Avoid the Self-Destructive Investment

The statistics for investing success are grim. About nine out of every ten those who set out to become investors in financial markets fail, either by losing all of their money or by losing so much of it that they are forced to give up investing.

This failure rate is very similar to that for small businesses, which is not surprising for three reasons. Firstly, investing is really just another type of small business. Secondly, a major reason for failure is lack of sufficient capital. Finally, and most importantly, a key reason is the lack of a business plan – not the lack of a sound business plan, but the lack of ANY formal plan.

This lack of a formal, written investment plan seems to be one of the key factors that differentiate successful from unsuccessful investors. Of all the elements that should be in an investment plan, money management is arguably the most important. Many play lip service to it, but few unsuccessful investors seem to understand it, or in most cases to have even thought about it. The end result is overtrading, which makes failure nearly a certainty.

Overtrading is the taking of investments in the market that are disproportionately large relative to the total investing capital available. Such large investment positions are dangerous because investing is an uncertain business, necessarily involving losses. Indeed, good investors struggle to have many more than 55 to 60% of profitable investments. Of course, their success rate will be higher in strong bull markets and easy initial success in such periods often blinds beginners from the realities until it is too late.

Good investors control losses by backing out of losing positions quickly and build profits by riding winning positions. Beginners, of course, do the exact opposite – they let losing positions run, hoping they will turn around, and grab small profits as soon as they appear.

Good investors succeed with a low ratio of successful investments because they use positions sufficiently small that no one loss will be catastrophic to their account. They tend to have sufficient capital to start with, but even where they do not, they understand that overtrading is fatal to their chances of success. Beginners tend to have insufficient capital to start with and compound that problem by overtrading, when they should be doing the exact opposite.

Money management is all about staying in the game by avoiding overtrading. This is done by controlling the size of every investment position so that only a small fraction of the investor's capital is at risk each time. That fraction will be much smaller than most beginners ever imagine. Really successful investors often talk of only risking half of one percent or less of their available capital on any one investment. This is probably unrealistic for most beginners unless they come to the markets with a large capital.

Ideally, beginners should have at least $50,000 capital. If they have less than that they are probably better investing through a manager. However, most will ignore such advice, so here are some rough guidelines on the maximum that should be risked on any one position:

Insufficient capital ($10,000 to $20,000)	5%
Minimal Capital (above $50,000)	2%

Medium Capital (above $100,000)	1.5%
Reasonable Capital (above $200,000)	1%
Large capital (above $500,000)	0.5%

The stark reality of this is table is that the more capital you have, the less the risk that you take and the more certainty that you will succeed. The incredibly debilitating effects of brokerage/commission, slippage and overheads on undercapitalised investors compound this situation.

A common misunderstanding of this aspect of investing is that these percentages do not refer to the amount of capital invested in the position. In other words, if we buy 100 shares of XYZ Ltd at $17.00, we are investing $1,700. The amount risked will be less than this, except in the case where the company fails completely.

The amount risked is the purchase cost less the amount that would be recovered if we cut our losses on a losing position. We should cut our losses if price falls so far that we know that we were wrong about the position. Such a level is called a 'stop-loss' level; a term borrowed from the US stock market and derivative markets where 'stop-loss' orders may be placed with our broker to cover the eventuality that the position moves against us.

Thus, if we bought 100 shares of XYZ Ltd at $17.00 and believed we would be wrong about the position if it fell to $15.00, our risk would be $2.00 per share or $200 in total.

Another common misunderstanding concerns how the risk percentage is calculated. It is NOT calculated on the total capital allocated to the position, $1,700 in this case. What it is calculated on is the total capital that the investor has available. At any one point this will be the total value of all current investments plus the reserve of capital that is not yet invested. For example, our investor may have shares she has bought with a current market value of $70,000 and cash on hand for investing of $30,000. Her total investing capital will in this case be $100,000.

So, assume when we bought 100 shares of XYZ Ltd, that we had $10,000 available to invest. Having bought the 100 shares of XYZ Ltd, we have shares worth $1,700 and remaining cash of $8,300. Our total capital remains at $10,000. The $200 we have at risk down to our stop-loss point of $15.00 will be $200 divided by $10,000, which is 0.02 or 2% of our investing capital.

A common trap is to get this far and then make a completely arbitrary decision on the stop-loss, which destroys its logic. The stop-loss level must not be simply what we think we can afford to lose. It must be where we are technically wrong about the position we are taking. Suppose we decide to buy into the uptrend in the stock shown in the chart below and that we are basing our stop-loss on the trendline. The logical technical place for the stop loss would be $5.30, which is clearly below the trendline and therefore if price fell that far, we could be sure the trendline had been violated.

However, the mistake that many beginners make is to then say: "but I cannot afford to lose that much, I will make the stop-loss level $5.50." This is a fatal error, because the price can fall to $5.50 and the trendline remain intact. Thus, our beginner will be shaken out of a perfectly good investment.

What our beginner fails to appreciate is that by raising the stop-loss level to where he could afford the loss, he has actually INCREASED the risk of losing, because a perfectly normal price fluctuation would take him out of the investment.

The only correct method in this case is to leave the stop-loss at the logical technical point where the investment would have gone wrong and instead, REDUCE the size of the position so that the amount at risk is bearable.

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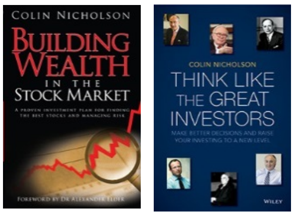

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