

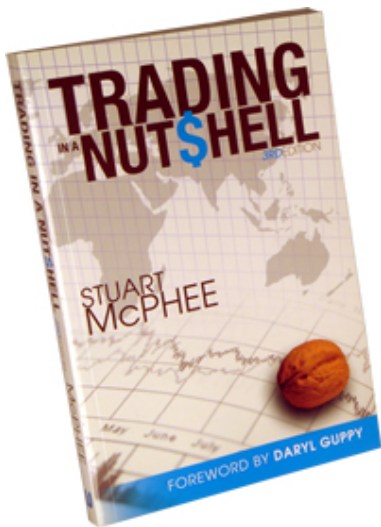
Excerpt From Stuart McPhee's "Trading In A Nutshell – 3rd Edition"

More info at:

<http://www.financialmarketplace.com/2008/10/03/review-of-stuart-mcpees-trading-in-a-nutshell-3rd-edition/>

Half the Risk

Let's say that your method over time returns equal number of profitable trades with losing trades. Accepting that managing our risk is critical and that every second trade on average will result in a loss, why not try this idea?



Whatever you determine your position size to be for a particular trade you are about to enter, halve it. If you position size is going to be \$4600, then make it only \$2300 and commit that to the trade. Everything else remains the same and you just leave the remaining \$2300 sitting in your account for the moment. You still enter at the same price level and your initial stop loss point is the same.

The key difference is that should your trade not work out and the price moves back to your initial stop loss, you still exit the trade but only lose half your risk amount. This simple modification to your position sizing model takes great steps towards protecting your capital even further.

Of course, the obvious question is about the other \$2300 that we have left out. Should the trade move in your favour, when your trailing exit has moved to breakeven or higher (theoretically your worst case scenario in the trade is now breakeven), add the remaining \$2300 into the position by purchasing more stock.

From this point onwards, the trade remains the same as if you had committed the entire \$4600 at the beginning, and you simply monitor the trade throughout moving your trailing exit when necessary and eventually closing the trade when your trailing exit point is triggered.

This significant step towards managing your risk even further comes at a price. You will have to pay two lots of commission for every second trade, on average. I personally think this is a small premium to pay for extra protection.

Developing your Trading Plan

Having a trading plan facilitates your decision making by removing your emotions from the equation and, therefore, will make you trade more efficiently. The best way to ensure you get the most from your trading plan is to write everything down. I believe your trading plan should take into account three broad areas, as I introduced right back in Chapter 1, as follows:

- your trading mindset (or psychology)
- your money management (position size, pyramid strategies, and so on)
- your trading method (requirements for trade initiation, filtering processes, daily routine, and so on).

One thing I have experienced over the years is many people who accept that a trading plan is an essential requirement to trading well, yet they don't know where to start to put one together. I accept that it can be overwhelming at first to tackle this issue.

So let me simplify this for you. There are three key decisions you need to make when trading and if we think in these terms and your trading plan answers each question, then you may have the makings of a simple yet robust trading plan. Despite what I listed previously as the three broad areas in your plan, your trading boils down to the following:

- Under what circumstances will you enter a trade?
- How much money will you commit to the trade?
- Under what circumstances will you close the trade?

Never picture your trading plan as a detailed document containing pages and pages of information because then it will overwhelm you and may deter you from compiling one in the first place. Think in the simple terms above and once you have answered the above questions, then you can add some detail to it as time goes by.

I would like to add a few comments about each of the questions above even though they are all covered in various chapters throughout this book.

First, under what circumstances will you enter a trade? Let me provide a slightly alternative view to what our trading plan is designed to do. Many would agree that your trading plan and the method listed therein is designed to get you in to the market. My view is counter intuitive as I believe my trading plan is designed to keep me out of the market.

Let me explain. There are theoretically an infinite number of trading opportunities every day. The vast majority of these do not fit our trading style and therefore our trading plan is constantly telling us not to initiate a trade. If a stock makes it through your selection criterion, then it has done so for very good reason. I discuss this idea a little further in the next chapter under the heading of control.

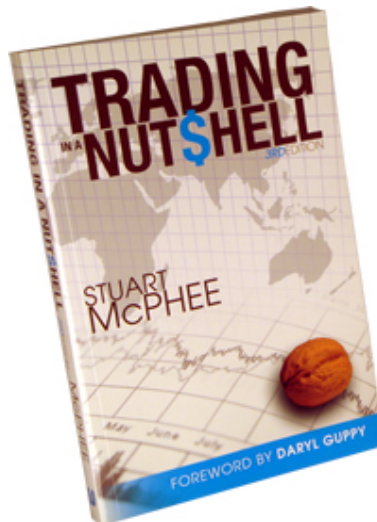
Next, is your position sizing. Remember back to Chapter 8, when I mentioned that protecting your trading capital is the most important thing you can do. Determine your risk amount, your maximum limit for each trade and then determine how you will calculate how much money to commit to each trade.

Finally, the most critical part and that is when to exit. Notwithstanding the importance of mindset and cutting losses etc, from a technical standpoint, this would be the most common problem inexperienced traders have. The problem is not that traders don't set initial stop losses etc, but where they place them.

Pick up your copy of
“Trading In A Nutshell – 3rd Edition”
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The foreword has been written by Daryl Guppy.



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