Money Management (Pt. I):Controlling Risk and Capturing Profits Money management is the process of analyzing trades for risk and potential profits, determining how much risk, if any, is acceptable and managing a trade position (if taken) to control risk and maximize profitability. Many traders pay lip service to money management while spending the bulk of their time and energy trying to find the perfect (read: imaginary) trading system or entry method. But traders ignore money management at their own peril.   The story of three not-so-wise men I know of one gentleman who invested about $5,000 on options on a hot stock. Each time the stock rose and the options neared expiration, he would pyramid his position, plowing his profits back into more options. His stake continued to grow so large that he quit his day job. As he approached the million-dollar mark, I asked him, "Why don't you diversify to protect some of that capital?" He answered that he was going to keep pyramiding his money into the same stock options until he reached three to four million dollars, at which point he would retire and buy a sailboat.I recently met a second gentleman at a dinner party. He told me that six months ago he began day trading hot stocks.   It was so profitable, he said, that he quit a flourishing law practice to trade full time. Amazed at his success, I asked him, "How much do you risk per trade, a half point, one point?" He replied, "Oh no, I don't like to take a loss."A third gentleman was making his fortune buying the hottest stock(s) on the momentum list(s). He, too, was on the verge of quitting a successful business.When asked about his exit strategy, he replied "I just wait for them to go up."When asked, "What if they go down?" his reply was, "Oh, they always come back."What ever happened to these "traders?" Gentleman number one is now homeless, and the other two are about to be. They are on the verge of financial devastation and the emotional devastation that goes along with it. This is the cold, hard reality of ignoring risk. How do we avoid following in the footsteps of these foolhardy traders? Three things will prevent this from happening: 1) money management, 2) money management, and 3) money management.The importance of money management can best be shown through drawdown analysis. **Drawdown** Drawdown is simply the amount of money you lose trading, expressed as a percentage of your total trading equity. If all your trades were profitable, you would never experience a drawdown. Drawdown does not measure overall performance, only the money lost while achieving that performance. Its calculation begins only with a losing trade and continues as long as the account hits new equity lows.Suppose you begin with an account of $10,000 and lose $2,000. Your drawdown would be 20%. On the $8,000 that remains, if you subsequently make $1,000, then lose $2,000, you now have a drawdown of 30% ($8,000 + $1,000 - $2,000 =$7,000, a 30% loss on the original equity stake of $10,000). But, if you made $4,000 after the initial $2,000 loss (increasing your account equity to $12,000),then lost another $3,000, your drawdown would be 25% ($12,000 - $3,000 =$9,000, a 25% drop from the new equity high of $12,000). Maximum drawdown is the largest percentage drop in your account betweenequity peaks. In other words, it's how much money you lose until you get back to breakeven. If you began with $10,000 and lost $4,000 before getting back to breakeven, your maximum drawdown would be 40%. Keep in mind that no matter how much you are up in your account at any given time--100%, 200%, 300%--a 100% drawdown will wipe out your trading account. This leads us to our next topic: the difficulty of recovering from drawdowns. **By Dave Landry To Read more,Please download the book.** Download This Book