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Fundamentals of Trading Strategy, Risk and Money Management

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Prologue: Trading Strategy

- Planning of a trade ⬄ Rationality vs. Impulsiveness
- Actionism is a ‘No Go’.
- Risk & Money management is implemented as part of the exit strategy
- A trading strategy is set of clearly defined rules.

- The following points must be defined in these rules (= System)

1.) Definition of markets

2.) Definition of time horizon

3.) Definition of signals for position entry

4.) Definition of signals for position exit (Stop Loss & Take Profit)

Definition of Markets

- Definition of the Market
- Definition of the asset class
- Selection of the specific underlying asset

- Even though trading performance is the highest priority, you should still feel comfortable trading. So if you are reluctant to trade a particular asset class, do without it!

Defintion of Time Horizon

- Definition of investment horizon, holding period and trading frequency. Would you rather position yourself in the market in the short or long term? The selection of the appropriate investment vehicle correlates here.

⇔ Short-term strategy e. g. for sideways markets (leverage products such as CFDs)
⇔ Long-term strategy e. g. for trend markets (classical direct investment)

The Entry Signal

- Clear definition on the basis of which criteria a position is to be opened in the relevant underlying. A distinction is made between two main approaches:

Criteria of Fundamental Analysis	Criteria of Technical Analysis
Medium to Long-Term Approach	Short-, Medium- and Long-Term
For equities, for example based on qualitative and quantitative company analysis	Independent of the underlying on the basis of trend lines, formations, indicators, etc.

- Decide which approach you would like to follow and write down the relevant entry criteria. This makes it possible to evaluate and successively optimize a trading strategy in addition to entry signals. By the way, both approaches complement each other. In this way, you avoid impulsive action and thus performance-threatening actionism.

Risk & Money-Management

- In addition to the components already described, a complete trading strategy always includes adequate risk and money management.

- Risk adjustment

  - ⇔ Related to the Trade
  - ⇔ Related to the Account

- The focus is as following:

A. The planned exit point (risk: stop loss)
B. The expected price target (take profit)
C. The optimum size of the position, taking into account the overall risk to be entered into

Chance & Risk

- Never enter the market without risk protection. No position without a stop-loss.
- With Stop Loss, the maximum risk or loss potential is fixed from the very beginning of every trade.
- When placing meaningful stop marks for a specific trade, the charting in particular provides valuable information. Gradient highs and lows, corresponding supports and resistances serve as orientation criteria.
- However, it is not only the risk that must be limited, but also the opportunity to define the profit target.
- The opportunity and risk of a trade should always be in reasonable proportion to each other.
- Risk/reward ratio (CRP) = opportunity/risk (= at least 2/1 = 2 to 1)

Further Rules for Exiting the Position

- The stop loss is irrevocable: it is only moved to reduce the risk, never to increase the risk or loss potential.
- If, for example, a trend reversal should become apparent against the original market opinion, stops can be tightened. In this context, however, not every position should be closed immediately.
- One possibility of dynamic profit hedging is the successive retraction of a stop.
- By placing a stop loss order, you are always aware of your overall risk. Do not only define the maximum loss potential, but also set an imaginary "time stop".
- A time stop frees your capital from a position whose value hardly moves or not at all.

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Money-Management

- Focus on managing and maintaining the custody account balance
- Determination of the appropriate size of the position and the number of items contained therein, taking into account the risk that the trader is prepared to take.
- Within the trading strategy or prior to the opening of a specific position, it is important to determine what percentage of your portfolio you are prepared to risk.
- Combined with the previously selected stop distance at the starting price, the appropriate number of units is then calculated.
- Experienced traders do not risk more than 1 - 2 percent of the account balance per trade..

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Draw-Down-Schedule

Accumulated Capital Loss	Necessary Performance
5%	5%
15%	18%
25%	33%
50%	100%
75%	300%
90%	900%

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Case Study: Bayer

- <u>Initial Situation</u>

  -> Planned Investment: Bayer Share
  -> Margin: 10%.
  -> Price: 105,00 EUR per Share
  -> Account Size: 10.000, - EUR

- <u>Risk management</u>

  -> Starting Price: 105.00 EUR
  -> Risk Limitation (stop loss): 104.00 EUR
  -> Opportunity/Price Target (take profit): 109.00 EUR
  -> Pot. Profit: 4 EUR
  -> Pot. Loss: 1 EUR
  -> CRP (Chance-Risk-Profile) = 4 / 1 = 4

- <u>Money management (position sizing)</u>

  -> Deposit size: 10,000 EUR
  -> Total Risk per Trade: 1% Regarding Account Size = 100 EUR
  -> Per Share: 1 EUR

  -> Total tradable number of Shares: 100 (Quantity = Total Risk / Risk per Share)
  -> Absolute Position Size: 10,500 EUR
  -> Margin: 1,500 EUR (Percentage Margin Rate x Position Size)

  -> Overall Opportunity: 100 Shares X 4, - EUR = 400, - EUR
  -> Return: Profit / Capital used
  -> 400, - EUR / 1500,- EUR = 26,6%.

Thank you for your interest

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