Position Sizing and Drawdowns

No trader can escape drawdowns. They're a reality of the business. But you *can* implement techniques to reduce their intensity and length. One of the best ways to do this is to scale back position size as you go on a losing streak. Backing off when things aren't going your way is the key to having a lengthy trading career.

A tiny drawdown, left untreated, can quickly turn into a blow up of account capital *and* mental capital. If you lose either of those two, you're out of the game for good.

A drawdown is a sign that either:

a) Your method is temporarily misaligned with market conditions
b) Your edge is eroding and you need to adapt
c) You're making trades outside of your expertise or normal process

It makes sense to reduce position sizing because in the moment, you never know *exactly* why an account is drawing down. Lowering size slows the process and gives you time to think about what's happening.

In the case of scenario a, smaller size makes it mentally easier to weather the storm.

For scenarios b and c, smaller position sizes will protect your capital and buy you more time to make adjustments and get back on track.

Success in this business is about long-term consistency and compounding. Starving a trading strategy that begins to underperform is extremely helpful in achieving this goal.

Position Reduction Strategy

The following is a methodical way to determine when and how aggressively you should reduce size.

First dig into your trading history and see if your losses "cluster." Are the losing trades sprinkled around winners? Or are there clear areas where a few losses lead to many more losses in a row? If you see a pattern of losses clustering, then your strategy will benefit from size reduction.

Check how many losses in a row typically cause the drawdown. Just one loser likely doesn't signal anything. It's usually a series of losing trades. That number could be 3 or more. It's different for everyone depending on their process. Evaluate your trading history and try to determine your optimal threshold.

For example, you might find that after three losing trades in a row, things start to get dicey for a few months. So the next time you run into three losers, start to cut back size. Keep cutting back until the drawdown stabilizes. Once the drawdown begins to recover, start adding the size back.

You can go beyond this rudimentary method by actually charting your account equity curve and developing trend following rules for it.

If your account value based on closing trades is above a 20-trade moving average, then use full size. If your account value falls below the 20-trade moving average, then back off size. This is a more defined "quant" way to go about it.

Varying position size will bring your returns to the next level. Markets deliver profits in cycles. If you tune into these cycles, you can exploit them and achieve better returns with fewer drawdowns.

Guys like Peter Brandt are amazing at this. He's great at knowing when to back off and when to step on the gas. This instinct is a huge part of his edge and it's why he's able to trade classical chart patterns so successfully.