SPECTRA MARKETS

Friday, December 17, 2021

am FX

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This has literally two uses

Current Views

Short ETHUSD @ 4210
Stop loss 4902 / Take profit 3010
(From MacroTactical Crypto #4)

Riffing on Risk

In my travels on Twitter and the internet, I consume a ton of trading-related content every day. Naturally, after 25 years of doing this, and writing two books about trading, I run into fewer "wow that's a great piece!" pieces. I *do* still find cool new stuff that helps me learn, though.

Today's piece is a guest post from a FinTwit Lord who goes by the handle "Horselover Fat". The name is a reference to a Philip K. Dick novel, which made me like the guy right away[1]. He's @Michigandolf on Twitter and his tag line is "Joking about life, serious about trading." That captures the vibe of his videos and Twitter. Excellent follow, highly recommend. He trades mostly ES and a bit of NQ (and other stuff), and he likes talking and writing about trading, as I do. His style is laid back, and his content is expert and original.

Fat wrote a piece last week that resonated with me because it addresses a third dimension of risk management that I have always found prickly: **Time**. If you know a trade will work immediately if your thesis is correct, can you take a much larger position? (yes) How long do you leave a trade on if it's not getting stopped out, but it's also not working? (depends on opportunity cost)

The time element is why many FX traders make most of their money on events. You're right or wrong and you move on. And opportunity cost is an issue in FX when you trade pairs like AUDNZD and NOKSEK, as they can often sit there and do nothing for ages while you wait. This uses mental and real capital. Generally, my view is that you just wait for the plan to work, or not, but Fat provides some compelling logic in his piece for why that is not always optimal. Or at least why it's critical to incorporate time as the 3rd dimension of risk management.

Many of these things come down to personal style and preference, but it's great to ingest as many viewpoints and approaches as possible and then digest what helps improve your process and discard what does not.

Without further ado, I bring you (with permission) "Riffing on Risk" from the tradefat.com blog. I have no personal or financial relationship with the author of this piece, and I have never met him and don't even know his real name. I hope you like the piece! FYI, t*here are a few bad words in here. :]*

Riffing on Risk *by Horselover Fat*

Since I started sharing with people how I trade, I've learned something that kind of surprised me:

Risk management is a difficult topic to discuss.

Probably because it means so many different things to different people. I often find myself feeling bad because I struggle to answer the most basic of questions people ask me, like "How many points should I risk on each trade?" or "How many contracts should I trade?"

I find myself thinking "Dude…I don't know!" I'm not you, I have no idea how you trade, what your goals are, what your experience is, etc. etc. etc.

[1] *My favorite PKD is "A Scanner Darkly" by the way. The movie and the book are both incredible (though not for everyone… watch the trailer first to see if it's up your alley).*

This is the conundrum with risk management: It's arguably the most important part of trading yet so universally difficult to teach because no two people trade exactly alike and there's no standard definition of what risk management means.

To help establish a baseline for this blog post, I'll define risk management in the most basic sense as **the process by which a trader attempts to avoid losing more than they make.**

If we can all agree on that basic definition, I'd like to share with you how I think about risk as a **trader**. As in, how I view risk management as a whole, not in regard to specific trades. As some of you know, I primarily trade futures intraday, but I also swing stocks and buy/sell options premium occasionally. So this blog post is about how I approach risk management in the long-term, which might help explain *why* I trade the way I do.

Ok, introduction over…let's get into it.

Let's start with 2 very basic factors in determining positional risk:

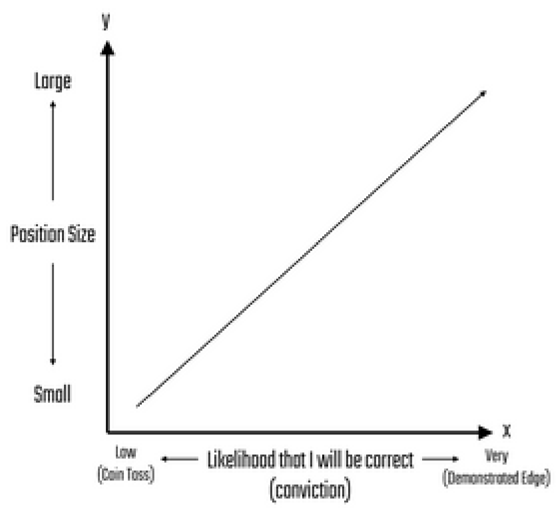
1. Likelihood that I am correct in my thesis.
2. My position size.

Logically, there should be a positive linear relationship between these two factors. The more likely I am to be correct when entering a trade, the larger my position size should be.

Some of you have watched the "How I Day Trade" videos I released and it should be no surprise that I approach trading like gambling. If you haven't seen the videos, I use the analogy of poker. In poker, you start with a stack of chips (i.e. your trading capital), and good poker players wait for hands where they know they have a statistical edge based on the strength of the cards. When they receive a "strong" hand they bet accordingly (i.e. heavily).

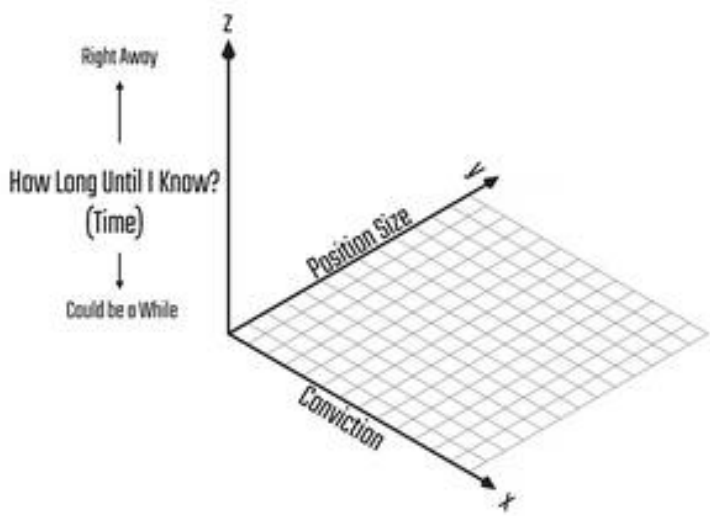
During tournament poker, a key part of any winning strategy is the ability to fold hands that are unlikely to win. To me, it's the same in trading. You have to be willing to cut losers and/or wait patiently for a setup that has demonstrated a high likelihood of success in the past. This core concept is what I'm referring to in Factor #1 (the likelihood that I'm correct in my thesis). If I'm entering a trade in the middle of nowhere, with no key Support/Resistance, no clear order flow information, etc., well that trade is essentially a coin toss…the market is just as likely to move against me as it is to move in my favor. To stay with the poker analogy, that's a hand I would fold.

But let's say the market is at a key area of confluence, and there's a VERY good chance it'll change direction, and I'm seeing order flow to support that thesis…well now I have a slight edge, so technically my position size should increase from whatever my minimum size currently is. We can represent this thinking with a basic graph:



Wouldn't it be nice if risk management was just this simple? It's not. Now we have to introduce a third factor on our Z axis: **Time.**

Specifically, the time it will take me to know if I am right or wrong in my thesis.



You might be thinking, "Horse what the hell does time have to do with risk management?"

That's a valid question. **It has to do with opportunity cost.**

Again, referencing our poker analogy, I have a limited stack of chips. I cannot place unlimited large bets with high conviction. I have to "manage" my chip stack, my capital. Therefore, I can't have too much tied up for an indeterminate amount of time hoping my thesis is correct. For me, it's sort of a "sh*t or get off the pot" scenario. The longer I have to wait to know if I'm correct absolutely impacts my likelihood of being correct AND my position size. In my opinion, this is why macro investing is so difficult. You could enter a position with a very sound thesis, but over time things change and you end up being dead-ass wrong…through no fault of your own. The more time that elapses, the more opportunity for things to change that impact your initial thesis. Sometimes those unknown factors are positives, but more often than not they seem to be negatives because your initial thesis generally accounted for the positives, right?

Earlier I used the word "process" to describe risk management. I absolutely view it as an ongoing process. Things change in markets—therefore I need to be prepared to change as well in order to properly manage risk in the long term.

So back to opportunity cost. I'm a trader in this for the long haul, I need to adjust position sizes and stop losses based on new information and time.

<u>Here's a couple examples:</u>

DWAC *(note from Brent.. Fat posted this DWAC trade in real time on Twitter, before the big move)*

One of my best equity trades this year was the DWAC SPAC (Note: Unintentional yet hilarious rhyme). Here's how it went down and how I thought about it in my weird "mental risk model" that we're discussing:

I developed a thesis for the trade after the markets were closed for the day. I heard the news about Trump possibly getting involved with a SPAC deal. I checked the price of DWAC after-hours and it was sitting almost at NAV (~$10), which had me scratching my head…why hadn't this thing run? Well the answer was simple: The news JUST broke and it wasn't priced in yet. So I decided that I'd take a very large position size pre-market the next day because I figured my likelihood of being correct (e.g. that it would pump on the news) was very high. I also factored in the time for our thesis to play out (our z axis) and determined that I'd know RIGHT away if I was right or not. The likelihood of it falling below NAV was extremely low, so it was "all systems go" for me and time to make an aggressive trade. The rest, as they say, is history.

GOLD

Another example that better showcases adjusting my risk management approach using the three factors we've discussed is a recent gold swing trade I took. In the final days of September, I started a large swing trade in gold micro futures (more on why I like the micros for gold some other time). The inflation narrative was picking back up, and even though gold is a bona fide piece of sh*t for an inflation hedge, my thesis was that the general public is too dumb to know that, plus gold had recently been beaten to a pulp and I figured it was oversold and there was an opportunity to BTFD.

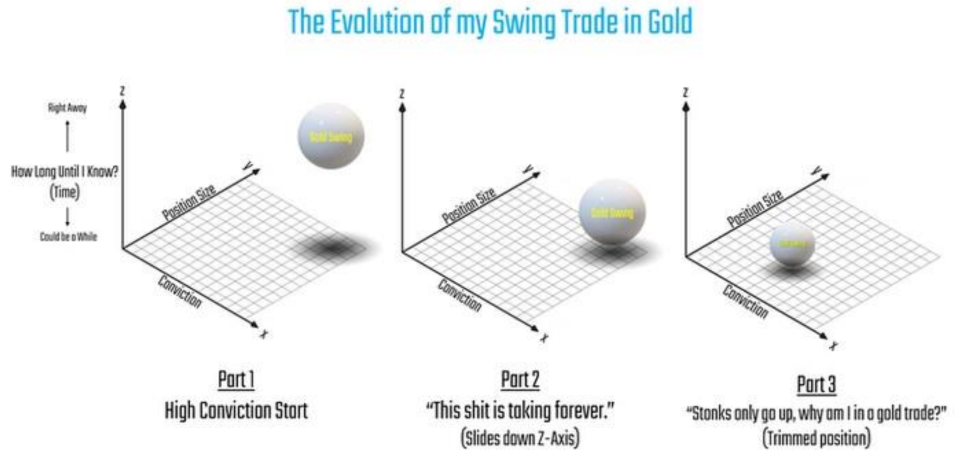
I also figured portfolios would be getting rebalanced Sept 30-Oct 1 and IF gold was to run it would likely happen FAST due to EOM rebalancing. Additionally, the technicals looked good to me as well…so all of the factors I was looking for were there: A reasonable bull thesis based on the incompetence of Average Joe investors, likely bounce area from a technical perspective, and I'd know quickly if I was right or wrong due to EOM (plus some key FedTalks and inflation data drops were on the horizon).

Some of you may remember from my obnoxious Twitter bragging, but I practically bottom ticked it and gold took off on a nice ~7.5% bull run.

But I'd be lying if I said I held that position full size for the entire run. **I didn't.**

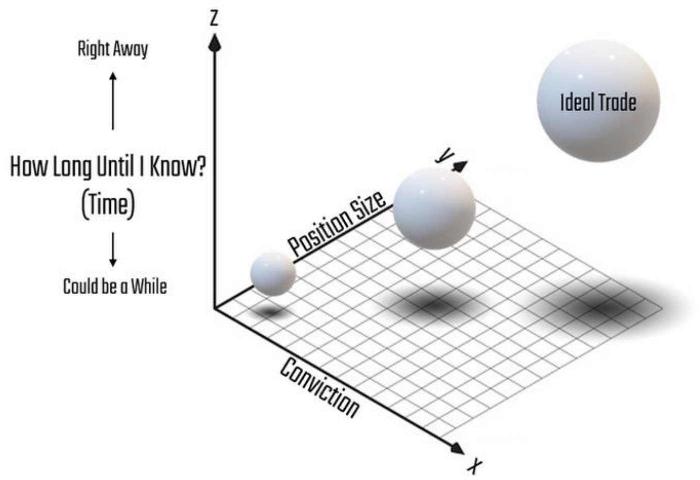
I trimmed it and I'll tell you why: My mental model for long-term risk management changed. In early November gold started to slip again, so I naturally questioned 2 of my key factors: Likelihood of being correct and time.

At this point, I had been in the position for over a month and truthfully I thought it would run harder than it did given the intensity of the inflation narrative. The index futures were looking more and more attractive in early November, as I was anticipating seasonal bullishness and continuation of recent momentum. So things began to shift on my mental risk model. Did I really want that many of my "chips" tied up in that one "hand" anymore, or would it be better deployed somewhere else? I determined it was time to trim the position considerably…of course gold ended up ripping right after that because, well, f*&k gold lol. But hopefully you get the point of this example: If I deem the likelihood of continuing to be correct has decreased AND the time it will take me to know is longer than anticipated, then I will actively manage my exposure (risk) and make changes.



These are ever-changing factors. As soon as you enter a trade they begin to change. This is the main reason I prefer to trade futures intraday: I am better at it than equities/options (therefore I typically have a higher likelihood of being correct) and I know IMMEDIATELY if I am right or wrong. Since futures are a leveraged product, I am able to quickly size accordingly…and size large if the thesis is strong.

One of the reasons I decided to write this post is to help you better understand why I am not phased in the least when one of my "Quickies" (usually equity swing trades) doesn't pan out. The position size is typically negligible compared to day trading futures because my conviction is usually much lower and the time it takes me to know if I'm right or wrong is usually much longer. It may seem weird to you, but it's all part of a holistic way of managing risk throughout my trading journey.



I love seeing a great equity swing trade pan out over time. Absolutely love it. **But I'm also very realistic about my strengths**, so my risk management approach needs to align with that awareness. When I see large orders on the Limit Order Book tipping their hand at a key level of confluence, I am usually VERY certain what is about to happen in the next 5 to 10 minutes. I can't say the same for swing trading stocks, therefore I can't size the same.

Now, I don't want you to read this and leave thinking there's anything wrong with the classic "risk 1-2% of your capital per trade" approach to risk management…there isn't. Everyone is different. I'm just simply providing a different way of approaching risk management in its entirety. Even if you're very disciplined about only risking 1-2% per trade, **things change once you take the position!** All I'm suggesting is to view true risk management as a *fluid* process, not a stagnant one.

I'm a firm believer that to be a sustainable trader, risk needs to be viewed on a "macro" scale. For example, I mentioned in the "How I Day Trade" videos that my sizing for short trades is ALWAYS smaller than my sizing for long trades. Why? Because markets are inherently bullish due to the incredible amount of passive investing flows. Seems like a small detail, right? Maybe. But not if you plan to sustainably trade for years to come.

That's what I want to do, and that's what I want for you…no matter how you do it.

So I hope this post is at least thought-provoking if nothing else. I know we didn't get into the details of stop losses and stuff, but I think that warrants its own post. For now, I just wanted to expand on how I think about risk management from a philosophical perspective.

Thanks for reading and thanks for being here.

Horse.

Hope you liked the piece. Have a fantastic weekend.

good luck ⇅ be nimble

Empty tubes of wrapping paper ... Do you ?

A.) Pretend it's a lightsaber

B.) Bonk it on someone's head.

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