

**Trading in practise**  
Risk management,  
initial stop loss,  
optimum position size

**Hands-on Workshop**  
ATAA Melbourne, October 2018

Robert Brain



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**When investing/trading shares:-**

**How to:**

- Minimise our risk?  
(so we can sleep at night)
- Set the **Stop Loss** price level?  
or an *Exit Strategy* of some sort
- Estimate our **Price Target**?
- “Optimise” the **Position Size**?



**So, how can we do all this?**

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**Session purpose**

(a) To consider a real-life trading example using historical price data.

(b) We will consider:

- Initial stop loss
- Position size calculation
- Reward / Risk Ratio
- We might look at trailing stop loss.

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## Session purpose...

- (c) To **share ideas and experiences**.
- (d) To **compare opinions**, and understand how **other people do it**.
- (e) To give you some **food for thought**.

**So, please feel free to contribute to the discussion with your own experiences and opinions!**



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## My challenge

- Some audience members:
  - will be experienced traders
  - will be novices
- There will be a variety of opinions about “best practise” — these are opinions.
- There will be several correct answers.

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## Introduction

### About... Robert Brain

**Nimble Short term Investor**  
consultant, educator and part-time\* share trader  
web-based sharemarket-support business

- Many years experience as trainer, presenter, conference facilitator (*Scouts*)
- Share Market – active 15+ years\* (slowly at first)
- Chartist ie. technical analyst (ATAA member and national director)
- Provide support and tuition to traders and investors **Braint's Share Market Toolbox**
- Member Mensa (former)
- Engineering Degree (structured thinking with an eye for charts and diagrams)
- 30+ years – professional experience (IT and management)
- **No AFS license!** (Can't give advice)
- **BullCharts software** (convenor Australian BullCharts User Group and authorised reseller with special pricing (since 2006))



\* - Not yet enough capital to live off the proceeds of trading (after trading as a hobby until a career change in 2008).

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**Conflict of interest?**

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 **Introduction**

### Important Notice — No Advice!

- This presentation does not include any advice.
- For proper advice, your personal financial situation needs to be considered.
- This presentation is pure education, only for your general awareness. 
- There are no recommendations to take any action, or to invest any money in any way.
- Always consult a properly licensed advisor before making investment decisions.

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 **Introduction**

### Important Notice



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**Teams**

1. Ideally, form into *competitive* teams:-
  - of 3 or 4 people
  - in the seats where you are
  - (turn round and say hello to your team members).
2. Preferably also have:
  - **Trading Work Sheet** (or a piece of paper),
  - Pen (or pencil),
  - A calculator might be handy.

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The paper work...

“Trading Work Sheet”

Same as last time (in 2016).  
Download a copy from here:

[www.robertbrain.com/files/trading-worksheet-sample.pdf](http://www.robertbrain.com/files/trading-worksheet-sample.pdf)

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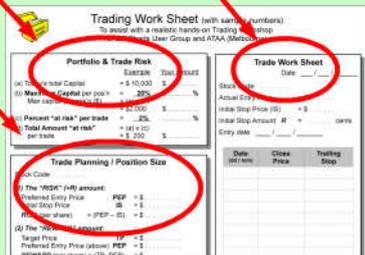
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Our Trading Work Sheet

This one has several elements:

- 1. Portfolio & Trade Risk
- 2. Trade Planning & Position Size
- 3. Trade Work Sheet



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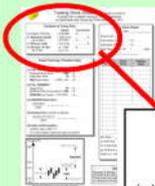
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Portfolio & Trade Risk Mgt



Portfolio & Trade Risk		
	Example	Your amount
(a) Today's total Capital	= \$ 10,000	\$.....
(b) Maximum Capital per pos'n	= <u>20%</u>	.....%
Max capital per pos'n (\$):	= (a) x (b)	
	= \$2,000	\$.....
(c) Percent "at risk" per trade	= <u>2%</u>	.....%
(d) Total Amount "at risk" per trade	= (a) x (c)	
	= \$ 200	\$.....

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## [R]isk per trade — 2% ?

NOTE:

- In this example we are using what is widely referred to as the “2 Percent Rule”; and
- We are using the amount of 2 percent; but
- A more conservative approach would be to use a value less than 2%, and perhaps as low as just 1%.

Also see: [https://www.incrediblecharts.com/trading/2\\_percent\\_rule.php](https://www.incrediblecharts.com/trading/2_percent_rule.php)  
 Also see: Colin Nicholson's web site discussion:  
<http://www.bwts.com.au/index.cfm/resources/ask-colin/817-could-you-explain-the-6-rule-as-opposed-to-the-2-rule-and-suggest/>

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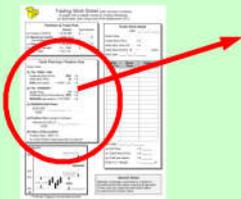
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## Position Size

Detail on next slide



**Trade Planning / Position Size**

Stock Code: .....

(1) The "RISK" (=R) amount:

Preferred Entry Price PEP = \$ .....

Initial Stop Price IS = \$ .....

RISK (per share) = (PEP - IS) = \$ .....

(2) The "REWARD" amount:

Target Price TP = \$ .....

Preferred Entry Price (above) PEP = \$ .....

REWARD (per share) = (TP - PEP) = \$ .....

(3) The REWARD:RISK Ratio:

$\frac{REWARD}{RISK} = \dots = \dots$

(4) Position Size (number of shares):

$\frac{Amount\ at\ risk\ (d)}{RISK\ (1)} = \dots = \dots$

(5) Position Value (\$ value amount for this position):

Position Size x PEP = \$ .....

Q: Is this Position Value less than (b) above?

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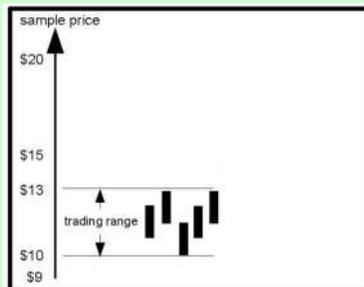
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## Diagram EXAMPLE

- Recent trading range \$10-\$13
- Anticipate a break out and rising trend.



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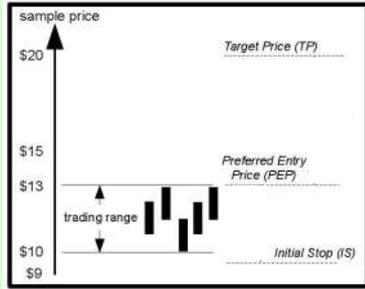
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## Diagram explanation

1) Identify three key price points:

- Target price = \$20
- Likely purchase (or entry) price = \$13
- Initial stop = \$9.50



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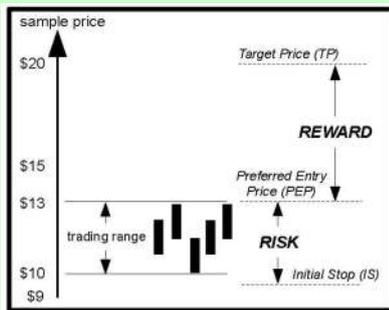
## Diagram explanation

2) Determine:

- Reward amount
- [R]isk amount

3) Calculate:

- Reward/Risk Ratio
- Ideally greater than 2



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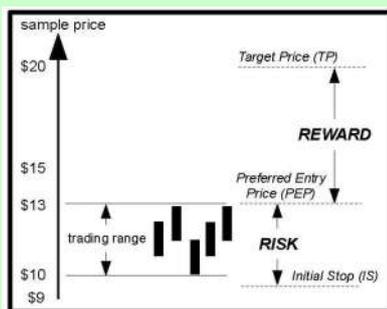
## Diagram explanation

Reward/Risk Ratio

$$= \frac{\$7.00}{\$3.50} = 2$$

The greater the reward, the better the ratio.

Great if 3, 4 or 5+



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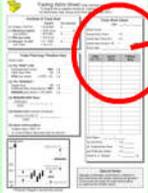
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## Trade Work Sheet

Daily / weekly reviews, can enter the details onto the Work Sheet, and a revised Trailing Stop value.



**Trade Work Sheet**  
Date: \_\_\_ / \_\_\_ / \_\_\_

Stock Code: .....

Actual Entry Price = \$ .....

Initial Stop Price (IS) = \$ .....

Initial Stop Amount: **R** = ..... cents

Entry date: \_\_\_ / \_\_\_ / \_\_\_

Date (dd / mm)	Close Price	Trailing Stop

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## Case Study

### Case Study Exercise #4

Are we ready?

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## Case Study — Assumptions

Our Case Study **Trading Plan** says:

- Invest / trade in **Australian equities**
- We only have **\$10,000 total capital**
- We won't use any leverage
- **Trend following** strategy
- Find an **up-trending** stock
- Join the trend.

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## The planning steps

### Up-trending stock — confirmed

We have decided to take the trade.

So let's consider:

- (a) Position Size — how much?
- (b) Initial Stop Loss — where?
- (c) what about a Target Price?

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## The planning steps

In the next slides we will:

1. Estimate **Preferred Entry (purchase) Price**
2. Set **Initial Stop Loss** value
3. Calculate dollar amount to **RISK** per share
4. Estimate a **Target Price**
5. Calculate the possible **REWARD** per share
6. Calculate the **REWARD / RISK** ratio.

**BUT, there are some questions:- . . .**

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## but some QUESTIONS!!

1. How much money (ie. **total amount**) do we need for our investing/trading activity? \*  
At least:-

- (a) \$ 500
- (b) \$ 1,000
- (c) \$ 5,000
- (d) \$ 10,000
- (e) \$ 50,000
- (f) \$ 100,000

?



\* - Shares, no leverage.

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## Our capital

In our Case Study  
we will use a value of  
**\$10,000**  
investment capital

Portfolio & Trade Risk		Example	Your amount
(a) Today's total Capital	= \$ 10,000	\$.....	\$.....
(b) Maximum Capital per pos'n	= 20%	.....%	.....%
Max capital per pos'n (\$):	= (a) x (b)	\$.....	\$.....
	= \$2,000		
(c) Percent "at risk" per trade	= 2%	.....%	.....%
(d) Total Amount "at risk"	= (a) x (c)	\$.....	\$.....
per trade	= \$ 200		

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## QUESTION #2

1. How much money (ie. total amount) do we need for our investing/trading activity?
2. What's our minimum position size?

- (a) \$ 500
- (b) \$ 1,000
- (c) \$ 2,000
- (d) \$ 5,000
- (e) \$ 10,000 or
- (f) it doesn't matter!

?



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## Position Size

In our case study,  
using this Trading Plan,  
we want  
Position Size  
**greater than \$1,500**

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### QUESTION #3

1. How much money (ie. **total amount**) do we need for our investing/trading activity?
2. What's our **minimum position size**?
3. How much of our **total investment capital** are we happy to have in each position?
  - (a) up to 5% of total capital
  - (b) up to 10% of total capital
  - (c) up to 20% of total capital
  - (d) up to 30% of total capital
  - (e) more than 30%.



See risk discussion points next slide...!

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### Discussion on risk

How much of our total investment capital are we happy to have in each position?

**What are the three biggest risks to capital loss?**

- (a) ?
- (b) ?
- (c) ?



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### Discussion on risk

The (three) biggest risks:

- (a) The **market collapses** and most of our positions plunge in value in short term

BUT: Will the falling values continue? If so, for how long?  
What if they fall significantly?  
What if this fall is very short term, and everything will be up tomorrow?

**We should have a plan to deal with this; but no discussion now.**

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## Discussion on risk

The (three) biggest risks:

- (a) The **market collapses** and most of our positions plunge in value in short term  
(we should have a plan to deal with this — no disc'n now)
- (b) Any one stock goes into **trading halt** and does not recover — entire position gone  
(nothing we can do about this? so limit the potential damage)

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## Discussion on risk

The (three) biggest risks:

- (a) The **market collapses** and most of our positions plunge in value in short term  
(we should have a plan to deal with this — no disc'n now)
- (b) Any one stock goes into **trading halt** and does not recover — entire position gone  
(nothing we can do about this? so limit the potential damage)

How can we limit the potential damage of (b)?  
Limit the % amount of capital in one position?

- (c) (The third risk... later...)

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## How much capital per pos'n?

**Limit the amount of capital in any one position to 20% max (but 10% might be preferable)**

3. How much of our **total investment capital** are we happy to have in each position?

- (a) up to 5% of total
- (b) up to 10% of total
- (c) **up to 20%** of total
- (d) up to 30% of total
- (e) more than 30%.

Portfolio & Trade Risk		
	Example	Your amount
(a) Today's total Capital	= \$ 10,000	\$.....
(b) Maximum Capital per pos'n	= <u>20%</u>	.....%
Max capital per pos'n (\$)	= (a) x (b)	\$.....
	= \$2,000	\$.....
(c) Percent "at risk" per trade	= <u>2%</u>	.....%
(d) Total Amount "at risk" per trade	= (a) x (c)	\$.....
	= \$ 200	\$.....

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## How much capital per pos'n?

Re: How much of our total investment capital in any one position?

- (a) If it is up to 20%, then we can only have five positions, and it is relatively high risk
- (b) If it is up to 10%, then we can have up to 10 positions, and is lower risk, but might miss the "Ten Bagger"

**Option (b) gives more flexibility.**

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## Discussion on risk (cont.)

The three biggest risks:

- (a) The market collapses and most of our positions plunge in value in short term (we should have a plan to deal with this)
- (b) Any one stock goes into trading halt and does not recover — entire position gone (nothing we can do about this? so limit the potential damage)
- (c) The share price of one position falls (eg. into a "confirmed downtrend")  
What do we do? — Implement Exit Strategy!

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## Risk management

1. In our case study strategy, if the share price falls, we will exit the position to protect capital! (our exit strategy defines this, and it could have several exit conditions)
2. So, how much are we prepared to lose? (our documented strategy ought to have a rule)
  - (a) A dollar amount? or
  - (b) A percentage amount?

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## BTW — Exit Strategy

By The Way — a note on Exit Strategies

In this study we will rely on:

- ATR based indicator (Wilson ATR Trailing Stop)
- Two consecutive daily closes below the Stop.

**Note down your own Exit conditions for this case study workshop; eg:**

- trend failure – price below uptrend line
- 30 week MA flattening and price below MA

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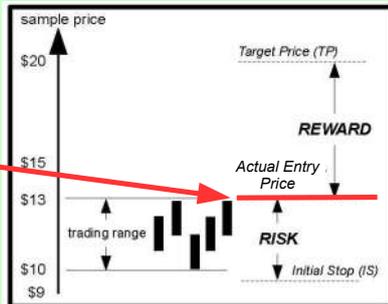
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## It falls... we sell...

If the share price falls and we close the position, how much money have we actually lost?

In this example the Actual Entry Price was \$13.00



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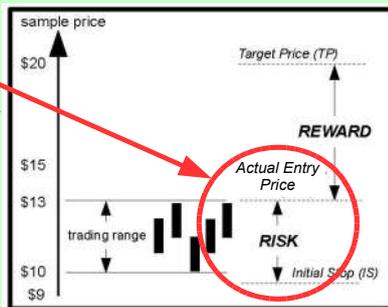
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## It falls... we sell...

If the share price falls and we close the position, how much money have we actually lost?

- The amount "at RISK"
- Assuming that we can sell at our Stop Loss value (ie. no slippage).



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## The amount "at risk"

- Many experts suggest to set the amount "at risk" at something like 2% of total capital
- This has led to the "2 Percent Rule" \*
- More conservative approach — use 1.5% or 1%
- Larger portfolios can use a smaller value (eg. 1%).



\* - The "2 Percent Rule" is very widely used. More details: Van K. Tharp, "Trade your way to Financial Freedom"

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## R = The amount "at risk"

It is common to refer to the "amount of money at risk per share" as the "R" value

And, for example, an amount of three times this is referred to as: 3R

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## Summary of our Risk

Portfolio & Trade Risk		
	Example	Your amount
(a) Today's total Capital	= \$ 10,000	\$.....
(b) Maximum Capital per pos'n	= 20%	.....%
Max capital per pos'n (\$):	= (a) x (b)	
	= \$2,000	\$.....
(c) Percent "at risk" per trade	= 2%	.....%
(d) Total Amount "at risk" per trade	= (a) x (c)	
	= \$ 200	\$.....

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**Back to the case study**

Now determine three things:

- Preferred Entry Price (PEP)
- Initial Stop Loss (IS)
- RISK per share (R)

(see larger chart on next slide)



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**We need to determine:**

- Preferred Entry Price (PEP)
- Initial Stop Loss (IS)

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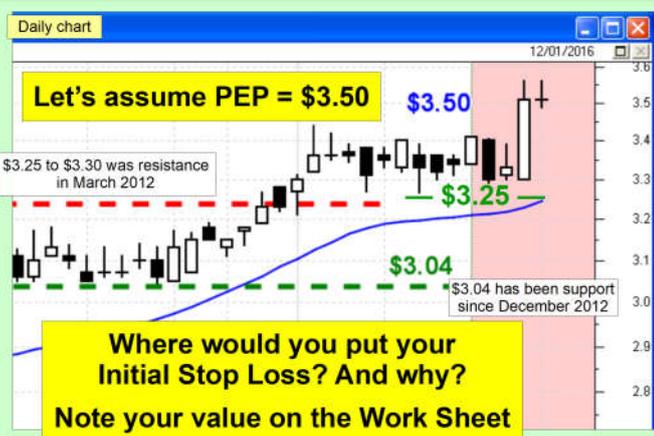
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(fill out the Work Sheet)

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## Target Price?

What is  
your estimate for  
the **Target Price**?  
(see chart on next slide)

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## More paper work...

Estimate your REWARD (item (2) on sheet):

- Target Price (TP) = ?
- Preferred Entry Price (PEP) = ?

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More paper work...

Estimate your REWARD (item (2) on sheet):

- Target Price (TP) = ?
- Preferred Entry Price (PEP) = ?

**REWARD per share**  
= [Target Price] — [Preferred Entry Price]

**Note down your REWARD amount...**  
(\$ .c per share or cents per share)  
Item (2) on the Work Sheet

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More paper work...

Estimate your REWARD (item (2) on sheet):

- Target Price (TP) = ? (eg. \$4.50 = 450c)
- Preferred Entry Price (PEP) = ? (eg. \$3.50 = 350c)

**REWARD per share**  
= [Target Price] — [Preferred Entry Price]  
(eg. \$4.50 - \$3.50 = \$1.00 per share, or 450-350=100c)

**Note down your REWARD amount...**  
(\$ .c per share or cents per share)  
Item (2) on the Work Sheet

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Reward to Risk Ratio

Calculate your:

Reward  
Risk

Item (3) on the Work Sheet

eg. 100c / 50c = 2  
or \$1.00 / \$0.50 = 2  
=> not bad

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## Position\* Size

Position\* size (the number of shares to buy):

$$\frac{\text{Total amount at risk}^{**}}{[\text{R}]isk \text{ per share}}$$

(eg.  $\$200 / \$0.50 = 20,000c / 50c = 400$  )

\*\* Total amount at risk in this study  
= 2% of \$10,000 = \$200

\* - In this Case Study, we are about to buy one *parcel* of shares; and we will not add to it, so this will be the total of our *position*.

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## Current value of this parcel\*

The Position\* Size x PEP = \$ \_\_\_\_\_

(eg.  $400 \times \$3.50 = \$1,400$  )

QUESTION:

Is this value less than Work Sheet item (b)?  
our Maximum Capital per position?

\* - In this Case Study, we are about to buy one *parcel* of shares; and we will not add to it, so this will be the total of our *position*.

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## Alternative Stop Loss

<b>Initial Stop (IS) =</b>	<b>\$3.00</b>	<b>\$3.25</b>
<b>(a) Entry Price</b>	<b>\$3.50</b>	<b>\$3.50</b>
<b>(b) Amount at risk per share [R] = (a) - (IS)</b>	<b>50 cents</b>	<b>25 cents</b>
<b>(c) Total \$ amount to risk (from Work Sheet)</b>	<b>\$200</b>	<b>\$200</b>
<b>(d) Position Size = (c) / (b)</b>	<b>400</b>	<b>800</b>
<b>(e) Position Value = (d) x (a)</b>	<b>\$1,400</b>	<b>\$2,800</b>

**Conclusion: A different Initial Stop can give different Position Size, for the same R value — “Total \$ amount to risk”. (Imagine the resulting difference in profit)**

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## Trade Work Sheet

On right hand side of the Work Sheet:

- If we place the trade, record the Actual Entry Price
- Complete other details at the top right of the sheet 29 Jan 2013, \$3.55, etc...
- Now let's go forward 6 months....

**Trade Work Sheet**

Date: \_\_\_/\_\_\_/\_\_\_

Stock Code: .....

Actual Entry Price = \$.....

Initial Stop Price (IS) = \$.....

Initial Stop Amount: *R* = ..... cents

Entry date: \_\_\_/\_\_\_/\_\_\_

Date (dd / mm)	Close Price	Trailing Stop

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## We purchased...

**Okay — we bought a parcel  
of 400 shares  
29 Jan 2013  
at \$3.55**

**Now view the charts ....**

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## Follow My Trade

- Any discussion / questions?



Now let's go forward  
another 12 months...

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## Follow My Trade

- Any discussion / questions?



Now let's go forward  
another 12 months...

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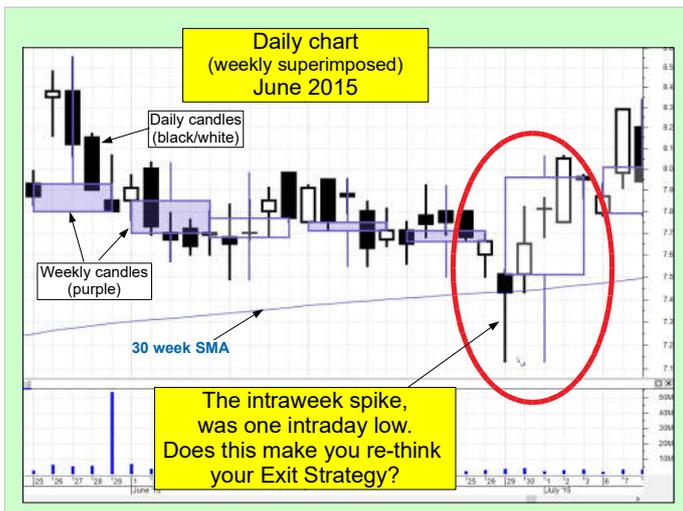
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**That's all for now**

That's all the price action we have for now.

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**Conclusion & Wrap UP**

- Where did you end up?
- Was your Stop hit?
- Was your Exit Strategy triggered?
- Conclusions?
- Comments?



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**More Information**

For more information  
about this subject,  
and related topics,  
see:

[www.robertbrain.com/presentations/](http://www.robertbrain.com/presentations/)

And another version of these slides will soon be available,  
incorporating the Speaker Notes for each slide; but only for  
subscribing members to *Brainy's Share Market Toolbox*.

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