

Risk Management

How to manage risk in Forex



«It's not whether you're right or wrong that's important, but how much money you make when you're right and how much money you lose when you're wrong.»

George Soros,
investor, business magnate,
and philanthropist

Table of contents

| | |
|---|-----------|
| Traits of the successful trader | 4 |
| Investment diversification | 4 |
| Interpreting indicators | 5 |
| Do not stay in front of your computer! | 6 |
| Cut losses, let profits run | 7 |
| Step by step strategy example | 8 |
| Trade size | 8 |
| Risk-reward ratio | 9 |
| Lock in profit gradually | 10 |
| Next steps – Start trading with Swissquote | 11 |

Traits of the successful trader

Successful traders seem to have behaviours in common regardless of which strategies they use to trade. In the following, we will look at four ways to increase the likelihood of joining their ranks.

Investment diversification

Even children’s stories teach us the value of risk management and diversification. Among others, the story of the woman who put all her eggs in one basket when carrying them to market speaks to this: the woman’s problem is not that she has many eggs in her basket, it is that she has them all there. Similarly, you might decide to make large trades, or put large amounts of money into one strategy. This is not in itself problematic – but the amount should be decided relative to your other investments.

The example later in this text will touch upon how to calculate trade sizes to stay within margin limits; in addition to this, ensure that you vary your trades so that one market movement or loss will not affect your account too adversely.

Depending on your style of trading, you may prefer to diversify using one or many parameters, for example currency pair, geography or strategy type.

There are several philosophies about diversifying. One is to hedge all trades so that if you lose on one, you win on another trade. To do this well, it is essential to let wins run and close losing trades, so that you come out better than even, and trading expenses do not eat all the profits. A second is to diversify along multiple parameters to ensure that any losing trade in one category is outweighed eventually by a solid win in another.

TIP Look for ways to diversify your trading according to your market preferences and trading style.

Interpreting indicators

Technical trading, that is, finding trading opportunities by using calculated indicators on price charts, is an art. Although most traders use price charts to enter trades, some believe that technical indicators are bogus. In opposition are the many traders who actively use technical indicators and simply emphasize that common sense should always be applied.



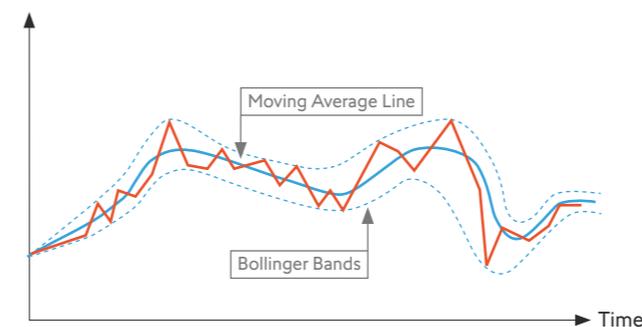
Experienced technical traders always use several indicators to discover and confirm trading opportunities. Many recommend selecting and experimenting with indicators of each kind – leading, lagging, volatility, trending etc. before settling on your favorite indicators for your temperament, trading style and preferred strategy, market or currency pair.

Price charts show past trades, and do not predict the future. Therefore, it is best practice to confirm even a clear trading signal by other means before opening a position.

Once you get a feel for your chosen indicators, it is much easier to apply the required common sense and discipline to your trading. Not all trade signals are viable, and experience and knowledge will help you discern.



TIP When researching your opening trades, always define your exit points, regardless of which technical indicators you are working with. Many indicators include rules of thumb for closing trades again.

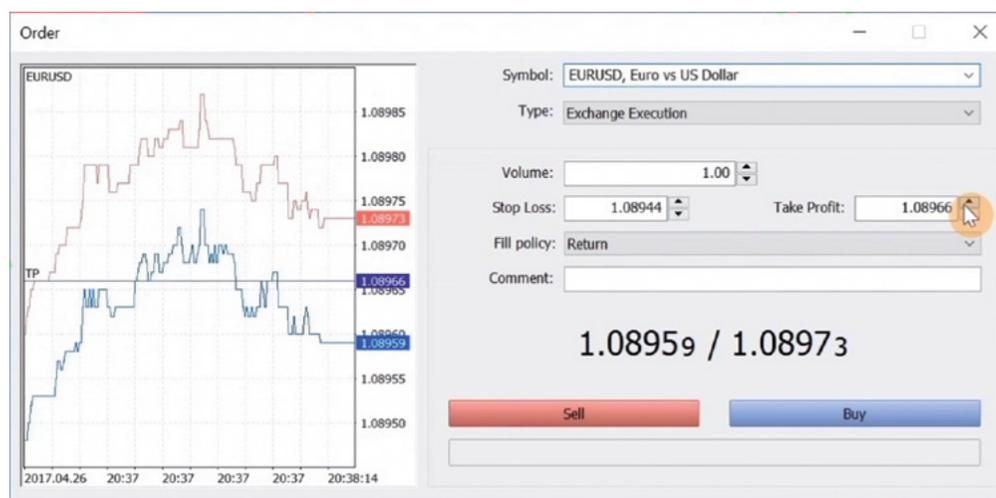


Do not stay in front of your computer!

Have you ever been carried away watching a game of sports, or enthusiastically watched one unimportant video after another on the internet? These are good examples of how whatever we are doing may achieve higher priority than necessary: you could read the sports results in the newspaper, and the videos were, after all, unimportant. This principle applies to trading too – if you are staring at developments on your trading platform, the action will ensnare you!

Researchers have shown that over time, less impulsive traders have more success than traders who are driven by emotion when trading.

Granted, watching price developments for a financial instrument that you have an open trade in can be exciting, especially if it is developing quickly, unpredictably and with a large amount of money in play. However, in the moment, you may be tempted to overrule your well-considered price-points for closing trades – sometimes with expensive consequences!



The best way to avoid this is to move on to the next trade, or an activity unconnected to trading, so you are not tempted to interfere on impulse.

TIP Finish your trade before you open it, that is, define your exit prices when you open your position.

Cut losses, let profits run

One single trade can lead to financial independence if you do it right. However, this is very unlikely, and is mentioned only to point out that the number of trades is irrelevant to your finances: the essential parameter is the relation between profits and losses. If you profit or lose the same amount on each winning or losing trade, obviously, you need to open more winning positions than losing ones to make money; but there is an alternative: if you ensure that the potential profit of each trade is greater than the potential loss, you need fewer winning trades to outweigh the losing ones.



For example, say your analysis has led you to four potential trades. For each trade, you define the price level where you will close the position. Set the potential profits (take-profit order) at 9 pips from the opening price, and the potential loss (stop loss order) at 3 pips from the opening price. Now, if only one of the four trades develops in the direction your analysis points, you will still come out even. If two of them do, you profit the value of 12 pips (only 6 pips of loss, but 18 pips of profit).

The risk: reward ratio varies depending on the currencies and market sentiment. Where the price movement is assumed to be limited, such as trading within a range, a risk to reward ratio of 1:2 is common. However, where greater movement is expected, e.g. following a trend, a risk to reward ratio of 1:3 is reasonable.

In short, by ensuring that the potential profits of each trade are greater than the potential losses, you reduce the ratio of how often you need to be right.

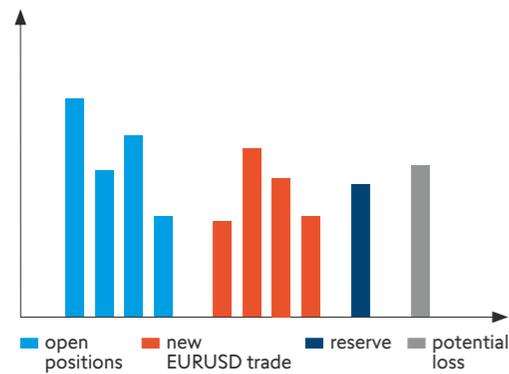
TIP Keep a simple tally of winning and losing trades, and note whether you are setting yourself up for success by letting the profits run.

Step by step strategy example

Trade size

This section will define a trade size, price levels for closing the trade, and how to lock in profits by closing the position gradually. In the following, imagine you wish to open a position and have a trading account of USD 10'000. Imagine further that you already hold positions that speak for USD 4'000 of your account value. In other words, you have the remaining USD 6'000 to leverage 1 to 100, providing USD 600'000 worth of trading. Note, though, that this is based on the maximum loss of USD 6'000, so – holding a little in reserve – imagine a risk appetite of no more than USD 5'000.

The first decision to make is trade size; one lot is 100'000 of any given base currency, so with the USD 5'000 leveraged at 100:1, you can buy EURUSD 400'000 with USD 441'800. In other words, you can buy 4 lots of EURUSD at 1.0045 dollars per euro, which puts USD 4'418 of the money in your account into play.



1 pip = 0.0001
A pip is the smallest possible price change on most trading platforms. For most currency pairs, this is the fourth number after the decimal point.

Next, check whether this trade size is within your risk appetite, or if it needs adjustment: since the value of one pip when buying one lot is USD 10 per pip, for the four lots of this example, the value of a one-pip price change is USD 40 per pip. If the price moves 10 pips, the profit (or loss) is USD 400, which is within the remaining risk appetite of USD 582 (the total risk appetite minus the sum tied up in opening the trade, i.e. USD 5'000 - 4,418 = 582). In other words, in this example, with the given risk appetite, the trader cannot afford much more than a 10 pip movement against the position.

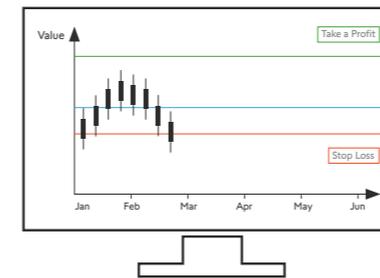
Note that this example uses a large leverage that amplifies the value of any price movement 100 times. Adjust your leverage depending on the confidence of your analysis and the trading equity available in your account. If you have a large trading equity, you can make the same profit (or losses) with less leverage.

TIP Always check the pip value when deciding trade size to ensure that the risk is within your risk appetite.

Risk-reward ratio

As previously mentioned, by ensuring that your potential profits are greater than your potential losses, you reduce the ratio of how often you need to be right about a trade. This is related to the risk/reward ratio, which indicates the relation between profits and losses:

$$\text{Risk/reward ratio or the profit/loss ratio} = \frac{\text{average profit per trade}}{\text{average loss per trade}}$$



There are several ways to measure risk. The simplest way is by trade size, trade value or pip value. Another is to note the volatility of the asset, that is, how far the price might move and how likely this is (magnitude and frequency of price changes). Once you know the risk, you can mitigate it by adjusting the trade size, the leverage, or the price levels of the exit orders for the position; alternatively, you can adjust the risk/reward ratio:

| | |
|---|---|
| The price movement is within a limited range | The price movement shows greater variation in magnitude |
| set the take-profit order twice as far from the entry level as the stop-loss order. | set the take-profit order three times as far from the entry level as the stop-loss order. |
| risk: reward 1:2 | risk: reward 1:3 |

Returning to the example, let us say the price is trending, i.e. a fair amount of price movement is expected. In this case, setting the exit orders with a risk/reward ratio of 1 to 3 is reasonable. Assume this is a long trade, so the stop-loss order will be below the entry price, and the take profit order will be above it.

In the section about trade size, we found that the assumed risk appetite of the example does not allow for price movement of much more than 10 pips against the position. Therefore, set the stop loss order at 10 pips below the entry price. With a risk to reward ratio of 1 to 3, the take profit order should be placed 30 pips above.

TIP Spend time analysing your preferred currencies and notice the general size of price movements in various situations. Use this information to decide the likely ratio for your markets and strategy.

Lock in profit gradually

Experienced traders often close winning positions gradually, sometimes to reduce risk gradually due to large trade sizes, others simply to lock in the profit as it comes available.

In our example of a long trade of four lots, where the risk appetite and market pointed at taking profit 30 pips above the entry price, closing the position gradually might be done in three steps:

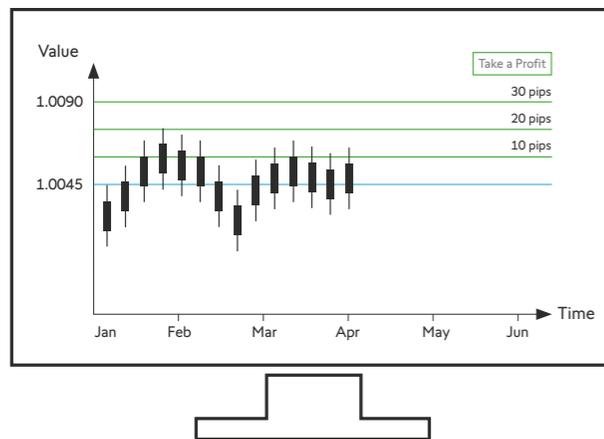
Take profit for 1 lot at 10 pips, letting the majority of the profit run = USD 100

Take profit for 2 lots at 20 pips, locking in the majority of the profit = USD 200

Take profit for 1 lot at 30 pips, taking the final profit of this trade = USD 300

Although the total is less than if the whole position were closed at once at the perfect moment, that moment cannot be known beforehand. Taking profits gradually ensures that you continually increase your equity and thus your ability to trade.

Discipline in taking profits is psychologically difficult for many traders. Paying attention to your impulses and habits can literally be valuable, as can exploring trading psychology in general.



TIP Explore the use of trailing stop-loss orders to reduce your risk further in less volatile markets: they move with the price in the direction of your take-profit order.

Next steps – Start trading with Swissquote

1

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