Brainy's Articles on

Share Trading

The 2 Percent Rule

Introduction

When investing or trading in the share market, there a number of risks involved. It is important to understand these risks, and to make a decision about how to minimise them. In many cases the impact of the risk (should it occur) can be reduced significantly. For an introduction to this topic, refer to the free Article **ST-4000, *"Risk and Money Management"***.

One of the risks that can affect how well we sleep at night is to do with the amount of our investment capital which we commit to any one investment position. If we were to invest most of our investment money in one specific position, then we could be at risk of losing a large chunk of our funds. This situation could help to interrupt a good night's sleep.

Conversely, if we were to risk just a small portion of our capital, then a loss would be insignificant, and would only put a small dent in our available funds. One way to manage this aspect is the use of the so-called "Two Percent Rule". And this could certainly help to put our mind at rest, and help us to "sleep at night"., knowing that we have put some risk management in place.

This Article in Brainy's series on Share Trading (number ST-4100) provides information on just one aspect of money management — the so-called 2 Percent Rule. This is actually known as the "Percent Risk" position sizing model. In the notes below we explain this approach and use two case study examples to demonstrate the idea and the details.

Readers should also refer to other Articles on risk and money management in Brainy's series of Articles on Share Trading:

- Article ST-4000, ***"Risk and money management"***
- Article ST-4300, ***"Risk and Reward"***
- Article ST-4400, ***"Position size and calculator"***
- Article ST-4505, ***"Stop Loss"***
- Article ST-5110, ***"Trade planning"***.

The amount "at risk"

The idea of the "amount of money at risk" is a very important one, and can be a little difficult to come to grips with. Basically it says that if we decide on a specific purchase price for a parcel of shares, and we decide on a Stop Loss value at which we will sell if the price is falling, then the difference between the buy price and the sell price is the amount of money "at risk".

In simplistic terms (with reference to Figure Error: Reference source not found below), consider the following:

- If we have $10,000 of available capital, and if we use "The 2% Rule", it means that we are prepared to risk 2% of the $10,000 — that's $200.
- Now if we intend to buy a parcel of shares at $13 per share, and if we will set our Stop Loss level at $10, then we are risking $3 per share.
- Now in this example, if we are comfortable with risking $200 of our $10,000 of capital, and this stock purchase will be risking $3 per share, it equates to a parcel size of about 67 shares (that's $200 at risk divided by $3 per share at risk).

Why use the amount of 2%?

It is possible that an investment can result in a catastrophic loss of funds — such as the investment vehicle going broke, and ending in administration. When investing in publicly listed companies in the share market, we can limit some risks by avoiding companies like the following:- thinly traded companies, those with tightly held capital, those with a record of poor management, or those with high debt. These types of companies can suddenly move into a trading halt, and eventually result in a possible large loss of one's investment funds. For potential situations like this we should limit the amount of our investment capital that is committed to any one position.

By prudently selecting our investment targets, we can assume that the vast majority of our investment positions do not result in a catastrophic loss of funds. So if we invest an amount of money with the

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