Introduction

Consider the following over-simplified scenario. Let's say we have $5,000 to invest in just one investment, and there are currently two investment options available. The first option has the potential to make a profit of $500, and the second one has the potential to make just $50. Assuming the risk is the same, and the planned investment time frame is the same, which investment option should we choose? Isn't this really a no-brainer? The first option is clearly preferred. The potential return is 10% of our total capital, whereas the second one is only 1% of our capital. But we have not said anything about the potential risks.

In real life it is not this simple, or easy. There is often a risk element that could threaten some or all of our investment. So let's factor this into the simple scenario above. Let's say that our investment will either start increasing in value immediately, on the road to the $500 profit amount, or it will start falling immediately, on the road to a loss.

Now let's assume that we have an investment rule that says we will not "risk" more than 2% of our $5,000 capital on any one trade or position — this is the infamous "*2% Rule*", explained below. This rule is saying that we don't want to lose any more than $100 (ie. 2% of the available $5,000).

In these terms, in the simplistic example above, the amount of money "at risk" is $100, and the amount of "reward" is stated as either $500 or $50 for the two options. From these figures we can calculate the potential ***Reward-Risk ratio***, which is often (perhaps incorrectly) referred to as the ***Risk-Reward ratio***. And this could help us decide whether the risk is worth taking.

In this article in Brainy's series on Share Trading (number ST-4300), we explore this notion of Risk versus Reward, and we look at the different and confusing ways in which it is often calculated, and referred to. It should be read in conjunction with other material related to Money Management and Risk Management, including Article **ST-4400, "*Position Sizing*"** (and others listed on the last page).

Definitions — Risk & Reward

Firstly let's explore this thing called *Risk* with a share market example.

Consider the Weekly price chart in Figure 1 below of AAG (Aragon Resources) which fell from above 20 cents in October 2009 to below 14 cents in February-March 2010. For a 6-week period the price was then stuck below *resistance* at 14c. Nobody was prepared to buy it at more than 14c. Whenever the buyers bid the price up to 14c, more sellers stepped in so that a sale price above 14c was not possible. Also notice the lowest price in this period was 12 cents.

Figure 1: Price breakout - AAG. Where is the risk and target?

If we had have spotted this price break-out with high volume in late March, then we could assume that the lowest price that it might retreat to is likely to be the last

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