<u>SIX TO TWENTY ONE STRATEGY RETESTED</u>

By Daryl Guppy

I can still remember my first contact with a broker. The message was blunt. "If you haven't got a minimum of $50,000 to start with then I am not interested." The broker's arrogant contempt struck a raw nerve because I felt I had as much right to make money in the market as anybody else. His comments spurred me on to understand the market, the money making opportunities, and the vital role that money management and risk control plays in trading success. In many ways, this broker bears responsibility for all the books that I have written because my objective is to cut through the arrogance of entrenched market money to show how these opportunities are available to everybody.

I started with $2,000 because that is all that I had available at the time. It was not money that I could not afford to lose. It represented a very significant part of my savings. Losing it would hurt a great deal and that immediately focused my attention on risk control. This was not a gamble. It was a well considered plan to make my capital work hard. $2,000 is not a good 'grub stake'. $6,000 is closer to the bare minimum required for trading because it gives the trader the ability to practice some risk diversification. Growing this capital to $21,000 is the first important step in market survival. Once trading capital reaches $21,000 it is much easier to spread the volatility risk across several open positions to protect and grow capital.

Six to Twenty One is the title of a chapter in **Share Trading** and readers have asked if the strategy is still relevant in 2016. We think it is and over the next few months we will put it to the test with real time trading.

Traders start with small accounts and are always undercapitalized. The challenge is to allocate trading capital in a way that leverages the return from speculative trades to grow capital but at the same time to protect capital through careful money management. This calls for good risk control and excellent trading discipline. Once the traders capital grows to around $21,000 he has a better opportunity to diversify across a range of stock volatility to maximize the growth of capital with a lower risk profile. The path for growing capital from $6,000 to $21,000 is difficult. Many traders do not succeed. However the skills learnt here are the foundations of success. Get from six to twenty one by trading and you have the skills necessary to quickly take you to much greater capital growth with significantly lower risk.

Some people continue to sneer and suggest that it is virtually impossible to grow capital from $6,000 to $21,000. This self defeating attitude is guaranteed to deliver trading failure, and failure in many other aspects of life. No one pretends trading the market is easy. It is not. It requires more discipline than many people have. It requires a willingness to work, and work hard. This is no gamble, and there are no short cuts. This upsets many Australians who love the Tattslotto approach to life and the markets where lots of money comes for little work. When they discover making money from the market requires more work than buying a tattslotto ticket they give in – and they decide that no one else can make money from the market because it is rigged, manipulated or controlled by insiders and those in the know. Their self defeating attitudes become self fulfilling.

The market remains the most effective legal place to grow capital through the exercise of risk management techniques and personal effort. Over the next few months we will be running a simultaneous case study portfolio designed to show how capital can be grown from $6,000 to $21,000. We will be using only ordinary stocks – no derivatives or CFDs.

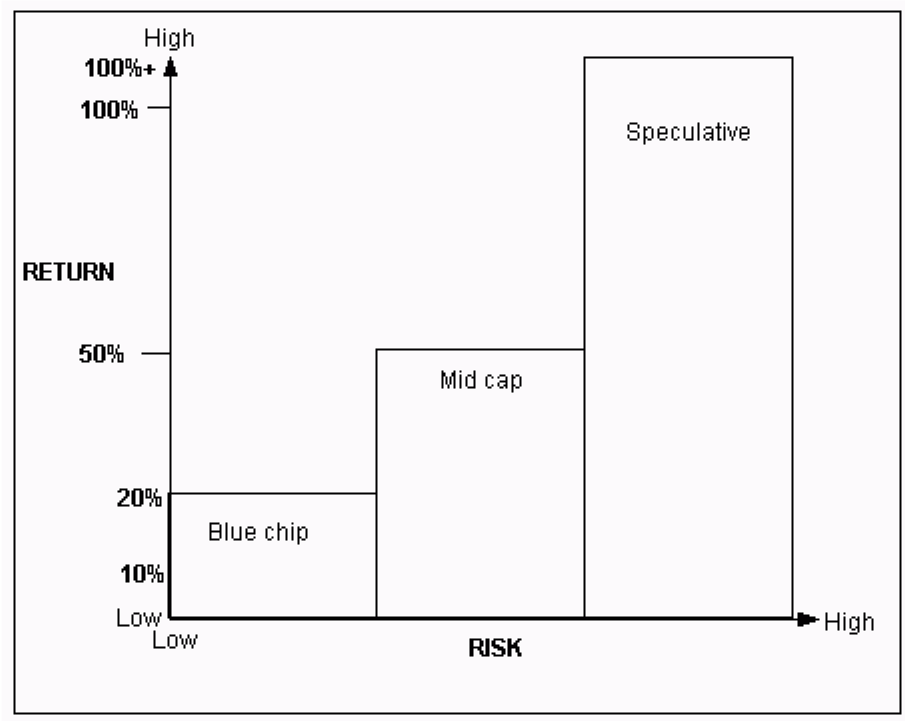
Success rests upon the way we approach risk with this small starting capital. This is the most important factor. Because when we start, our focus is always on protecting capital. Usually it has taken some time to gather the capital, and we do not want to lose it. This throws up an important contradiction which any trading approach must resolve.

The way to grow capital quickly is by trading stocks which promise a higher return per trade. These are stocks with greater volatility. They can move up dramatically, and move down dramatically. This increases the risk of loss if the trade fails.

An important caveat here. This increases the risk of loss **only** if the trader follows a buy and hold strategy. The market experience since 2008 clearly demonstrated this. The returns from many managed and superannuation funds also confirmed this.

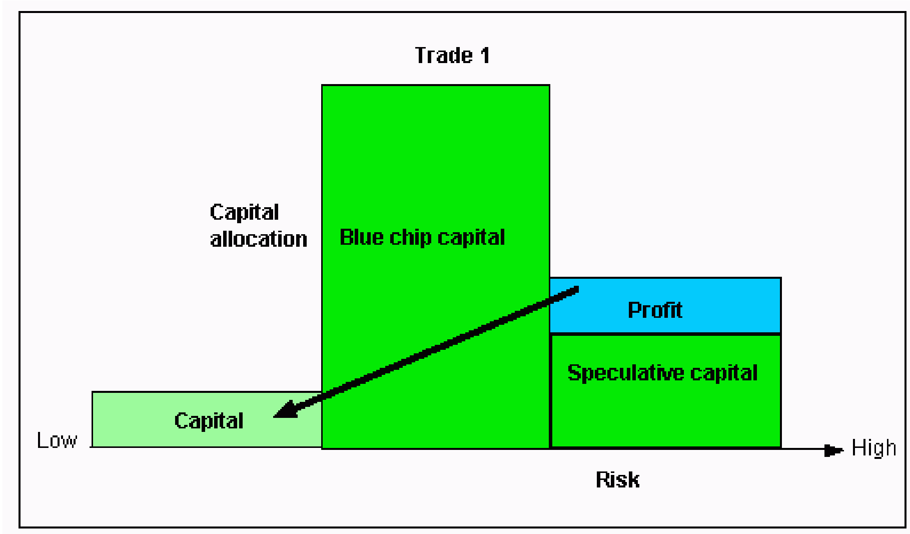
The first powerful impact of risk management is understanding that the **trader manages risk.** The market does not manage risk. The 'I'm in for the long term' approach believes that the market manages risk, so simply by waiting any losses can be managed. The market creates a risk environment which we manage through our own actions.

Resolving this contradiction and reconciling it with the need to protect capital involves two steps. The first is to classify stocks according to their volatility. Rather than create new categories for this, I used existing categories – blue chip, mid cap, and speculative – as a shorthand. This decision has plagued me ever since and has been a source of confusion for some readers of **Share Trading.** The second is to allocate capital in a way that maximizes returns within a money management structure that protects capital, and which grows capital as a result of trading activity. This is the essence of the 6 to 21 strategy.



We start the strategy with a basic understanding of the relationship between risk and reward as shown in the diagram. Blue chip stocks are those which have the capacity to return 10% to 20% in a single trade. These figures are moved up a little in a bull market, but in general these are the types of returns we aim for with a blue chip stock. Trades may last months or longer with these stocks. Note that it is the return from the trade that defines the category. It is not the quality of the stock, although it is fair to say that most blue chip stocks also have a large capital base.

- The mid cap stocks are capable of returning 30% to 50% in a single trade. In a long term trend they may return much more, but our focus is on a single trade that may last weeks or months.
- A speculative stock is capable of returning 50% to 100% in a single trade. Typically these trades will last days or weeks. Some last months, but this is unusual.



As we move from blue chip trades to speculative trades, the risk increases. Speculative trading opportunities generally carry greater risk than blue chip opportunities. This is partly a function of volatility, and partly a function of momentum. Fast movers can also drop quickly. Slow movers can drop steadily for months on end as people discovered with banks in 2008 and 2016. The speed of the collapse does not diminish the risk in the trade. The risk is diminished by the activity of the trader. The trader who does not act on a stop loss signal automatically increases the risk, and the size of the loss, in the trade. The primary difference between blue chip and speculative stocks in this sense is that most times the blue chip trader will have more time to make a decision.

The obvious and enticing way to grow our capital quickly is to trade the speculative stock opportunities. If we only do this, and pyramid the returns from each trade into the next trade then we can grow capital very rapidly. Unfortunately it does little to protect our capital. With each new trade our capital and profits are exposed to the same level of market risk as when we first started. This is the gambler's approach and is a short cut to ruin unless your luck holds.

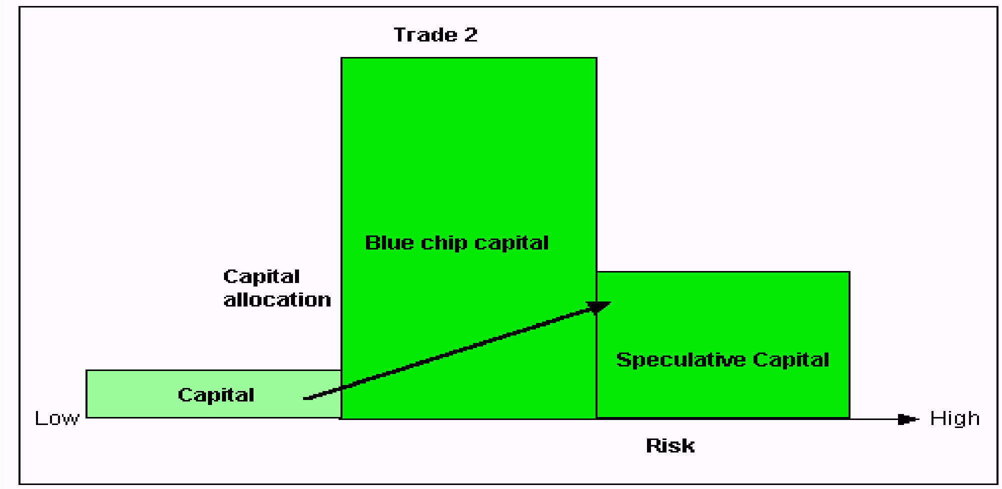
The resolution to this problem, as covered in **Share Trading,** is to use only a fraction of capital in the high risk trades. This strategy uses speculative profits to add to capital.

The process is shown in the diagram. Our starting capital - $6,000- is divided into a 1:2 ratio. Two thirds of the capital - $4,000- is allocated to a blue chip trade. This is not going to earn a great deal, but it should earn better than bank interest which is the other alternative use of our capital. There are two objectives. One third of the capital is allocated to a speculative trade. This means the position size is $2,000 and this is about the minimum size trade that is realistically possible. It is this minimum size, coupled with the 1:2 ratio that gives us the minimum size for starting capital - $6,000.

To primary objective is to protect our capital. This is achieved by allocating more to blue chip stocks than to speculative stocks.

The next objective is to grow capital quickly by taking greater risk in the market. This is achieved by using a smaller proportion of our capital. This small proportion grows slowly as our total trading capital – profits and original capital – increases.

The profits from each trade are added to our trading capital. The diagram shows a successful speculative trade. The profit from this trade is swept initially into our bank account.



This profit becomes part of the total trading capital available. As a new speculative trade is opened the profit from the original speculative trade is added to the capital used in the next speculative trade. This is an aggressive Egyptian pyramid approach designed to fast track capital growth.

Although this is potentially a very profitable strategy, it is also a strategy that carries a higher level of risk. This is managed firstly by using tightly defined stop loss points and entering trades as close to the stop loss point as possible. We discussed techniques for this in recent newsletters.

The second way this risk is managed is by stopping this pyramid approach once we reach $14,000. The objective is to quickly reach the $14,000 level. Once this level is achieved, the capital ratio changes to the 1:2:4 ratio. This puts 1/7 of capital in speculative stocks, 2/7 in small or mid cap stocks, and 4/7 into blue chips. Again, the shift to this new ratio is based on the minimum acceptable trading size of $2,000. Applying 1/7 of trading capital to a $14,000 account gives a position size of $2,000.

Once $14,000 has been reached the next objective is to reach $21,000. At this level the combined impact of the speculative and mid cap trades can add significantly to the growth of trading capital. Growing capital is like pushing a heavy load. At first progress is slow, but as momentum builds the speed increases and it appears to take less effort to obtain a better result. As capital grows, the leveraged impact of speculative and mid cap trades increase and capital grows quickly. The difficult part is getting from $6,000 to $21,000. Over the next few months we will show some of these difficulties in real time. The skills learnt in this process underpin long term trading success.