Money Management

Written by Joe Ross

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Money Management

Written by Joe Ross

There are some common mistakes I've seen traders make in the area of money management. First, let's understand what money management is all about.

Money management overlaps with risk, trade, business, and personal management, yet it has many aspects that make it unique, distinctly different from all of the other areas of management. In this chapter we want to examine some areas of money management that seem to involve mental quirks leading to costly mistakes.

Listening to Opinion

Kim can't make up her mind.

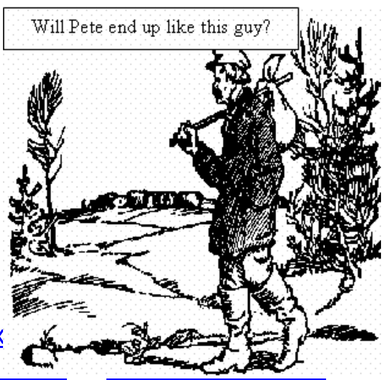
Kim has entered a short position in crude oil after carefully studying as many factors as she could reasonably include while making her decision to trade. She has entered the trade because her study of the underlying fundamentals has her convinced that crude oil prices must soon begin to fall. Then Kim turns on her television set and begins to watch one of the financial news stations. An "expert" in crude oil is being interviewed. He begins to talk about how crude oil inventories are almost certain to drop this year because oil companies are not doing as much exploration as they have in previous years. Kim listens intently to what he has to say and then begins to doubt her decision about the trade she has entered. The more she thinks about it, the more panicky she becomes. She considers abandoning her position even though she will end up with a loss. The fact that an "expert" has decided something else completely shakes her confidence. She exits the trade intraday and takes a $400 loss. Prices have not come near her protective stop, which was $700 away from her entry. The market never moves sufficiently far to have taken out her stop. By the end of the day, her crude oil futures have made a new high, and in the following days explodes into a genuine bull market. Instead of a magnificent win, Kim has a loss. The loss is more than money, she has lost confidence in herself.

What should be done?

You should set your own trading guidelines and trade what you see. Forget about opinion, your own and especially that of others. Unless you are one of a very rare breed whose opinions are sufficiently good for trading, do not trade on them.

Make an evaluation based on the facts you have and then go with the trade. Just be sure you have a strategy for extricating yourself before losses become big. Had Kim stayed with her original strategy and stop placement, she would have ended up a happy winner instead of a regretful loser.

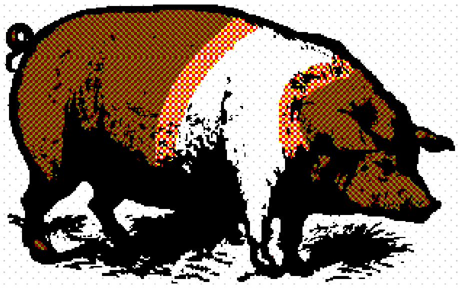
Taking Too Big a Bite



Will Pete end up like this guy?

Biting off more than can be chewed is a weakness of many traders. This form of over trading derives from greed and failing to have clearly defined trading objectives. Trading only to "make money" is not sufficient.

Pete has sold short T-Bonds and is now ahead by a full point. He notes that he is making money on his trade. Feeling very confident and thinking it would be smart to be diversified, he enters a long position in silver futures, and also sells short Call options of wheat which he is sure is headed down. Almost as soon he is in the market, wheat prices explode upward and his Calls are in trouble. Pete buys back the losing short Calls and sells additional Calls on a two-for-one basis at a higher strike price. At the end of the day he looks at other positions. Silver had an intraday reversal leaving a spiked bottom as they close at the high of the day. The T-Bonds have made an inside day, but to Pete they suddenly look weak, he is down a few ticks. At the end of the day, he finds that most of the money he had made on his short T-Bonds was used to buy back the short wheat Call options. He covered those and now has additional premium in his account, but he also has additional risk, and is short Calls in a rising market – not an enviable position. Moreover, he is now worried about his long silver futures based on the fact that silver closed at its lows on what seems to be a genuine reversal. To further aggravate the situation, he has lost confidence in himself. What was once a happy, simple, winning silver long, has now become an ugly, confusing mess, and Pete has a good chance of ending up a loser on all three trades. If Pete keeps over-trading in this fashion, he could end up like the poor fellow in the picture.



Is this Tim or one of his herd?

What should be done ?

Break every trade into definitive goals. Make sure you achieve those goals before adding other positions. Even with a single short sale of the T-Bonds, Pete could have set himself a goal for the trade. One or two full points might have been all he needed to satisfactorily retire that trade as a winner. Then he could have made his trading decision for an additional position. There are very few traders who can successfully manage multiple positions in a variety of markets.

Overconfidence

Overconfidence is a particular kind of trap that springs shut when people have or think they have special information or personal experience, no matter how limited. That's why small traders get hurt trading on no more information than “hot-tips.”

Tim is a farmer. He raises hogs and purchases huge amounts of feed to provide for his hogs. Tim has a large farming operation which is quite profitable. He takes 250 hogs a week to market. Because of a steady flow of hogs from his operation to the market, Tim has no need to hedge his hog business because he is able to dollar average the prices he gets for them. But Tim does want to indirectly reduce the cost of the feed he has to buy, so he purchases soy meal futures. Tim listens to weather and farm reports all day long. He attends meetings of other farmers, and tries to gather all the information he can that might help him be more profitable. But Tim has a major problem, called tunnel vision. When he looks out at the grain fields in the area where he lives, whatever he sees there he extrapolates to the whole world.

In other words, if Tim sees that the surrounding fields are dry, he suspects that all fields everywhere must also be dry. One year Tim witnessed a local drought. He checked with all the local farmers and they said they were truly experiencing drought conditions. He looked at the news on his data feed, and sure enough it said that there was a drought in his area. In fact, the entire state where Tim raises his hogs was undergoing drought.

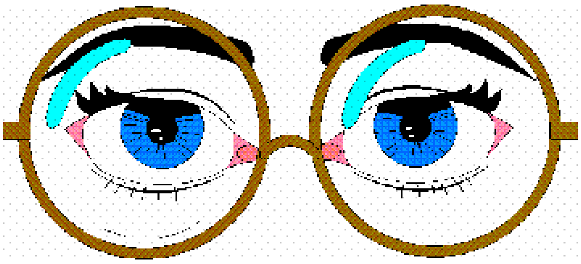
Tim wasn't too concerned about his own feed bins. He had plenty of it in his silos from previous bumper crop years. Tim decided to be piggish and speculate on what he considered to be inside information. He called his broker and bought heavily into soy meal futures. Tim was confident. He was sure that soy meal prices would explode upward some time soon, and that he was going to make himself a small fortune. Tim's greed may have turned him into a hog. However, the futures he purchased started moving down and the value of his investment began to shrink markedly. What Tim failed to do was to have a broader perspective. Everywhere else that grains were grown, farmers were experiencing rain in due season. The drought was localized almost entirely within the state in which Tim did his hog raising. Tim lost because he was confident in the limited knowledge he had.

What should be done?

We all need to broaden our horizons. We need a humble attitude relative to the markets. We can never afford to wallow in overconfidence in what we perceive as special knowledge. A trader can never afford to let his guard down. Tim thought he knew something that others hadn't yet caught onto. In so doing, Tim made another mistake as well. He heard only what he wanted to hear.

Hearing What You Want to Hear – Seeing What You Want to See

Marketers call this preferential bias. Preferential bias exists among traders. Once they develop a preference for a trade, they often distort additional information to support their view. This is why an otherwise conscientious trader may choose to ignore what the market is really doing. We've seen traders convince themselves that a market was going up when, in fact, it was in an established downtrend. We've seen traders poll their friends and brokers until they obtained an opinion that agreed with their own, and then enter a trade based upon that opinion.



Seeing what they want to see is a common problem among traders. When that happens, they usually hear only what they want to hear!

A student of ours, Fran and her husband, John, decided they wanted to go to live in the Missouri Ozarks. Everyone told them that there was no way for them to make a living there.

Everyone they asked advised them not to do it.

Finally, a minister in the Church they proposed to attend told them that they were to serve there. Out of twenty or thirty people they asked, that minister was the only one who told them to come. Of course, it was exactly what they wanted to hear. They sold their home and most of their possessions accumulated over a lifetime. They moved to the Ozarks and went broke within a year. They had to leave and begin all over again. John, who had been semi-retired, now had to find a job. So did Fran. She had to give up a promising start as a trader to go out to put food on the table.

What should be done?

Look at each trade objectively. Do not allow yourself to become married to your opinion. Learn to recognize the difference between what you see, what you feel, and what you think. Then, throw out what you think. Lock out the input of others once you have made up your mind. Don't let your broker tell you what you want to hear. Never ask your broker, your friends, or your relatives for an opinion. Turn off your TV or radio, you don't need to see or hear what they have to say. Take all indicators off your chart and just look at the price bars. If you still see a trade there, then go for it.

Fearing Losses

There is a huge difference between being risk averse and fearing losses. You must hate to lose. In fact, you can program your brain to find ways to not lose. But not losing is a logical thought-out process, rather than an emotion-based reaction.

Two human -based tendencies come into play. The first is the sunk-cost fallacy and the second is the exaggerated-loss syndrome.

Sunk-cost fallacy: You are in a trade that begins to go against you. You reason that you have already spent a commission, so you have costs to make up for. Moreover, you have spent time and effort researching and planning this trade. You reckon that time and effort as cost. You have waited for just such an opportunity and you are afraid that now that it has come you will have to miss this trade. The time spent waiting for opportunity is something you also count as cost. You don't want to waste all these costs, so you decide to give the trade a little more room. By the time you realize what you've done, the pain is almost overwhelming. Finally, you have to take your loss which is now much larger than it might have been. The size of the loss adds to your fear of ever losing again. The end result is brain lock and inability to pull the trigger on a trade.

Exaggerated-loss syndrome: You give the importance of losing on a trade two to three times the weight of winning on a trade. In your mind, losses have greater significance than wins. In reality, neither is more or less important than the other. In fact, wins do not have to be as numerous as losses as long as the wins are significantly larger in size than the losses. Of course, best is to have more wins than losses with the wins greater in size than the losses.

What should be done?

Evaluate your trades solely on their potential for *future* loss or gain. Ask yourself, "what do I stand to gain from this trade, and what do I stand to lose from this trade?" Think the matter through. "What is the worst thing that can happen to me if I take this trade, and do I have a plan and a strategy for extricating myself long before it happens?" "If I begin to lose, is there a way I can turn things around and come out a winner?" Learn to look at the costs of a trade as part of your business overhead. Try to have a mind set that you will not throw good money after bad. When you give a trade more room, you are doing just that – often throwing away money.

Valuing invested money More Than won money

Traders have a tendency to be more careless with money they've won than with money they've invested. Just because you won money on good trades doesn't mean you should gamble with that money. People are more willing to take chances with money they perceive as winnings as though it were found money. They forget that money is money. Valuing money depending on where it comes from can lead to unfortunate consequences for a trader. The tendency to take greater risk with money made from trades than with money invested as capital makes no sense. Yet traders will take risks with money won in the markets that they would never dream about with money from their savings account.

Won money is as important as any money!

What should be done?

Wait awhile before placing at risk money won on trades. Keep your trading account at a constant level. Strip your winnings from your account and put them in a safe conservative place. The longer you hold on to money, the more likely you are to consider it your own.

Forgetting About Margin Inflation

Before the crash of 1987, S&P 500 stock index futures carried an exchange minimum margin of about $12,000 . Immediately after the crash, margins required by some brokers rose to $36,000 and higher.

A trader we know, called Willie, figured that if prices on an index he was short went down, he would continually add to his position whenever prices first pulled back and then broke out to new lows. The index he was trading became very volatile, and his broker raised margins to by 1/3 rd. Willie was trading a small account, and when he tried to sell short additional contracts onto his already short position, his broker would not allow him to do so. Willie complained bitterly, but the broker was adamant in his refusal. The broker would not allow Willie to use unrealized paper profits to cover the additional margin required for adding on. He explained to Willie that to do so would in effect allow Willie to build a pyramid position and that was not going to be allowed by the broker's firm.

The mistake Willie was making was what some call the "money illusion." Willie assumed that because his position was moving in his favor that he had more selling power and more margin. His broker quickly brought Willie face to face with reality. While some brokers may allow it, unrealized paper profits do not truly constitute additional funds that may be used for margin. Willie's dream of fabulous profits from this trade were just that, a dream. Willie should be thankful that his broker did not allow him to get in trouble. Pyramiding with unearned paper profits is not the way to succeed as a futures trader.

What should be done?

You should realize that each so-called "add-on" to an open position is really a whole new position. Each add-on carries all new risk, and each add-on brings you closer to the add-on trade which will fail and become a loser. When planning a trade, be aware that if the market becomes volatile, margin requirements may go up, thereby defeating any strategy for adding on to your position. There is nothing wrong with building a position one leg at time as prices ascend or descend, but when volatility dictates an increase in margin requirements, beware of trying to add on and be aware that you may not be able to add on.

Option sellers can quickly get into similarly difficult positions. As they roll out to new strikes to defend a threatened short options position, they can find themselves not only facing the need for a larger position, but also facing increased margins in creating that larger position. They may discover that they no longer have sufficient margin to defend a particular position and thus have to eat a sizable loss.

MORE KEY MISTAKES

Throughout our courses we mention some key mistakes commonly made by traders. Here are a few more:

Error: **Confusing trading with investing.** Many traders justify taking trades because they think they have to keep their money working. While this may be true of money with which you invest, it is not at all true concerning money with which you speculate. Unless you own the underlying commodity, for instance, selling short **is speculation**, and speculation is not investment. Although it is possible, you generally do not invest in futures. A trader does not have to be concerned with making his money work for him. A trader's concern is making a wise and timely speculation, keeping his losses small by being quick to get out, and maximizing profits by not staying in too long, i.e., to a point where he is giving back more than a small percent of what he has already gained.

Error: **Copying other people's trading strategies.** A floor trader I know tells about the time he tried to copy the actions of one of the bigger, more experienced floor traders. While the floor trader won, my friend lost. Trading copycats rarely come out ahead. You may have a different set of goals than the person you are copying. You may not be able to mentally or emotionally tolerate the losses his strategy will encounter. You may not have the depth of trading capital the person you are copying has. This is why following a futures trading (not investing) advisory while at the same time not using your own good judgment seldom works in the long run. Some of the best traders have had advisories, but their subscribers usually fail. Trading futures is so personalized that it is almost impossible for two people to trade the same way.

Error: **Ignoring the downside of a trade.** Most traders, when entering a trade, look only at the money they think they will make by taking the trade. They rarely consider that the trade may go against them and that they could lose. The reality is that whenever someone buys a futures contract, someone else is selling that same futures contract. The buyer is convinced that the market will go up. The seller is convinced that the market has finished going up. If you look at your trades that way, you will become a more conservative and realistic trader.

Error: **Expecting each trade to be the one that will make you rich.** When we tell people that trading is speculative, they argue that they *must* trade because the next trade they take may be the one that will make them a ton of money. What people forget is that to be a winner, you can't wait for the big trade that comes along every now and then to make you rich. Even when it does come along, there is no guarantee that you will be in *that particular* trade. You will earn more and be able to keep more if you trade with objectives and are satisfied with regular small to medium size wins. A trader makes his money by getting his share of the day-to-day price action of the markets. That doesn't mean you have to trade every day. It means that when you do trade, be quick to get out if the trade doesn't go your way within a period of time that you set beforehand. If the trade does go your way, protect it with a stop and hang on for the ride.

Error: **Having profit expectations that are too high.** The greatest disappointments come when expectations are unrealistically high. Many traders get into trouble by anticipating greater than reasonable profits from their trading. They will often get into a trade and, when it goes their way and they are winning, they will mentally start spending their winnings, and may even borrow against their anticipated winnings to take on additional risk. Reality is that you seldom make all of the money available in a trade. I cannot count the times that I had for the taking hundreds or thousands of dollars in unrealized paper profits only to see most of those profits melt away before I was able to or had the good sense to get out. One trader I know had $700 per contract profits in a short eurodollar trade. The next day his position literally imploded on news of a 50 basis point cut in interest rates. He was lucky to get out with $350 per contract. The money from trading often doesn't come in as fast or as plentifully as you have expected or been led to believe, but the overhead costs of trading arrive right on schedule. False profit expectations have caused aspiring traders to leave their job before they were really successful. The same false hope causes them to lose the money of friends and family. False hope causes them to borrow against their home and other fixed assets. Too high expectations are dangerous to the well-being of every trader and those around him.

Error: **Not reviewing your financial goals.** Before you make a position trading decision, or before you begin a day of day trading, review your motives and your goals.

- Why are you trading today?
- Why are you taking this trade?
- How will it move your closer to your goals and objectives?

Error: **Taking a trade because it seems like the right thing to do now.** Some of the saddest calls we get come from traders who do not know how to manage a trade. By the time they call, they are deep in trouble. They have entered a trade because, in their opinion or someone else's opinion, it was the right thing to do. They thought that following the dictates of opinion was shrewd. They haven't planned the trade, and worse, they haven't planned their actions in the event the trade went against them. Just because a market is hot and making a major move is no reason for you to enter a trade. Sometimes, when you don't fully understand what is happening, the wisest choice is to do nothing at all. There will always be another trading opportunity. **You do not have to trade.**

Error: **Taking too much risk.** With all the warnings about risk contained in the forms with which you open your account, and with all the required warnings in books, magazines, and many other forms of literature you receive as a trader, why is it so hard to believe that trading carries with it a tremendous amount of risk? It's as though you know on an intellectual basis that trading futures is risky, but you don't really take it to heart and live it until you find yourself caught up in the sheer terror of a major losing trade. Greed drives traders to accept too much risk. They get into too many trades. They put their stop too far away. They trade with too little capital. We're not advising you to avoid trading futures. What we're saying is that you should embark on a sound, disciplined trading plan based on knowledge of the futures markets in which you trade, coupled with good common sense.