Trading Tips: Optimizing your trading strategy by analyzing your Risk/Reward ratio

As we have said in our previous article, one of the most important aspects of trading in any market and especially forex, is Money Management. Money Management can be defined as the way a trader manages his equity, number and size of trades, open positions, stop loss limits and take profit targets and optimizing its Risk/Reward ratio in order to yield positive results in the long run. To understand this, first you have to recognize that no one can always get it right and we all get losing trades. This is a fact in a traders life and the soonest a trader accepts it the better his chances of being profitable in the long run. We often hear traders speak as if they are certain what the markets will do next. We try to view the markets in probabilities and always have an analysis to support our opinion. Whether you are looking at fundamental news announcements, a combination of technical tools, or a simple moving average, what traders are looking for are patterns that put the probabilities in their favor so they will profit in the long run. In other words, we are looking for how the market has reacted in the past to certain conditions, and speculating how the market will react in the future to similar conditions. When it comes to trading, there is no absolute certainty. That is why good money management is essential in making trading profits grow over time.

To take an extreme example lets suppose someone has inside information about an interest rate change ahead of its release. Can this fact alone predict exactly how the market will react? What if other insiders also knew this information and acted in advance as well? What happens if there are real orders from big corporate or banks that need to buy or sell after the announcement? What if enough market participants felt the rate would move higher and bought prior to the announcement - they took profits after the announcement causing the currency to move lower (buy the rumor, sell the fact)?

So the big question is how to put the probabilities on our side? Actually any trading plan that is profitable in the long run is good enough. Some traders lose far more trades than they profit, but when they profit, they usually profit big. Some traders utilize a strategy targeting to profit the vast majority of their trades while risking a lot, but gaining little.

We try to use a more calculated approach in our trading tactics by applying money management considerations to our analysis of the market situation. First we recognize that the market is always trading on a trend or a range and that we have much better probabilities of being profitable if our trades are following the trend.

-If the market is on a trend we try to follow the trend on the vast majority of our trades (usually around 80% of our trades are following the trend). In this case we apply a risk:reward ratio of 1:2 with a big stop loss (usually more than 150 pips) and a big take profit target (usually more than 300 pips).

-If we have a trend and still decide to go against the trend for the correction we apply a risk reward ratio of 1:1 but with much smaller stop loss and take profit (usually around 50 pips).

-In the case the market trades within a range we are trading the extremes of the range applying a risk:reward ratio of 1:1.5 with a medium stop loss (less than 100 pips) and take profit target (usually more than 150 pips).

Since in both market situations (trend or range) the risk:reward ratio is ranging between 1:1.5 and 1:2 (except when trading corrections which is a rare situation), even if we trade profitably just 50% (or even less) then this model gives very good returns over time. Anything above 50% profitable trades would be outstanding. Based on this model, it is pretty easy to see why it makes little sense to get very excited when a trade wins or very upset when a trade loses which results in one more very important added advantage in forex trading- much better trading psychology.