Risk Management

It sounds too simple to be true, but when it comes to stocks or options, one of the keys to making money over the long-term is doing all that you can to avoid losing money over the short-term. Unfortunately, occasional losses are an inevitable part of any investment strategy... and you should run away from anyone who claims to have a "riskless" investment program they want to share with you (probably "on 3 CDs for three easy installments of $49.99 each"!).

While there is always room for improvement and fine-tuning when it comes to any approach to investing, the following are some general guidelines investors may want to keep in mind as they attempt to maximize their long-term investment success.

Stocks

In general, investors are encouraged to diversify their stock portfolios across 12-20 different stocks. Any fewer than that and insufficient diversification will be achieved, and any more than that is likely to result in diminishing returns in terms of balancing the amount of diversification obtained vs. the amount of time required to keep track of all the positions.

Among the list of 12-20 stocks, some will be more speculative than others. As a result, investors are encouraged to give a slightly smaller weighting to these more speculative stocks, and to also give a higher percentage weighting to the 3-5 stocks in the portfolio that appear to have the most solid long-term fundamentals.

While the use of margin can greatly increase returns in a stock account during bull markets, it can also result in much larger losses than would otherwise be experienced in bear markets... and investors are thus encouraged to use margin judiciously. Generally speaking, if you are on margin and find your account shrinking in value for more than five or six days in a row, it is probably a sign that you have the wrong mix of stocks to be using margin with, and you may therefore want to consider selling some of the poorer-performing stocks until the market changes direction again. In addition, if you find yourself unable to sleep at night due to anxiety over your account, it is probably also a good sign that you need to sell some

stocks until you get down to "the sleeping point" - investing should be enjoyable and fun, not a source of stress!

When it comes to the question of "when should a stock be sold?," the answer is most often either a) when the long-term fundamentals of the company begin to deteriorate, b) when the stock itself refuses to "act correctly" (i.e. it is declining while the rest of the market is rising), or c) never!

While this last choice (c) is admittedly a bit tongue-in-cheek, when everything falls into place from an investment perspective, investors really are encouraged to let their profits run. Unlike options, stocks have no "expiration date" associated with them, and truly great companies often find ways to grow their sales and earnings for several years (and perhaps even decades!)... and while nobody grows poor taking profits, the real money in stock investing is made by letting small positions turn into very large ones over the course of several years through the magic of compounding interest.

Of course, the converse of this situation is when stock positions lose value on a regular basis, and the easiest way to prevent this from occurring is to implement choice (a) or (b) as soon as it becomes apparent a stock is struggling to hold its own in the marketplace.

To summarize these risk management rules for stocks: Diversify across 12-20 stocks, sell small losers before they become big losers, and hold on to your winners long enough to give them time to grow into big winners!

Options

Unlike stocks, which simply require an investor to be correct about a company's prospects over the long-term (and perhaps be patient while they wait), options require an investor to be right about a stock's movement over the short-term - and this is far easier said than done! In fact, most option trades result in losses for the buyers of option contracts. However (and this is the important piece of "the options puzzle" to keep in mind!), since options provide tremendous leverage and can yield spectacular gains in very short periods of time, one big winner can offset the losses generated by several losing trades.

Given that trading losses are an unpleasant - but unavoidable - fact of life when it comes to trading options (again, if someone tells you they have a system that is "risk free," turn around and run the other way), it is important for investors who want to trade options to have a clear game plan for asset allocation in place before they start trading options.

While it is very possible for even the most seasoned of option traders to encounter a string a ten consecutive losing trades, a good rule of thumb when getting into the options game is to look at the amount of money available for option trading and then divide it into at least ten equal amounts (that will each then be used for individual trades). For example, if an investor has $25,000 that they were willing to bet (and possibly lose!) on option trading, they should mentally think of this money as representing ten bets of $2,500 each.

A modified version of this strategy is to mentally allocate the account into $2,500 pieces to begin with, but then, if the first four do not work out (i.e. the account is reduced to $15,000 without producing a winning - or even breakeven - trade), the investor then switches to a "10% of capital" rule for each subsequent trade. In other words, in order to preserve capital (and thus stay in the game waiting for "a big one" to come along in the win column), an investor would only bet $1,500 (10% of $15,000) on their next trade. If that did not work out either, the next bet would only be $1,350 (10% o f the remaining $13,500), and so on.

While it is true that this "10% of assets" allocation strategy for option trading does not guarantee an investor will be able to avoid "disastrous losses" over the long-haul if he or she encounters too many bad trades in a row, it does decrease the odds of a such a "wipeout" occurring before the tide turns a bit in the investor's favor. Once the account's value has been built back up to $25,000, the "$2,500 per trade" strategy can once again be put into effect.

When it comes to selling options that were purchased for speculative purposes, another good rule of thumb is to sell half of a position if it the options have doubled in price. Doing so essentially means that the unsold half becomes a "free ride," thus allowing the holder of the options to become a little bolder in terms of "swinging for the fences." Beyond that, deciding when to take profits in options really needs to be done on a case-by-case basis, taking into account the volatility of the stock, the time left on the

contract, the overall status of one's account at the current time, and a variety of other interrelated factors.

On the flipside, sometimes options should be sold before they become profitable if there is enough time value and/or intrinsic value left in them to salvage. In general, options that are purchased with less than six weeks of time left on them should be thought of as "bets that will not be salvageable" if they do not turn profitable shortly after being purchased... and investors need to prepare themselves for the potential of a "100% loss" each and every time they enter into a short-term option trade.

To summarize these risk management tools for options: Never bet more than 10% (or so) of your portfolio on a single trade, self half your position if it doubles, mentally prepare yourself for 100% losses on some trades, and remember that success in the world of options trading is most often achieved by finding a just a few big winners (and perhaps a few small winners) to offset the inevitably longer list of small and big losers that will be encountered along the way.