

Technically Speaking

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Risk Equalization

by Michael Covell

In the quest for trading success, many traders are seduced into a fruitless search for a perfect entry or exit technique. While they hunt in vain, they miss some very simple strategies that enhance trading returns yet do not involve entry or exit. One strategy most traders overlook altogether is risk equalization. Risk equalization allows a speculator to make proportional adjustments to their account while staying within their tolerance for risk.

Risk equalization means you adjust the number of contracts or shares to stay within pre-determined risk guidelines. For instance, a trader wouldn't trade a Corn futures contract the same as he would trade an S&P 500 futures contract. The two contracts are dissimilar in size and move differently.

Frequently however, traders get a 'lot size' mentality. They are comfortable trading one contract of many markets, but get skittish at the possibility of having 10 contracts on one instrument and 2 on another. Many traders become anxious if they have different contract sizes in different markets.

If you suffer from this anxiety don't let it get you down. I've seen professional and seasoned traders get caught in this trap. Here's an example: I personally witnessed one trading program that did not risk equalize their portfolio. During 2003 this program returned north of 40%. Money under management quickly blossomed from less than a million dollars to over \$20 million in just

a month period. All indications pointed to a very promising future.

Early in 2004 I noticed they were trading one CME Eurodollar contract and one CBOT Ten Year Note contract concurrently. A trader with just a few months of experience realizes, in terms of risk, one Eurodollar is not equal to a single Ten Year Note contract. In comparison with the Ten Year Note, Eurodollars typically have a smaller margin requirement and smaller daily fluctuation. The trade ended with Eurodollars up and Ten Year Notes down. Since risk was not equalized, the two positions netted a loss. If risk had been equalized then the trades would have netted to nearly break even. This program ended 2004 down more than 50% and their assets under management quickly dwindled back to a few million dollars. I firmly believe inadequate risk management, specifically risk equalization, shortened the life of their program.

There are several methods you can use to equalize risk on your own. For example, what if you're a futures trader? Futures traders have a distinct advantage due to margin. Exchanges and brokerage firms factor in market volatility to set margin requirements. Simply stated, markets with high margin have a larger daily monetary fluctuation than those with a low margin requirement. A market with a \$500 margin requirement will move slower than a market with a \$5,000 margin requirement.

Recall the Eurodollar/Ten Year Note example. Typically CME Eurodollars have a margin requirement of \$400 and CBOT Ten Year Notes' margin is around \$1,200. You can quickly see it takes 3 contracts of Eurodollars to equal one contract of Ten Year Notes.

Another method of risk control involves measuring the risk you want to take on each trade or fixed fractional trading. Fixed fractional trading simply means you trade the same percent of your account on each trade. For instance 5% risk per trade on a \$25,000 account means you use a maximum of \$1,250 per trade. (Figure 1)

As the account increases in value so does the risk per trade. At \$35,000 5% risk per trade equates to \$1,750. (Figure 2)

Risk for each market does not exceed 5% of the

total account size in either example. Your personal situation may be different, but the math works the same. The risk in dollars fluctuates as the account increases or decreases in size; however risk is always contained to a fixed percent per trade.

This method is versatile enough to accommodate stock traders. Your monetary risk is the distance between entry price and the stop setting. For example: if you own a stock at \$50.00 per share and use a stop of \$46.00 then monetary risk is \$4.00. If you wanted a maximum risk of \$1,250 then divide \$1,250 by \$4.00 to get the number of shares, or 312 for this example.

Implementing this type of risk control allows you to take advantage of your trading capital without becoming over extended on one trade. Both novices and veterans fight the temptation to become married to one trade. This temptation can force you to take a larger position because you feel a trade will work out regardless of short-term fluctuations. Most times the trade never works out as expected and losses mount, the unenviable position of most investors who simply buy and hold. You may even be forced into retirement with extreme losses. Having a clearly structured money management scheme that you adhere to allows you to promptly size up risk and control it.

Manage risk or it will manage you. Don't be a trader who is afraid to take bigger positions in smaller markets. Subscribe yourself to the old trading axiom, trade all markets equally and equally trade all markets.

Michael Covell



Michael W. Covell is the founder and President of Trend Following™. A researcher of the most successful Trend Following investment managers, he has been in the alternative investments industry consulting on Trend Following to individual traders, hedge funds and banks for ten years. His best selling book, *Trend Following: How Great Traders Make Millions in Up or Down Markets* (Prentice Hall, May, 2004) is a complete and concise guide to trend following. Mr. Covell is also Managing Editor at TurtleTrader.com®.

Account Size: \$25,000		Maximum Trade Risk: 5% - \$1,250	
Market	Stop In Terms Of Dollars	Contracts To Trade	Risk In Dollars
Eurodollars	\$400	3	\$1,200
Corn	\$500	2	\$1,000
Ten Year Notes	\$1,000	1	\$1,000
Wheat	\$800	1	\$800

Figure 1

Account Size: \$35,000		Maximum Trade Risk: 5% - \$1,750	
Market	Stop In Terms Of Dollars	Contracts To Trade	Risk In Dollars
Eurodollars	\$400	4	\$1,600
Corn	\$500	3	\$1,500
Ten Year Notes	\$1,000	1	\$1,000
Wheat	\$800	2	\$1,600

Figure 2

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From the Editor's Desk



John Kosar, CMT

Happy Holidays to all our Technically Speaking readers. Since this is the season for giving and also for giving thanks, I'm going to use a little of this space to request the former and do the latter. First of all, many thanks to people like Ashton Dorkins, Garry Rissman and Matt Blackman, who have been a huge asset for the Newsletter since I have been Editor. They have been providing content almost every month.

Also, thanks to people like Jeannette Young in New York City and Ross Leinweber in Chicago, we are now starting to get some newsletter participation from the MTA's regional chapters. That's the good news. However, there are 16 more Chapters out there that we have not heard from yet, so we clearly can do much better. So, to those involved with a regional group, please drop me a line at editor@mta.org and let me know that you are willing to give a gift to your fellow MTA colleagues by covering your Chapter's next meeting.

For those of you that are relatively new to the business and/or the Association, Technically Speaking is a great way to get your name and face in front of the rest of the membership as we will include your picture and bio in every submission to TS that gets published. I also encourage anyone who has an interesting analytical technique they would like to share, or who has read a great book on technical analysis and would like to share their views on it with the rest of us, please consider writing an article for TS. This is your Newsletter – we would like to fill it with content from as many of you as possible.

Now, on to this month's issue. On the cover, Michael Covell discusses some simple but important techniques for equalizing risk between investments to adjust for differences in volatility and leverage. Inside, MTA affiliate and CMT candidate Matt Blackman reviews a new investment software product that integrates several different approaches into one package. In addition, money manager Rob Hanna uses back-testing to come to some interesting conclusions regarding the effectiveness of the 200-day moving average as an investment tool. Finally, Executive Director John Kirby reports on the MTA's two most recent accomplishments, the launching of our new technology platform and the debut of the new and improved MTA website.

Hope you enjoy the issue. I also hope you will consider contributing to future issues of TS.

John Kosar, CMT
Editor

From the President's Desk "Dear Santa"



Jordan Kotick, CMT

Every month since becoming President, I have been able to report to you the successes we have had as an organization. I wanted to change tunes and do something different, something that I do not think has been done before and something that should be done. I wanted to briefly highlight where, as President, I have not done well, things I have failed to do. I do this not only to be totally transparent but more importantly, to highlight what is on my MTA plate as my Presidential term winds down in its final six months.

We have further work and negotiations to do with the Canadian Securities Institute. They are currently offering a very successful technical analysis course and we need to continue to work closer with them. The Long Term Planning committee has been inactive since well before I became President. This needs to be reinvigorated. The call from outside the US for closer relations with the MTA is growing louder and stronger. We need to consider creating international ambassadors and representatives per country. The Constitution has suggested revisions put forth earlier in the year. We need to tackle this hefty project and incorporate or dismiss the suggestions made. There are still lingering issues concerning the relationship with the MTA and the MTA Education Foundation that need to be resolved. While the relationship here is strong, there is further work to be done on both ends. The International School of Technical Analysis, a joint effort agreed to a few months back, has to be kicked into gear.

Other ongoing issues remain a potential move back to New York for our offices, working out the kinks in our new website and computer platform as well as the computerized testing of the CMT. And of course, the unpredictable issues that always seem to emerge and demand attention.

To be honest, will I be able to lead the MTA to fully complete all of the above before I am done being President in June 2006. Will I be successful. To be perfectly honest, probably not. But it will not be for lack of trying.

Wishing everyone a happy, healthy and profitable 2006.

Jordan Kotick CMT

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