

>: Managing Risk

Friday, November 17, 2006 / Teeka Tiwari

I've had a lot of new readers of the Tycoon Report contact me wanting to know how much they should be putting into a trade. This is a great question and I wrote an article several months ago about this exact topic and I wanted to share it with you newcomers to the Tycoon Report.

There are sometimes in life when you do everything you're supposed to do but things still don't work out.

Frustrating isn't it?

Because of its very nature this can happen quite often in the stock market.

Personalizing these moments is probably the absolute worse thing a trader can do. There is nothing personal about the stock market. It doesn't care where you went to school, who you know or what religion you follow. And it's the only area in life where you are graded on your success or failure virtually every minute of every day.

That's a lot of pressure for the uninitiated - and newer investors have an especially hard time adjusting to some of the uglier realities of investing in the stock market.

This is where good risk management comes into play. If you're betting the ranch on every trade then you've got a right to be anxious and nervous! The first lesson of stock speculation is good capital management. That means knowing exactly how much you are willing to allocate to stock speculation.

The second part is figuring out how much you want to risk on each individual trade. Remember that most pros are wrong more of the time than right. What separates the pros from the amateurs is good money management. Pros don't bet it all on one idea and hope it works out. They spread their investments around, let their winners run and have a very clearly defined set of limits of how much of their capital they are willing to lose on one given trade.

Most professional money managers won't risk more than 2% to 5% of their total capital on a single trade and 5% is really pushing it. In my experience the majority top out at around 3.5%.

So what does this mean to you?

Let's say you have a \$100,000 portfolio, does it mean that you invest no more than \$5,000 into any one idea? (Assuming that you are using the 5% max loss rate.)

Yes and no. Let me explain: If you're buying stocks then what you would simply do is figure out what your stop loss is on the stock trade. (A stop loss on a stock is a point where if the stock hits it, it's telling you that you got it wrong and you should bail. Stop loss is also referred to as "stop order" or "stop-market order.")

This is where stock charts can come in very handy. The charts clearly show support levels for most stocks and you can simply place your stop loss point below the support level. Once you know how low you are prepared to let the stock go you can then figure out how much to invest.

Here's an example using our hypothetical \$100,000 portfolio. The shares of ABC Company are trading at \$20 and the chart shows support at \$18 ½ and you decide that \$18 is a good stop loss point. If you're using a max loss of 5% on a \$100,000 portfolio that's \$5,000 per trade that you are willing to risk. To figure out how many shares you can buy you would simply divide the amount you're willing to risk (\$5,000) by the amount of points between your purchase price (\$20) and your stop loss point (\$18). The difference is 2 points, 5,000 divided by 2 equals 2,500.

This shows us that we can buy 2,500 shares at \$20 with an \$18 stop loss for a theoretical maximum risk of \$5,000.

Why do I say theoretical? Because stocks can gap down and trade through stop loss points. The stop loss is not a guarantee, in a fast market a stock may gap down significantly before your order ever gets processed.

So what's a trader to do?

This is where options come into play. Most new traders make the mistake of buying options the same way they buy stocks. That is if they normally buy \$10,000 worth of stocks at a time they then go ahead and buy \$10,000 worth of options at a time.

DO NOT DO THAT. YOU WILL GO BROKE!!

The way to buy options is to use the same methodology as before except instead of tying up \$50,000 (2,500 shares at \$20) you simply take the risk capital portion of that investment (the \$5,000 that you were prepared to actually risk) and use only that amount to buy the options. The amount you commit to the option essentially becomes your stop loss.?

In whippy markets, stop loss points can be very easily triggered and the stock can turn right around again and break out to the upside!

The option gives you huge staying power that direct equity ownership cannot. You have the peace of mind knowing that your maximum loss can be no greater than the \$5,000. No matter what the stock does on the downside you are protected. On the upside you have huge leverage because of the very nature of options.

Remember, Options give you options.



Teeka Tiwari
Chief Investment Officer

>

