



Spice Prop

Embrace the risk

OR HOW TO MANAGE IT
NATALIA BOJKO

Introduction

The forex market - otherwise known as the international foreign exchange market - is a dynamic environment. Participants from all over the world trade a variety of currencies on it.

Forex trading is extremely attractive due to its huge trading volume. In addition, its availability 24 hours a day, 5 days a week is equally attractive.

However, before we move on to the subject of how to generate potential profits in the market, let us start with the subject of risk. This accompanies any investment in the stock market.

Risk in Forex can take many forms. Experienced traders and those just starting out in the foreign exchange market will be equally affected (without emotional risk).

This ebook will focus on the key aspects of the risks involved in currency trading. I hope it will raise your awareness and help you make more informed and responsible decisions.

One of the main risks in Forex is exchange rate risk. Changes in currency prices can be rapid and difficult to predict, which can lead to significant losses.

In addition, the market is affected by a variety of factors, such as geopolitical events, macroeconomic data or even market speculation. Investors need to be aware that even the most well thought-out strategies can be disrupted by sudden changes in the market situation.

As an introduction - before I talk about specific risk management models, let us say what are the risks involved in trading CFDs.

Here are some of them:

Exchange rate risk:

Related to the volatility of individual currencies - forex is characterised by high volatility of currency prices, which can lead to sudden and significant changes in the value of assets - including your positions.

If you are a trader who holds your trades overnight and keeps them over the weekend you should factor into your overall position risk the size of potential swaps.

Leverage risk:

Leverage: trading CFDs often involves the use of leverage, which allows traders to take larger positions than their account capital. While leverage can increase potential profits, it is important to remember that it also increases risk. Even seemingly small price movements can lead to large losses.

Market risk:

Macroeconomic factors - otherwise macroeconomic events, such as interest rate decisions, employment or inflation data, can and do affect financial markets. Investors should keep an eye on this information and adjust their strategies to the changing economic situation.

Not every strategy works well on news/data with high market impact. Before implementing it in your pro trading, test carefully how it behaves during a stock market swing.

Political and geopolitical risks:

Political decisions including political/economic events such as elections, changes of government or international conflicts can affect the overall stability of currency markets. Unexpected political decisions can lead to sharp price movements. Long-term conflicts/geopolitical events tend to affect overall market sentiment.

Risk of closing a position at an unfavourable rate:

Position liquidation risk: In conditions of increased market volatility and sudden price movements, Forex brokers may use procedures to liquidate a trader's position to protect against further losses.

Psychological risk:

That is, in short, the trader's emotions, which are related to the fact that Forex trading can be stressful and strong emotions such as fear, desire for revenge or greed can influence investment decisions.

Controlling emotions is key to avoiding impulsive decisions and incurring potentially high losses.

Of course, there are many more risks involved in trading CFDs. However, we are not here to tell you about them all. Rather, let us

talk about the issues involved in calculating and managing them directly in your accounts.

We will certainly devote several blog articles to emotional risk and methods of dealing with it. We therefore encourage you to look there.

Drawdown

Drawdown is a term from the field of finance that refers to the largest loss a trader or investor incurs in their account before reaching a new high. In the case of CFDs, drawdown is measured as the difference between the account's peak balance and the lowest balance before a new profit record occurs.

Drawdown is an insanely important element in capital management. It tells us, first and foremost, about the potential for risk generation, risk management and the trader's ability to use trading leverage. All our programmes have this ratio, which directly tells us the maximum drawdown in our accounts.

A stop loss policy is not required, by which we require the trader to plan their own risk in line with our maximum daily and total drawdown policy. Controlling the level of drawdown is all about:

- Capital protection - traders want to avoid a situation where a significant loss could lead to too large a reduction in available capital. Controlling the drawdown minimises the risk of losing funds. Look into your trader dashboard to keep track of the maximum acceptable risk.

- Mental comfort and self-discipline - some say that controlling risk is more important than market analysis itself - we can agree. The habit of risk control will not only help you to get better by bringing more self-control and discipline into your trading life. It will help you 'sleep soundly'. Not getting emotional also means being more rational in your decision-making.
- Avoiding over-leveraging - you are probably well aware that over-leveraging in everything is not advisable. It is exactly the same with the forex market. Precise risk control will protect you from being leveraged in a 'casino' style all in. Long-term earning in prop trading is not a race to see who has the biggest position.

How to control the drawdown?

Although we do not require a stop loss order to be set for a position - it falls within a responsible trading policy. Controlling the maximum risk in an account requires not only the basics of mathematics (that's what we have tools for), but above all rigid rules and solutions to help you stick to them. The level of drawdown can be controlled with:

- stop loss/trailing stop orders - especially when we are not at the chart and the macroeconomic calendar is teeming with high market impact events;
- hedging strategy - on an ad hoc basis instead of a stop loss order - in the long run it is simply freezing a loss;

- portfolio diversification - using more than one instrument to trade in the case of positions opened on shares;
- appropriate position sizing - calculating the maximum size of the position based on the percentage of risk and the size of the stop loss (one method); optionally, a single lot measure can be used; risk can also be based on, for example, the ATR indicator;
- education and use of tools to help you manage - the internet is full of trading panels to help you manage your risk, also have a look at our tools tab, where tools used by our traders appear;
- unconventional SL placement – in other words, not at obvious places such as the top or bottom, where most traders place their SLs;
- too tight SL – SL placed due to ATR is always is adjusted to the current market volatility;
- ATR allows for adjustment to the current market volatility.

Remember that risk control should take place in two main areas: the risk of the whole account (the result of all the positions taken) and the risk of a single trade.

One of these risks is decided by us - in the form of the maximum and daily drawdown rule, the other by you - it is up to you how much of this risk you want to use per trade.

ATR-based risk

The use of an ATR-based stop loss order can be effective with different trading strategies. Short-term traders can adjust the stop loss according to current market conditions.

As I will show in a moment - the ATR indicator is an interesting tool available on MT4/5 that provides a mass of information about risk ranges. An ATR-based stop loss provides a flexible approach to risk management. Keep in mind, however, that it is not a one-size-fits-all solution.

Perhaps your preferences, trading skills or current experience are currently at a different ceiling. If you don't know how to manage risk in a different way than a classic SL based on a random low/peak, ATR-based risk can be helpful in constructing your own system.

ATR is an indicator created by J. Welles Wilder that measures the average true volatility of a financial instrument. It offers an objective measure of how much an instrument's prices can fluctuate over a given period. Using the ATR to set stop losses makes sense because of:

ATR formula:

$$ATR = \frac{1}{n} \sum_{i=1}^n \max(\text{High}_i - \text{Low}_i, |\text{High}_i - \text{Close}_{i-1}|, |\text{Low}_i - \text{Close}_{i-1}|)$$

You do not need to focus on the formula itself. On the other hand, note that it answers the question: where is the current liquidity taken into account in the ATR?

By using the maximum and minimum price in the formula, the ATR indicator examines ranges of movement. Therefore, the ATR indicator will show the current volatility expressed in pips.

In order to use the ATR, it is still worth thinking about the multiplier that we will use to adjust the stop loss. Usually it has a value of $2 \times \text{ATR}$ - which in practice means that if the ATR shows us 5 pips, our stop loss will be set at 10 pips (2×5).

Suppose a trader uses a 14-day ATR and chooses a multiplier of 2. For a given instrument, the price is currently USD 100 and the ATR is USD 3.

The trader intends to buy the asset (in the case of a reverse position, we do not subtract but add the ATR from the current price). The stop loss calculation will be as follows:

$$\text{Stop Loss} = 100 - (2 \times 3) = 94 \text{ USD}$$

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The value of USD 94 represents the level below which the trader sets the stop loss, adjusted for the current volatility of the instrument.

What if we want to base our stop loss on a specific % of capital and the size of the ATR?

This example will allow me to illustrate one important thing to you - you can use one % risk per position and different stop losses, which will be adjusted each time to the situation and market volatility and at the same time will not increase the assumed loss.

Taking into account the % of capital in the formula, we will get an indication of the size of the position I have to throw into the market with the assumed stop loss and the % risk from the capital.

Our calculation will be a tad more complicated than the previous one, but it will look like this:

We have USD 1000, I risk 1% on the position, I have an ATR of 8 pips.

Formula: X (position size) = (capital x risk percentage) / ATR (nominal - we convert pips to USD for 1 lot)

Example above: $X = (1000 \times 1\%) / 80^* = 0.12$ Lot

80 = 8 pips x 10 USD (we assume that 1 pip for 1 lot gives a movement worth 10 USD)

The ATR periods themselves should also be explained here. Like most indicators, the ATR also has the possibility of adjusting the number of candles from which it is calculated.

The length of the ATR period has a significant impact on the flexibility of the indicator. In practice, periods of 14 days are often used, as a result of a tradition stemming from the initial use of this indicator.

However, there is no single 'ideal' period, as different trading strategies and trading styles may require different ATR settings. The smaller the period the ATR is set to, the smaller the range of

volatility will be considered - personally, I use smaller periods on larger intervals (d1, h4).

If the ATR period is short, the indicator reacts quickly to changing market conditions, which can lead to frequent stop loss adjustments.

On the other hand, a long ATR period makes the indicator smoother, which is beneficial during periods of stable prices, but can delay the reaction to sudden price movements.

I use the long ATR for intraday trading for a simple reason - it allows me to embrace the volatility risk from a given session in a much broader perspective than a few minutes (when used in a 14 setting on candles with m1).

Risk management based on the ATR indicator is one of many examples of building a trading system responsibly. You can just as well use any system that allows you to precisely (numerically) determine the value of a stop loss order.

Remember to keep your trading plan as simple as possible with risk management instructions. Make sure you label and monitor your risk range in your trading log!

About



Natalia Bojko

SpiceProp CO-CEO and Founder

Head of Analysis at Finmex. As portfolio manager associated with an Israeli protrading fund. Author of the book "Demand and supply zones - an introduction to the Smart Money Concept". Actively involved in stock market and forex trading since 2016. She was serving as an analyst for Investing.com, Forex Club, FXMAG for several years. Managed currency risks in the Trefix project. Bachelor's Degree of Economic and Law in University of Białystok. Postgraduate studies of Clinical Psychology in Wyższa Szkoła Kształcenia Zawodowego, Wrocław.