Unlock Your Potential with the Realities of Trading

SAMPLE

Chapter 21: The Risk-to-Reward of 1 to 2 – a Magic Ratio

EUR AUD

The Ideal Positive Expectancy

***"It is especially in short-term trading, with a wealth of trading signals, that consistent trading in the overall trend direction pays off."* – Arne and Falk Elsner**

One of the big factors in trading success is to think in terms of the risk-to-reward ratio (RRR). That's your risk in terms of the potential reward. You know, for you to survive in the markets, you have to target at least two dollars for every dollar you risk.

Some target three, four, five or more dollars for each dollar they risk; which is fine. This is the logic behind positive expectancy. In contrast to this, anyone who risks two, three, five… two hundred or five hundred dollars to target one dollar or a few dollars is using a negative expectancy approach. Anyone who doesn't use stops and who's determined to run the losses till they break even is using a negative (worse) expectancy approach. The fact is: anyone using a negative expectancy approach can't last long in the markets.

The Benefits of the RRR of 1:2

Now, let's go back to the idea of 1:2. In all the years of my grappling with the markets, I've seen that the RRR of 1:2 is the most optimal one. These are some of the reasons.

1. The 1:2 expectancy is the least that should be sought by sensible traders. Risking one dollar to target less than two dollars is really not in the trader's best interest.

2. With optimal stops and targets, the ratio 1:2 is more easily achieved than 1:3, 1:4, 1:5… 1:10 etc. While a higher RRR like 1:5 requires a hit rate of 20% or less to attain profits, it's very

difficult to practice, requires a high level of discipline and requires an unending patience to run the winners. How many traders can surmount the emotional hurdles?

3. With rational and logical fine-tuning of one's strategy, one might be able to achieve a hit rate of 40% or more over time, thus the RRR of 1:2 is enough to make one a consistent winner.

4. The best trending pairs and crosses in Forex are often the ones most analysts tend to ignore. Remember that you need price movement before you can make money. No movement in the price, no profits/loss. If you trade highly trending Forex instruments, it's more probable that you will achieve good results with the expectancy of 1:2 so that your stops/targets are triggered quickly as you look at short-term and medium-term biases. When more liquid and highly trending trading instruments are sought and played, the possibility of roll-downs is reduced while the rise in equity becomes noticeable. When the EURAUD is bullish, you need not give yourself any headache by going for complicated analysis. When the cross is bullish, you will see the price going upwards.

5. If you use the RRR of 1:2, it will be possible for you to reach breakeven with a hit rate of 33.3%. This means that recent losses are easily recovered. The risk-to-reward of 1:2 is indeed a magic ratio!