Proper Position Sizing

How to size your positions properly for maximum profit and less risk

Robert Walsh
Best Stock Picking Services

What is Position Sizing?

Position sizing is THE most important aspect of a trading, yet, like expectancy (how much you expect to made on each trade), it's rarely talked about in trading books or articles about trading.

Position sizing is simply 'how much' or 'how big' of a position to take. Position sizing is the key factor in whether or not you stay in the game, blow out your account or make a fortune.

It determines whether your gains are huge or minimal. It is <u>that</u> important.

Determining how much stock as a percentage of their account to accumulate on any trade is usually overlooked aspect of trading. It is not "sexy" like a new trading indicator or the latest and greatest trading strategy.

You will find tons of books discussing chart patterns and technical analysis. However it is rare to find a book devoted to the "How Much" should I buy and plenty on what to buy and when.

Traders frequently will take a random position size; they may take more if they feel "really sure" about a trade, or they may take less if they feel leery.

Trade size may be determined by their mood, account size, whether or not their last trade made money or was a loser.

These are not valid ways to determine position size. A trader should also not take a set position size for all circumstances. Many traders take the same position size regardless of how the trade sets up, and this style of trading will likely lead to underperformance over the long run.

Also a major factor in position sizing is the volatility of the stock they are thinking of trading.

Volatility refers to the amount of uncertainty or risk about the size of changes of a stocks share price. A higher volatility simply means that stocks share price will vary over a larger range of values.

This means that the price of the stock can change dramatically over a short time period in either direction. A lower volatility means that a security's value will not fluctuate as dramatically, but will change in value at a steadier pace over a period of time.

As an example let's compare Wal-Mart and YY Inc. that are roughly equal in share price:

Wal-Mart has a Beta of .40 which meant it has 40% the volatility or percentage movement in price as the S&P 500 so this is a LOW volatility stock.

YY on the other hand has a Beta of 3.48 so it is 3.48 times a volatile as the S&P 500 and 8.7 TIMES more volatile as Wal-Mart.

So if you buy YY you are taking on 8.7 times more risk than Wal-Mart for the same dollar amount.

Most traders would not take this into consideration and take an equal dollar size position in both, then wonder why they just lost so much money on the trade.

How to Determine Position Size

Let us look at how position size should actually be determined. The first thing we need to know before we can determine the proper position size is the stop level for the trade. Stops should not be set at some percentage. You will see many people advising setting a stop loss point at 7 or 8%.

This makes no sense; you could be risking way too much or not enough depending on how volatile the stock is. Comparing WMT and YY again, a 7% stop on Wal-Mart would be risking too much to know if you are right with your position and probably not enough with YY.

A stop needs to be placed at a logical level, where it will tell the trader they were wrong about the direction of the trade. We do not want to place a stop where it could easily be triggered by normal movements in the market.

Using YY as an example, your logical stop might be about $54, just below support. If you decide to go long at the current price of $64.97 you would be risking $10.97.

A good rule of thumb is you should never put more than 10% of your account into any one position. The reason will be made very clear shortly.

So once we have determined where you should logically place your stop, we now know the risk and can now determine our position size. The next thing we need to consider is the size of our account.

If we have a small account, we should risk a maximum of 1-3% of our account on a trade with 2% being a good percentage to use. Normally as our account size grows larger we commit smaller percentage of our account to each trade and risk a smaller percentage of our account per trade.

The percentage of the account we are willing to risk is often misunderstood, so let's look at an example.

Assume a trader has a $10,000 trading account. If the trader risks 1% of their account on a trade, that means the trader can lose $100 on a trade. If the trader uses a 3% risk level, then he or she can lose $300 (which is 3% of their account).

Well use Plug Power as an example to determine position size:

So here is how we determine how many shares to buy:

Assuming a $10,000 account and we are buyer here at support at about $3.90. We decide that if the price goes below support at about $2.20 we are going to exit the trade.

Since we should not put more than 10% of our account into one position and we should never risk more than 3% on any one trade we can calculate how many shares we can buy:

Account Size = $10,000

Risk is 2% of $10,000 = $200

$3.90(Buy Price) – $2.20(Stop Price) = $1.70

We then divide $300 by our risk per share amount so 200/1.70 = 117 shares

To find the Dollar Value of the position: 117 x $3.90 = $456 or about 4.5% of our account, this falls within our parameters and we can take the trade. If the amount is greater than 10% we can either pass on the trade or buy fewer shares so it less than 10%.

So the formula is: (Account Size) X (The % We Want to Risk) = $Risk ($Risk) / (Buy Price – Stop Price) = Shares to Buy (or Short)

Using this formula we will know exactly how many shares we should buy. It also takes into account the volatility of the stock and our account size.

So now to explain why we should NEVER put more than 10% of our account into any one position.

Even though we are in theory risking at most 3% that doesn't always mean you will get out of the trade at your intended stop loss. To see what I mean, see the chart below.

While you thought you may have been risking only 1-3% of your account on a trade, suppose you were feeling really good about this trade and decided to put 25% of your account into PRAN.

If You Lose:	Gain Required to Break Even:
5%	5
10%	11%
15%	18%
20%	25%
25%	33%
30%	43%
35%	54%
40%	67%
45%	82%
50%	100%
75%	300%
90%	900%

How are you feeling on April 1st when an unfavorable FDA ruling came out? You just lost 75% of your position even though you had a stop in place and thought you were being conservative risking 3% of your account.

So let's see:

25% of $10,000 = $2,500 you lost 75% = $1,875 or almost 19% of your account was wiped out overnight!

Looking at the breakeven chart to the left, if you lose 18.75% you need to make about 25% to get to breakeven.

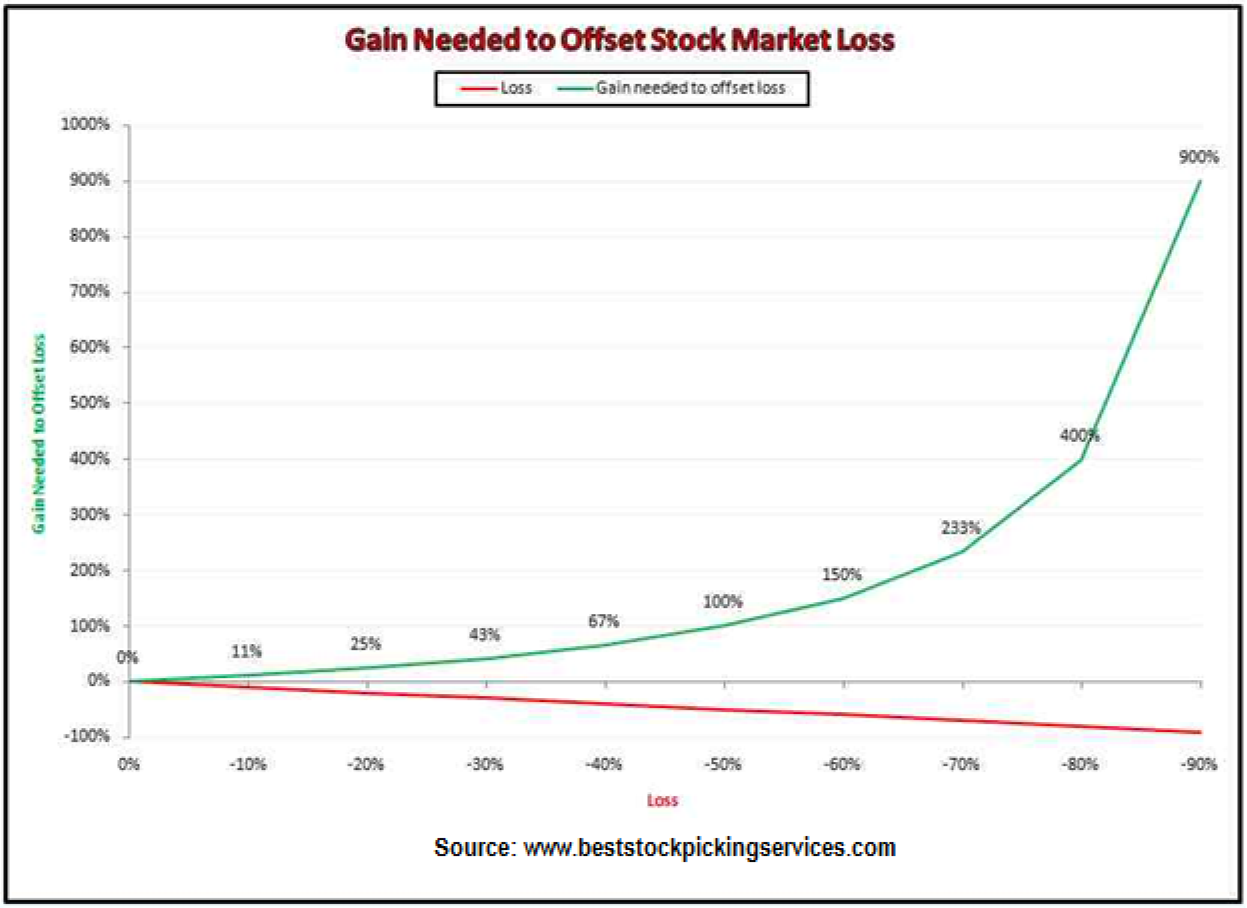
This chart should make it quite clear why you need to avoid large losses like the plague. It takes a 100% gain to erase a 50% loss.

In other words you need to **double** your money to offset a 50% loss of account value!

You cannot afford to take loses like that and hope to survive.

Think this an extremely rare occurrence? Think again. Had you owned SRPT in Dec you would have just lost over 60% of your money overnight!

Just to illustrate how damaging large losses are, this graph shows it a bit more clearly how hard it is to recover from large losses.



The bottom of the chart shows the loss amount and above shows how much you need to make just to get back to breakeven. As you can see it is an exponential chart.

Think about it in dollar terms: a stock that drops 50% from $10 to $5 ($5/$10 = 50%) must rise by $5, or 100% ($5/$5 = 100%), **just to return to the original $10 purchase price**.

Many investors forget about simple mathematics and take in losses that are greater than they realize. They falsely believe that if a stock drops 20%, it will simply have to rise by that same percentage to break even.

These charts make it clear how important it is to not put too much of your account into any one position and how important it is to keep losses SMALL.

The Breakeven Fallacy

When the financial crises of 2007-2008 hit and the market started its descent into a bear market, investors froze like deer caught in oncoming headlights. Many didn't even react until the value of their portfolio holdings had declined by as much as 50-60%.

There is absolutely no guarantee that a stock will ever come back. In fact, waiting to break even - the point at which profit equals losses - can seriously erode your returns.

Trading is a game of probability

This means that every trader will be wrong at times and have losing trades. When a trade does go wrong, there are only two options: to accept your predetermined loss and liquidate your position, or go down with the ship.

This is why using stops and proper position sizing is so important. Many traders take profits quickly but also hold on to losing trades - it's simply human nature. We take profits because it feels good and we try to hide from the discomfort of defeat.

A properly placed stop order takes care of this problem by acting as insurance against losing too much. In order to work properly, a stop must answer one question: At what price is your opinion wrong?

Why Traders Need to Focus on Position Sizing and Trade Management

With a relatively fixed account balance to start trading any market, you must focus on the position size you will have on each trade. You've likely heard the phrase, 'cut your losses short and let your winners ride,' but many traders make a key mistake.

They hold on to their losing trades and decide they it will become an "investment". They will also quickly sell their winners, depriving themselves of potentially much larger gains.

Some will even make a bigger mistake; they will add to losing trades trying to buy the bottom in a downtrend and do so with more leverage.

This is the surest way to lose all your money, don't do it!

Many successful traders have a few key components of their trading strategy in common. For example in the book, Market Wizards, by Jack Schwager, most successful traders feel that any person can place a winning trade, but unless you can control risk, you have little chance at overall success.

Here is my favorite quote:

"You have to minimize your losses and try to preserve capital for those very few instances where you can make a lot in a very short period of time. What you can't afford to do is throw away your capital on suboptimal trades."-- Richard Dennis

I hope if nothing else I have made you aware of how important position sizing and money management are to your success. So once you have determined which of my recommended stock picking services is best for you, you now have the knowledge to know how much of each stock to buy for your account size.

Here are the two stock picking services I use and can recommend:

Jason Bond Picks

Microcap Millionaires

I have also put together a guide on the 7 Habit of Millionaire Traders, it will give you tips and advice I have learned from very successful traders. It will help you become a more profitable trader.

Robert Walsh