Chapter 23 The Must-Have Money Management Chapter

Every trader has a little, Dr. Jekyll and Mr. Hyde in them, having two conflicting voices when saying "look at all the money we can make, this stock is never going down, trade more aggressively; do 10 contracts instead of 1, we will be millionaires in a month." The other voice is saying "Whoa, slow down, we have to be careful, that's too much risk for one trade, what happens if the trendline breaks?" You should be listening to the sane voice that wants to protect your money.

Be a Risk Manager First and Trader Second

Paul "Bear" Bryant one of the top college football coach of all times said "Offense sells tickets, but defense wins championships." If you want to be a great trader, use that same approach and always think money management first. Regardless of how well you can predict what the market will do, if you cannot defend your money and limit losses, you will not be a successful trader in the long run, sure you may have a great streak for an extended period of time, but it won't take much to turn that around.

I was chatting with a friend today who told his friend had made over two million dollars in the previous year, but gave it all back in 3 months due to reckless aggressive trading when the market started falling. This guy was missing two key steps of trading: Money Management and Discipline

I have never taken a huge loss from making bad trading decisions, of which there have been quite a few. The big losses have always been from poor allocation of money and taking on too much risk. This is not to say that stock picking, market timing, and technical analysis skills are not important in your success. However, without proper trade and risk management, you will fall short of being top-level trader. Don't worry so much at the early stages about how much money you can make and learning everything you can about option trading and technical analysis. That will come in time, but if you cannot learn how to allocate your money and limit losses, you will not be trading long enough to learn everything. I will venture to say that a trader with mediocre trading knowledge and amazing money management skills will over time outperform someone with the reverse set of skills.

Trading comes with risks and rewards that should be balanced, without tossing risk off to the side. When you do take a risk make sure it's worth the rewards. Taking a trade with a 3-to-1 risk-to-reward ratio with a 50% chance of being successful is a poor trade, as is risking $975 to make $25.

When I started this book, I wrote trading is a business and every business needs some kind of money control to stay alive. They need to be aware of exactly what risks they can take and those they can't. As a trader you need to stay on top of this as well. You will take losses, many of them, and occasionally get blindsided, that is normal and unavoidable, but you should have a risk plan to keep those losses acceptable and for every risk you take the reward for taking it should be worthwhile.

Lowering Risk

There are going to be times when you realize either you have too much dollars at risk, too much Delta exposure, or the markets are not behaving rationally. At this point it's time to de-risk and start lowering your total exposure. If you were overly long, and lowered your exposure and the market rallied like crazy afterwards you need be able to say "SO WHAT" as it's better to be safe than sorry. As an example next Friday there is a Producer Price Index report followed by a Federal Reserve decision a few days later. I am expecting a huge move in the market, but not sure which way. I am currently as long Delta as I normally feel comfortable with. But I will definitely reduce that to Delta neutral in the next few days to lower my risk as well as taking off some decent winners I have, that are starting to get Gamma heavy. I am willing to forgo some profits to be safe and will take it stride if the market rockets up.

You May Want To De-Risk If:

The market is getting too volatile
You are on a losing streak
You are on a winning streak
You feel you have no feel of the market
Your positions are too lopsided
It takes you 3 hours to review all your current positions
You can't sleep worrying about your portfolio
Your fingernails are chewed down to nubs

Beware of Winning Streaks

Worse than a losing streak, is having a great winning streak, especially in your early days of trading. A good winning streak can confuse you into thinking you are invincible. This can lead to overconfidence, which leads to you increasing your size and taking on greater risk than you should. Sure enough at some point that streak will end and reverse your fortunes faster than you would like. It can be easy to misinterpret being constantly long in strong bull market as being a good trader. When the tide eventually turns you may be in for a big surprise if you are overextended. The only way to protect against this is to constantly be conservative with your money.

It is funny how it can take you a year to make X amount of money and lose it in 5 weeks. This happens most likely because you increased your position size and total number of positions and started putting on riskier trades as you made money. Once you start losing you may refuse to lower your size to where it should be, and your account quickly shrinks. Losing after a winning streak may tempt you to revenge trade and trade even more aggressively to make back money you just gave up on the last loss.

Netflix Massacre

When a stock closes at $509 and opens at $400 like Netflix did on 1/21/2022 after bad earnings and you are short a 530/480 strangle, there is not a thing you can do. You are going to be down $8,000 when the market opens. It will have been a miserable night as that fall happened right after the market closed when earnings were announced. This will be the outlier you never expected nor can account for in your money management. You will most likely need it to happen to you before you believe it can happen and learn to trade small. Luckily, when this happened to me I only had an iron condor on and just lost $775.

Avoiding the Big One

You never want to be in a position where one trade can wipe out 30% of your account. Not only is it painful, but it can mess with your mind. If your account is $5,000 you shouldn't be trading a strangle that eats up $3,500 in buying power. One bad day can easily cost you $1,500. It's not just the one big bite that can hurt you but it's also a rapid string of small losers. Once it gets to you, it can lead to making irrational decisions in other trades. From holding too long, to trying to make it back too quickly with too much risk, to trading scared and not giving trades a chance, your trading can change if your mind takes a beating.   It is best not to let it get to that point so don’t put yourself in a big loss situation.

Don’t Accept Max Loss

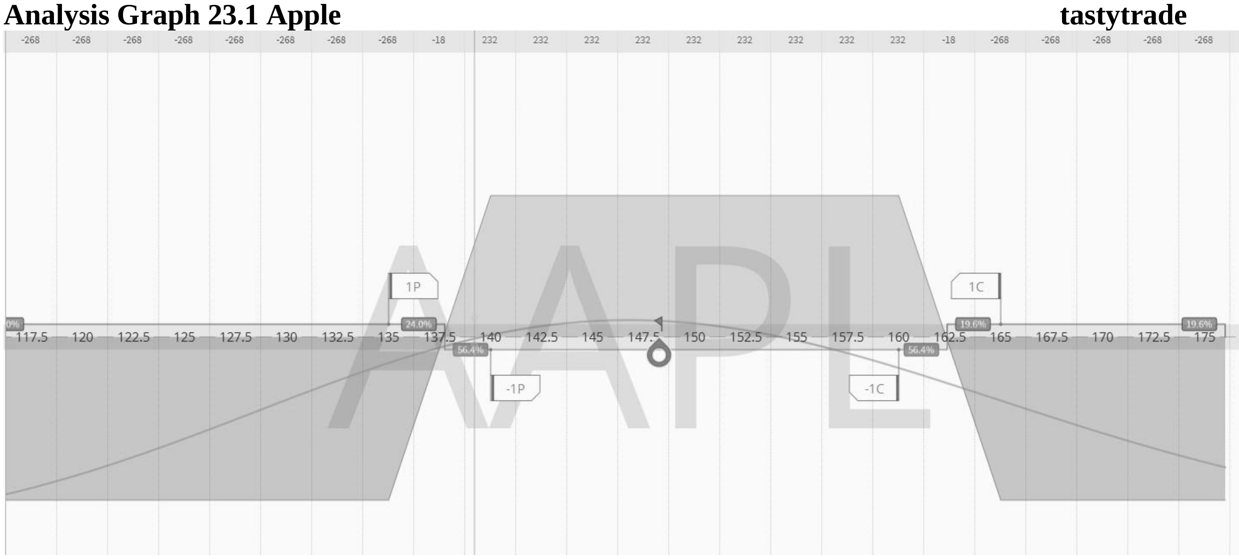
Luckily with option trading, for any defined risk trade, max loss is an easy to determine number. But you don’t need to accept this number as absolute and you should manage trades before that point. It’s the undefined ones that are harder to control. Even if you have exit targets or stops, they may mean nothing. Sure you can say “if I’m down $1200 on a strangle I will exit”, but as Robert Burns said, “the best laid plans of mice and men often go awry”, well not often but once in a while is enough.

With limited risk trades, the max loss should be a reference point only. Though every trade is different I try not to lose more than half that amount. And not even because I set that as a target but because my other exit parameters get me out first though 50% is great target to manage risk at.

For example, looking at the Apple **Analysis Graph 23.1** Here is an iron condor that I just put on with a max loss of $268, but I am not letting it get to that. For this trade to get to its max loss it really would have to either move quite a lot or held to expiration. Getting out early helps avoid the latter. I will look to get out if the stock goes outside the strike price of one of my long options which are $135 and $165.

This is not a set rule but a serious evaluation mark, I will look at a chart first to see if it is at a support or resistance level or if one of my indictors tell me it may come back. Most of the time I do get out, but if I do stay in, I will keep a very close eye on it getting out at any sign it’s not going to work. If you do this you must think with a clear head and say “what would I do if I had no position on”?

Analysis Graph 23.1 Apple **tastytrade**



Would You Like a Free Luxury Car or Two?

One thing to take from this chapter is that taking a loss preserves capital.   The Apple trade has 49 DTE and the options have plenty of extrinsic value in them. Even if Apple blew through one of exit areas, it may still have $50 in extrinsic value. That is your money, that could be used better somewhere else than hoping Apple comes back.   There is no need to let it dwindle to zero. Remember it doesn’t matter where the price was when you got into a trade, it only matters where it is now and where it’s going next. $50 in your pocket is better than no dollars.   If you saw a $50 bill on the street you would pick it, wouldn’t you? Or would you prefer somebody else take it.

While on this topic the reverse is true. When you are in a profitable trade those paper profits are not house money, it's your money. Giving back $50 of a trade that was up $200, is a loss of $50 in my opinion. Same as dropping $50 on the street. Do our best to protect every penny, winning or losing. I would venture to say I make at least 1000 trades a year even, if I gave away $20 a trade, that's $20,000 of money I could have had that I don't, or the yearly car payments for a real nice Tesla and Mercedes plus their insurances.

MAKING A RISK PLAN

Every Trader Is Different

No two traders are alike and each will have different risk tolerant levels. Of course how much you have makes a different as $5,000, $25,000, and $100,000 accounts have to have different risk parameters. It's not just how much you have but your goals as well. Is this money you need to live on or pay for a kid's college or is this just play money? Is your options trading your only trading or is a small part of all your investment assets. Are you conservative or a risk taker? There are people out there who don't care if they lose and are just buying options as long shot bets for entertainment, while others are hoping to make a steady 15%-20% a year. Each of these traders has a different risk profile so there is no one size fits all approach. But I will lay out what a prudent trader should do.

Risk Management Begins Before You Enter a Position

Like having an exit plan for each trade you make, you should have a general set of risk parameters that encompasses all of your trading activity. This includes everything I talked about in the chapter 20 on exiting trades, but now it gets more detailed as too how much you can actually afford to lose on any giving position or in total. Having a risk plan will help you grew your account and lower the risk of disaster and outlier moves. In the next chapter I will talk about putting together a trading plan, but first, you should start with the risk portion of it.

The next few sections on setting up your **Risk Parameters** will be the key to keeping your risk in check and hopefully keep you from blowing up. Take the time to actually do this, put it down on paper and then follow it. Unfortunately with a small account you will have to stretch the optimal rules a bit, but try to not to do so too much. You should still make a risk management plan regardless of account size.

RISK MANAGEMENT PLAN

Putting together a money/risk management plan can be made easier by having the answers to the questions below. These are the basics you need to know that will help you lower risk and ensure you survive the worst of times.

Percentage of your account can you risk at once?

The first thing you need to do if figure out how much you have to trade with and what you are willing to risk at any one time. A good rule of thumb is never risk more than 50% of your allocated options funds. I like to keep my option's account separate from my futures and equities accounts. Making it easier to access its risk profile and to easily keep track of how much margin or buying power I am using. It would be too difficult to do if I only had one big commingled account. In the options account I try to keep my total amount used to around 50% of my buying power or that the max loss of all my trades combined is less than 50% of account. If my positions are so diverse and opposite each other that it's hard to get hurt on all of them at once, then I go to about 75%. But regardless I never max out.

Using only 50% leaves you room to survive an outlier move or two, not worry about margin calls, not have to liquidate if you ever get assigned or get a margin call, and should you ever blow up, you have another 50% in reserves to trade with. If you are maxed out all the time then any of these things can occur.

50% doesn't mean you have always have to stick to that. If in low IV times (like with the VIX under 16) you can't find enough good opportunities, scale back. If there is nothing good to trade, you shouldn't force trades and you may want to use only 25-30% of your capital on options, and buy some safe dividend yielding stock with the rest. Likewise if volatility is great and there are more opportunities you can go with a little more than 50%. I know sticking to 50% is harder to do with a $2000 account, as 2 or 3 trades can eat that up quickly, but do your best to manage it.

Percentage of your account to risk on one any trade?
This gives you guidance on what your max loss on a trade or a worst case scenario on an unlimited risk trade would be. In actuality you should be managing your trades at a smaller loss than this total number. Once again account size makes a big difference here. If you have a $100,000 account then you should keep you risk per trade to 1-3% of your total riskable capital. Don't make trades where you are risking $5,000 or $10,000, that's just too much at any given time. You are better of making 10 smaller trades than one big one, just in case the unexpected happens on any particular stock. Losing streaks will happen and if you get into one, it's hard to survive if you are risking 20% of your account per trade.

With a smaller account I would risk no more than 10% on any trade, but you should aim for 5% or under. There are plenty of trades you can make that have a $200 or $300 max loss and I would stick to that if your account is under $5,000. And no not do strangles or any trade with a naked option. If you do start making those trades stick to low priced stocks that will not kill you if they move 20%. Think of a trade as not how many dollars it can make you, but how much it can cost you if wrong. Limiting your total loss per trade will let you survive a losing streak where 8 trades in a row go bad.

You need to keep in mind that 5 similar types of trades in 5 oil drillers or having similar trades in SPY, QQQ, and IWM at once is in really about one big trade. Don't fool yourself into risking 5% in each, thinking you are spreading out risk, in reality this is like being exposed to 15% of your capital on one trade. I keep an excel spread sheet that I update nightly with my balances, that gives me how much I can risk per using 3% of my allotted capital as a max amount.

Max Beta Weighted Delta?
You should also establish a max amount of Beta weighted Delta (BWD) you are willing to be directional by. This moves the focus from dollars at risk to how big your Beta weighted Delta directional bias is. A good rule of thumb is not have more than +/-0. 5% of your total account in Beta weighted Delta. If you have a $10,000 account that's only 50 BWD. If all your positions are is the same direction and your BWD is over 50, you should start lowering it, if it's at 148 it's way too much and you really can't afford it. That would be the equivalent of about $65,000 worth of SPY which is a bit much for your account size. Even 0.5% can be too directional as Delta neutral would be under to 0.2%.

Max portfolio Theta?
Like Delta, too much positive Theta can hurt you because it carries Gamma risk with it. You should set a limit to how much you will keep on. To make things easier keep this in the 0.2% to 0.5% range the same as you would for BWD. If you start at a total Theta of 30, and your positions are profitable, Theta will gradually increase. If all your positions have the same expiration it may get too high as you near the 21 DTE mark. As you start to exit trades then enter into new ones it will decrease naturally to a safer level. If you stagger expirations it will stay more constant.

Max exposure per sector?
After setting up your risk per trade allowance, you need to think about the diversity of your active trades. It is normal to like one sector more than others and at times find yourself too mega cap or tech heavy, but you should fight that temptation to do so. I have my list of favorite things to trade and then I mix them up never having more than 15% to 20% in any sector at most, though I prefer to keep it closer to 10%.

This is not an exact science that I will weigh out every night, but it's something you can eyeball quickly looking at your positions. If you have 5 equally weighted positions all long Delta on and it looks like either QQQ, SPY, AAPL, MSFT AMZN or JPM, GS, WFC, MS, BAC (all banks) you need to start following this advice. Instead something better would look like SPY, JPM, XOM, GLD, (TGT and WMT). This is meant to be capital at risk in each sector, not number of positions. So in the latter example, if you have $5,000 total at risk you can risk $1,000 on each except $500 each on WMT and TGT as they are both retailers. If you want to add QQQ to the list then lower the amount to you are risking on SPY. With $5,000 at risk you could probably have 10 positions risking $500 each and no sector at more than $1,000 and maybe a mixture of SPY, IWM and QQQ at 20%.

What position size to trade?
This is fairly straight forward after knowing how much you can risk per trade. For risk defined trades if your plan allows for $1,000 risk per trade and the trade you like takes up $300 in buying power or has a max loss of $300, you can do up to 3 contracts if you want to. However you can accomplish the same result by moving the Delta of your long options further away. So instead of selling three 100/95 put spreads for a $900 total credit, with a $600 potential profit you could sell one 100/85 put spread for a similar result. It may cost a little bit more in buying power but not much more and it improves your chances. The difference will be you will have a better breakeven point and higher POP with the wider spread. This is due to the cheaper price of the protective option making the premium collected per contract more valuable. I personally prefer to have multiple contracts on so I can scale out at different times.

One thing to consider is that if you had a choice between being short one naked 40 Delta put option at $8 as opposed to four 10 Delta puts at $2, it is not the same thing. Yes they start out with the same Delta of -40, same profit potential, and the 10 Deltas puts have a much lower breakeven. But the second trade has much more risk potential from an outlier move that could destroy an account instead of just denting it. It will also come with about substantially bigger margin requirement.

Max positions on at once?
How much can you handle at any giving time? When starting out you should stick to no more than 10 position, with 5 to 8 being optimal. I find 20 to be the most I want to handle at one time. After that it is too hard to manage effectively and they need to be managed systemically like exiting at 21 days or 50% profit. I prefer to actively manage and constantly evaluate them based on my rules. I especially like to manage my losers and not allow them to get to max loss. I rather have larger size on per trade than more positions, as after a while you can only diversify so much and they tend to be similar positions. You also don't need reach that max position all the times if there is nothing to trade, it's okay to trade less.

How much you can loss at any given time?
Another piece of information you should have is establishing how much drawdown you will take. What are you willing to lose in total before getting out of everything and/or reevaluating? For example you can say if I lose money 10 days in a row, I will close out all my positions. If I lose 25% of my tradeable capital, I will take a break to look over my strategy or clear my head. I recently had a streak where was I dead wrong for 2 weeks. I decided I had had enough and liquidated every losing trade I had, which was most of them, keeping the few good ones. I took a weeklong break to clear my mind before entering any new trades and have been doing much better since.

KISS

To wrap things up, your number one goal is to not blow up. Here are some rules to help. **KISS** usually stands for "keep it simple, stupid" and in this case it is definitely true, but I want to expand to "keep it stupidly small" as well.

1. Never risk more the 50% of total capital
2. Never risk more than 1 to 5 percent per trade
3. Exit trades 2 to 3 weeks before expiration
4. Have uncorrelated positions and stay diversified
5. Expect the unexpected
6. Stay Delta neutral
7. Know your exit before you enter
8. It's okay to take a loss
9. Get out when you feel uncomfortable
10. Don't overstay your welcome
11. Trading small is your only protection from total disaster

Final Thought

You must be able to act as a risk manager as well as a trader, taking the risk control extremely serious. Don't trade without some sort of money management guidelines, as they will give you a reference point to control those risks and help you succeed.