

READERS' QUESTIONS: DRAWDOWN

By Tom D'Angelo

SUBJECT SUMMARY

THE BUSINESS OF TRADING

Trading is a business. The trader deals in buy and sell contracts and has an inventory of shares that are the same as the 'stock' in a retail shop. His customers do not walk in the door. They are found throughout the country and are connected by a broker and an exchange which facilitates the sale of 'shares'. Every business has its profitable, and less profitable sections. Trading is no different and our profits come from particular techniques and processes. Successful traders create a professional trading environment to manage their trading activities similar to a successful business.

Good software assists in this process. These articles explain how ManusRisco money management software is used to improve the business control and management of trading.

Failure to adopt a professional, disciplined businesslike approach towards speculation and investment will significantly decrease your chances of achieving long term profitability in today's volatile trading arena. These articles are designed to teach you how to create a professional trading environment so you can manage your trading activities similar to a successful business and make confident, disciplined trading decisions.

Over the next few weeks we will cover these topics:

- Introduction - How successful businesses are organised
- The Profit Centre business model applied to trading
- A professional, disciplined money management methodology
- Positive and negative expectation games
- **Drawdown**
- Return on Investment
- PTR / UTR
- Breakeven Analysis
- The edge: Who has it and how to get it.

In previous articles, we learned the basics of creating a disciplined money management methodology, organising your trading results, using proven business models and the importance of playing only positive expectation games.

Our Profit Centre structure organises our trading results into manageable businesses and we are now able to create the Analysis Reports which are necessary to make confident and educated trading decisions.

In this article, we will discuss drawdown, which is one of the most important reports produced by our business organisation. Drawdown is defined as a decrease from a previous equity high. For example, if you start off with \$10,000 and make three winning trades for a total of \$1,000, equity has reached a new equity high of \$11,000. If your next trade loses \$500, you are in a \$500 drawdown and you will continue in drawdown until the previous equity high of \$11,000 is surpassed.

Most traders, even very profitable ones, will be surprised to learn that they are in a drawdown at least 70 % of the time. Drawdown is both financially and psychologically destructive, and to compound the problem, many traders do not have the business structure designed to provide the information required to reduce the fear and anxiety produced by drawdown.

If trading results are not organised in a structured, businesslike environment, the trader is left in the dark as to when, where, why and how much drawdown is occurring. The lack of information creates the fear of the unknown, which causes many of the psychological problems traders must confront on a daily basis.

As discussed in our article “**The Profit Centre Business Model Applied To Trading**”, a properly designed business structure can organise trading results to provide the information necessary to produce informative and practical Analysis Reports, such as the Drawdown Report.

A properly designed Drawdown Report should contain the following information:

% of Time at New Equity High
% of Time in Drawdown

Current % Drawdown
Worst % Drawdown
Average % Drawdown

Current \$ Drawdown
Worst \$ Drawdown
Average \$ Drawdown

Current \$ Profit / Current \$ Drawdown
Current \$ Profit / Worst \$ Drawdown
Current \$ Profit / Average \$ Drawdown

\$ Difference Between Worst \$ Drawdown and Current \$ Drawdown

The first image displays a Drawdown report on a trade by trade basis. The second image displays the Summary Page of the Drawdown Report, which summarises all the important statistics described above.

Practice		Individual Trades Drawdown Analysis							
		ALL Trade Dates							
Trade Date	Symbol	Pos	# Traded	\$ P/L	Cum \$ P/L	Equity	\$ DD	% DD	Cum \$P/L / \$ DD
Beginning Trading Capital						\$ 13,000			
09/08/2004	ES	Buy	2	(\$ 318)	(\$ 318)	\$ 12,682	(\$ 318)	(2.5 %)	
09/08/2004	ES	Buy	2	\$ 182	(\$ 136)	\$ 12,864	(\$ 136)	(1.1 %)	
09/08/2004	ES	Buy	2	\$ 82	(\$ 54)	\$ 12,946	(\$ 54)	(0.4 %)	
09/08/2004	ES	Sell	1	(\$ 209)	(\$ 263)	\$ 12,737	(\$ 263)	(2.1 %)	
09/08/2004	ES	Buy	1	\$ 41	(\$ 222)	\$ 12,778	(\$ 222)	(1.7 %)	
09/08/2004	ES	Buy	2	(\$ 318)	(\$ 540)	\$ 12,460	(\$ 540)	(4.3 %)	
09/08/2004	ES	Buy	1	\$ 141	(\$ 399)	\$ 12,601	(\$ 399)	(3.2 %)	
09/08/2004	ES	Buy	1	\$ 191	(\$ 208)	\$ 12,792	(\$ 208)	(1.6 %)	
09/08/2004	ES	Buy	1	(\$ 209)	(\$ 417)	\$ 12,583	(\$ 417)	(3.3 %)	
09/08/2004	ES	Buy	1	\$ 91	(\$ 326)	\$ 12,674	(\$ 326)	(2.6 %)	
09/08/2004	ES	Sell	1	(\$ 209)	(\$ 535)	\$ 12,465	(\$ 535)	(4.3 %)	
09/08/2004	ES	Buy	3	(\$ 252)	(\$ 787)	\$ 12,213	(\$ 787)	(6.4 %)	
09/08/2004	ES	Buy	1	\$ 91	(\$ 696)	\$ 12,304	(\$ 696)	(5.7 %)	
09/08/2004	ES	Buy	1	\$ 91	(\$ 605)	\$ 12,395	(\$ 605)	(4.9 %)	
09/08/2004	ES	Sell	2	\$ 182	(\$ 423)	\$ 12,577	(\$ 423)	(3.4 %)	
09/08/2004	ES	Buy	1	(\$ 109)	(\$ 532)	\$ 12,468	(\$ 532)	(4.3 %)	
09/09/2004	ES	Buy	1	\$ 141	(\$ 391)	\$ 12,609	(\$ 391)	(3.1 %)	
09/09/2004	ES	Buy	2	\$ 382	(\$ 9)	\$ 12,991	(\$ 9)	(0.1 %)	
09/09/2004	ES	Sell	1	\$ 141	\$ 132	\$ 13,132	\$ 0		
09/09/2004	ES	Buy	1	\$ 91	\$ 223	\$ 13,223	\$ 0		
09/09/2004	ES	Buy	1	(\$ 259)	(\$ 36)	\$ 12,964	(\$ 259)	(2.0 %)	
09/10/2004	ES	Buy	1	\$ 91	\$ 55	\$ 13,055	(\$ 168)	(1.3 %)	0.3
09/10/2004	ES	Buy	1	\$ 191	\$ 246	\$ 13,246	\$ 0		
09/10/2004	ES	Buy	1	\$ 66	\$ 312	\$ 13,312	\$ 0		
09/10/2004	ES	Buy	1	\$ 141	\$ 453	\$ 13,453	\$ 0		
09/10/2004	ES	Buy	1	(\$ 109)	\$ 344	\$ 13,344	(\$ 109)	(0.8 %)	3.2
09/10/2004	ES	Sell	2	(\$ 293)	\$ 51	\$ 13,051	(\$ 402)	(3.1 %)	0.1
09/10/2004	ES	Sell	1	\$ 41	\$ 92	\$ 13,092	(\$ 361)	(2.8 %)	0.3
09/10/2004	ES	Sell	1	\$ 104	\$ 196	\$ 13,196	(\$ 257)	(1.9 %)	0.8
09/10/2004	ES	Buy	1	(\$ 59)	\$ 137	\$ 13,137	(\$ 316)	(2.4 %)	0.4
09/10/2004	ES	Buy	1	\$ 128	\$ 265	\$ 13,265	(\$ 188)	(1.4 %)	1.4
09/10/2004	ES	Sell	1	(\$ 96)	\$ 169	\$ 13,169	(\$ 284)	(2.2 %)	0.6

Practice	Individual Trades Drawdown Analysis	
	ALL Trade Dates	
	Summary	
Equity High:	\$17,690	1/3/2005
Equity Low:	\$12,207	9/10/2004
\$ Difference Equity High & Equity Low:	\$5,483	
% Difference Equity High & Equity Low:	31.0 %	
Total Trades:	426	
Time at Equity High	33	
% of time at new Equity High	7.7 %	
Time in Drawdown:	393	
% of time in Drawdown:	92.3 %	
Worst \$ Drawdown:	(\$3,571)	12/13/2004
Worst % Drawdown:	(26.9 %)	12/13/2004
Average \$ Drawdown:	(\$1,468)	
Average % Drawdown:	(10.2 %)	
Current \$ Drawdown:	(\$159)	
Current % Drawdown:	(0.9 %)	
Final Cum \$ P/L / Worst \$ Drawdown (Recovery Factor)	1.27	
Final Cum \$ P/L / Average \$ Drawdown	3.09	
Final Cum \$ P/L / Current \$ Drawdown	28.50	

The trader who has taken the time to organise his trading business using the techniques described in previous articles, will be able to create a Drawdown Report for any combination of Profit Centre, Symbol and Number Traded. For example, a Drawdown Report for the Breakout Profit Centre, ES Symbol and Number Traded, where the trade was for more than 2 contracts.

The trader now has the information which significantly reduces the fear and anxiety produced by trying to trade in the dark. He knows if he is currently in a drawdown and by how much, how much worse the drawdown can get compared to his historical performance and how much profit he has to "cover" his average, current and worst drawdowns.

The trader who attempts to beat the trading game without the information provided by an informative business structure, will not know where he was, where he is or how to get to where he would like to go. Information produces knowledge, which creates confidence, which leads to a professional approach towards the trading game.

Another benefit of trading in a business environment is the ability to determine your percentage return on profitable and unprofitable trades, one of the most important factors which will determine your eventual success or failure in the trading arena, and that will be the subject of our next article.

Tom D'Angelo is the CEO of ManusRisco Inc. The money management methodology described in these articles is used by ManusRisco money management software which can be found at www.manusrisco.com. This software adds an important business dimension to the business of share trading.