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Risk Equalization

by Michael Covel

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.

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

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.

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