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So Why Do You Need Money Management? Bennett McDowell Tells You

TradersCoach.com founder and president Bennett McDowell, considered an expert in technical analysis and complex trading platforms, lectures frequently, is internationally recognized as a leader in trading education, and teaches trading techniques to students worldwide. McDowell has written two books on trading, The ART Of Trading *and* A Trader's Money Management System, *both published by John Wiley & Sons. McDowell resides in San Diego, CA with his wife and two children and can be reached at Bennett@TradersCoach.com.*

STOCKS & COMMODITIES Editor Jayanthi Gopalakrishnan (JG) and Staff Writer Bruce Faber (BF) interviewed Ben McDowell on June 4, 2008, via phone.

We have found that in order to consistently implement a money management system, you have to believe you need it.

Ben, tell us how you got involved with trading.

I got into trading when I was working on Wall Street in the early 1980s. I also went on to trading and managing money as a broker for Prudential Securities and Morgan Stanley in the 1990s, and along the way I've managed my own money as well. We started TradersCoach.com around 1998. The firm started out by providing consultation and coaching services for active traders and even investors. We did a lot of work with money management. We did a lot with trading psychology. We built up a good referral business. Then people started asking me how I traded the market. At that time I had developed a proprietary system, Applied Reality Trading (ART), which we brought to the market in 2003. ART was initially a home study course and then we introduced software, and since then it has taken off. It was a good product to offer in conjunction with our other services.

JG: Why was your focus so much on money management?

Money management is as important as entries and exits. A lot of people, especially those just getting into the business of trading, think that software is going to do it all for them. Software is important and can be used as a tool, but one of the most important skills a trader has to develop is money management. Traders also have to develop other skills such as identifying market cycles and selecting markets. But without money management it is difficult for a trader — even if they have a decent trading system — to be successful. Money management is something that everybody needs, whether they are investors, daytraders, position traders, or if they trade the forex market, whether they just trade stocks, commodities — it doesn't matter. The money management part of the equation is paramount to their success.

JG: Have you ever found yourself in a situation where you actually placed trades without stops?

That is a great question, and the answer is, "Of course." Most traders, at the beginning of their careers, unless they were lucky enough to be associated with other traders who could teach them about money management, probably incurred a few large losses. We have found that in order to consistently implement a money management system, you have to believe you need it. And usually that belief doesn't happen until you get hit in the face with a large loss. That is why so many new traders focus on entries and exits instead of money management, because they haven't experienced the downside. Once they experience that, they want to implement money management.

BF: What led you to money management?

Early on in my trading I took a loss because I didn't adhere to a stop. That loss grew and grew to a point where my anxiety level was so high that I could not take the pain of one more dollar going against me. So I got out. Of course, you usually get out at the wrong time. Then the market turns around. If I had

taken the loss earlier, I would have been a lot better off.

From that day on I promised myself that I would learn all I could about money management. To this day, I have adhered to that promise. It has saved me many times and kept my profitability and consistency on track. It is important to have a money management plan, and I cannot stress enough that it is as important as entries and exits.

JG: People tend to be stubborn. Do you think it is necessary for somebody to experience a loss like that to realize that you have to implement a good money management system in your trading system to be successful, or have you seen people do it right from the start?

You can definitely do it from the start. That is the whole purpose of the book that I wrote, *A Trader's Money Management System*. The idea is to teach people *before* they experience an actual large loss. You don't have to do it that way. Trading is a funny game. Some people believe you just have to get in there and lose a whole bunch of money to learn the business. I disagree. What you need to do is be prepared before you actually jump into the markets with real money. This could include paper trading, or experimenting in a safe environment with your trading approach like airline pilots do with flight simulators.

These traders get put into difficult situations so if they get into a real situation, they can respond as if it were second nature. That is what you want to do with your paper trading and when you prepare to trade with real money. This is where learning the proper rules of money management can also be developed. So you do not have to learn by losing money first. In fact, I would suggest that is *not* the way to do it. But some people just have to experience that pain before they believe anything.

JG: Before you enter a trade, long or short, what are some of the conditions you take into consideration?

With my trading it is very specific. I use my system, Applied Reality Trading (ART). When you get ready to enter a trade, you know exactly where your initial stop-loss is going to be. So if you know your entry, and you know where your exit is, then you can calculate your trade size — that is, your position size — to keep your risk in line.

As a rule, traders can take a look at their trading edge. They can look at their payoff ratio — how many dollars are earned for every dollar lost, their win ratio, what percentage of the trades are winning trades. What percentage of their capital are they risking on each trade? All of these can be taken into account to deliver the exact risk the trader should be taking on each trade. From that, if you know the trading account size, you know your exact entry, your potential exit, and your commissions that you are going to pay. You can then calculate what your position size should be, whether it is shares per stock or contracts for options or commodities. To sum that up, it is important that before you enter a trade, you always know where you are going to get out.

JG: So that is how to calculate risk. What is a good way to determine your trade size?

We have a specific formula. In fact, I think we published it in an article in S&C a few years ago. It gives the actual formulas. We also have a trade size calculator that automatically calculates the position size for you. It involves a couple of calculations, which are not that difficult, that we do on every trade. It is going to keep you out of trouble.

JG: You discussed different exit strategies, such as scaling out and so forth. Can you talk about those?

Sure. One of the things I'd like to talk about on exits and stops is how to set them. There are different ways to set stops. If you find a method that works for you, then stick to that method. However, one of the recommendations I make is that we set all of our stops based on the marketplace. That usually corresponds to support and resistance levels in the market. It is important when people set stops not to just arbitrarily say, when they enter a trade, "If the trade goes against me by a point, I am going to get out."

BF: That's a bit extreme.

That's because they tend to just make up a level at which they are going to get out. It is not really trading the realities of the marketplace. It would be better if they chose an actual support level to exit the market if prices got above or below a level based on the direction they are trading. That is what we suggest doing in ART, which picks out specific levels to make it easy to see where they are. We pick our stops and use those new support levels as trailing-stop areas. We also scale out of trends at certain times. These are usually when we get pivot points in the opposite direction of the trend after a move away from our entry point and away from the current stop-loss level. Again, this is the kind of information we go over in my book *The ART Of Trading*. We have a specific set of guidelines on how to scale out and scale into trends as well.

JG: I see two things here. I see somebody developing a trading system on one hand, and on the other they are trading on personality, if you will, like their ability to take risks overnight. The ideal way to manage your trade is to have a combination that works for you personally.

That's right. That's a great observation. As you know, some people trade mechanical systems and some don't. Some people mix the two. It is better to mix them than to trade a purely mechanical system because you can adapt to different market cycles in a more efficient manner. It becomes part of your trading rules on how you want to implement scaling out.

BF: What's an example?

One of your rules may be: If prices get 8% above my current stop-loss level and I get a reversal bar in the opposite direction of the trend, indicating a major, short-term top, then that may be where I want to scale out. Somebody else may be able to see a move, and when prices move up five, or six, or seven elongated price bars in a row without pulling back, that may signal in *their* trading rules to look for a reversal. So it can be subjective. This is where paper trading comes in. The idea is to

trade and experiment to see what works on a consistent basis for your style of trading.

JG: You could have a total of nine systems that may work for you. But not all of them will work in every market. So how do you pick?

Some traders may be trend traders, while others may prefer to countertrend trade based on their psychology. Some may prefer to scalp channels. The idea is, all those market cycles will require a different set of skills or rules in which to trigger stops, and how you want to get out of markets, and how you want to scale. That is part of why backtesting just one particular method may not be the best way to see how you are going to do. Mechanically, anyway. You need to be able to determine that based on this market cycle, you're going to be trading it with this set of rules. This is how you will be doing it. Then when the market cycle changed, you are going to be using these sets.

JG: Does your ART system work in all time frames?

Yes. The system is designed to give you eight reality-based signals that are based off price activity, support/resistance levels, or volume. Depending on how you use and mix and match the different signals, you can develop your own style or approach to trading using the different signals in different combinations. That's why some people can trade ART as a trend trading system, while others like to trade it as a scalping system, depending on how they mix and match the individual signals.

Getting back to money management — while the ART system gives the trader flexibility in being able to almost coauthor their trading approach using our signals, there is definitive structure in the system that never lets a trader *not* use money management. So it allows you to design your approach to the markets, yet it is structured in when you should get out of markets. That is a powerful combination because you are implementing a sound money management system. Yet at the same time it gives you the flexibility to make discretionary decisions based on your style.

JG: Obviously, every single trade isn't going to work. So what would you say is a good success ratio?

That's a great question. It varies whether the person is experienced. For example, the overall average anybody can expect to do with most trading systems is about 60%. That means that for every 10 trades they win six and lose four. But if in the four trades you lose, you are keeping your losses at 2% on each trade, your drawdown is 8%. If on the remaining six winners you are letting your profits run, you can do very well. Let your winners run and exit the losers before losses get above 2%.

For a more experienced trader, the situation may be different. Say that particular trader is a trend trader. He or she has spent time gaining experience on how to spot solid trending cycles. That person may have better ability in going from one winning trend trade to another and from one market to another more consistently. Therefore, their win ratio may be much higher than six wins out of 10. That's what experience and being a master trader is all about. It's knowing yourself, knowing your style of trading, knowing what market cycles your style works best in, knowing what market cycles it does not work in, and then being able to spot market cycles in time to make those kinds of judgments.

Finally, there is money management. The difference that separates master traders from the novices is that master traders are optimistic about their trade, but also realize that every trade they take has the potential of failing. So they protect their downside with stops and position sizing so that when they take a loss it is within the risk-of-ruin tables.

BF: When you're talking about this 2% on your money management, does that mean that if you have, say, $200,000 that you are trading, you should have 50 stocks that you started out with investments of $4,000 each, or does that mean that whatever amount of each stock you have, you should not risk more than $4,000?

If you have a $200,000 account, 2% of that is $4,000. So on any given trade you don't want to have a loss on that trade be more than $4,000. And you control that through your position size. But you also have to think about portfolio risk. How much risk should a $200,000 account incur total? Any one trade is $4,000, but you should not have any more than a 6% total portfolio risk at any given time. And that risk should be spread out over different sectors. If you have one trade at a $4,000 potential risk-of-ruin loss, then don't buy any more in that sector. Buy something else in another sector.

If you are in the commodities market, that would work out to maybe a $4,000 risk in wheat, $4,000 risk in the metals, or something along those lines. You don't want to exceed that 6%. As you get better, that percentage may go up. This is conservative, but the reason we do it this way is because of market risk. Market risk overrides trade risk. Trade risk is something that traders can control through position sizing. Market risk may cause the markets to gap past our controlled stop-loss area. Therefore, it would create a risk much larger than we had calculated. That is why people ask me, "Well, I have $1 million, and I am a really good trader, why shouldn't I trade the entire million?"

BF: Why shouldn't you?

Market risk. If you have a market risk event occur, even though you are a very good trader and you are careful about calculating your trade size, you may get a gap past your stop that you are using to calculate your trade risk on, something that throws your results way off. Back in the early 2000s, there was a very popular stock that everybody was trading. Some negative news came out on the stock that caused it to gap down, literally, 35 points. There is no trading system in the world that would have saved you had you had your stop set. By the time you got filled, you would have been 30 points lower than what you thought you would have been.

JG: What happened?

As it turned out, they found that the news that came out about the stock was untrue and fraudulently placed by somebody who used to work at a newswire who was shorting the stock. By the end of the day the stock had recovered, but

if you had had a stop in place, with a market fill at the stop, you would have been in trouble. You would have probably lost 50% to 80% of your account on that one trade. This is why you should never trade with all of your money. Anything is possible in the market, and you want to be very controlled with your risk capital.

BF: Do you have any bias when you are setting stops on the long side, or the short side?

I don't have a bias whether I go long or short. I do about where to place stops, and I rely on the pyramid trading points that our system forms to identify key support levels in the marketplace. The software does it for me, because it is basing its calculations off momentum as it moves up toward a resistance level, in an uptrend, for example, and then back down to support. It is measuring the momentum in the market and the volume to determine if the support/resistance levels are high-probability areas.

JG: We know when to get out of a trade when it is losing, and hopefully we will be able to implement it, but now suppose we have a winning trade. How do we know when to get out?

On a winning trade, in our system we have pyramid trading points. These are trend indicators within the ART system, and while in a trend, new pyramids will form. The bottoms of these pyramids represent support levels in the marketplace. We trail our stops using these bottoms until these stops get violated.

Once you enter the market, you are monitoring your trade. It is a passive method in that you are basically allowing the market to tell you what to do. The market has to do something to make you get out. So you wait until the market tells you what to do.

JG: So the market is the controller, not you.

That's right, and a lot of people have a hard time with this. That is why I call it a passive skill, but you still have to be alert. You can't be asleep at the wheel. But you are not trying to force the market to do something. You are just following it.

JG: If you realize the market is the controller, then you realize the importance of money management. If you lay it out in terms of numbers, you will eliminate the emotional aspect, which gets in the way.

Of course. When we talk about money management and trading systems, it is a question of where one starts and the other ends. Your emotions should be controlled by your trading system because your entries and exits should always be well defined by your trading system or approach. Your system should always be telling you where your entries and exits are. Your money management system should be answering these questions: If the trade I take loses, how much will I lose? And is that loss within the risk-of-ruin tables?

The tables let you know that if you adhere to the percentage that you might lose on each trade, based on your performance history, then it is difficult to go bust on any one trade. It will keep you out of trouble over time based on your performance. That is important.

BF: Why?

Because part of trading is survival. You could have three or four losses in a row and if you don't have a money management strategy in place, those losses could be so large that you have to stop trading or you may be so emotionally discouraged that you give up. If you have money management in place, though, it is limiting your exposure or risk on each trade, and you can handle three and four losses because you are within the risk-of-ruin guidelines and your drawdown is not severe.

JG: Doesn't a lot have to do with how you select your trades?

All that comes under the umbrella of experience. Remember, we were talking about the master trader who could go from one winning trade to another. Picking particular markets to trade and market cycles are also important parts of the trading pie. The trading pie is not just one slice. Money management should be a slice, entries and exits, trading systems, psychology, and even risk capital should all be slices. If you are using money you can afford to risk, then chances are that is going to allow you to be more calm and objective. And selecting markets, something I really put under a part of your trading system, also comes into play because that is an important part of the pie.

JG: But wouldn't you have to have different combinations of all these slices, for all the different situations that could arise?

Absolutely! I put things like selecting markets, entries and exits, and trading rules all under the system. I separate money management from that because that deals with risk capital, and how much you will lose if the trade is a loss based on current results. That involves recordkeeping too.

JG: In your book* A Trader's Money Management System, *you stress understanding personal strengths and weaknesses. How important is that?

Money management can be very complex once you get into the risk-of-ruin formulas. It can be as complex as calculus. The purpose of the book was to take that information, develop tables, and simplify it so that the trader can implement it in an understandable and simplistic way. Everything a trader is going to need to know about risk control is going to be in that book.

JG: It is quite fascinating, with lots of variables.

And it's regardless of the trading system you use. It is not limited to ART. The concepts will be helpful in implementing a sound money management program into any trading system for their particular style of trading or investing.

BF: When you are trading, and you say don't put all your money in the market, what* do *you put it in? Where do you park your money when you are not trading it?

The money I am not trading I define as investments. I will park those in a variety of different areas from real estate, to other areas of stock investments of long-term appreciation. When I invest, I look to see what I want to achieve based on historical norms at a certain point of time. So let's say I am investing

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for retirement, and I know it is 20 years away. I know that if I use the Ibbotson model of diversification, I can get an average return of about 8% a year through diversification and proper allocation. It is a more conservative investment approach. Trading is much more active and I expect to get paid a lot for doing that.

BF: What happens when your investment goes south? Southern Californian housing prices aren't what they were two years ago.

It is all about diversification. If you have all your eggs in one basket, then you are going to get hurt. If you have some money in real estate and some money in stocks, one will outperform the other, and as long as your time horizon isn't so short, it should not be an issue. That is similar to the way Warren Buffett does it. Buffett buys quality companies and doesn't worry about the timing. He knows over time that those companies should do well. Is he right all the time? Of course not, but you diversify. That is the difference between investing and trading. Trading really is a business. It takes a lot of energy. You should get paid for that energy just like you would at a job.

BF: Do you devote most of your time to trading or to teaching?

Ten years ago it was mostly to trading. Now I find myself rolling over, a lot, into teaching.

BF: Why is that?

I simply don't have time to do everything. I try to daytrade every week, but I am not doing it five days a week like I used to. But I do position trade. You can make great money position trading. Daytrading takes energy. You have to be in front of the monitor every minute and it's a great way to learn trading because you learn it so much quicker. It seems most people who position trade and drop down to daytrading time frames find that it is a totally different animal. The response rate comes at you so fast in terms of your profit and loss that some people can't emotionally handle that. In the first two or three hours of the day you could be up $4,000 or down $4,000.

Now, if being down $4,000 in three hours bothers you, then don't do it. For some reason, it is much easier for a position trader to stomach a $4,000 loss over three weeks than it is over three hours. That is what many people find so hard about daytrading; it is an emotional roller-coaster. This is where money management is so important, and also knowing how your system performs before going into the markets with real money.

BF: Give me an example.

If you have four losses, but they are operating within the way your system works and you are using risk control, then that should be business as usual. It should not bother you. But if you don't have the confidence in your system because you didn't properly prepare before making the trade, then it will bother you. It is all about preparation.

JG: If you were to focus on one aspect of money management, what would it be?

It is important to know where your initial stop-loss is *before* you enter the trade. If you don't know where you are going to get in and out before you take the trade, you cannot calculate your position size.

For example, some people like to trade off of stochastics crossover methodology. That will tell them when to get into a trend or a trade, but it won't tell them where to get out until it crosses back over. So how do you set your initial stop?

BF: How?

You guess. What we would rather have that person do is use a market reality to set that stop. You should find a support level that is as close to your stop as possible and use that as a stop-loss level area. Trading systems that give you your entry and exit at the time of entry are more valuable than trading systems that only give you the entry. If you have the second variable, which is the initial stop-loss at the time you take the trade, and that initial stop-loss is set based on market reality, then you are able to confidently select a trade size that makes sense to the market dynamics.

JG: You just brought up a good point about when people use just one indicator to determine their entry. They are forced to guess where to get out.

Yes! My experience from counseling traders is that a lot of them know when to get in and their system will tell them when to get out, but it won't tell them when to get out at the time they get in. So they can't determine their position size and control their risk.

JG: If you think about it, if you have a stochastic crossover, it is happening in an oversold area at around the 20 level. When it crosses over, you feel that the market is going to trend up.

Right, so you go long. But if that fails and it crosses back over, you will get out. So when is it going to cross back over?

JG: That's right. Because you think it is going to be trending the way you* want *it to trend.

Exactly, so you are left with the question of how much should you buy when it crosses over to go long, and it is hard to answer that unless you know at the time you take the trade where you are going to get out. That is what I call basing your trading decisions on market realities such as support and resistance levels.

JG: Thanks, Ben.

SUGGESTED READING

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