UNDERSTANDING RISK MANAGEMENT IN THE STOCK MARKET

True Market Insiders

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Click a link to jump to a section.

Traders are always interested in track records and winning percentages. Any discussion of risk management is met with a glazed look and a slight roll of the eyes.

But the simple truth is that risk management is the key to growing your portfolio!

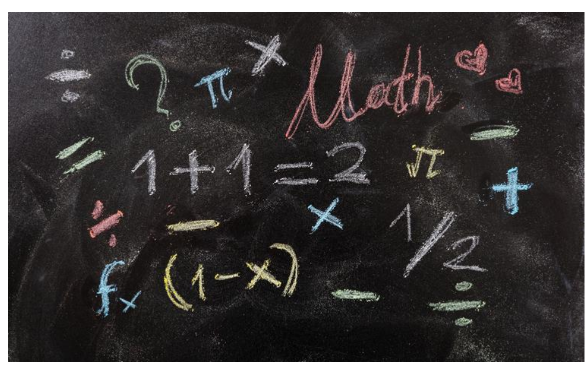
Sector allocation (WHAT you invest in) and market timing (WHEN you invest) are both important. But with a good risk management strategy (HOW you invest) can make you good money even without either of those other two.

But without a strict risk management discipline, your portfolio has little to no chance of growing over time.

Let's begin by reviewing the math behind risk management. Then, we'll look at some bad habits you might have developed.

Finally, we'll bring it home with a look at something called heuristics.

The Math Behind Risk Management



Let's say you execute four trades. Each trade risks $100. If you make $25 on one of those trades, you would have made 25% on that trade. That's pretty good.

Now, let's say you made 25% on three out of the four trades. You'd have a winning percentage of 75%. That's a decent winning percentage.

But say your 4th trade *loses* 100%. That would be a $100 loss, in total. So instead of making a net gain of $75 on three trades, you would have a net loss of $25. Even though you had a 75% *winning percentage*, you still experienced a net loss in terms of capital.

Let's try this instead…

We'll set a 25% stop loss on each of our four trades. So, the most we can lose is $25 per trade.

Say three trades make $25, and one trade loses $25. We still have a net profit of $50. That's a net gain of 12.5% on all four trades combined. Now that 75% winning percentage is working in our favor thanks to the risk management we applied.

I'll throw in a third scenario. This time, three out of the four trades lose 25%. But the fourth trade makes 100%. With only a winning percentage of 25%, we still saw a net gain of $25.

The point of this exercise isn't to persuade you that a 25% winning percentage is just fine. It's not. Obviously you would rather have a winning percentage of 75% or more.

The point is that there are many ways to look at winning percentages. Any scenario that results in a net profit almost always relies on risk management.

How to Analyze Track Records

The next time you analyze a track record, don't begin by looking at the periods of growth. Focus on the drawdown periods first. Determine how much risk the manager had to accept in order to get that net return.

You'll often find that track records with the biggest gains had to accept the biggest risk to get those returns. While I don't think that it's as simple as saying that "risk is commensurate with reward," there *is* a lot of truth to that statement.

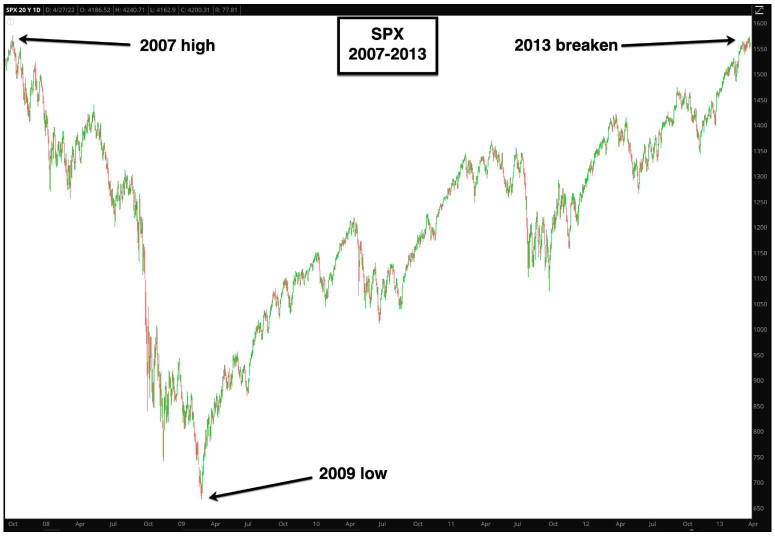
Consider your own temperament for a moment. If *you* had your money invested into a fund whose track record you're analyzing, how would you react during steep drawdown periods? Would you stay the course? Abandon ship?

How Much Risk Is "Too Much Risk?"

If your portfolio is tightly correlated to an index like the S&P 500, and if that index falls 50%—which the S&P did during the 2008 crash—it'll then take a 100% return from the low just to get you back to breakeven.

A 50% loss in your total account is too much risk.

Remarkably, the S&P 500 did fully recover from the 2008 crash– *five years later, in 2013*. You can't count on the market recovering that quickly again.



Instead, think about the incredible bull run in stocks from 2009 through 2013. If you had cut your losses in the 2008 crash with proper risk management, you could have made net profits during that bull run instead of just getting back to where you were at the market's high in 2007.

In order to hold your losses to something much more reasonable than 50%, you would have needed strict risk management discipline.

I'll now mention some very bad investing habits I've observed.

Do You Make These Mistakes In Your Portfolio?

Traders often stuff their portfolio with more trades than they could ever possibly manage. To justify this gluttony, they tell themselves they are "diversifying their portfolio."

There are two pitfalls here.

1. Too many trades at once…
2. And some misconceptions about diversification.

Too Many Trades at Once

Don't take on more trades then you can reasonably monitor. You also need to manage all of these positions even when the market is in turmoil, whipsawing up and down. That is, when it's the most challenging to monitor your trades.

In any case, with good risk management discipline, you'll always know how much risk you can take *per position*. If you take on too many positions, you'll need to continuously lower your risk-per-position profile so your account as a whole is not exposed to more risk than you can handle.

Which brings us to ETFs.

These are funds that trade just like individual stocks, but are made up of groups of stocks or other assets. So instead of buying, say, 20 stocks in a particular sector, you could consider buying one ETF. Instead of having to manage 20 positions, you only have to manage one.

Misconceptions About Diversification

Diversification is supposed to be a tool of risk management. But for diversification to play that role, each tranche of your portfolio needs to be uncorrelated with every other tranche.

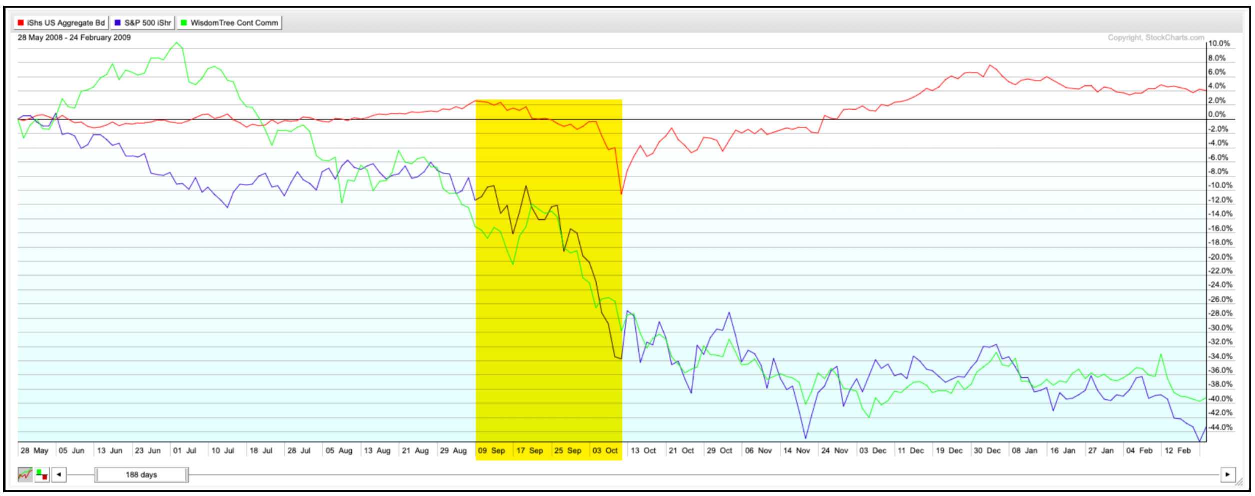
Think about it…

If all of your stocks rise and fall together, then for all intents and purposes they might as well all be just one giant investment. They need to move up and down differently or diversification has failed.

The idea is that as one portion of your portfolio struggles, one or more of the others outperforms. This outperformance offsets your losses from the struggling segments.

A worse problem with diversification is that *stocks tend to become more correlated in bear markets*. So at the exact time when diversification is most needed… it abandons you.

Look at this historical chart from StockCharts.com.



It shows the **iShares Core U.S. Aggregate Bond ETF (AGG)**, **iShares Core S&P 500 ETF (IVV)**, and **WisdomTree Enhanced Commodity Strategy Fund (GCC)**. During the deepest decline of 2008, all three were trending lower.

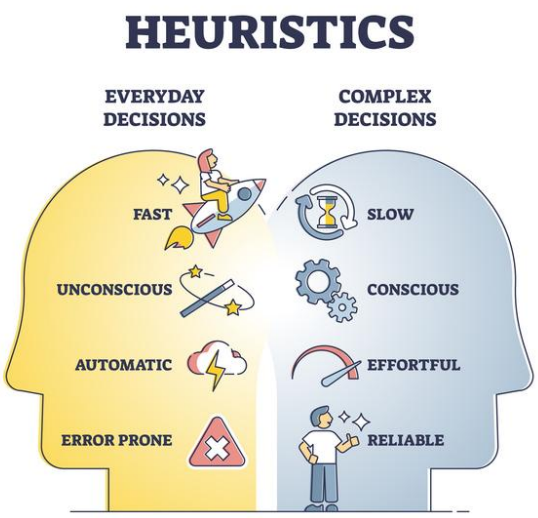
In the market's darkest hour, "diversification" was AWOL.

That leads me to the most important part of this report, if you're out to become the best investor you can be.

It's a little-known concept called…

Heuristics

Have you ever spoken to a family member, friend, or even a stranger about their investment portfolio?



Have they boasted about how well their account was doing, causing you to feel that pang of jealousy? What happened next?

Maybe you called your financial advisor, told them how well your "friend" is doing, and demanded to know why your account wasn't doing better.

A similar thing happens when we sit in traffic, frustrated as cars in the lane next to ours cruise by.

And it happens in the grocery checkout line. The lane you're NOT in always seems to move faster than the one you ARE in. So you jump to another line and then see that if you had just stayed in the line you were in before, you'd be in the parking lot loading your Bounty and Rice Krispies into your trunk.

What you're doing in these scenarios is the same thing people have been doing for thousands of years. You're using a problem solving technique called *heuristics*.

According to **Investopedia**, "A heuristic is any approach to problem-solving that uses a practical method or various shortcuts in order to produce solutions that may not be optimal but are sufficient given a limited timeframe or deadline."

Heuristics are not sufficient when it comes to managing your stock portfolio. But it does make sense that many investors use them.

There's a lot to think about when it comes to the markets. There is a massive amount of information about the markets being thrown at you by the internet, TV, your brother in law, etc.

How can you possibly consider and process all that information? You can't.

So, your brain defaults to a trial-and-error method to select the information it thinks is most important. Since you want to grow your account, it naturally focuses on information pertaining to growth, things like: winning track records, winning percentages, or even someone you hardly know bragging about that ten-bagger they just made.

Your brain does *not* default to risk management, which is about minimizing losses. Since you don't *want* losses, your brain has trouble focusing on them.

You need to learn to fight off your natural tendency to rely on heuristics when it comes to investing.

Conclusion

You can use stop loss orders to manage risk. You can buy Put options and use them as insurance to limit losses. You can set up a math-based discipline where you don't risk more than a certain amount per position.

And you can diversify your portfolio properly so that diversification works in your favor, when you need it to

You could use a variety of active management strategies like sector investing as the cornerstone of a robust trading discipline.

The common denominator for success will remain risk management.

So, the next time that heuristics bug starts nagging the back of your mind, counter it by asking the less fun question. "*What kind of risk do I have to accept to get this return? Is that amount of risk right for me*?"

Finally, stop worrying about missed opportunities. We're talking about the stock market.

A new opportunity is coming when that bell rings again tomorrow morning.

Bill Spencer
True Market Insiders

Bill Spencer
Editor-in-Chief, True Market Insiders

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