"Don't Be a Gunslinger"

Kevin J. Davey
www.kjtradingsystems.com

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I love shoot 'em up Western movies. I'm sure you know the type of movie I'm talking about: bad guy strolls into town, enters the saloon through the creaky swinging half doors, sees the sheriff sitting at a barstool. Ominous music plays in the background. Bad guy demands that the sheriff step outside. The sheriff obliges, and the two opponents line up twenty yards apart, arms at their side, hands twitching by their gun holsters. They quickly draw their weapons. Both shoot, and one falls to the ground, usually the bad guy.

For most people, this is forex trading.

They see an "opportunity," and jump in the market, shooting wildly. More often than not, they end up dead, out of trading capital.

The typical gunslinging forex trader (let's call him Mr. Gun Slinger, although he could just as easily be female) usually makes one of four fatal mistakes. If he stays away from each of these, there is a chance he will start playing the role of the sheriff, living to fight another day.

Insufficient Capital

The first characteristic of a gunslinger is trading without sufficient capital. In one of the best trading books ever written, "Market Wizards," by Jack Schwager, the consensus is that anyone who risks more than 5% of his or her account on any one trade is a gunslinger. So, for a small $5,000 account, this means a $250 loss is the maximum loss per trade. With standard size forex lots, this is a small 25 pip swing. Many times, this type of swing happens within an hour!

Of course, our Mr. Gun Slinger does not care about how much he could lose, he only sees how much he will win with his $5,000 account. Then, he decides based on market volatility that $1,000 losses are sufficient. And, he thinks, what are the chances of wiping out the account, if 55% of the time he wins $1,000, and 45% of the time he losses $1,000 (which is a pretty good system)?

Using Monte Carlo simulation, we can see if Mr. Slinger can survive this much risk. Assuming 25 trades, our "hero" has roughly a 15% chance of zeroing out his account, with a $1,000 average loss. Note though, that this has two big assumptions in it. First, Mr. Slinger must trade perfectly, never missing a signal, nor entering a trade incorrectly. Second, the maximum loss never exceeds

$1,000, even in extreme market conditions. So, even with a very good system, Mr. Slinger can still lose!

It is interesting to see how this risk of ruin changes with starting capital. In our simple example, doubling the account to $10,000 reduces the chance of ruin to about 3%, and with $20,000 starting capital, the risk of ruin is near zero. Coincidentally, a $20,000 account with $1,000 losses is the maximum 5% risk point discussed in "Market Wizards."

What does this mean for our trading? Simple: do not undercapitalize yourself at the beginning. If you have only $5,000 to start, unless your stop loss point is $250 or less, you should probably stick to mini-lots. To trade the regular size lots, an account in the $20,000 range should be sufficient, assuming you have a trading system that has an edge. But, we'll discuss that later.

Adding to Losers

Gunslingers add to losers, which is another leading cause of trader death. A AUD/USD long trade initiated at 0.9350 looks even better at 0.9300, even though the open loss is $500. Double up on the position, and price recovery to 0.9325 will get our gunslinger to breakeven. Since Mr. Slinger had good reason to enter at 0.9350, it is an even better entry point at 0.9300, correct? No way! The problem is that the downward trending price is more likely to drop to 0.9200, and now the open loss is suddenly much larger. Being a true gunslinger, Mr. Slinger adds another unit, and his risk jumps up again. Soon, a reasonable loss runs into the thousands of dollars, and before he knows it, our gunslinger is out of trading capital "bullets."

How quickly can this happen? Just look at Figure 1. Here, our gunslinger went long at 0.9350, which showed a slight profit for a while. Then, when the price fell to 0.9300, he added another position, and kept adding every .0050 down (at 0.9250 and 0.9200). When the price bottoms at 0.9187, Mr. Slinger's losses total $3,520, compared to a $1,630 loss if he had held on to just one lot. And since there is no telling how low the price will go, our friend has put himself in a very precarious position. Keep in mind that this takes place within 20 hours of initiating the trade, hardly enough time for our trader to rationally reflect on what havoc he is causing to his account.

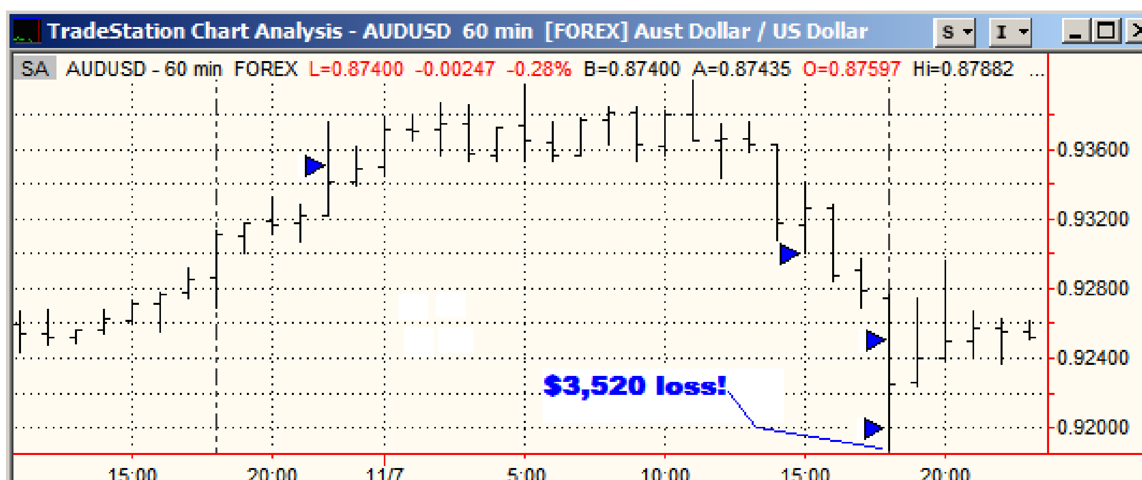

Figure 1

The “averaging down” mentality, popularized by mutual fund professionals, may be a good way to invest long term, but it will eventually mean death for someone who tries it in forex. In my 19 years of trading, I have seen myself do it, and others do it, numerous times. In every case, it means only one thing, chasing a bad trade in the hopes of making it good. Unfortunately, this tactic sometimes works, which just reinforces the bad behavior for the next time. In the long run, however, this method will eventually lead to ruin. Unless you have unlimited trading capital, and can continue to add to the position as it goes against you (if you have unlimited capital, why are you even trading?), eventual ruin is guaranteed.

So, what should our trader do? Simple – trade with a firm stop loss point, and never, ever add to a losing position. Mr. Slinger should just close the bad trade, walk away, and live to fight another day.

Adding To Winners

Let’s say Mr. Slinger opens a long position in EUR/USD. As the price advances in his favor, he builds up a nice profit. Itching to make more profit on a good trade, he adds to his position. The question is, at what point or points should he add to a winning position?

This is a tricky question, since it is nice to think the additional risk by adding lots is using the “market’s money,” not your own. Thus, the incorrect thinking goes, there is no additional risk to you. Unscrupulous system providers or brokers will show heavy pyramiding throughout a trend, and of course, exiting profitably before the crash. In my early trading days, I recall seeing such a chart with sugar, and how a $5,000 investment could have made $1,000,000 in a short period of time. Mentally living through such a trade sequence would probably

prove extremely difficult, but it was theoretically possible to making that much money.

Pyramiding is a great concept, but tough to pull off in actual trading. Figure 2 shows an example. Mr. Slinger, being a risk taker, decides to add to his position at every .002, after entering at 1.462. So, by the time the price reaches 1.474, he has accumulated 7 lots, and a nice profit of $4,200, compared to the $1,200 he would have had with just 1 lot. Things are looking good until a few hours later, when the price collapses back to his original entry point. Now, the $4,200 profit has turned into a $4,200 loss. If Mr. Slinger had stayed with one lot, he'd be back to breakeven. As with the earlier example, this wild swing happens in the span of a day, which leads little time for trader reflection and analysis.

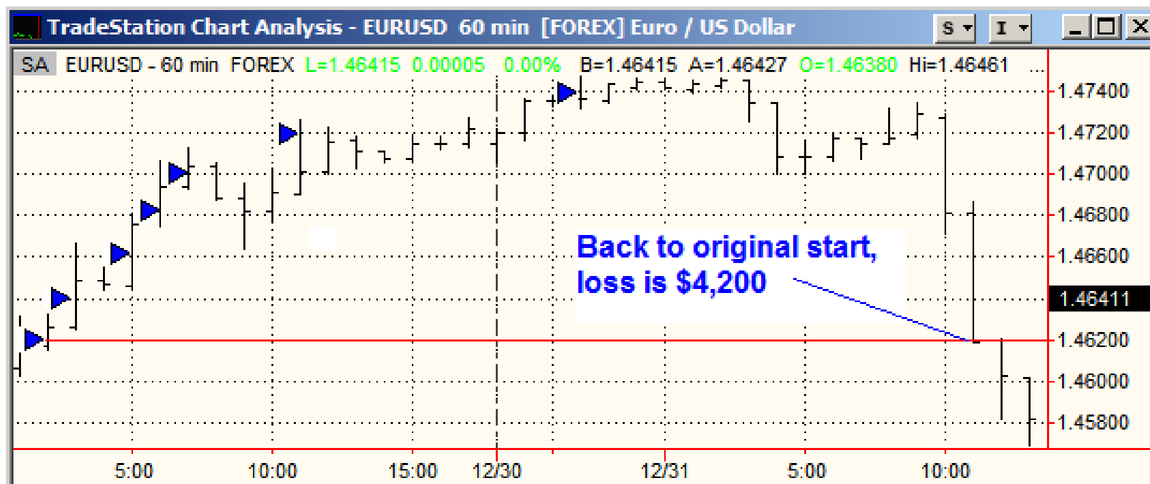

Figure 2

So, what is the lesson here? Simply put, don't treat open profits as "play money" or "the market's money." This unrealized profit is just as real as the cash in your account. Unless your account is big and can withstand large losses possible with pyramiding, it is probably better not to pyramid, ever. Until your account gets large, your goal should be to stay in the game and avoid catastrophic losses.

<u>No Edge</u>

If Mr. Slinger walked into a saloon and called out the sheriff, you would assume that he knew how to shoot a gun. But what if he didn't know how to use a gun, or worse yet, what if he did not even have a gun – would you give him any chance of surviving? Probably not. But that's how most forex traders enter a trade – ill equipped, inexperienced and generally over their heads.

To trade effectively, you need an edge. How do you know you have an edge, and better yet, how do you get one in the first place? Knowing you have a historically proven edge turns out to be much easier than finding that edge.

A trading edge is most easily calculated by determining the expectancy. To do this, you need three numbers:

> Average winning trade amount (WinAmt)
> Average losing trade amount, negative number (LossAmt)
> Average winning percentage (WinPct)

Then, to calculate expectancy:

> Expectancy = [(WinPct * WinAmt) + ((100-WinPct) * LossAmt))]/(-LossAmt)

Of course, to calculate all of these numbers, you need a statistically significant historical track record. This should be a minimum of 30 trades.

The higher the expectancy, the better. Any system with a negative expectancy will lose in the long run.

Now that you know how to calculate whether or not you have an edge, now comes the tougher part - finding the edge in the first place. Unfortunately, there is no easy or quick way to do this. To do it correctly, you need backtesting software, and plenty of market data. Numerous iterations, numerous entry and exit theories and numerous blind alleys are all part of the game while trying to find an edge. For example, it took me about six months of research and development to finalize my contest-winning futures system. And I consider myself lucky that it only took that long! Typically, my goal every year is to research and implement one profitable new trading system per year. And that goal is very difficult to achieve.

Suffice it to say, all the nuances of finding an edge are beyond the scope of this article. Thankfully, there are many resources on the Internet and in trading literature to help in this regard. My advice is to take plenty of time researching both your own potential systems, and those for sale to the general public.

Conclusion

If this article makes it seem like there are more ways to lose in forex trading than ways to win, you have learned an important lesson. For any trader, but especially the beginner and intermediate traders, the goal should be just to stay in the game, not to necessarily maximize profits. That is because maximizing

profits typically means taking chances, and unnecessary chances at that. Here is a quick recap of how not to trade like a gunslinger:

1. Trade with sufficient initial capital, or don't trade at all. Run Monte Carlo simulations to calculate your risk of ruin.
2. Never, ever add to losing trades.
3. Be very leery of adding to winning trades (pyramiding). If the trade is truly that good, the maximum contracts you trade should be put on at the beginning of the trade (subject to rule number one).
4. Trade with an edge. If you don't know your edge, or how to calculate it, chances are you don't have one. Take the time to research the market, and learn about your edge. It will pay dividends when losses cause you to question your system.

In short, your goal in beginning trading should be just to stay in the game, and not get taken out.

Gunslingers may survive a few gunfights, but remember, gunslingers usually end up six feet underground. In forex trading, don't be a gunslinger.

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Kevin Davey is a professional trader and a top performing systems developer. Kevin is the author of "Building Algorithmic Trading Systems: A Trader's Journey From Data Mining to Monte Carlo Simulation to Live Trading" (Wiley Trading, 2014.) . He generated triple digit annual returns 148 percent, 107 percent, and 112 percent in three consecutive worldwide futures trading contests using algorithmic trading systems.

His web site, http://www.kjtradingsystems.com/, provides trading mentoring, trading signals, and free trading videos and articles. He writes extensively in industry publications such as Futures Magazine and Active Trader and was featured as a "Market Master" in the book The Universal Principles of Successful Trading by Brent Penfold (Wiley, 2010).

Active in social media, Kevin has over 15,000 Twitter followers (@kjtrading). An aerospace engineer and MBA by background, he has been an independent trader for over 20 years. Kevin continues to trade full time and develop algorithmic trading strategies.

Important Info - My Strategy Factory Workshop

Don't spend years and years gambling and being a gunslinger, instead of trading. Learn the CORRECT way to create a trading strategy, and how to create a diversified portfolio of strategies, at my Strategy Factory webinar**. Click here for all the details.**