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Effective Position Sizing

Traders often make the mistake of randomly determining the size of their positions based on their confidence level in a trade. However, this approach is not strategic or well-informed. A more effective methodology for determining position size involves considering the risk as a percentage of your current account capital, rather than simply the number of contracts traded. By keeping the risk consistent in dollar terms, you can avoid significant losses.

Attempting to predict in advance which trades will be winners and which will be losers is nearly impossible. What we do know is that over a large sample size, a strategy with favorable probabilities or an asymmetric risk-reward structure should yield positive results. For example, if you trade credits, you are positioned on the side of probability, and as probabilities play out, your profit will grow steadily and linearly. Similarly, if you trade long butterfly spreads, you have an asymmetric risk-reward structure, and allowing winning trades to work can lead to steady and linear account growth.

Consistently generating profits requires having a process or methodology for determining directional bias, criteria for entries and exits, and appropriate position sizing. These processes must be executed consistently to allow probabilities to work in your favor.

Effective Position Sizing

To effectively determine the position size for your trades, it is important to consider the risk as a percentage of your capital allocated for trading in the current market. Before calculating the position size, you should decide what portion of your trading capital you are willing to risk in each trade. Here are some commonly used risk ranges:

- Conservative: 1-3%
- Moderate: 3-5%
- Aggressive: 5-10%

If you are new to trading or learning a new strategy, it is advisable to start with the lower end of the risk range and gradually increase it over time if it aligns with your risk tolerance.

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Max Risk

To calculate the maximum risk for a trade, multiply your total capital by the risk percentage. For example, if you have $20,000 in your trading account and you want to risk 3% of it, the calculation would be:

Max Risk = Capital * Risk %
Example: $20,000 * 3% = $600

Stop Loss

The stop loss is the price level at which you plan to exit the market. It represents the distance between your entry point and the potential exit point for the trade.

For credit spreads, it is generally recommended to set a stop loss at 2x to 3x the premium received. On the other hand, for butterfly spreads, it is not typical to use a stop loss. Instead, the trade should be sized in a way that considers the risk as the full premium lost.

The calculation to determine the risk per contract is as follows: multiply the premium received and the stop loss then subtract the premium received. This calculation helps determine the potential risk associated with each contract traded.
Here is the equation:

Risk Per Contract = Premium Received * Stop Loss - Premium Received
Credit Spread Example: $100 * 2.5x - $100 = $150

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Contract Sizing

Once you have determined the risk per contract, you can calculate the number of contracts to trade by dividing the maximum risk (previously calculated) by the risk per contract. Here's an example:

Number of Contracts = Maximum Risk / Risk per Contract
Credit Spread Example: $600 / $150 = 4 Contracts
Butterfly Spread Example: $600 / $100 = 6 Contracts

Risk as a percentage of capital should be consistent and contract size adjusted accordingly.

Advanced Position Sizing

Experienced professional traders often employ a different approach when it comes to position sizing and risk management. They increase the risk on their high-probability setups that have shown consistent profitability and reduce the risk on their lower probability setups that may still be profitable but to a lesser extent. However, reaching this stage requires a trader to consistently follow a well-defined trading process for a minimum of six months and maintain thorough documentation of their trading statistics.

Unfortunately, many new traders fail to reach this stage because they often lack the discipline and persistence to adopt and stick to a trading process long enough to fine-tune their position sizing and risk management strategies.

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Managing Expectations

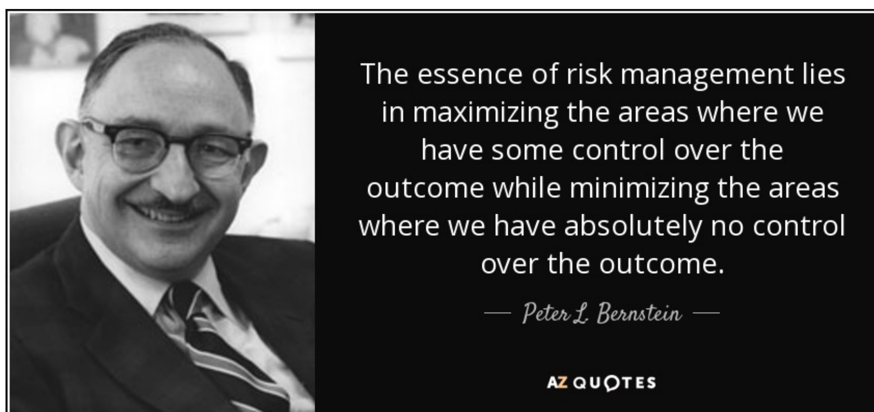
New and aspiring traders often harbor unrealistic expectations about trading, which can lead to disappointment and failure. Many believe they can quickly turn a small amount of capital, such as $500, into a substantial sum like $100,000 within a year. However, this mindset of wanting too much too soon can be detrimental to their trading journey.

One of the common mistakes made by new traders is taking excessively large position sizes, hoping for massive gains. They also tend to hold on to losing trades for too long, expecting a miraculous turnaround. Unfortunately, this approach often results in blowing up their trading accounts, leading them to conclude that trading doesn't work.

To succeed in trading, it is crucial to let go of unrealistic expectations from the outset. Embracing the possibility of losses is essential because losses are an inevitable part of trading. The key is to manage those losses by adhering to a well-defined trading plan and utilizing stop-loss orders. It's important to understand that not all losses are indicative of mistakes or poor trading decisions.

No trading setup or strategy will be foolproof and work perfectly all the time. Exiting a trade through a stop-loss order is not a failure; instead, it should be viewed as an opportunity to learn and reassess the trade idea. Embracing the learning process and treating each trade as a valuable experience can contribute to long-term growth and development as a trader.

Above all, it's crucial to enjoy the journey of trading. Trading is a continuous learning experience, and embracing the process rather than focusing solely on the outcomes can lead to a more fulfilling and sustainable trading career. By maintaining a realistic perspective, managing risks, and adopting a growth mindset, aspiring traders can increase their chances of long-term success in the challenging world of trading.



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