistance and overbought, some profits could be taken or a tight protective stop utilized. The purpose is to lock up or protect profits. If the trend then resumes, any liquidated positions can be reinstated. It's best to avoid trading only one unit at a time. The increased flexibility that is achieved from trading multiple units makes a big difference in overall trading results.

WHAT TO DO AFTER PERIODS OF SUCCESS AND ADVERSITY

What does a trader do after a losing or a winning streak? Suppose your trading equity is down by 50%. Do you change your style of trading? If you've already lost half of your money, you now have to double what you have remaining just to get back to where you were in the first place. Do you get more selective choosing trades, or keep doing the same things you were doing before? If you become more conservative, it will be that much harder to win back your losses.

A more pleasant dilemma occurs after a winning streak. What do you do with your winnings? Suppose you've doubled your money. One alternative is to put your money to maximum use by doubling the size of your positions. If you do that, however, what will happen during the inevitable losing period that's sure to follow? Instead of giving back 50% of your winnings, you'll wind up giving it all back. So the answers to these two questions aren't as simple or obvious as they might first appear.

Every trader's track record is a series of peaks and troughs, much like a price chart. The trend of the equity chart should be pointing upward if the trader is making money on balance. The worst time to increase the size of one's commitments is after a winning streak. That's much like buying into an overbought market in an uptrend. The wiser thing to do (which goes against basic human nature) is to begin increasing one's commitments after a dip in equity. This increases the odds that the heavier commitments will be made near the equity troughs instead of the peaks.