Risk Management Audio Transcript

Hello my name is Clive Lambert and I would like to welcome you to this video lesson on Risk Management which is part of the advanced online three month Institutional Trader Programme developed by Knightsbridge Trading Academy in association with London Stock Exchange Group Academy. This lesson is divided into four modules.

Module 1 explores the concept of risk management and why it is such an important part of your trading strategy, then we go on to look at how important it is to understand yourself and your own risk tolerances. In the third module, we explore how to manage your "live" position and finally we look at portfolio management and hedging, as well as bringing your learning togther.

Now let's turn to Module 1.

Trading is about making informed decisions to place trades that can improve your P&L.

If you don't manage risk you can lose all of your money very quickly, so this has to be a major consideration with respect to the phrase "informed decisions".

An inherent aspect of trading is risk taking, and, as with life, larger risks can often also lead to larger rewards. For example, Trading USDJPY versus EURGBP. Dollar Yen generally has a range of well over 100 pips per day whereas historically Euro Sterling only has a range of around 50 pips. So arguably there is more risk involved in trading Dollar/Yen.

A trader needs to be fully aware of all the risks surrounding any individual trade and/or a trading strategy, and often this is a trader's downfall. One example that lives long in my memory, was a trader who (15 years ago!) knew everything about Nokia shares and when announcements were due and such like. I asked him why the fascination?! He was a Futures trader after all! He explained that the main instrument that he traded was the Eurostoxx 50 and Nokia was a very large component of this particular index. I remember one day seeing the Eurostoxx drop 20 points in an instant, whilst other related markets didn't budge. It was Nokia releasing their results!

One of the first things to consider is your account size and the leverage you plan to use or have on offer, and the effect that losses may have on that basis.

The percentages are against you!

If you start off with an account for 50,000 pounds and lose 20% you need to MAKE 25% of your account to get back to where you started.

These numbers only work further against you the more you lose. If you lose 50% of your capital, you have £25,000 left, so you now need to make £25,000 to get back to your original account size; so you have to make 100%. It gets tougher!

And look what happens if you lose 75% of your money… Ouch!

What this tells us straight away is that when trading, one of the best pieces of advice you can heed (from every pro trader I have ever met!) is "keep losses to a minimum".

Losses are a part of the business of trading. If you cannot handle the idea of taking losses, you may need to consider a different career!

The best traders in the world (if you read books like "Market Wizards" by Jack Schwager) are well practised and comfortable with the concept that trading is about minimising losses and maximising profits on a trade by trade basis.

What this means in essence is, to be a successful trader, you need to manage two key human emotions; Fear and Greed.

Trading and the markets (and arguably life!) are about Fear and Greed

FEAR of losing money will lead a trader to hold onto a bad trade, fearing that crystallising/realising/taking the loss is admitting you were wrong and that it was a bad trade and that you are a failure!

GREED sees traders taking profit too early on winning trades, seeing a profit and wanting to grab it, not looking to maximise the opportunity.

Mitigating/Managing these emotions is KEY to a successful career as a trader.

Reward/Risk is a key element of any trader's system and thought process on this basis.

And that concludes the first module. In the next module we'll look deeper into reward/risk and understanding risk.

Module 2

Now let's begin Module 2 – Understanding risk and reward/risk.

Another important consideration when working out your approach to risk management is knowing what sort of trader YOU are.

Some traders are very risk averse by nature and therefore will be happy to trade markets that are "boring" but offer opportunity if they can be patient and methodical.

Other traders may be a lot happier trading markets that are fast moving and offer much swifter resolution to trades, either in the form of profit or loss!

KNOWING your own mind and your own tolerance to risk is therefore a key element to the voyage of discovery that is becoming a successful trader.

Trading is one of the most effective ways of discovering what sort of person you are, and what your strengths and weaknesses are. There are very few other people a trader can "blame" for their results. It is the ultimate meritocracy!

In the spirit of "minimising losses and maximising profits" it is worth comparing trading with a clear trading strategy to gambling in the casino. Consider this:

The odds of "winning" when playing "Black or Red" on a roulette table in a casino are approximately 50/50 (bar the ball landing on "zero")

If your trading strategy is along the lines of "buy at 20, stop at 10, take profit at 30" then your "odds" are 50/50. In trading this is known as a Reward/Risk ratio of 1:1, ie you are risking 1 "unit" to make "1 unit" of profit, or using the example above, risking 10 units to make 10 units.

In other words if this is your strategy you may as well go and play roulette!

It is generally accepted that ANY trading strategy needs to employ a Reward/Risk ratio of better than 1:1. Most successful strategies have an inherent reward/risk ratio of 2:1 or better.

If you used a Reward/Risk ratio of 3:1 you can actually have more losses than profits and still make money:

7 losses at 1 unit each = 7 units lost total

3 profits at 3 units each = 9 units of profit

= 2 units of profit "net"

This doesn't, of course, take into account commissions/costs, but what it hopefully illustrates is that you can have a trading strategy where you have more losing trades than winning trades but still make money. As long as you employ "proper" reward/risk parameters.

And that concludes the second module.

Module 3

Welcome to module 3 – managing your live position.

Another major consideration with respect to Reward/Risk is knowing what could have an affect on your trade/position once it is "live".

Examples:

"Event risk" – What economic releases are due out that may move the markets? Are there any Central Bankers speaking? A good example is the Nokia announcement I spoke about earlier!

Time of day – In most markets there are different times of day when activity varies, for example in Stock Markets the first hour of trading, and the first hour of trading in the US, are often volatile periods as markets find their feet as trading gets under way each day.

Where the market is and where it's been? Basically Technical Analysis! Many traders use Technical Analysis to help them to time trades and make sure they're getting in at optimal levels, and not just entering a trade in "no mans land".

Reward/Risk is the cornerstone of any trading strategy or any successful trader's system/mind set.

But there are a whole host of other things to consider, not least DISCIPLINE!

Discipline with respect to trading can cover so many aspects:

Being prepared to constantly watch and listen to the markets. "Every day is a school day!"

Being patient and waiting for your setups.

Respecting your stops, otherwise your reward/risk will decrease. If you are in a trade and getting close to being stopped out and you move your stop further away you are giving way to fear, not sticking to your plan, and decreasing the reward/risk on the trade.

"Respecting your stops, otherwise your reward/risk will decrease"

What is a "stop"? It is short for "stop loss", but there's more to it than that.

It's the price level a market hits where you have to say "I'm wrong" on a trade, and if you're saying that then GET OUT!

Trades should always be decided based on where your stop is, in order to understand your initial risk

Technical Analysis can be a solid aid with respect to setting entry levels, stop levels and potential targets.

 "Respecting your stops, otherwise your reward/risk will decrease"

Using Technical Analysis, especially trend following tools such as moving averages or trendlines, means you can move the stop (turning it from a "stop loss" into "stop profit" with the market), and use it as a reference for stopping out of a winning trade only if and when the market reverses.

This is a good example of "maximising profits"; staying in the good trades; as discussed earlier.

Trade size versus account size is an important consideration

Futures are a "leveraged" product. You don't need to put 100% of the money up to buy 1 FTSE Futures contract (which is "worth" £62,500). When trading on many "retail" CFD and Forex platforms, high levels of leverage are available. This can be very dangerous!

Make sure your trade size means you won't get "wiped out" in one trade.

Consider that you may have a number of losing trades in a row. What would your draw down be in this instance?

"Don't put it all on red"!

And here are some other things to think about:

Trading is extremely mentally demanding, and will test your "mental" limits on so many different levels. A few things to think about (by no means an exhaustive list!) are:

- Fail to prepare, prepare to fail… <u>DAILY – </u>the best traders I know spend at least an hour before the markets open each day, making sure that they are prepared for what that day may bring.
- Look after yourself, physically and mentally. Don't trade if you are feeling unwell or have problems on your mind.
- Don't be a slave to the screens – you need "down time".
- Don't overtrade
- Manage your emotions – When winning and losing!

With all this in mind any new trader has a lot to digest before embarking on a successful career, not least designing a strategy that will "fit" together the pieces of a big jigsaw:

- What is my personality?
- What is the "personality" of the markets I am trading?
- How am I going to manage risk in order to minimise losses and maximise gains?
- What do I need to do on a daily basis, and going forward, to improve/refine my strategy, and also to evaluate my own state of mind?
- What am I going to do if it stops working?

And that concludes the third module.

Module 4

Welcome to module 4 where we'll look at risk management for portfolio managers and introduce the concept of hedging.

Another important consideration is knowing your objectives and parameters and the type of trader you are, as mentioned earlier.

If you decide you are an investor, or if you are in Fund Management, many of the things already discussed would not be so critical.

<u>This is an entirely different universe, with a different set of considerations.</u>

Investing and Managing Money is much more about asset allocation; finding a balanced portfolio of assets that can weather different market conditions and events, that can minimise draw-downs while offering a risk profile suitable for the portfolio and the clients' objectives.

In portfolio/money management your task is to find a balance between safe investments that will often, by nature, offer smaller returns with smaller draw downs, versus more risky assets where potential profit is greater, as is the potential for losses!

For example, Small Cap Stocks, often in the Mining Sector, have long been a favourite for smaller investors looking for big returns, whereas Bonds offer steady Income and a safe haven for client money.

A "balanced" portfolio would have a bit of everything, not just asset class wise, but also geographically. Emerging markets are often a favourite for the more risk averse.

It is conventional wisdom that money "flows" between asset classes and that to achieve a "balanced" portfolio, you need to be invested in a wide range of asset classes in order to take advantage of when these flows are going in a particular direction.

For example, quite often when Equity markets are weak, money flows out of Equities into Bonds and commodities like Gold.

This is where the phrase "Risk on/Risk off" comes from:

Risk on = Periods of time where confidence is high and riskier assets (ie Equities) are considered worthwhile investing heavily in.

Risk off = Periods of market uncertainty, volatility or unrest, when it is prudent to invest in (perceived) "safe haven" assets like Bonds and Gold.

I am not a big fan of this particular "mantra" for a number of reasons, not least these relationships are not "set in stone" and quite often don't work as well as one would hope! I also think it overused and way too simplistic, and that managing risk on an asset by asset basis, is far more prudent.

There are also a number of instruments, generally called "derivatives" that can be used to hedge risk, in fact, this is what Futures were invented for in the first place!

The early futures exchanges mainly catered for farmers and food producers who wanted to guarantee their future income against crop failures due to bad weather and the like.

Equity Index Futures can be used to "hedge" against a "Blue Chip" Equity portfolio. For example if you had £250,000 invested in a balanced portfolio of FTSE 100 stocks, but you felt there was significant risk of a market correction, you could sell 4 FTSE Futures, which would make money if there was a correction, ideally the same amount of money that you would lose on the portfolio. This saves on dealing costs of having to “turn” the entire portfolio.

Options can also be a useful tool for managing risk on a portfolio.

Again let’s consider the example of owning a portfolio of UK Blue Chip Stocks but wanting to find a way to guard against a big drop in the near future.

You could BUY an “out of the money” PUT. What does this mean?

It means you pay a premium for the right to SELL the futures at a fixed date in the future at a fixed price. If the market crashes you will make money on this position to offset the losses on your portfolio. Let’s look at a simple example to show how this might work:

Example: Buying an “out of the money” put:

BUY 8 Feb 6700 PUTS @ 10p.

(market currently trading at 7250).

If there was a 1000 point sell-off between now and the expiry of the option you would make 440* points (£10 a point) X 8 = £35.200 on the option. Why 440 points? This is the difference between the strike price and the market price on expiry, minus the premium you paid for the option in the first place).

So with the market dropping 14%, instead of losing £35,000 on your £250,000 portfolio, you would only be flat to small up, all for the initial “cost” (risk) of £800.

Think of it like paying an insurance premium against a big move in the market.

One thing to note about Options is that a large part of the premium calculation is to do with <u>time</u>.

A longer dated option is more expensive, as there is a greater chance of volatility to reach the strike price the longer the strategy has until expiry.

So a 6700 put with an expiry in June, for example, has a much higher premium (125 points in this instance), most of which is “time” related.

This is just one example of a simple Options trade. There are hundreds of different permutation and strategies you can employ to “insure” against large moves higher and/or lower, even to make money if the market stays exactly where it is!

There are a myriad of names like Straddles and Strangles… but that’s for another day!

Trading is a massive journey, but you won’t get too far on the journey if you don’t employ sensible and relevant risk management.

Risk Management has a number of different aspects that need to be considered:

- Fear and Greed, and managing YOURSELF!
- Reward/Risk
- Account size vs trade size
- Knowing your strategy, and being comfortable with it!
- Discipline, especially with respect to stops.

Thank you for watching and listening. If you have any questions about anything we have covered, please do send me a question via the Institutional Trader Programme platform or ask your online course tutor during the course of your three month online programme. Thank you for listening.