

How to Trade Like a Business

Lesson #9

Breakeven

In previous lessons, we learned how to create a Profit Center structure designed to organize our trading results using a technique similar to that of a successful business. We also took a look at the Drawdown, Return on Investment, and PTR/UTR reports which can be created from the trading results we entered into our Profit Centers.

In this lesson we will take a look at Breakeven. Every trader has a breakeven point which consists of the relationship between the percentage profitable trades and the Ratio of Average Profitable Trade to Average Unprofitable Trade. The higher the percentage of profitable trades, the lower the Ratio required to breakeven, and vice versa.

The breakeven point for % Profitable Trades is calculated using the following simple formula:

$$P = \frac{1}{R + 1}$$

Where P = % of Profitable Trades and R = Ratio of Average Profitable Trade divided by Average Unprofitable Trade.

If R = 1.00, then the % of Profitable Trades required for breakeven is 50%, which is calculated as follows :

$$P = \frac{1}{1 + 1} = 1/2 = 50 \%$$

The breakeven point for the Ratio of Average Profitable Trade to Average Unprofitable Trade is calculated by the following simple formula:

$$R = \frac{1 - P}{P}$$

P

Where P = % Profitable Trades and R = Ratio of Average Profitable Trade divided by Average Unprofitable Trade.

If you are achieving 40% profitable trades, then you must attain a Ratio of at least 1.50 to break even, which is calculated as follows:

$$R = \frac{1 - .40}{.40} = .60/.40 = 1.50$$

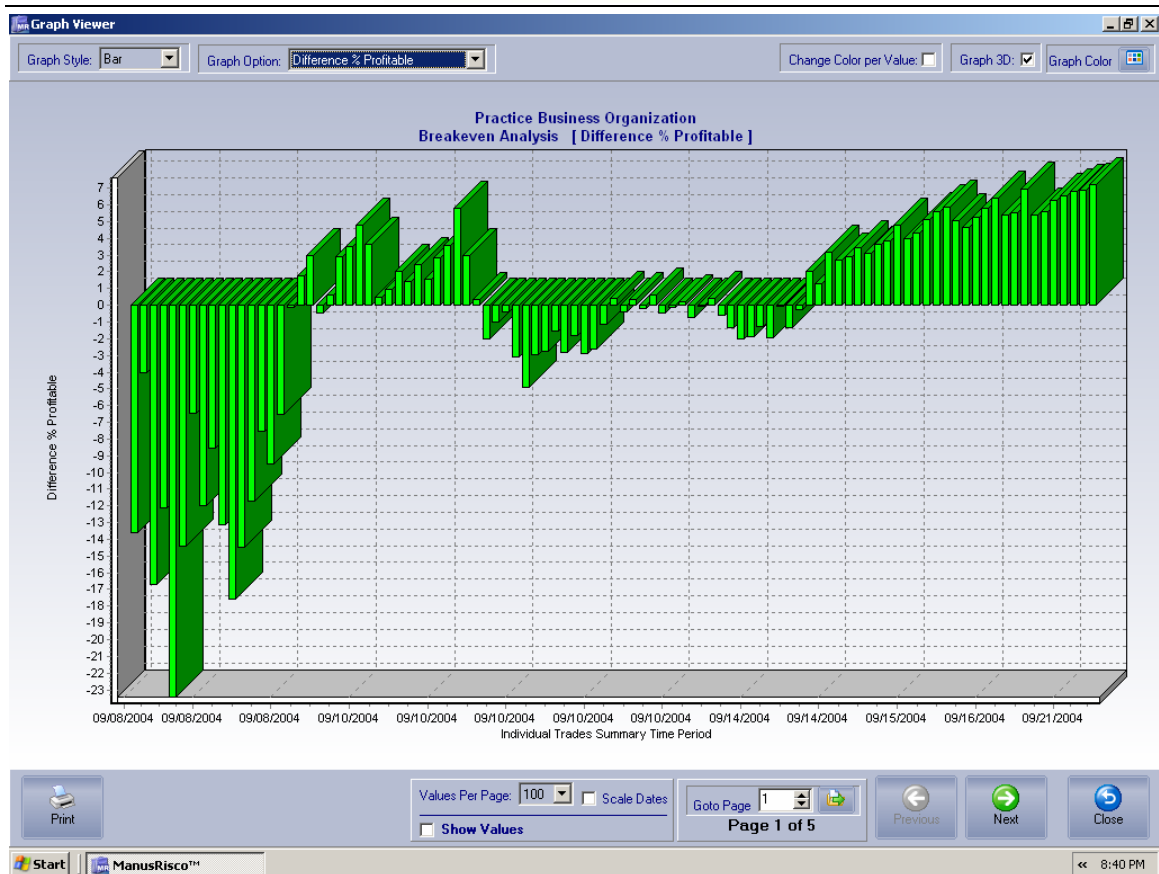
The informed trader always knows where his breakeven point is as well as the relationship between the % profitable trades and the Ratio.

For example, if the trader has 40% profitable trades, the Ratio for breakeven is 1.50. If his actual Ratio is above 1.50, then the trader is in a profitable situation. If the Ratio is below 1.50, then the trader knows that at 40% profitable trades, he must increase his Ratio by increasing his average profitable trade relative to his average unprofitable trade.

If he cannot increase the Ratio and he cannot hit more than 40% profitable trades, he will go broke.

Likewise, the breakeven % of profitable trades for a Ratio of .90 equals 52.6%. If the trader is hitting more than 52.6% profitable trades, he will be profitable. If he is hitting less than 52.6% at a Ratio of .90, he will eventually go broke.

The attached screenshot created by ManusRisco displays a graph of the Difference between the breakeven % profitable trades and the actual % profitable trades. You would like to see this Difference above zero and increasing as displayed on the graph. The Difference was initially below zero, but is now heading in the right direction.



The breakeven point for the % Profitable Trades and the Ratio will be constantly changing, especially for active traders. Therefore, the trader should know the breakeven relationships after each trade in order to examine his trading strategy and know whether he has to either improve his % Profitable Trades or his Ratio.

Many traders obviously try to increase both the % Profitable Trades and the Ratio, but this is very difficult to achieve. If you increase the % Profitable Trades, the Ratio will probably go down, and vice versa. This is similar to a horseplayer who is trying to increase his % of winning bets and also increase the payoff odds on his winners. Unfortunately, if his % winners go up, it is because he is betting on more favorites, which means he gets paid less on winners, and his Ratio will go down. The same logic applies to trading.

The professional trader knows which way the two statistics which comprise his breakeven point are trending, so that he can adjust his trading strategy to accommodate current trading performance and maintain his trading edge.

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Which brings us very conveniently to the edge - who has it and how to get it - but that subject will be in our next and last lesson.

Tom D'Angelo
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Spread Scan™

By Joe Ross & Trading Educators Inc.

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