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Guidelines for Risk Management In Commodities Trading

"There are bold traders, there are old traders. BUT there are no old bold traders."

Risk control is an essential part of trading successfully. Effective risk management requires not only the careful monitoring of risk exposure, but a strategy to minimize losses as well. Understanding how to control risk exposure allows the trader, beginner or veteran, to continue trading even when the inevitable losses occur.

While every trade involves a degree of risk, some general principles of risk management, if applied, reduce the potential for loss. A few of the generally accepted market axioms for controlling risk are noted below and are applicable to anyone who has ever traded or ever considered trading.

Rule 1: Do your homework

Doing your homework before you trade is a must; there is no substitute. For every buyer there is a well-informed seller, and for every seller there is a well-informed buyer. Each is trying to maximize his return. Before you put your money at risk, you should have a solid, well-thought-out reason why you would buy something that someone else wants to sell. Trading, after all, is a zero-sum game. Ask yourself, what do I know that the seller (or buyer) does not? Be cautious and show some respect for the person on the other side of the trade. You should have a clear understanding of the financial risk you face at any point in time. Part of that homework includes an estimate of the potential loss if the market goes against you by, say, 5% or 10% or 20%. Doing your trading homework also helps you calculate the worst possible outcome. These potential losses, together with estimates of the probabilities of those losses, provide a realistic picture of your risk exposure. Your risk may be reduced if you restrict trades to your area of expertise (that is, *do your homework*).

Rule 2: Develop a trading plan and adhere to it

Every trader should develop a personal methodology for trading. The methodology, or trading model, may be based on fundamental factors, technical indicators or a combination. An important part of your trading plan is to set a limit on what you are willing to lose. If you reach that limit, get out. Stick to your trading plan and avoid impulsive trades. If you don't follow your plan, you *have* no plan. A trading plan helps you identify and evaluate key factors that affect your trades and can be an important learning tool for subsequent trades. A sound trading plan will also give you needed confidence under pressure. With specific guidelines to follow, you will also be less likely to trade impulsively. Do not follow a trading plan blindly, however. If you do not understand what the market is doing or if your emotional equilibrium is severely disturbed, then close out all positions.

Rule 3: Diversify

Portfolio risk is reduced through diversification. Don't bet everything on one trade. Diversify your risk exposure by trading no more than 1% to 5% of your capital on any one position. (Contracts on different maturities of the same commodity count as one position.) To be effective, diversification must involve commodities that are not highly correlated (that is, that do not move in the same direction at the same time). High positive correlation reduces the benefits of diversification. **Predetermined stop orders limit your risk exposure and will cut your losses in fast-moving markets. Adopt a rigid stop-loss rule (for example, get out of a trade quickly if it loses 5-7%).**

Rule 4: Don't invest all your money

Before you enter a trade, be sure that you have adequate capital to cover an unexpected loss. If the trading opportunity looks unusually good, you are probably being too optimistic. Markets are rarely as good as they may seem. If the market takes an unexpected turn down, it is prudent to have some capital available to cover the small losses or margin calls. A little capital on the sidelines also reduces stress in difficult markets, reduces the inclination to take unnecessary risks and generally helps you sleep better at night.

Rule 5: Use stop orders

Predetermined stop orders limit your risk exposure and will cut your losses in fast-moving markets. Adopt a rigid stop-loss rule (for example, get out of a trade quickly if it loses 5-7%). Even the most experienced (not to mention successful) traders use stop orders to limit their risk exposure. Make a commitment to get out if your game plan does not work out. Price stop points are available to protect you. Use them as you get in. Some traders also use time stops. If the market does not break as they expect, they get out even if they are not losing money. Time stops are a reminder that you should get out of the market if you are not sure what is really going on.

Rule 6: Trade with the trend

You will be less likely to incur a loss if you are following the market trend. The direction of the market does not matter as long as you are positioned for the trend that occurs. If you are not well positioned, then systematically reduce your risk exposure.

Rule 7: Admit mistakes and take losses

An important aspect of controlling risk is the ability to admit you are on the wrong side of the market and to get out promptly, even if it means taking a loss. Even the best traders suffer losses from time to time. But we all hate to admit we've made a mistake, so this is a difficult lesson to implement. The axiom is true: *Let your profits run and cut your losses.* Reduce your risk exposure if the market moves against you. Don't add to a losing position in the hope of recouping your loss, and don't wait to get even before you get out. More often than not, this strategy will compound the loss. If you do not understand what the market is doing, *get out.* It is also a good idea to let some time pass between your loss and your next trade to lessen the potential for trading on your emotions.

Rule 8: Trade defensively

Trading great “Paul Tudor Jones” opined that, in football terms, "the most important rule in trading is to play great defense, not great offense." Think about what you could lose as opposed to what you could gain. Anticipate the "what ifs" and plan ahead, rather than have to react after the fact. To trade defensively, assume that the market is going to go against you. Calculate your maximum possible drawdown. Adjust your stop points, if necessary, to where you feel comfortable. Develop a plan to get out of the market. Then if the market moves against you, you are prepared. *Protect what you have.* To minimize unpleasant surprises, keep a vigil for a market change. Listen to what the markets are saying. Momentum and sentiment indices are often the first to signal changes in the market.

Rule 9: Don't overtrade

Reduce your risk exposure by cutting down on the number of trades you make and keeping your bets small. Be selective about the risks you take. Restrict your trades to the ones that are the most attractive. This forces you to do your homework and reduces impulsive and emotional trades. Because there will be fewer trades, you will have to be much more patient.

Rule 10: Control your emotions

Recognize that all traders experience high levels of stress and suffer losses from time to time. Anxiety, frustration, depression (and at times desperation) are all part of the trading game. Part of risk management is the ability to control these emotions. Don't let these emotions take control of your trading. *Stay focused on what you are doing.* Trade on the basis of informed, rational decisions, not emotions and wishful thinking. One way to maintain emotional stability is to have a meaningful diversion from the market. This may include family activities, trips and vacations, a hobby, religion, the arts, physical activity, community service, politics, and other interests that provide a balance in your life. A well-rounded personal life contributes to emotional stability and in turn emotional stability contributes to better trading. Networking with other traders is another way of maintaining control over your emotions. Other traders understand the problems you face and can provide important emotional support when you get discouraged. It helps to know that you are not alone and that others have faced and survived similar problems. Taking an occasional day off may help you reduce stress and maintain a positive attitude. If you have been doing well, it is a well-deserved reward. If you have been doing poorly, the break will help you avoid battle fatigue and may help you see the market with a different perspective.

Rule 11: If in doubt, get out

Personal doubts indicate that something is wrong with your game plan. Get out of the market quickly if:

- The market is behaving irrationally
- You are unsure about a position
- You don't know what to do
- You can't sleep at night.

Before you put your money at risk, you should be reasonably confident about what you are doing and reasonably confident that you will be successful.

CONCLUSIONS

Risk management basically involves four essential steps:

1 Fully understanding the risks of the trade

2 Eliminating unnecessary risks where possible

3 Being selective about which risks to take

4 Acting quickly to reduce risk exposure if the market moves against you.

According to many seasoned traders, the key secret to controlling risk is the ability to cut losses before they lead to ruin.

As Edwin LeFèvre, author of *Reminiscences of a Stock Operator*, wrote: "The [trader's] deadly enemies are: **Ignorance, greed, fear, and hope**." While these internal enemies may never be conquered, effective risk control techniques can minimize their negative influences. A rational risk control strategy, in turn, should lead to fewer and less costly unprofitable trades.

For any queries, please contact research desk at commodity@angeltrade.com

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