



Brainy's Articles on Share Trading Risk and Reward

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page 1 of 3
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Introduction

Consider this scenario. Let's say we have \$5,000 to invest, and there are currently two investment options available. And let's assume that we have an investment rule that says we will not "risk" more than 2% of this \$5,000 on any one trade or position (the infamous "2% Rule" — see below). That is, we don't want to potentially lose any more than \$100 (ie. 2% of the available \$5,000).

Now, the first investment option has the potential to make a profit of \$500, and the second one has the potential to make just \$50. Assuming the risk is the same, and the planned investment time frame is the same, which investment option should we choose? Isn't this really a no-brainer? The first option is clearly preferred. The potential return is 10% of our total capital, whereas the second one is only 1% of our capital.

In this simplistic example, the amount of money at "risk" is stated as \$100, and the amount of "reward" is stated as either \$500 or \$50 for the two options. From these figures we can calculate the so-called **Reward-Risk ratio**, which is often (incorrectly) referred to as the **Risk-Reward ratio**.

In this article in Brainy's series on Share Trading (number ST-4300), we explore this notion of Risk versus Reward, and we look at the different and confusing ways in which it is often calculated, and referred to. It should be read in conjunction with other material related to Money Management and Risk Management, including Brainy's Article ST-4400, "Position Sizing".

Definitions — Risk & Reward

Firstly let's describe this thing called Risk with a share market example.

Consider the Weekly price chart in Figure 1 below of AAG (Aragon Resources) which fell from above 20 cents in October 2009 to below 14 cents in February-March 2010. For a 6-week period the price was then stuck below resistance at 14c. Nobody was prepared to buy it at more than 14c. Whenever the buyers bid the price up to 14c, more sellers stepped in so that a sale price above 14c was not necessary. Also notice the lowest price in this period was 12 cents.



Figure 1: Price breakout - AAG. Where is the risk and target?

(More details on
pages 2 and 3...!)