Synthetic High R trading using trade sequences and compounding

By Sebastiaan76

This article assumes you already have some kind of trading system or method you are comfortable with, and are at the very least trading breakeven or better with it.

If you are still looking for a method or system – this article, while interesting, won't be much use.

Also, in this article you will see references to 'R' and in the context of our article we are referring to 'Multiples of Risk' i.e. a trade that returns .8R is a trade that returns 80% or funds risked. Or, a trade that returns 1R is a trade that returns exactly what your risked. 2R is double what your risked and so on. Google it if you still don't understand ☺

With that disclaimer out of the way – let's start.

We all know that there are 3 basic pillars to trading

1. Strategy/method/system
2. Money Management
3. Psychology

Typically most traders overcome the fact that they are only right 50 – 60% of the time by aiming for trades that have a favorable risk/reward (i.e. 2R or 3R or more). They also use Money Management to risk only a very small fraction of their account (1% to 5% max) on any trade. This is the kind of money management spruiked by most books and others you will come across.

Logically, if each trade has a RR of 1:2 (or 2R) or more and you are correct at least 51% of the time, you should make money. Only risking 1 - 2% of your account per trade also means you will be around long enough to trade another day. I think we can all agree that would be 'common wisdom' in trading circles.

That logic is undeniable, and works great in theory! Why is it then that so many traders fail? Even those that I'm sure try to adhere to this.

Often our psychology gets the better of us, and if that doesn't, then the structure of the market will take care of the rest.

I would argue 3 things that work against us.

1. The markets aren't necessarily configured to allow high R setups easily without being stopped out (unless you have really wide stops – or you are a trading God with awesome entries).
2. Most people hate to be wrong, and picking a large swing in the market that will return a high R is much more difficult than picking where the market will bounce the next 5 pips or so.
3. Most people won't have the discipline required to let a profitable trade go for something like 9R+. Many won't even let it go to 1R!

At least the above is true for many traders (myself included). But few would argue that higher R trades are NOT easy to pick. If you are regularly pulling 3R or 4R trades most times, congratulations ☺

What if I told you there was another way. That having to strive for those 3R and 4R trades and only getting them 30 - 50% of the time wasn't the ONLY way to make money in trading? That you could easily trade reliable short term setups and get 9R+ doing so? Intriguing, I hear you say!

Using very high probability setups that of themselves have low R returns + compounding, we can put together trade sequences that allow very high returns.

For this example we will use Binary options (high/low binaries). Binary options are useful as they provide a fixed risk AND a fixed return. Although the return is always less than the risk (usually .75R to .85R).

Binary Options are an instrument with which you can take a view of the market i.e. Market will be higher/lower than current price by x time and you then choose how much to risk, and your return is fixed also. Some Binaries are slightly different, but that's the main idea of them.

Once you choose your market direction, risk amount and time until expiry. You are locked in. You will either win or lose +0.8R or -1R.

You could also do this in the Spot FX or Futures markets by only aiming for ~1R trades, fixing your Stop and Target and then walking away to either let the trade win or lose – no partials allowed!

By trading high probability setups that we know will likely work in the short term, we can string together trades into a sequence of 3 or 4 (or more if you are super confident or less to start)and get 9R (based on .8R return on each trade) on each sequence of 4, even though each trade returns < 1R on it's own.

Many would say that the markets are random, and that picking where a market is going to be at any point in time is nearly impossible (or at the very least it's hard)! News can come out, a large player can come into the market, Volatility can change etc. All these things contribute to where the market will go over time and HOW it gets there.

But the manner and behavior of the market and the way it moves ISN'T random. Think of it as a car driving along. We don't know the driver or where they are going! Trying to pick where the car will be 2 days from now is virtually impossible, as our driver speeds up and slows down at random and uses whatever backstreets he wants. Our driver also gets distracted by the radio and when he hears any news about traffic jams or free donuts, he changes course abruptly!

But we do know HOW the car moves, i.e. when it turns a corner, we know the front wheels will both move together in a certain direction, and an indicator light will come on, probably some braking as well. A co-ordinated turn will ensue, and it will probably be 90 degrees in the direction indicated by the wheels.

Trading shorter ‘hops’ in the market is more predictable, as certain behaviors are often observed. Here we can trade the car wheels turning and the indicator light coming on, rather than trying to pick the ultimate destination.

e.g. Support and resistance levels & trend lines will often break & re-test/bounce. Sometimes the bounce goes a long way, sometimes it doesn’t. But often it will bounce. This is what we are looking to profit from.

What about a pinbar doji? We will often see price moving in the opposite direction after a pinbar (at least for a short time – sometimes for a long time). If we know the market is likely to move in a certain direction – at least for the next 5 minutes, let’s profit from that! Who cares if it goes another 500 pips, or whether it turns shortly after. We just want to take the sure money and use it to compound the next sure money.

I’m sure you get the idea. Basically, rather than trying to pick an entry, and a huge target, which has a lot more room for external factors to influence it. We are looking to trade more predictable market behavior. But we will use aggressive compounding over a short series of trades to profit. This often results in winning trades, even if the market doesn’t continue in your desired direction.

A nice way to summarise this is by taking on the mantra of: ***“Conservative Trading – Aggressive Money Mangement”.*** This is also the mantra of a great trader called ‘CherryCoke’ who has a very inspiring tale of success – just google her and you will find out more.

Here is an example of a trade sequence using compounding

Starting account: $5000

2% risk is $100

So normally we would trade and be happy to risk 2% and get 2 – 4% return i.e 1R or 2R (1 x Risk or 2 x Risk). That would be awesome.

But to do that, we would probably need a stop loss of 10 pips minimum (even on very low timeframes) and this would need to account for the spread too.

So to make 2R the price would need to move >20pips………happens all the time, sure…..but how often will there be false breakouts and stop hunts before the ultimate 20 or more pips is reached? Quite often! So you either need to widen your stop, and reduce your RR or you need better entries. Neither is easy. One is hard to pick (entry), and the other is difficult psychologically (wider stop). Going for 4R or more often means you would need to catch the much of the instruments entire ADR for the day. Not easy to do consistently.

Instead what if we took profit @ .8R – 1R and compounded each trade in a sequence of 4.

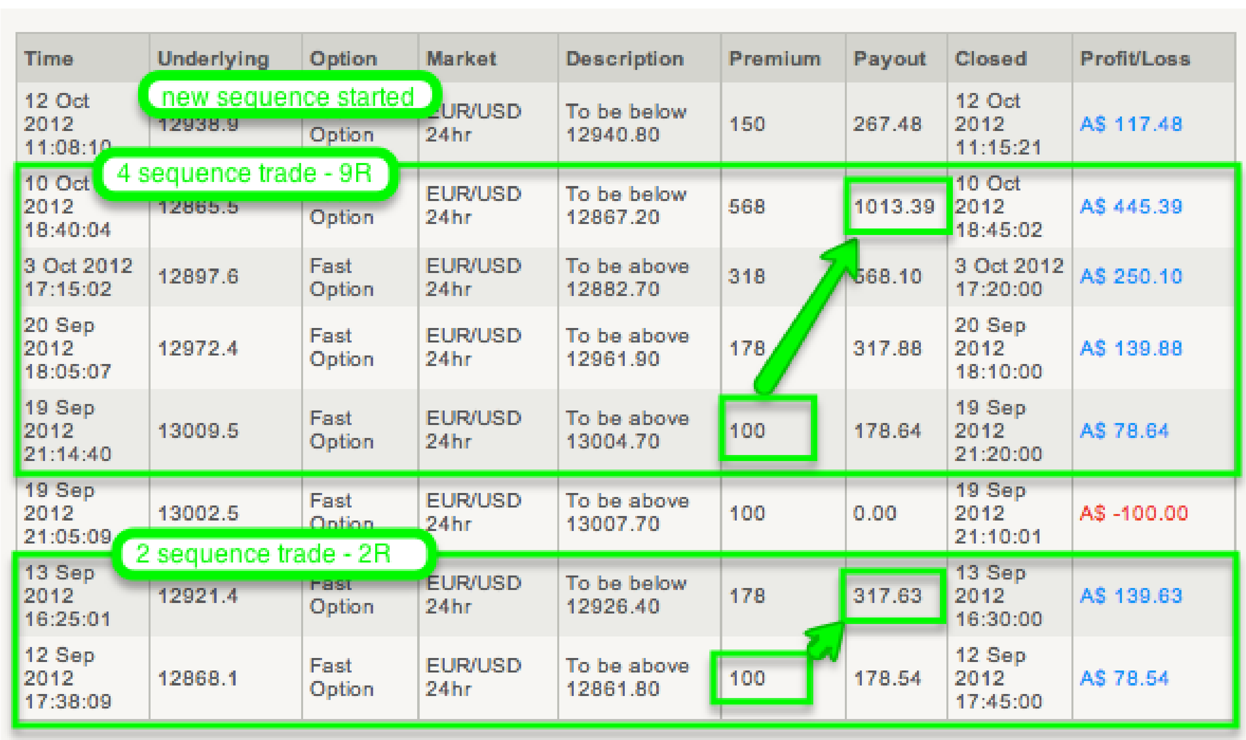
e.g. using binary options which have fixed Risk/Reward as an example, lets say each option had a return of .78R (typical return for IG Markets custom options at time of writing) and we risk 2% of our $5000 to start our sequence:

Starting account $5000 – risk 2% per sequence ($100)

risk $	100	Risk %	100.00%	Return %	78.00%	
Trade #	**Risk**	**Profit**	**Cumulative**	**net profit**	**R factor**	**cum R**
1	$100.00	$78.00	$178.00	$78.00	0.78	0.78
2	$178.00	$138.84	$316.84	$216.84	1.39	2.17
3	$316.84	$247.14	$563.98	$463.98	2.47	4.64
4	$563.98	$439.90	$1,003.88	$903.88	4.40	9.04

At no time, was any more than 2% of our initial capital at risk.

This is what an account statement looks like in reality when this is done (read from bottom up):



Time	Underlying	Option	Market	Description	Premium	Payout	Closed	Profit/Loss
12 Oct 2012 11:08:10	12938.9	Option	EUR/USD 24hr	To be below 12940.80	150	267.48	12 Oct 2012 11:15:21	A$ 117.48
10 Oct 2012 18:40:04	12865.5	Option	EUR/USD 24hr	To be below 12867.20	568	1013.39	10 Oct 2012 18:45:02	A$ 445.39
3 Oct 2012 17:15:02	12897.6	Fast Option	EUR/USD 24hr	To be above 12882.70	318	568.10	3 Oct 2012 17:20:00	A$ 250.10
20 Sep 2012 18:05:07	12972.4	Fast Option	EUR/USD 24hr	To be above 12961.90	178	317.88	20 Sep 2012 18:10:00	A$ 139.88
19 Sep 2012 21:14:40	13009.5	Fast Option	EUR/USD 24hr	To be above 13004.70	100	178.64	19 Sep 2012 21:20:00	A$ 78.64
19 Sep 2012 21:05:09	13002.5	Fast Option	EUR/USD 24hr	To be above 13007.70	100	0.00	19 Sep 2012 21:10:01	A$ -100.00
13 Sep 2012 16:25:01	12921.4	Fast Option	EUR/USD 24hr	To be below 12926.40	178	317.63	13 Sep 2012 16:30:00	A$ 139.63
12 Sep 2012 17:38:09	12868.1	Fast Option	EUR/USD 24hr	To be above 12861.80	100	178.54	12 Sep 2012 17:45:00	A$ 78.54

As you can see on the 4 sequence trade, we risked our $100 and got our .78R return, our bankroll is now $178. We wait for our next setup, and we risk the $100 and the $78 profit from the previous trade. The trade wins, and we make .78R on that trade. Our Bankroll is now $316. We go again with our $100 + the now $216 of profit we have accumulated and it wins, now our Bankroll is $563. One more time. We risk $100 + our $463 of profit and it wins. Our Bankroll is $1003. Not bad with only $100 or our risk capital at work, and the rest provided by the market! (the example above has slightly different figures, as IG markets has slight differences in payout of between 78% and 79% but you can see it's largely as per the spreadsheet example).

At the end of this 4 trade sequence, you would bank all but $120 - $150(2 - 3% of your new total balance of trading account) and start again.

But, hang on! Getting 4 trades right in a row is hard!? Yes it is, but 4 trades that return .8R on their own isn't as hard as picking one trade that will return 9R. If you are patient, and wait for no brainer setups that are very high probability, it's not that hard. You will notice in the example above, that the dates are spread over a fairly long period of time (granted, most of that gap was because I was on holiday during half that sequence), why take average setups, when you know, eventually the market will offer up no brainer setups. Remember. Conservative trading – aggressive money management.

At the very least, if you are pulling in trades with less than 1R return, you should consider re-investing that profit into the next trade or two to at least end up with 2R – 4R or more at the end of the sequence.

Personally, I would recommend sequences of minimum 3, which return 4R (with .78R return per trade).

Being patient is a lot easier psychologically when you know that in a few short trades, you are going to profit 9 fold on your initial risk. After all, we trade to make money don't we?

Another thing, psychologically, as you are only in the market a short time, it's easier to achieve.

OK, so what happens when you lose on the third or fourth trade! Well, you lose $100 of your risk capital (yes, yes, and the accumulated profits, but of your actual money – still only the $100).

It will happen. But when you get your 4 sequence trade, you will have enough profit to cover another 9 attempts. Of those 9, you should achieve at least a few more 4 sequence wins – end result, with that kind of return from each sequence, you will make money. After a few 4 sequence trades, you may like to try a 5 sequence and get a 16R return.

Now before you go off compounding like you just found the holy grail. Here are some tips.

Depending on your trading style, have a good look at past trades, and see which would have easily gone to 1R. Even more important, how often would you have had consecutive winners?

The most important thing with this Money Management system is that your trading method MUST allow for consecutive winners. The trade off is, you don't have to pick huge moves in the market.

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