



# Money Management For Forex Traders



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## Introduction

Successful forex trading typically involves managing profits and losses wisely. Ideally, there should be large profits and small losses for most traders. Having a sound money management component in a trading plan helps ensure this is the case. Hence, an understanding of well-established money management techniques is essential for most, if not all, successful forex traders.

While having an effective trading plan may seem sufficient, a lack of money management in forex trading can be catastrophic for a trading account. A forex trader must be emotionally prepared to take losses since if they are not taken sooner rather than later, they can result in the complete loss of funds in an account. Once trading losses have consumed their account, a trader's confidence tends to be shot as well.

Exercising appropriate money management techniques when trading on a forex account cannot be stressed enough. A forex trader that pays no attention to money management is gambling and not trading. The management of risk for each trade as well as the trading account overall, helps lead a trader toward having a profitable trading business.

While money management practices may limit some of the potential profits on a given trade, sound money management is one of the forex trader's tools to being consistently profitable in the market. Trading in a volatile market such as the currency market requires the trader to use all of the tools at their disposal to make profits and - above all - to limit losses.

## Principles Of Money Management

Incorporating a comprehensive set of important money management principles into a trading plan is strongly recommended for any forex trader strategically approaching the often unforgiving forex market. Such well-established money management guidelines might include:

Do not trade with money you cannot afford to lose. One of the basic rules of thumb of money management is that trading capital should not consist of grocery money, money for the mortgage or rent, or money intended for any other basic necessity of life that needs to be met financially. When trading, remember only to use risk capital, which are funds that can be safely put at risk of a complete loss.

In essence, risking funds that would otherwise be used for basic necessities could cause the trader to undergo undue emotional stress when facing a losing trade. Trading under such stress can severely affect a trader's judgment and impede them from making sound trading decisions.

Determine optimal risk-reward ratios. Knowing how much risk you are willing to take with each trade is another basic money management principle. Forex traders should assess how much they can risk and how much that risk is expected to pay off.



## Principles Of Money Management

For example, some traders use a risk-reward ratio of 1:2, in other words, they are willing to risk one unit to make an anticipated two units of profit. Other traders may wait for an opportunity to make three units by risking only one unit, which would be a risk-reward ratio of 1:3.

Looking for trades with a higher expected risk/reward ratio can help a trader filter out less attractive trading opportunities. The trader can then concentrate their attention and capital on initiating trades under better trading circumstances. Also, depending on the level of margin and leverage the trader might have in their forex account, they can choose to establish a larger position when a better opportunity presents itself.

Determine your optimal position size. Knowing the proper trading unit size in relation to the size of a trading account can help safeguard the remaining funds in the account. By keeping the trade unit size in a suitable relation to the amount of money in the forex account, only a certain percent of the account will be at risk at any given time.

For example, many successful forex traders only put 20% of their accounts at risk at any given time. Even if the complete 20% is lost, the trader still stands a decent chance of recovering the loss quickly with the remaining funds in the account, versus if they typically put more at risk.



## Principles Of Money Management

Some forex traders will adjust their position size based on how high they calculate the probability of the trade being profitable. Such a trader will generally increase the size of a trade depending on their estimated probability that the trade will be a winner.

Enter a stop-loss order on each trade. Once the size of each trade is determined, along with the percentage of the account that will be at risk at any given time, the trader can then establish a position in a currency pair based on their forex analysis. Before initiating the trade, it is strongly recommended that the trader determines an exchange rate level where the maximum tolerable loss should be taken and the position liquidated.

Many traders enter their stop-loss orders immediately upon initiating a forex trading position to help them remain disciplined. By entering a stop-loss order, the trader automatically exits the position in the event that they are wrong on the direction of the market. Trading with stop loss orders is an important component of forex money management that can save the trader a considerable amount of money in the event of an extreme adverse move in an exchange rate.

Some traders will also use a trailing stop loss as the initial position becomes profitable.

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After the exchange rate has moved in a favourable direction for the trading position, the original stop-loss order is moved up in the case of a long position or lower in the case of a short position. This trailing stop technique ensures that the trader does not ride a profit into a loss in the event of a significant market reversal.

Enter a take profit order on each trade.

While this strategy may conflict with the “let your profits run” adage, knowing where to exit a trade is almost as important as when to initiate a trade. Once the trader has established an exchange rate position, entering an order to exit the trade at a realistic (but still attractive) level of profits, allows the trader to take a profit without seeing their profit diminish or even turn into a loss.

This strategy may seem counterproductive for some traders, especially in a strongly trending market. Nevertheless, the market will often reach a certain level before hitting resistance or support and then, in many cases, react significantly in the opposite direction like an overstretched rubber band snapping back into shape.

A trader with a take profit order in the market can exit the trade at their target level and then seek to re-establish the position once the market has corrected.







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The disadvantage, of course, is that the market may continue to move in the direction of the trade without a pullback, leaving the trader either side-lined out of the market or having to initiate a new position at a level that might not be optimal.

In addition to incorporating the basic principles of money management cited above, successful trader will often customize their money management techniques to fit their trading plan. An example of how a trader might develop their trading plan by incorporating sound money management techniques is illustrated in the section below.

## Using Money Management In A Forex Trading Plan

To employ money management, the first objective is to develop a calculated approach in strategic forex trading and then apply the techniques detailed above to positions established using the trader's analysis of current market conditions. Initially, the trader should recognize that forex market is typically either trending in a general direction or trading within a limited range.

Recognizing the trend, or deciding the limits of a trading range, gives the trader much better probabilities for being profitable by either following the trend or trading within the parameters of the trading range. Selecting the optimal entry and exit points could, for example, be determined by using technical forex analysis for the currency pair to be traded.

For example, if the market is trending, a trader could plan on following the trend on a majority of their trades, generally about 80 %. In this case, a risk-reward ratio of 1:2 would be acceptable, with a stop-loss order placed at a considerable distance from the initial trade, maybe 150 or more pips. The take profit in this instance would be twice as much as the stop loss, or 300 or more pips.

If the forex trader decides to make a trade contrary to the trend during a correction, then a risk-reward ratio of 1:1 could be used.

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However, a much tighter stop loss and a lower take profit objective of around 50 pips would be appropriate.

Alternatively, if the market is trading within a range, the trader would then initiate positions at the extreme points of the range, perhaps covering short positions and going long at the low end of the range, or taking profits and shorting the market at the high end of the range. In this type of market, the trader might use a risk-reward ratio of 1:1.5, placing stop-loss orders around 100 pips away and with a take profit level of 150 pips or so.

Notice that in both types of market conditions, i.e., trending or ranging markets, the estimated risk-reward ratio of trades taken is ideally kept to 1:1.5 or 1:2, except for trading corrections. Of course, a trader that makes money more than half the time using the above model would be exceptional. Still, even if only half of these trades were ultimately profitable, the above model should give positive returns over time. In addition, adhering to this type of money management strategy helps eliminate some of the emotional problems that can arise when trading and can be highly counterproductive to success.



## Conclusion

Understanding the basic money management principles and using sound techniques for limiting risk in a forex trading account can make the difference between being consistently profitable and having your forex broker terminate your trading positions when your losses exceed margin requirements.

Basically, forex trading can be a serious long term business for a good money manager or a temporary whirlwind that can completely consume a person's risk capital quite quickly for those who do not manage their money wisely. Maintaining a realistic handle on profits and losses by using established money management principles allows a forex trader to be relatively impartial and not let their emotional reactions sabotage their trading efforts.

