



## Adding Efficiency To Your Trading Process

*There is a lot to this game of trading...*

Whether you are an individual trader, have set up your own shop, or operate under a larger company's structure; every trader has to wear multiple hats...

**Successful traders must be skilled at a number of different functions** including idea generation, security selection, industry and stock-specific research, trade execution, risk management, performance tracking and reporting etc.

Even if some of these functions are handled by an administrative team, it is still important to keep your finger on the pulse of all of these areas to maintain the best returns and lowest amount of risk.

*But how do you create time for all of these tasks? How can you effectively research new ideas, manage an existing book of trades, communicate with clients, and still have time to eat and sleep?*

Reader David F. recently posed the question:

*Could you recommend or explain how you and Jack stay on top of these things in an efficient manner?*

*As I get ready to jump into the water with my trading, it almost seems as if admin and recon is going to take away from analysis.*

*Any thoughts on this would be greatly appreciated...*

Well, the short answer is that there really is no "short answer." Trading is hard work and to do it right, you MUST allocate a significant amount of time to administrative and trade management tasks – in addition to the more "sexy" research and execution functions.

But **creating efficient processes to your trading approach can save a tremendous amount of time** – and in this business where time truly is equivalent to capital, efficiency is a beautiful thing.

David's specific questions centered around position sizing, risk management, and time constraints; so today we'll touch specifically on these issues. In the future, we can tackle





other issues like research processes, client reporting, and other functions. If you have specific areas you would like to see covered, send an email to admin [at] MercenaryTrader [dot] com...

To begin with, I want to outline a few important terms we use when putting on a new trade, or analyzing our current risk.

- **Initial Risk:** This is the amount of risk we take when we put on a new position. The number is expressed in basis points (see [Standardized Units of Risk](#)). Initial Risk represents the “worst case scenario” if a position moves against us and is stopped out for a full loss.
- **Open Risk:** This is the amount of risk from the current price to our risk point. Once again, this number is expressed in basis points. If a long position rallies sharply after our purchase, open risk will increase because there is now more space between the current price and our risk point.
- **Locked In Profit / Loss:** This figure measures the total profit or loss (in basis points) for an existing trade if it reaches our risk point. Locked In Profit / Loss is equal to Initial Risk until our original risk point is adjusted. When tightening a risk point, our total risk on the trade declines. Ultimately, tightening the risk point above the original entry point (for long positions) results in a “locked in profit.”

## New Trade Setup

So each time we set up a new trade for our accounts, we begin the process by identifying our entry point, our risk point (or stop level), and the amount of risk we want to take on the position.

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IS BEAUTIFUL!**

Since our risk is measured in basis points, it can be universally applied to different sized accounts by simply multiplying the number of basis points times the account value for individual accounts.

If you're trading for accounts with different risk parameters, one solution might be to set up a “baseline” risk level (say 50 basis points for a “full size position”) and then increase or decrease the the number of basis points for more aggressive or conservative accounts.



The formula can be set up in excel and might look something like this:

*Note: \$ value to risk depends on the number of basis points at risk times total account value*

$$\text{Shares} = ( \$ \text{ Value to Risk} / (\text{Entry Px} - \text{Risk Point})$$

It takes a bit of time to set up a position entry spreadsheet to calculate trade size based on price and risk parameters, but the beauty of setting up these formulas is that new trade ideas can be plugged in quickly – making every future trading decision much more efficient.

Simply plug in your entry price, risk point, and number of bips at risk (assuming the account value remains stable or is automatically updated) and the formula spits out your trade size.

For ease of use, the [Mercenary Live Feed](#) has a position sizing calculator with these formulas already built in.

### **Monitoring Changes In Open Risk**

Once you have a trade on the books, the open risk for that position will change with any fluctuations in price. For long positions, if the security moves in your favor, the open risk will increase because the distance between the current price and your risk point has increased.

Conversely, when the position moves against you, your unrealized loss will increase but at the same time, your open risk in the position will contract. After all, you're getting closer to the point at which you will close out your trade.

While open risk fluctuates, the "locked in" profit or loss will only change when you make an adjustment to your risk point. So if you move a risk point above your initial purchase price, you have already "locked in" a profit on the trade.

Of course there is always the risk that a position will gap through a risk point – and traders should always allow extra room for unexpected price movements. But from a risk measurement perspective, we consider profits "locked in" if our risk point would cause a position to be closed at a profitable price.

We keep all of our positions in a constantly updated spreadsheet that calculates the open risk along with locked in risk on a position-by-position basis.



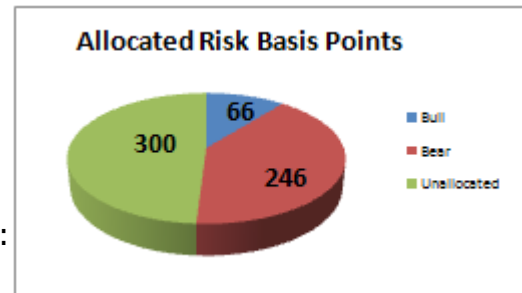
Once again, the process of setting up this spreadsheet may be a bit tedious, but the ultimate time savings by having all the information clearly represented is well worth the initial time investment. Each day, we simply update the current price column – and any changes to our risk points – and all of our risk measurements are updated automatically.

## Managing the Portfolio

OK, now that we have the risk parameters measured on an individual position basis, let's take a look at how this looks for our entire portfolio of trades.

For our managed accounts, we allocate a certain number of basis points we are willing to risk each calendar quarter (*more information on this in future posts*). The number may differ based on risk tolerance, but we always track open risk in terms of basis points.

We total the open risk (in basis points) for both bearish and bullish positions and graph the amount in a pie chart to make it easy to “eyeball” our exposure based on the total number of basis points in play for the calendar quarter. To the right is a recent example:



According to this chart, if we are stopped out of our bearish positions right now, we will lose 246 basis points. Our bullish trades represent a total risk of 66 basis points, and we have 300 “available” basis points according to the amount we are able to risk in a calendar quarter.

**It's important to look at these numbers in proper context...** In many cases, bullish exposure can help to counter-balance bearish exposure. So if we were stopped out of our bullish positions, one might reasonably argue that our bearish positions would add profit and offset the 66 bips at risk.

But that logic doesn't always ring true. For instance, if our bullish exposure consists of “flight to safety” long positions like gold or high dividend stocks, while our bearish exposure is made up of short positions in speculative names, the positions could end up being negatively correlated.

In this case, it might be reasonable to expect that higher price movement in our bearish book of trades (price action against our positions) would coincide with a decline in “safe” stocks. In this case we could lose on BOTH sides of the ledger.



The point is, you can't blindly assume that bullish and bearish exposure will naturally offset. It is important to have a "qualitative" assessment of your trading exposure – on top of efficient systems to monitor the statistical measures of risk.

Creating systems and procedures for setting up new trades, and monitoring adjustments to your current trading book will require time and energy initially. But ultimately, creating a simple but effective infrastructure for blocking out these processes will pay off long-term by saving time and cognitive energy.

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**p.p.s. If you haven't already, check out [the Mercenary Live Feed!](#)**

