ReadySetCrypto Futures Masterclass

Module Six: Futures Risk Management

Module Six
Futures Risk Management

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Introduction to Futures Risk Management

I've said this several times to this point in the program:

"It's not what you MAKE, it's what you get to KEEP that matters."

Professional traders know that it's all about Risk Management. This keeps them in play, maintains their precious capital, as without it they're ***done***. And this is the critical mistake that so many retail traders make.

We get excited, we get impatient, we see a setup and we go "all in" on it. And maybe it even pays off for us, which is unfortunate because now you're reinforcing bad habits. It's only a matter of time before you show up on a "rekt" list on Twitter. Let's not do that.

If you paid attention in Module Three, I went through a fairly structured "progression" that one should follow before they start live trading, or trading with "production" sized positions. There were two rules that we didn't cover in that module, just to get your framework built..now we get to dive into them.

Rules Number One and Two of Risk Management

By far the two most common errors that I see from retail traders are also responsible for the majority of all losses. They don't identify exits until the positions are in trouble and threatening your account, and most retail traders are using positions that are far too big for their account or for their skill set.

Rule Number One: Do not place a live position in the market without FIRST defining what your exits are.

It's the simplest thing in the world to do…..but no one does it!

Think about how powerful this is….you are defining your exits BEFORE you own the asset, BEFORE you get a chance to get nervous and make panicky, emotional decisions.

And I want you to be precise about them as well. None of this, "well, if I see weakness in the price I'll sell it." Not good enough, those are not specific instructions.

Remember, all of us are flawed human beings. We become irrational when decisions come about that involve risk. We sell at the first sniff of profits, afraid that they will evaporate. We hold onto losers too long, convinced that somehow they will come to their senses and rally. (I already referred to this as Eating Like a Bird and Crapping Like an Elephant)

The best way to do this is to create these forward instructions when we are NOT irrational, such as BEFORE we own a position.

And if you want to know, YES you should also define your profitable exits on a position ahead of time as well. This exact technique will depend on whether you are investing, scalping, swing trading, etc. You should plan out each trade and then follow that plan going forward. Admit that you're a flawed, irrational human and just follow the plan that the "smart guy" created before you owned the position, thus effectively ending your ability to be objective.

Now, some of you that are going to define your exits with "stops" or defined "stop losses" will need the second rule below.

Rule Number Two: Do not risk more than two percent of your account per trade entry.

I call this the "Golden Rule" as this creates the "Midas Touch" to most traders once they start to incorporate these rules. Here are some of the benefits:

- **Fear** - you no longer live and die with each tick or candle while holding the position.
- **Risk** - you will experience no more than a 2% haircut with a loser.
- **Diversify** - by placing smaller positions, you don't create a huge "target" in one monolithic position, giving you the ability to add several smaller positions to diversify your holdings.

As I mentioned earlier, those using a "stop loss" to manage your position's risk with Rule Number One will do so at a two-percent (or less) level, which I'll cover in the video.

The first objection to this rule that I get from people is "*TWO PERCENT?!!! How will I "Lambo" with only a two percent position?!*" Well, I'm not saying that this one two-percent position is the only one that you can enter in your account. You can create multiple two-percent positions, however I would not lump them all in one spot.

(But seriously, if "when Lambo?" Is the extent of someone's vocabulary then they will be unable to follow this rule and preserve capital)

Now, two percent is a guideline. That means that you'll have to lose fifty trades in a row to go belly-up, unlikely to happen. In practice, I find that I often risk far less than two percent on many trades.

How should you go about setting the risk level? And how big of a position size should we use? Well, depending on which broker that we use, this might be somewhat of a complex issue, or it could be a simple one. Let's see if we can "afford" the stop first.

Can You Afford the Stop?

This somewhat odd-sounding title will make more sense in a minute. Let's look at a potential entry point in Figure 1 below:

Figure 1

As you can see by the arrows, I would like to go long at the 3804 level, and if I'm wrong, the price would trade below 3788 and I'd be "stopped out."

Can I afford to take this stop-out?

We don't know yet, do we? We're lacking a lot of information that we need to understand first. And this is where the new retail trader loses patience and just shoots from the hip, usually to regret it later.

Let's say that we're trading a 1BTC account; that represents the entire capital that we have in the account. If we placed our entire account behind that trade, we would only be risking ($3804 - $3788) or $16. To normalize that against an account which is currently valued at 1BTC or $3804, this trade represents a risk of .42% to our account, well within the limits of Rule #2.

In fact, we could actually factor this ahead of time, and say that the stop distance that we COULD afford with this account would be ($3804 x 2%) = 76 points. So we could employ a stop down at (3804 - 76) = 3728 and we'd still be within our risk limits.

Now, that example was using the spot currency. What if we were using two contracts of the /XBT futures on TDAmeritrade? First off, we would be using entry/exit points divisible by 5, so our entry point would be 3805 and our stop loss would be 3785; we lose a little bit of "granularity" with those contracts. The risk for that move per contract would be (3805 - 3785) or $20, so with two contracts of /XBT futures we would be risking $40 of loss plus $10 of round-trip commissions for a total risk of $50 on the trade. Can we afford the stop?

That depends on our account size; if we divide $50 by 2% then we arrive at a figure of $2500; this would be the ABSOLUTE MINIMUM account size that we could use with this trade, should we want to trade two contracts of /XBT futures and maintain a stop that is $20 below the entry point.

So as you can see, it's going to depend on our broker, because some Synthetic Futures brokers do not designate "position size" but instead allow you to define the leverage instead. Managing risk on one broker is going to be different from another vendor. We'll have to cover that on a case-by-case basis when we get to Module Eight.

Fractal Energy Trading and Risk Management

Many folks look at huge rallies and start counting the gains from what they could have made during the run-up that they were not in. “If I got in here and ran it up to there, I would have made this much.”

But it doesn’t work that way.

The emotions that come out during a huge run to the upside in any market will completely swamp any ability that you have to rationally calculate an effective exit point.

But I want you to consider executing risk management in this manner: lighten up. Yes, lighten up your buy/hold position if you see an absolutely, infinity-slope parabolic uptrend that screams higher every day. Take some off the top. Lighten up the position and book some gains.

Your monthly and weekly charts will likely show exhaustion at this level, which means that the uptrend’s on fumes and has a high likelihood of nasty failure before long….people got a big shock when Bitcoin dropped from 20k down to 11k in four days.

Use those larger-timeframe “exhaustion” signals as a red flag, and then be prepared to trail a “stop” up behind a parabolic asset. It’s OK to sell into strength, although you might be disappointed at the time.

But quite honestly, most of our trades with Futures will be in and out within hours or minutes, not days.

Just don’t let greed blind you to the other side of risk, which is NOT taking profits into a parabolic uptrend.

Currency Risk

Most of the time we don't think about "Currency Risk" at all. We buy equities or other assets that are denominated with your own sovereign fiat currency. For the most part, those sovereign currencies are fairly stable on a day-to-day basis.

And then there's Bitcoin, which is the defacto Cryptocurrency basis currency. You must generally move BTC to a new Futures broker to establish funding for the account. This creates a small inventory of BTC that you maintain as the "cash" for that account; when you close a trade, it is generally settled in BTC.

So what happens to the value of that account when BTC falls over time?

Well, you guessed it, the value of the overall account goes down.

So unless you're also taking predominantly short trades while the BTC market falls, you might find it somewhat like trying to walk up the "down" escalator.

Something that can be done is to execute "just in time funding" and move your BTC over to a broker where you can transfer that into some other stable coin, or other asset that is at least holding value. And then transfer the BTC back over to the futures broker when you're ready to execute the next trade.

This is one advantage of futures brokers that operate off of fiat, such as the CME and CBOE futures contracts.

Stop Loss Risk in Futures Markets

To this point in the program I have shown you “OCO Bracket Orders” such as those I used in the Module One video. These are “one cancels other” orders, which “bracket” the price into either a stop-out or a take-profit exit. And I use these orders exclusively in active, liquid futures markets on US equities, or other heavily-traded commodities like Gold and Oil.

But here’s the rub; they are **unreliable** in today’s crypto futures markets.

First off, the depth of the spot market is not the same as the depth of the specific futures market that you are trading. You’ve seen those “depth of market” graphs from spot brokers, like this one in Figure 2 from GDAX:

Figure 2

That shows the thousands of bids below the market, and thousands of offers above it. This is a visual indication of the “depth” of supply and demand.

But each futures broker has their own proprietary “market” for that asset, which they hedge off/fulfill in the back end through the spot market. What can happen is momentary “air pockets” show up where the “market” for that futures pair can instantaneously lift or drop depending on what happens with liquidity in that second.

Stop loss orders are “market” orders and this means that the futures broker can determine at any given millisecond what the “market” is for that coin. And it does not need to agree with what’s printed on the chart, nor what the spot market shows at that second. For this reason you must be very careful when you use “stop loss” orders and they must be used as a last resort with these synthetic futures brokers.

Even the CBOE/CME futures brokers do not allow you to enter stop orders. You must monitor and punch out should your stop level be reached.

Summary - Futures Risk Management

Risk Management is one of those topics that no one really pays much attention to at the beginning of your efforts. Honestly, most people pay attention to the “fun” side of trading which are the entry strategies and the technical patterns and the optimistic side of trading, which is that every trade is a winner.

But after a while, you’ll realize that there’s no point in paddling a boat if there are more leaks in it than buckets to bail it out.

Eventually you will turn back to Risk Management to help fix the “outflow” side of the equation. This module is by no means 100% definitive on this topic, but just following a couple of very simple rules over and over again without exception should have a dramatic impact on the “cost” side of your business.

Homework and Next Steps

Please complete the following tasks before moving to the next module:

- [ ] Watch the associated video for this module.
- [ ] Take the module quiz.
- [ ] Can you see violations of rules 1 & 2 of Risk Management in your previous trading? How did these violations impact your account?