

RETURN ON INVESTMENT

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 how to create a Profit Centre structure designed to organise our trading results similar to a successful business. We also took a look at the Drawdown report, which can be created from the trading results we entered into our

Profit Centres.

In this article, we will take a look at another important report, the Return on Investment (ROI). The ROI report measures the percentage profit or loss of Trading Capital on a profitable or unprofitable trade. If you have \$10,000 in Trading Capital and you lose \$300 on a trade, you have lost 3 % of trading capital.

There are many complex formulas and techniques of portfolio management and money management, but to make life as simple as possible, you should make every attempt to never lose more than 1 % of trading capital on any one trade. If you consistently lose a high percentage of trading capital on every trade, such as 3 % or 5 %, you will lose a significant percentage of trading capital when you hit that inevitable bad series of losing trades, such as 10 out of 12 losers, or 14 out of 18 losers.

The ROI report should be created so that profitable and unprofitable trades are listed separately on the report for ease of viewing. Each profitable trade and each unprofitable trade should display the % of trading capital gained or lost.

In addition, the report should display a Running Average of the percentages. For example, if the first three unprofitable trades had a 2 %, 1 % and 3 % loss as a percent of trading capital, then the Running Average after the third trade would equal:

$(2\% + 1\% + 3\%) / 3 \text{ trades which equals } (6\%) / 3 = 2\%$

You would always like to see this Running Average never worse (more negative) than 1 %.

Use the same technique for profitable trades. For example, if the first three profitable trades had 4 %, 2 % and 3 % profit as a percent of trading capital, then the Running Average after the third trade would equal:

$(4 \% + 2 \% + 3 \%) / 3 \text{ trades which equals } (9 \%) / 3 = 3 \%$

You would obviously like to see this Running Average as high as possible and increasing.

Now divide the Running Average of profitable trades by the Running Average of unprofitable trades to obtain the Running Average Ratio, which in our example after the third trade equals:

$3 \% / 2 \% = 1.50$

You would like to see the Running Average Ratio as high as possible and increasing, indicating that you are making a higher percentage profit on profitable trades than on unprofitable trades.

These simple calculations are the mainstay of a very effective money management methodology. The percentage of trading capital that you make or lose on profitable and unprofitable trades will eventually determine your eventual success or failure in the trading game.

The goal of trading is to play a positive expectation game and risk a small percentage of capital on each trade and get into the long run, similar to a casino. If you risk a high percentage of capital and play a negative expectation game, you will go broke very rapidly.

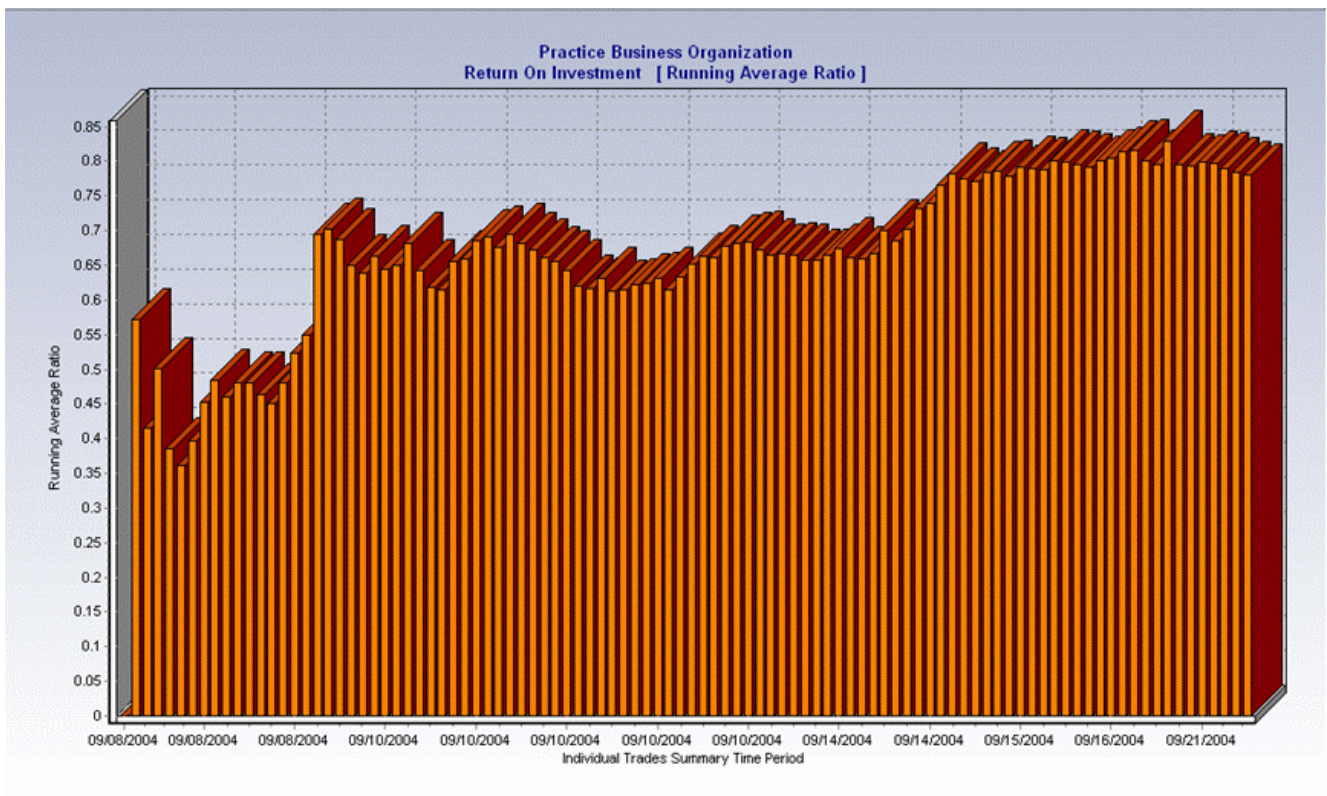
Now comes the most important part, which is to create graphs of all the above statistics. Graphs not only reveal the value of the statistic, but also the trend.

If the Running Average of unprofitable trades is consistently worse than 1 % and becoming more negative, you will have to examine your stop loss strategy to determine if your stops are too large relative to the trading capital. You could be in for big trouble when that long series of losing trades occurs.

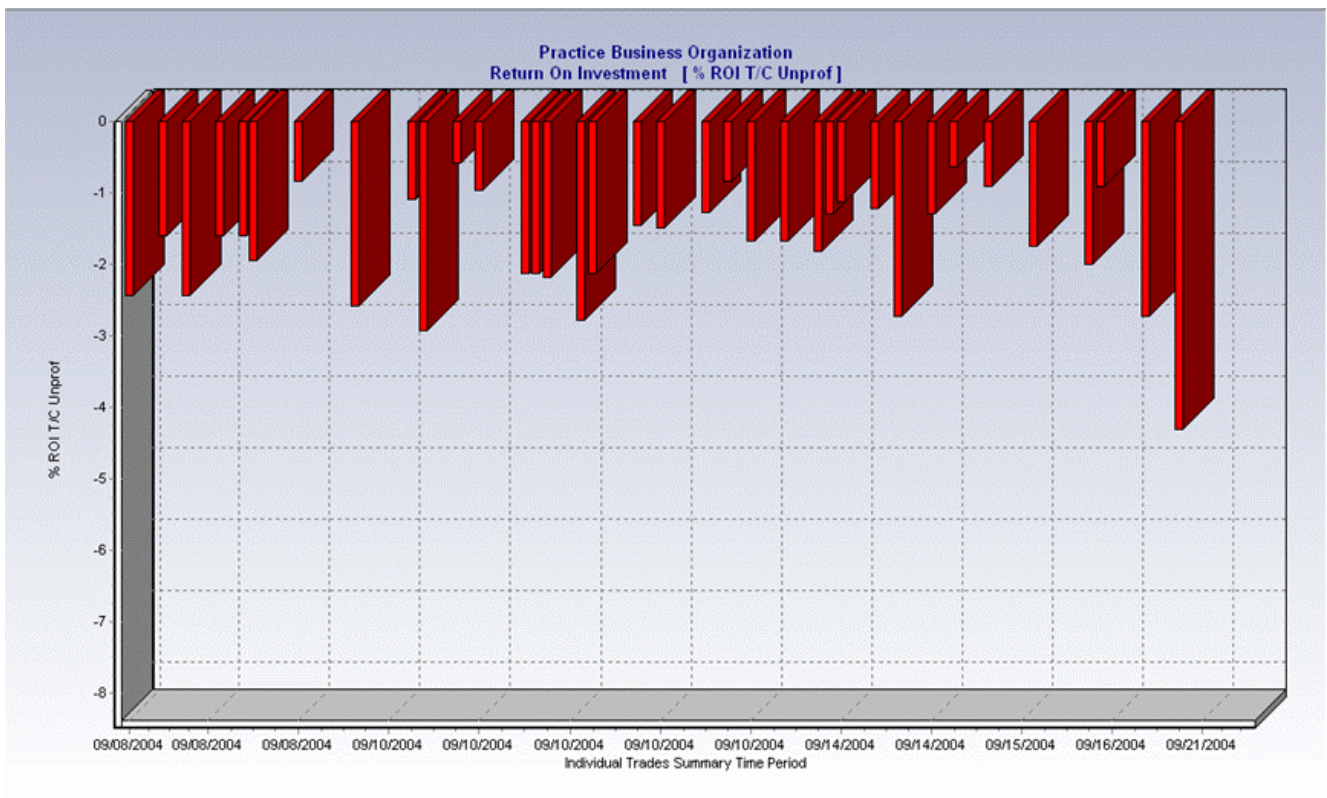
If your Running Average of profitable trades is decreasing, you will have to examine your trading strategy to determine if you are taking too small profits and not letting profits run.

If the graph of the Running Average Ratio is decreasing, then you have the worst of both situations - the percentage of trading capital you are making on profitable trades is decreasing relative to the percentage of trading capital you are losing on unprofitable trades. Both your profit objective and stop loss strategy need to be examined to determine the problem with your trading methodology and take steps to fix it.

The first image displays the graph of the Running Average Ratio. The Ratio is increasing, which is good, but ideally, the Ratio should also be above 1.0, which it is not.



The second image displays the percentage of Trading Capital lost on an unprofitable trade. You would not like to see this percentage worse than 1 %. Since most of the percentages on the graph are worse than 1 %, this would be a high risk and dangerous situation.



An image of an ROI report which displays all the above statistics can be seen below.

Practice Individual Trades Return On Investment ALL Trade Dates											
Beginning Trading Capital = \$ 13,000											
Trade Date	Trading Capital	Symbol	Pos	\$ P/L	Cum \$ P/L	% ROI T/C Prof	Running Avg Prof	% ROI T/C Unprof	Running Avg Unprof	Running Avg Ratio	% ROI Begin T/C
09/08/2004	\$ 13,000	ES	Buy	(\$ 318)	(\$ 318)			(2.4 %)	(2.4 %)	0.0	(2.4 %)
09/08/2004	\$ 13,000	ES	Buy	\$ 182	(\$ 136)	1.4 %	1.4 %		(2.4 %)	0.6	(1.0 %)
09/08/2004	\$ 13,000	ES	Buy	\$ 82	(\$ 54)	0.6 %	1.0 %		(2.4 %)	0.4	(0.4 %)
09/08/2004	\$ 13,000	ES	Sell	(\$ 209)	(\$ 263)			(1.6 %)	(2.0 %)	0.5	(2.0 %)
09/08/2004	\$ 13,000	ES	Buy	\$ 41	(\$ 222)	0.3 %	0.8 %		(2.0 %)	0.4	(1.7 %)
09/08/2004	\$ 13,000	ES	Buy	(\$ 318)	(\$ 540)			(2.4 %)	(2.2 %)	0.4	(4.2 %)
09/08/2004	\$ 13,000	ES	Buy	\$ 141	(\$ 399)	1.1 %	0.9 %		(2.2 %)	0.4	(3.1 %)
09/08/2004	\$ 13,000	ES	Buy	\$ 191	(\$ 208)	1.5 %	1.0 %		(2.2 %)	0.5	(1.6 %)
09/08/2004	\$ 13,000	ES	Buy	(\$ 209)	(\$ 417)			(1.6 %)	(2.0 %)	0.5	(3.2 %)
09/08/2004	\$ 13,000	ES	Buy	\$ 91	(\$ 326)	0.7 %	0.9 %		(2.0 %)	0.5	(2.5 %)
09/08/2004	\$ 13,000	ES	Sell	(\$ 209)	(\$ 535)			(1.6 %)	(1.9 %)	0.5	(4.1 %)
09/08/2004	\$ 13,000	ES	Buy	(\$ 252)	(\$ 787)			(1.9 %)	(1.9 %)	0.5	(6.1 %)
09/08/2004	\$ 13,000	ES	Buy	\$ 91	(\$ 696)	0.7 %	0.9 %		(1.9 %)	0.5	(5.4 %)
09/08/2004	\$ 13,000	ES	Buy	\$ 91	(\$ 605)	0.7 %	0.9 %		(1.9 %)	0.5	(4.7 %)
09/08/2004	\$ 13,000	ES	Sell	\$ 182	(\$ 423)	1.4 %	0.9 %		(1.9 %)	0.5	(3.3 %)
09/08/2004	\$ 13,000	ES	Buy	(\$ 109)	(\$ 532)			(0.8 %)	(1.8 %)	0.5	(4.1 %)
09/09/2004	\$ 10,000	ES	Buy	\$ 141	(\$ 391)	1.4 %	1.0 %		(1.8 %)	0.5	(3.0 %)
09/09/2004	\$ 10,000	ES	Buy	\$ 382	(\$ 9)	3.8 %	1.2 %		(1.8 %)	0.7	(0.1 %)
09/09/2004	\$ 10,000	ES	Sell	\$ 141	\$ 132	1.4 %	1.3 %		(1.8 %)	0.7	1.0 %
09/09/2004	\$ 10,000	ES	Buy	\$ 91	\$ 223	0.9 %	1.2 %		(1.8 %)	0.7	1.7 %
09/09/2004	\$ 10,000	ES	Buy	(\$ 259)	(\$ 36)			(2.6 %)	(1.9 %)	0.7	(0.3 %)
09/10/2004	\$ 10,000	ES	Buy	\$ 91	\$ 55	0.9 %	1.2 %		(1.9 %)	0.6	0.4 %
09/10/2004	\$ 10,000	ES	Buy	\$ 191	\$ 246	1.9 %	1.3 %		(1.9 %)	0.7	1.9 %
09/10/2004	\$ 10,000	ES	Buy	\$ 66	\$ 312	0.7 %	1.2 %		(1.9 %)	0.6	2.4 %
09/10/2004	\$ 10,000	ES	Buy	\$ 141	\$ 453	1.4 %	1.2 %		(1.9 %)	0.7	3.5 %

Properly designed Drawdown (discussed in the previous article **Drawdown**) and ROI reports are an absolute requirement if the trader desires to achieve long term profitability playing the trading game.

You also need to be an efficient trader, which is measured by the PTR and UTR. What is the PTR and UTR? Well, we will have to wait for the next article to find out.

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.