Confusing Risk with Volatility

Too often, people confuse risk with volatility. Risk and volatility are not synonymous!

Risk is usually defined as the potential for loss. But to us, risk is really unmanaged volatility. Volatility arises from random price movements which occurs naturally in every market. Without volatility, there can be no profit opportunity. Volatility is what drives markets either up or down and helps form and sustain trends. The greater the volatility, the greater the profit opportunity. Conversely, when there is little or no volatility, there is little or no profit opportunity. Markets will tend to drift sideways. To us, harnessing volatility is managed risk.

Volatility is like electricity. It can be both dangerous and useful. For instance, a downed power line is dangerous. It frightens everyone except the repairman. He understands the risk because he's been trained to identify it and then manage and contain it. Once the downed power line is repaired, what was once dangerous becomes useful again. But because its dangerous, should electricity be avoided? Hardly. To be useful, electricity must be harnessed or managed. The same holds true for trading.

Entering a market without first identifying risk is foolish. And doing so without protecting against risk is as foolish as someone walking through a puddle of water with a downed power line across it. Like electricity, volatility should be respected, not feared. When properly harnessed, volatility becomes extremely useful because it fuels profits.

Each time you enter a market, you must identify the risk associated with that particular trade. Once identified, you need to limit the risk with a protective stop loss order. In the event that volatility forces the market to move against you, a stop loss order acts like an electrical fuse. It quickly and safely gets you out of the trade, thus preserving the lion's share of capital for the next opportunity.

An Illustration

Take Crude Oil. Crude is a very volatile market. Consequently, it tends to trend very well and often. And when it trends, the profit potential can be huge. Conversely, without managing volatility, it can be extremely dangerous.

Because of the leverage used to trade Crude, each time it moves a penny, your account balance would change by $10.00 for each contract traded. Thus, a $1.00 move would represent a $1,000 change per contract. So, if you bought Crude Oil and it moved up by $1.00, your account balance would increase by $1,000. Conversely, if it moved down by 1.00, it would decrease it by $1,000.

Suppose you bought 3 contracts when Crude Oil was trading at $63.00. Suppose you also set a stop loss order to sell it if it dropped back to $61.90. If it did, you'd exit with a loss of $1,100 per contract ($63.00 - $61.90 x $10.00) or $3,300 in total. That would be well within your risk tolerance of 3.5% for a $100,000 account.

If Crude moved up by $1.50, your account balance would increase $1,500 x 3 or $4,500. But suppose after it moved up $1.50, it moved down $2.00 a few hours later. Crude can frequently move $1.00 in an hour. One moment, your account balance swelled by $4,500 only to turn negative by $1,500 within hours. To the uninitiated and inexperienced, that can be unnerving.

Remember though, you set a protective stop at $61.90. You predetermined that, after you enter the trade, you were willing to let the market move as much as $1.49 against you before it moved back in your favor. In this example, the trade moved $4,500 in your favor and then $3,297 against you. That $7,800 differential is volatility. It is not risk. It's completely normal and must be expected.

Now suppose Crude had momentarily moved up $4,500 only to later hit the protective stop which caused a loss. To the inexperienced, they might think they just lost $4,500 in profits. That's certainly easy to think after the trade ended. It also presupposes you knew Crude wouldn't move higher than $4,500 before falling back and hitting the stop. Both suggestions of course are equally ridiculous.

Reality tells us something else. First, all markets ebb and flow. Between the time a trade begins and ends, the market is going to move up and down. Second, its impossible to capture the entire range of a trade between entry and exit. If you are able to capture 50%, consider yourself fortunate. So, if you bought Crude at $63.00 and

it traded to a high of $69.00 before you exited, you might capture only $3.00 of the move. And if you did, you'd net at least $9,000 ($1,000 x $3.00 x 3 contracts). That's a return of $9,000 having risked just $3,300.

There is considerable leverage trading commodity futures. That's why the profit potential is so enormous. In the illustration above, you saw that a one penny move in Crude Oil represents a potential $10 gain or a $10 loss. Leverage can certainly magnify volatility. But it doesn't necessarily increase risk.

With a risk management strategy that caps risk at 3.5% for every market traded, the degree of volatility is no longer an issue. A 3.5% loss trading Crude Oil is just the same as a 3.5% loss trading Exxon stock. But where a one penny move in Exxon is worth only a penny, a one penny move in Crude is worth 1,000 times more. If you knew that your risk was limited to 3.5%, which would you rather trade? The answer should be obvious.

There is something else to keep in mind. As an account balance grows, as more markets are being traded, and the longer trends last, the fluctuations of an account's balance will become even more pronounced. But no matter how dramatic the volatility may be, it won't change risk.

Now take this one step further. Suppose you were trading Crude Oil plus the Swiss Franc and the Dow Index. Also suppose you capped risk at 3.5% for each market. Theoretically at least, if you were trading all 3 markets at the same time and each market moved against you by 3.4% without ever hitting your protective stop, your account balance would momentarily drop by over $10,000. And if those 3 markets later moved simultaneously in your favor by $4,500 each, your account balance would appear to skyrocket from a negative $10,000 to a positive $13,500. That $23,000 differential would not be unusual. It would be normal volatility. And the risk never changed.

Such fluctuations do not reflect trading performance and should not be used as a measurement. It would be foolish to judge the effectiveness of a trading methodology by fluctuations in an account balance. It would be even more foolish to draw any conclusions based on momentary spikes to an account balance. Trades can only be judged after they're closed.

Hopefully, this illustration shows why volatility is not the same as risk. Risk, or more specifically unmanaged risk, arises when you fail to set protective stop loss orders that let a trade go more than a predetermined amount or percentage against you. Remember, volatility drives markets and fuels profit opportunity. Volatility is good. Unmanaged risk is bad.

In the final analysis, the only aspect of trading that you can control is risk. Nothing else. You can't control profits anymore than you can predict what a market is going to do or when. But risk always remains within your control and is the most important aspect of profitable trading. You might say that successful trading is much more a game of defense than of offense.

Once identified, protective stop loss orders limit risk to a small, predetermined percent of capital. That allow the market to perform naturally. If it moves in your favor, the stop order will be moot since you will probably exit the trade with a profit. And if the stop order is hit, you can reset assured that your loss was small and manageable and that your capital wasn't damaged.

Combining a trading methodology that has an expectancy of a positive outcome every time you enter a market with well conceived risk management, you will ultimately succeed because you will generate more profits from winning trades than loses from losing trades.