Limiting Losses

It is simply not possible for any trader - whether amateur, professional or anywhere in between - to avoid every single loss. The disciplined trader is fully cognizant of the inevitability of losing hard-earned profits and, as such, is able to accept losses without emotional upheaval. At the same time, however, there are systematic methods by which you can ensure that losses are kept to a minimum.

The System

Every trader should employ a loss-limit system whereby he or she limits losses to a fixed percentage of assets, or a fixed percentage loss from capital employed in a single trade. Think of such a system as a circuit breaker, or collar, on the trade. After a certain percentage has been lost from his or her trading account or principal traded, the trader may very well stop trading entirely or may immediately exit the losing position. With this system, exiting a losing position is a single, unemotional decision that is not affected by any hopes that “the market is sure to turn around any minute now.”

A 2% Limit of Loss

A common level of acceptable loss for one's trading account is 2% of equity in the trading account. The capital in your trading account is your risk capital, the capital that you employ (that you risk) on a day-to-day basis to try to garner profits for your enterprise.

The loss-limit system can even be implemented before entering a trade. When you are deciding how much of a particular trading instrument to purchase, you would simultaneously calculate how much in losses you could sustain on that trade without breaching your 2% rule. When establishing your position, you would also place a stop order within a maximum of 2% loss of the total equity in your account. Of course, your stop can be anywhere from a 0% to 2% total loss. A lower level of risk is perfectly acceptable if the individual trade or philosophy demands it.

Every trader has a different reaction to the 2% rule of thumb. Many traders think that a 2% risk limit is too small and that it stifles their ability to engage in riskier trading decisions with a larger portion of their trading accounts. On the other hand, most professionals think that 2% is a ridiculously high level of risk and prefer losses to be limited to around 0.5-0.25% of their portfolios. Granted, the pros would naturally be more risk averse than those with smaller accounts - a 2% loss on a large portfolio is a devastating blow. Regardless of the size of your capital, it is wise to be conservative rather than aggressive when first devising your trading strategy.

Monthly Loss Limit of 6%

So, you have now established a system whereby your loss from each individual trade is limited to 2% of your risk capital. But it doesn't take a rocket scientist to realize that even losing a moderate 1% of your account's value in ten days within a month results in a rather devastating 10% of your account's value within that month (not withstanding any profits that you might have made in the other 12 odd trading days within the month). In addition to limiting losses from individual trades, we must establish a circuit breaker that prevents extensive overall losses during a period of time.

A useful rule of thumb for overall monthly losses is a maximum of 6% of your portfolio. As soon as your account equity dips to 6% below that which it registered on the last day of the previous month, stop trading! Yes, you heard me correctly. When you have hit your 6% loss limit, cease trading entirely for the rest of the month. In fact, when your 6% circuit breaker is tripped, go even further and close all of your outstanding positions, and spend the rest of the month on the sidelines. Take the last days of the month to regroup, analyze the problems, observe the markets and prepare for re-entry when you are confident that you can prevent a similar occurrence in the following month.

How do you go about instituting the 6% loss-limiting system? You have to calculate your equity each and every day. This includes all of the cash in your trading account, cash equivalents and the current market value of all open positions in your account. Compare this daily total with your equity total on the last trading day of the previous month and, if you are approaching the 6% threshold, prepare to cease trading.

Employing a 6% monthly loss limit allows the trader to hold three open positions with potential for 2% losses each, or six open positions with a potential for 1% losses each and so forth.

Making Necessary Adjustments

Of course, the fluid nature of both the 2% single trade limit and the 6% monthly loss limit means that you must re-calibrate your trading positions every month. If, for example, you enter a new month having realized significant profits the previous month, you will adjust your stops and the sizes of your orders so that no more than 2% of the newly calculated total equity is exposed to a risk of losses. At the same time, when your account rises in value by the end of the month, the 6% rule of thumb will allow you to trade with larger positions the following month. Unfortunately, the reverse is also true: if you lose money in a month, the smaller capital base the following month will ensure that your trading positions are smaller.

Both the 2% and the 6% rule allow you to pyramid, or add to your winning positions when you are on a roll. If your position runs into positive territory, you can move your stop above breakeven and then buy more of the same stock - as long as the risk on the new aggregate position is no more than 2% of your account equity, and your total account risk is less than 6%. Adding a system of pyramiding into the equation allows you to extend profitable positions with absolutely no commensurate increase in your risk thresholds.

Conclusion

The 2% and the 6% rules of thumb are highly recommended for all traders, especially those who are prone to the emotional pain of experienced losses. If you are more risk averse, by all means, adjust the percentage loss limiters to lower numbers than 2% and 6%. It is not recommended, however, that you increase your thresholds - the pros rarely stray above such potential for losses, so do think twice before you increase your risk thresholds.

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