

Forex Flight Contingency Plan

A contingency plan is an amazing foresight into potential emergencies, and many scenarios that are not blatantly obvious. Airlines have teams of consultants imagining absolute ‘worst case scenarios’, then creating systems and procedures around them in the event that they ever arise. Every team member knows exactly what to do; from the pilots, hostesses, attendants, ground crew, control centre personnel, even the baggage handlers – the list goes on and on.

So what would happen if there hadn’t been any airline emergency plans envisaged and mapped out? There would be utter chaos and confusion whilst everyone ran around in different directions, it would be absolute mayhem. Everyone could only guess their next steps, whilst hoping and praying that their actions work in their favour to save their own life or avoid critical bodily harm.

This is all too familiar for traders who have leapt into the market without a trading plan, or they don’t have the discipline to follow the one they have. They move through states of confusion, astonishment, shock, fear, panic and bereavement, before closing their eyes and hitting the sell button to finally ease the pain; or worse, closing down their trading platform, walking away and giving up in despair as they are unable to make any sort of decision around reasonable judgement. They are bumping around, shaken by the extreme turbulence which is simply the markets natural movements, not realising that a systematic approach could have saved them a lot of money and anxiety.

Managing risk is essential in any of life’s functions, and certainly carries through to investing within the financial markets. It is funny to hear people who are inexperienced make comments like ‘trading is risky’, but what they don’t realise is that the risk can be predetermined, and very often down to the last cent.

It’s those people that jump into the markets without any safety net are exactly like a skydiver jumping out of a plane without a parachute – logically you just wouldn’t do it, but weirdly enough and as insane as it does sound, the majority of novice traders do this every day.

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These people find that their actions can only ever be based upon emotions, but to succeed you must base your decisions upon strategy and processes. They go in expecting to profit and inevitably when a position goes against them, even if only temporarily, they act like a mouse caught in cat house - panic stricken.

When you compare normal every day essential safety measures like seat belts, car brakes, balcony railings, boating buoyancy vests, non-slip floor surfaces, it is ludicrous to even consider 'trading naked' in the financial markets.

The most common forms of risk management and planning are tools and strategies such as;

- the Stop Loss,
- Position Sizing and
- maximum Account Risk.

The Stop Loss is the price at which you will immediately exit should the position go against you. So if you were to enter the market at 1.4250 and set your Stop Loss at 1.4200, this means you would lose 50 pips.

The placement of the Stop Loss varies from Trading Plan to Trading Plan, and each trader's individual preference. The calculations can range from;

- a set number of pips,
- a set dollar amount,
- a set percentage risk,
- or even simply placed at natural resistance and support levels within the market.

The potential loss of each trade should also be a maximum portion of your total account balance. Many traders do not like to risk more than a percentage of their overall account balance on each trade – a common amount is 2%, others may choose a flat dollar risk – for example \$2,000 (this would need to be relevant to their account size where you would not risk too much in the one go. The percentage works better because as your account grows the figure will change).

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Assuming a trader had a \$100,000 trading account, for them to adhere to this rule within their Trading Plan, they could not risk any more than \$2,000 on each trade.

This calculation then flows through to the placement of your Stop Loss and the Position Sizing with the number of Lots you can purchase.

Looking back at our original trade, where the entry was intended for 1.4250 and the Stop Loss was to be placed 50 pips below the open, if the trader was trading from a Standard Account where the minimum currency units start at a 100,000 lot size, we need to work out how many lots they can purchase whilst remaining within the maximum 2% account risk rule.

Looking at all the calculations as follows;

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|---|--|
| Maximum Account Risk | $\\$100,000 \times 2\% = \\$2,000$ |
| Stop Loss Risk | $1.4250 - 1.4200 = 50 \text{ pips}$ |
| Standard Account - Value per Pip | \$10 |
| Max Risk per Lot | $\\$10 \times 50 \text{ pips} = \\500 |
| Max Risk divided by Max loss per Lot | $\\$2,000 \text{ divided by } \\$500 = 4 \text{ Lots}$ |

Our trader can purchase 4 lots (400,000 currency units) within their Standard Account and remain within their Trading Plan rule - to not risk any more than 2% of their overall trading capital.

All these combined together work like the well designed emergency plans of every airline, a multitude of risk variances, that if arise are quickly and carefully minimised or removed where possible. All personnel are trained with the safety procedures until they become internalised.

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This way when faced with a dangerous situation they do not take the instinctual reaction of fight or flight. They can move through the processes with minimal fear, panic and unproductive emotion.

This is precisely why Risk Management strategies are extremely important to traders, so they can then function within an environment which is very unnatural. The reason it feels so unnatural is that all of a sudden we are in a situation where there are no rules or external influences – unless we create and enforce them ourselves.

From children until we are adults we always have some sort of external influence directing our decisions, but in the market if we ourselves cannot make the decision to get in or get out of the trade the result of our non-actions can be disastrous.

Many people like to compare trading and investing to gambling, however within gambling there is always an end to the game, and if you do nothing you stop losing. However, in the markets there is no end unless you make the decision to get out of the trade at some point, because if you do nothing you may continue to lose.

The onerous is entirely on the individual traders' shoulders, this is why it is so important to create the discipline to manage your risk; and the best part is that it can be managed to the point that you understand the potential loss before you even enter the trade.

Risk management rules are not only to do with price calculations, traders should also incorporate rules around risks to do with their own psychology. Every day life pressures that pop up where you are feeling particularly overwhelmed, right through to a major crisis needs, all of these need to be identified as a risk toward your trading activities and a plan of actions is needed.

The greatest thing about trading the Foreign Exchange is that the risk is limited – Brokers have margin policies that must be followed where they close out traders positions if the traders account balance falls below the margin policy minimum. Therefore, traders cannot lose more than what is in their trading account.

Other instruments will keep heading into the red, and if a trader does not have a stop loss set and is trading a large number of contracts, in a fast moving market could suddenly find out they need to quickly sell one of their major assets to fund the loss.

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The moral of this story for the Forex trader is to not have more money in your trading account that you cannot afford to lose, and always trade with a Stop Loss.

Q&A – Questions

QUESTION & ANSWER SECTION

| | | Answers |
|---------------------|--|---------|
| Question 1: | Risk strategies and rules within a Trading Plan is optional. True or False? | |
| Question 2: | Can risk within the financial markets be predetermined? | |
| Question 3: | What are the 3 common forms of risk minimisation tools used in trading? | |
| Question 4: | A Stop Loss is a traders 'worst case scenario exit'. True or False? | |
| Question 5: | One of the most common percentages used for the Maximum Account Risk is? | |
| Question 6: | If a trader entered the market at 1.1280, with a stop loss at 1.1240, what is their potential risk? | |
| Question 7: | To work out the number of lots you can safely purchase you divide the potential loss per lot into the maximum account risk. True or False? | |
| Question 8: | There is no end to the trading game unless we choose one, or run out of money. True or False? | |
| Question 9: | It is the traders' individual responsibility to have a Risk Management Plan and execute it. True or False? | |
| Question 10: | Risk Management strategies are exactly the same from one trader to the next. True or False? | |

Q&A – Answers

QUESTION & ANSWER SECTION

| | | Answers |
|---------------------|--|--|
| Question 1: | Risk strategies and rules within a Trading Plan is optional. True or False? | False |
| Question 2: | Can risk within the financial markets be predetermined? | Yes |
| Question 3: | What are the 3 common forms of risk minimisation tools used in trading? | Stop Loss, Position Sizing, & Max Account Risk |
| Question 4: | A Stop Loss is a traders 'worst case scenario exit'. True or False? | True |
| Question 5: | One of the most common percentages used for the Maximum Account Risk is? | 2% |
| Question 6: | If a trader entered the market at 1.1280, with a stop loss at 1.1240, what is their potential risk? | 40 pips |
| Question 7: | To work out the number of lots you can safely purchase you divide the potential loss per lot into the maximum account risk. True or False? | True |
| Question 8: | There is no end to the trading game unless we choose one, or run out of money. True or False? | True |
| Question 9: | It is the traders' individual responsibility to have a Risk Management Plan and execute it. True or False? | True |
| Question 10: | Risk Management strategies are exactly the same from one trader to the next. True or False? | False |