Position Sizing

The following interview is one you'll want to print out and read again and again until it becomes second nature.

It's one of the most important ideas any investor can learn. It's an essential element of success for everyone, from the conservative novice investing for retirement to the professional short-term trader. Ignoring this idea is responsible for more losses than any other investment mistake.

To explain this idea, we welcome Brian Hunt. Brian is a successful private investor and trader, and the Editor in Chief of Stansberry & Associates Investment Research, one of the country's largest independent financial publishing firms.

If you're looking to take your investing or trading to the next level, you must master this idea.

Stansberry & Associates: Brian, one of the most important things any new investor can learn is correct position sizing. Can you define the idea for us?

Brian Hunt: Sure... Position sizing is an incredibly important part of your investment or trading strategy. If you don't know the basics of this concept, it's unlikely you'll ever succeed in the market. Fortunately, it's an easy concept to grasp.

Position sizing is the part of your investment or trading strategy that tells you how much money to place into a given trade.

For example, suppose an investor has a $100,000 account. If this investor buys $1,000 worth of shares in company ABC, his position size would be 1% of his total capital. If the investor bought $3,000 worth of stock, his position size is 3% of his total capital.

Many folks think of position size in terms of how many shares they own of a particular stock. But the successful investor thinks in terms of what percentage of their total account is in a particular stock.

S&A: Why is position sizing so important?

Hunt: Position sizing is the first and probably most important way investors can protect themselves from what's known as the "catastrophic loss."

The catastrophic loss is the kind of loss that erases a large chunk of your investment account. It's the kind of loss that ends careers... and even marriages.

The catastrophic loss typically occurs when a trader or investor takes a much larger position size than he should. He'll find a stock, commodity, or option trade he's really excited about, start dreaming of all the profits he could make, and then make a huge bet.

He'll place 20%, 30%, 40% or more of his account in that one idea. He'll "swing for the fences" and buy 2,000 shares of a stock instead of a more sensible 300 shares. He'll buy 20 option contracts when he should buy three.

The obvious damage from the catastrophic loss is financial. Maybe that investor who starts with $100,000 suffers a catastrophic 80% loss and is left with $20,000. It takes most folks years to make back that kind of money from their job.

But the less obvious damage is worse than losing money... It's the mental trauma that many people never recover from. They can get knocked out of investing forever. They just stick their money in the bank and stop trying. They consider themselves failures. They see years of hard work – as represented by the money they accumulated from their job or business – flushed down the toilet. It's a tough "life pill" to swallow. Their confidence gets shattered.

So clearly, you want to avoid the catastrophic loss at all costs... And your first line of defense is to size your positions correctly.

S&A: What are the guidelines for choosing a position size?

Hunt: Most great investors will tell you to never put more than 4% or 5% of your account into any one position. Some professionals won't put more than 3% in one position. One percent, which is a much lower risk per position, is better for most folks.

Seasoned investors may vary position size depending on the particular investment. For example, when buying a safe, cheap dividend stock, a position size of up to 5% may be suitable. Some managers who have done a ton of homework on an idea and believe the risk of a significant drop is nearly non-existent will even go as high as 10% or 20% – but that's more risk than the average investor should take on.

When dealing with more volatile vehicles – like speculating on junior resource stocks or trading options – position sizes should be much smaller... like a half a percent... or 1%.

Unfortunately, most novices will risk three, five, or 10 times as much as they should. It's a recipe for disaster if the company or commodity they own suffers a big, unforeseen move... or when the market in general suffers a big unforeseen move. These big, unforeseen moves happen with much greater frequency than most folks realize.

S&A: Can you explain how the math works with position sizing?

Hunt: Yes... But first I need to explain a concept that goes hand in hand with determining correct position sizing: protective stop losses.

A protective stop loss is a predetermined price at which you will exit a position if it moves against you. It's your "uncle" point where you say, "Well, I'm wrong about this one, time to cut my losses and move on."

Most people use stop losses that are a certain percentage of their purchase price. For example, if a trader purchases a stock at $10 per share, he could consider using a 10% stop loss. If the stock goes against him, he would exit the position at $9 per share... or 10% lower than his purchase price.

If that same trader uses a stop loss of 25%, he would sell his position if it declined to $7.50 per share, which is 25% less than $10.

Generally speaking, a stop loss of 5% is considered a "tight stop"– that is close to your purchase price – and a 50% stop loss is considered a "wide stop" – that is a long way from your purchase price.

Combining intelligent position sizing with stop losses will ensure the trader or investor a lifetime of success. To do this, you need to understand the concept many people call "R."

S&A: Please explain...

Hunt: "R" is the value you will "risk" on any one given investment. It is the foundation of all your position-sizing strategies.

For example, let's return to the example of the investor with a $100,000 account. We'll call him Joe.

Joe believes company ABC is a great investment, and decides to buy it at $20 per share.

But how many shares should he buy? If he buys too many, he could suffer a catastrophic loss if an accounting scandal strikes the company. If he buys too little, he's not capitalizing on his great idea.

Here's where intelligent position sizing comes into play. Here's where the investor must calculate his R.

R is calculated from two other numbers. One is total account size. In this case, it's $100,000. The other number is the percentage of the total account you'll risk on any given position.

Let's say Joe decides to risk 1% of his $100,000 account on the position. In this case his R is $1,000. If he decided to dial-up his risk to 2% of his entire account, his R would be $2,000. If he was a novice or extremely conservative, he might go with 0.5%, or an R of $500.

Joe is going to place a 25% protective stop loss on his ABC position. With these two pieces of information, he can now work backwards and determine how many shares he should buy.

Remember... Joe's R is $1,000, and he's using a 25% stop loss.

To calculate how large the position will be, the first step is to *always* divide 100 by his stop loss.

In Joe's case, 100 divided by 25 results in four. Now, he performs the next step in figuring his position size. He then takes that number – four – and multiplies it by his R of $1,000.

Four times $1,000 is $4,000, which means Joe can buy $4,000 worth of ABC stock... or 200 shares at $20 per share.

If ABC declines 25%, he'll lose $1,000 – 25% of his $4,000 – and exit the position.

That's it. That's all it takes to practice intelligent position sizing.

Here's the calculation again:

- 100 divided by your stop loss equals "A."
- "A" multiplied by "R" equals position size.
- Finally, position size divided by share price equals the number of shares to buy.

Now... what if Joe wants to use a tighter stop loss – say 10% – on his ABC position? Let's do the math...

- 100 divided by 10 equals 10.
- 10 multiplied by $1,000 equals $10,000.
- $10,000 divided by the same $20 share price equals 500 shares.

So you can see that using a tighter stop loss with the same R allows Joe to buy a larger number of shares, while risking the same amount of his total account... $1,000.

Next, let's say Joe wants to use a super-tight stop loss of just 5% on his position. In this case, if ABC declines just 5% to $19 per share, he's out of the trade.

This tighter stop loss means he can buy even more shares. Let's do the math again...

- 100 divided by 5 equals 20.
- 20 multiplied by $1000 equals $20,000.
- $20,000 divided by the $20 share price equals 1,000 shares.

Again, a tighter stop loss with the same R of $1,000 means he can buy twice as many shares and still risk the same amount of his total account.

As you can see, you can use the concepts of position sizing and stop losses to determine how much of any asset to buy... from crude oil futures to currencies to microcaps to Microsoft.

If you're trading a riskier, more volatile asset, the stop-loss percentage should typically increase and the position size should decrease.

If you're investing in a safer, less volatile asset, the stop-loss percentage should decrease and the position size should increase.

And like I mentioned earlier, a good, "middle of the road" R that will work for anyone is 1% of your total account. Folks new to the trading game would be smart to start with half of one percent of their account. This way, you can be wrong 10 times in a row and lose just 5% of your account.

S&A: Any closing thoughts?

Hunt: Again, the biggest thing intelligent position sizing does is keep you from suffering the catastrophic loss. The golden rule of investing or trading is, "Don't lose money." Intelligent position sizing ensures you always follow rule number one.

S&A: Thanks for talking with us.

Hunt: My pleasure.

Summary: Position sizing is your first line of defense against catastrophic loss. Combining intelligent position sizing with protective stop losses will ensure the trader or investor a lifetime of success.

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