Let Profits Run -



Allowing profits to run is advice found often in trading literature, but unfortunately the methods suggested are usually inadequate. Sometimes the authors suggest securing profits with trailing stops, sometimes the author uses technical analyses, and in some cases actual fixed amounts are suggested for profit realisation (a method that under no circumstances should be used). What's missing from all those techniques is a reference to the trading account and a fundamental money management model.

The Rudiments of Profit Realisation

When working with traders on a daily basis one is always confronted

with the fact that about 70% to 90% spend most of their analysis time trying to pin-point entry and determine market direction (fundamental analysis, technical analysis, trading systems or other methods). In most cases priorities are misplaced and consistent success is difficult to achieve. That's because security analysis has no direct connection to profit or loss, even though that is a widely held belief. Opening a trade does not make profits; only exiting the position can do that. On the contrary, in most cases positions are at a loss right after opening because commissions must be paid, even if only a small one. Thus, it is much more important to analyse an open position than it is to analyse a security before putting on a trade. There is also no direct



connection between trade analysis and the trader's account, because analysing a trade does not change the account, but opening a trade does.

Let's repeat that point again; most traders view the search for the right entry point and the right trade direction as essential, but it does not have any effect on the amount of profit or loss. Sure, analysing the entry may eventually raise or lower a trade's hit rate. But, in most cases little regard is placed on the connection of the trade to the account, even though it is essentially more important to success or failure, as we shall soon see.

So, as far as the rudiments are concerned, managing an open trade and defining an exit point are indispensable. For that purpose, there are a few measures that must be considered. It must be ensured that the trader control parameters he can control. If the principles of control are neglected in favour of the principles of hope, then profits are purely a matter of luck.

That's why a trader must become acquainted with three major subjects, namely risk, money, and profit management. She must learn about and be able to apply the details and particularities of each subject. Since all measures are interrelated, it is inadequate to engage in risk management, for instance, by setting stops, whilst ignoring the other two subjects.

The Account as a Control Parameter

One of the most important parameters in the control of profit taking is the trading account itself; not, as is widely assumed, the price of the security. Additionally, a trade's holding time is determined by the fluctuation of an account's in- and outflows. Here an example.

Assume a \$50,000 starting account value. The first trade achieves a profit of \$1,000, bringing the account to \$51,000. The following trade therefore has a total account risk buffer of \$1,000. If the \$1,000 is lost, the account falls back to its starting value of \$50,000. In this case the trader has a made a profit but also a loss of the same amount, and in the end has earned nothing and the account has not suffered a loss in total. This is admittedly not entirely correct, as over time losses will incur through commissions and opportunity costs (benefits that could have been received by taking an alternative action). To accommodate for this, the trader must secure a small part of the profitable trade and allow the second trade to incur a loss up to that level but to not go beyond it. If a limit had been set, for example, by only allowing half of the profit of the first trade to be risked for the new trade, then profits would have been retained because the second trade would only have been allowed to lose \$500.

This is an example of securing profits based on the account and not on the price of the stock or the point on a chart. Also, if stops are set at support or resistance lines on the chart, as is widely practiced, they have no direct correlation to the account. The stop ends up being too wide for any profits to be secured or too tight for any position to breath. This shows that when it comes to lasting attainment of profits, solid money management basics must absolutely be studied and mastered.

Risk Management

The subject of risk management cannot be covered here in its entirety, but a few essentials should be discussed, as they are absolutely



necessary for profit realisation. Basically, risk management answers the question "how much can a trader be allowed to lose?"

Again, of course – as is so often the case – charts are used to find the answer. Figure 1 clearly shows why this doesn't work well. Assume a 1,000-share position is opened at \$37.79 following a previous trade that achieved, as in our example, \$1,000 profit. The natural support level at about \$35 is not a sensible stop level because the potential loss of \$2,700 would be unacceptable. Even the crossover point of the two moving averages (20/50) is not a suitable stop because the

resulting \$1,000 loss would nullify the previous trade's profit. By the way, this example also shows why technical analysis provides a weak basis for stop placement, as the signals lack any direct connection to the trading account. It is really just luck if a signal based on the chart actually allows a profit or loss that makes sense for the account.

Therefore, we can use risk management to determine stops, but stop levels must be in direct connection to the account. Charts provide no meaningful reference and cannot be used. Additionally, risk management also serves to determine individual risk levels. For example, it's important to determine risk categories for individual trades. Is it a relatively harmless trade in a stock with little movement, or a highly speculative trade in a hectically traded stock moved by news events? Also mixed trades in stocks and futures have differing risk levels requiring account-based stops.

Money Management

Money management is also more complex than can be demonstrated here, but is an essential part of profit realisation. Basically it answers the question of position size, which is dependent on a number of aspects.

Firstly, position size must be dependent on total account size, meaning positions using 50% or more of available capital should not be opened. If, for example, a trading exchange closes and telephone contact is not possible, then positions of that size would present a disproportionate risk to the account. Anyone believing that situations like these do not occur anymore in these times of area-wide access to DSL should remember September 11, 2001. Also in August 2003 all of New York and major portions of the American east coast experienced a sudden power outage two minutes before the stock exchanges' official close. Because no one knew if it was a terror attack or not, the entire market dropped nearly 12% in 30 minutes - closing positions was not possible. That kind of a major loss cannot be tolerated. That's why position sizes of between 15% and 30% of available capital have established themselves as sensible values depending on risk level taken.

Additionally, position size is directly dependent on risk level, which must be determined beforehand. Position size should be small if a trade has a high level of risk, whereas small risk levels allow for an increase in position size.

Profit-Hedging

Naturally, there are a variety of ways of dealing with profits. No doubt one of the most important is profit hedging. This method involves categorising profits and calculating them against each other.

But first, a few comments before delving into this subject. It may sound trivial, but profits can only be realised if open positions are, in fact, held. In other words, you must participate in the market. Furthermore, profits can only be realised if several positions are utilised. Profit taking becomes a game of chance if only one position is traded. Since the trader has no influence on market direction (unless the position is so big that it alone moves the market), he can only take control when the position actually moves into profit. If the trade develops negatively, it is stopped out, so a profit hedge is not possible with one position.

Now back to an explanation of profit hedging with the help of figure 2. Three groups are used to categorise profits (G1-G3). Group 1



represents the large profits and losses (in this example there is only one large profit). Group 2 is the medium sized profits and losses and Group 3 the smallest ones.

In order to utilise profits as efficiently as possible, Group 1 with \$1,000 in profits initially takes on a special priority. At first the stop for this trade is moved to 0 i.e., the trader is prepared to give up the entire profit of this position. You may ask if that is clever and the explanation is guite simple, the open profit creates a buffer. The risk for all open positions can be intercepted using this profit meaning the risk it is not taken by the account but is instead transferred elegantly to the market, whilst open positions (= chances) remain in the portfolio. To achieve that you must try to attain as much profit as possible on the first trade, which starts small and is increased slowly according to the Anti-Martingale method (size is increased when position is profitable) until a useable profit has accumulated. Then proceed as described opening a new position, transferring the risk of the new trade to the profit of the first. The trick is transferring the risk, and in turn gaining the opportunity to open new risk-free trades. If the second position moves into the profit zone (as in the example of the second trade in figure 2, assigned to Group 2 and showing a profit of \$200), then the first trade's stop can be moved up, since the new profit takes over a part of the old profit. Now a number of new trades can be opened with the large open profit acting as a solid buffer. If one of the new positions moves into loss, it is closed immediately or reversed depending on the strategy. Accordingly, one must guard against new positions causing substantial losses.

The hedging process begins with the smallest position results. In figure 2, positions 7 and 8 are cleared against each other and the results of positions 4 and 6 are added against position 5.

That leaves the big open profits of position 1 and 2 untouched and keeps the account balanced. Of course the question is, what happens in case of loss, and in this case it only applies to the first trade, as all further trades are cleared against each other. Depending on the strategy, the risk management stop for the first trade is set and the trade opened. If the trade fails to move into profit, it is stopped out and a new trade is opened (depending on strategy and volatility, the old trade could also simply be reversed). This procedure is continued