EQUITY

A Simple Formula for Compounding Profits

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A Simple Formula for Compounding Profits

The exponential power of compound interest is an important aspect of creating wealth. In this article, I'll be explaining how to use a different type of compounding (also known as scaling in) to increase your position sizing for greater returns without increasing your risk.

Let Your Winners Run, Cut Your losers Short

As the saying goes, 'let your winners run and cut your losers short'. This is an essential key to successful trading, especially if your ***win rate*** is less than your loss rate.

Instinctively we're not wired to do this. Instead we're more likely to hold on to (and even add to) losers in a hope that they reverse back in our favour. Alternatively, when we start to see a profit on our trade we're likely to want to take the profit in fear that we'll lose that small profit we have.

Trend trading is all about capturing as much of the trend as possible. We're never going to enter right at the beginning of a trend. Nor are we going to exit right at the top. Instead we take a high probability trade with a wide stop loss. This allows the trend's pullbacks take place without being stopped out.

When price reverses or deeply pulls back, we'll exit the trade with a trailing stop loss for a profit. Despite what some 'experts' claim, we don't actually know when the top of a market will occur. For that reason we let our winners run for as long as they trend.

On the other hand, we want to cut our losses quickly if they do not go on to trend as expected. This loss will be no more than 1-2% of your account, based on an ATR or *support/resistance* based stop loss.

Compounding into Profitable Trends

To really make the most of the above technique, instead of just holding winners, as trend traders, we add additional positions. This is known as compounding and can really accelerate our profit taking.

The key to safe compounding is to ensure our first position is risk free before we add another. Alternatively we can test the trade with a small position and then add to the trade so our total positions add up to our maximum risk. This way we're increasing the position size working for us, without increasing our risk exposure too much on a single instrument.

There are few different methods of compound, which I'll explain briefly below:

Flat Compounding

Flat compounding is when we add positions after a predetermined ATR or price percentage.

As an example, let's say we take out our first position at $136 in Apple stock. We may then add an addition position when price increases by 5% or a multiple of ATR.

Technical Compounding

Technical compounding is when we add a position when we get a valid entry signal.

This may be in the form of a ***breakout or a pullback***. If our initial position is in profit and the instrument then breaks out again, we can take that entry and make our initial position risk free. If each position is taken out at 1% risk than we have 2% risk working in our favour with only 1% live risk. We can continue to do this if the trend allows until we have 5% position size working for us.

The Power of Trend Trading

It's the above technique that can turn a good trading year into a phenomenal year. A couple of strong trends using compounding per year can really create life changing returns. In addition to this, the lowest time frame we look at as trend traders is the daily. This means we only have to look at charts once per day. Doing so limits our screen time and means we can complete our entire trading routine in just minutes per day, leaving time for our busy lifestyles!

Another, method is to increase your risk exponentially. So your account starts at $10,000, for example. You are going to risk 2% - $200.

Within a month your account increases by 20% to $12,000. You now risk 2% of the $12,000 - $240 with each position. WARNING - do not compound too soon, wait until the end of the month, then re-adjust your risk exposure.

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