Investopedia.com

The Myth Of Profit/Loss Ratios

by Grace Cheng,See Grace's Forex blog at www.gracecheng.com,
FREE Forex Report - The 5 Things That Move The Currency Market (Contact Author | Biography)

When trading the forex market or other markets, we are often told of a common money management strategy that requires that the average profit be more than the average loss per trade. It's easy to assume that something that has been so widely advised must be a good thing. However, if we take a deeper look at the relationship between profit and loss, it is clear that the "old", commonly held ideas may need to be adjusted. In this article, we'll look at this common trading advice in terms of the profit/loss ratio.

Profit/Loss Ratio

A profit/loss ratio refers to the size of the average profit compared to the size of the average loss per trade. For example, if your expected profit is $900 and your expected loss is $300 for a particular trade, then your profit/loss ratio is 3:1 - which is $900 divided by $300.

Many trading books and "gurus" advocate a profit/loss ratio of at least 2:1 or 3:1, which means that for every $200 or $300 you make per trade, your potential loss should be capped at $100. (For related reading, see *Limiting Losses*.)

At first glance, most people would agree with this recommendation. After all, shouldn't any potential loss be kept as small as possible and any potential profit be as much as possible? The answer is: not always. In fact, this common piece of advice can be misleading, and can cause harm to your trading account.

The blanket advice of having a profit/loss ratio of at least 2:1 or 3:1 per trade is over-simplistic because it does not take into account the practical realities of the forex market (or any other markets), the individual's trading style and the individual's average profitability per trade (APPT) factor, which is also referred to as statistical expectancy.

APPT is Key to Profitability

Average profitability per trade basically refers to the average amount you can expect to win or lose per trade. Most people are so focused on either balancing their profit/loss ratios or on the accuracy of their trading approach that they are unaware that a bigger picture exists: Your trading performance depends largely on your APPT.

This is the formula for average profitability per trade:

Average Profitability Per Trade = (Probability of Win x

Average Win) - (Probability of Loss x Average Loss)

Let's explore the APPT of the following hypothetical scenarios:

Scenario A:
Let's say that out of 10 trades you place, you profit on three of them and you realize a loss on seven. Your probability of a win is thus 30% or 0.3, while your probability of loss is 70% or 0.7. Your average winning trade makes $600 and your average loss is $300.

In this scenario, the APPT is:

(0.3 x $600) – (0.7 x $300) = - $30

As you can see, the APPT is a negative number, meaning that for every trade you place, you are likely to lose $30. That's a losing proposition!

Even though the profit/loss ratio is 2:1, this trading approach produces winning trades only 30% of the time, which negates the supposed benefit of having a 2:1 profit/loss ratio. (For related reading, see *The Importance Of A Profit/Loss Plan*.)

Scenario B:
Now let's explore the APPT of a trading approach that has a profit/loss ratio of 1:3, but has more winning trades than losing ones. Let's say out of the 10 trades you place, you make profit on eight of them, and you realize a loss on two trades.

Here is the APPT:

(0.8 x $100) – (0.2 x $300) = $20

In this case, even though this trading approach has a profit/loss ratio of 1:3, the APPT is positive, which means you can be profitable over time.

Many Ways of Becoming Profitable
When trading the forex market, there is no one-size-fits-all money management or trading approach. Traditional advice, such as making sure your profit is more than your loss per absolute trade, does not have much substantial value in the real trading world unless you have a high probability of realizing a winning trade. What matters is that your APPT comes up positive and that your overall profits are more than your overall losses.

For more forex money management tips, see *Money Management Matters*.

by Grace Cheng (Contact Author | Biography)

Grace Cheng is a forex trader, creator of the PowerFX Course and author of "7 Winning Strategies for Trading Forex" (2007, Harriman House). This revealing book explains how traders can use various market conditions to their advantage by tailoring a strategy to suit each one. The book is a perfect complement to the PowerFX Course. The PowerFX Course, designed for both new and current traders, teaches tools and trading approaches that combine technicals, fundamentals and the psychology of trading forex. It also includes Grace's proprietary tips and tricks. Grace's works have been published in *The Trader's Journal*, *Technical Analysis of Stocks & Commodities*, *Smart Investor* and other leading trading/investment publications.

Visit her popular forex blog at www.GraceCheng.com.