Pyramid – A Trade Management Methodology

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Pyramid – A Method of Trade Management

What does it mean to “trade with the market’s money”? That’s right, I am going to show you how to scale in or “pyramid” into a winning trade, without taking on more risk. This essentially means you will add to an open winning position without taking on more risk and possibly even creating a risk-free trade, all while dramatically increasing your potential profit. It is not too good to be true, but there are certain times when scaling into a trade works better than others, which we will discuss in the following article. (Note: scaling in is the same thing as adding to a position or pyramiding in)

You’ve probably heard the saying “Cut your losers short and let your winners run”, but how do you actually do that? Today’s Forex trading training lesson is going to teach you how to properly scale into an open trade that’s in profit, so that you get the most out of your winning trades. With all many strong trends that are taking place in the various markets recently, let us look through how best to maximize your winning trades.

How to safely scale in or “pyramid” into a winning trade

1) The stupid way – Scaling into your position but not trailing your stop up or down to reduce risk on the previous position(s), thereby voluntarily taking on more risk.

2) The smart way – Scaling into your position at predetermined levels and trailing your stop up or down each time you add a new position so that you never risk more than you are comfortable with losing, or more than what you have predetermined is a good 1R value for you (1R = the amount you risk per trade).

Before we get started I need to stress one thing:

WARNING: Just because you can scale into an open position that is in profit doesn’t mean you SHOULD. There are certain times when the strategies you are about to learn will work well and certain times when they won’t. In general, you can try to scale into a winning position when a market is in a strong trend or during strong intra-day moves. You should not try scaling in when the market is range-bound or trending in a choppy manner with a lot of back and filling.

Now, because you are adding a new position each time your current trade moves a certain distance in your favor, your breakeven point on the whole position moves closer to the market price. This means the market does not have to move as far to put you into negative territory. Now, this won’t be a problem if you have trailed your stop loss on the previous position(s) so that you maintain your overall 1R risk, but where traders get into trouble is scaling into positions and not moving their stop losses to reduce risk. If this all seems a little confusing right now I promise the diagrams below will clarify...
Example scenario:

Let’s say the EURUSD is trending lower. You see a solid entry strategy that formed showing rejection of the 1.2625 resistance level. You decide that since price has respected this level and it’s obviously a “key” level, it’s a good place to set your stop loss just above. So you decide to put your stop loss for the trade at 1.2750. We always set our stop loss before deciding on a potential profit target. This is because risk management is the most important aspect in trading. If you don’t properly manage your risk on every trade you will not make money.

Next, there is no obvious / significant support that you can see until about 1.1900, so you decide to aim for a larger profit on this trade and see if the trend won’t run in your favor a bit. Your pre-defined risk on the trade is going to be $500, to keep the math simple let’s say you sold at 5 mini-lots at 1.2650; 100 pip stop loss x 5 mini-lots (1 mini-lot = $1 per pip) = $500 risk.

You decide to aim for a risk reward of 1:3 on this trade, so you set your initial target at 1.2350 and you plan on adding two positions to this trade, 1 when you are up 100 pips and another when you’re up 200 pips. You plan on doing this because the market is trending strongly and you have decided based on your discretionary trading skills that there’s a good chance the trend will continue.

Here is a diagram of what your trade looks like at the beginning:

You sell 50K units of EURUSD at 1.2650 and set your initial stop to 1.2750. Risk on the position is $500 and potential gain is $1500.
The trade pushes on in your favor and you decide to scale in with another 50K units at 1.2550. Your overall position size is now 100K or $10 per pip on the EURUSD, this increases your potential reward to $2,500 if price hits your target at 1.2350. Since you trailed down the stop on your initial position to 1.2650, that position is now at breakeven; the stop on your new position is also at 1.2650, meaning your overall risk on the trade stays the same at $500.

You sell 50K more units of EURUSD at 1.2550 and put the stop for both positions now at 1.2650. This moves the first position to breakeven and leaves a 100 pip stop on the second, so your overall risk is still only $500 whilst your profit potential now moves from $1500 to $2500.

Next, the trade continues on in your favor and you decide to pyramid in with another 50k units at 1.2450. This means your overall position is at 150k or $15 per pip on the EURUSD. Your overall reward potential is now $3,000 if your target of 1.2350 gets hit; note that your overall reward is now double what it was when you started whilst your overall risk is now at $0 as you’ll see now...

You trail down the stops on both previous positions to 1.2550 thereby locking in a profit of $500 on the first position, reducing the second position to breakeven and offsetting the $500 risk on your new position to $0...you now have a breakeven trade. The catch here is that the market is only 100 pips from your breakeven point on the whole trade, so there’s a bigger potential of the whole position getting stopped at breakeven. The good part is you have increased your potential for profit without taking on any more risk.
You sell 50K more units at 1.2450 and put all 3 stop losses at 1.2550. This locks in a $500 profit on the 1st position and moves the 2nd one to breakeven. You now have a free trade since the $500 risk on the 3rd position is offset by the $500 locked in on the 1st. This trade now effectively has a risk reward of 1:6, since you only ever had $500 at risk with the potential of making $3000.

The trade continues on in your favor and hits your target at 1.2350, all three positions are now closed and you’ve netted a 1:6 risk : reward. You never risked more than $500, which was your predefined 1R risk amount, and you gained $3,000. This is an example of how to take advantage of a strong trending market like we have seen recently in the EURUSD and other markets.

The trade continues on in your favor and hits your predetermined target at 1.2350. You profited $3000 on all 3 positions and never took on more than what you are comfortable with losing in the markets on any one trade. This is how you safely add to a winning trade!
Why Scaling Out may not be optimal

I am sure that some of you are probably wondering about scaling out. Personally, I do not scale out, and I do not recommend you do either. But, obviously what you do in the markets is up to you, however, I will briefly explain to you why I personally believe scaling out makes no sense. When you scale out of a trade you take partial profits on your full position as the market moves in your favor. Sounds good on the surface right? Well, the problem with it is that you are limiting your gains on a winning trade. We want to maximize winning trades, not minimize them. What I am saying is that by scaling out you are purposely limiting a winning trade.

You see, when you scale out of a trade you are cutting down your position size as the trade becomes more profitable by moving further in your favor. What this means is that as the trade moves in your favor you’re going to be holding the smallest portion of your position at the most profitable part of the trade does not seem like the best way to let your winners run does it? Remember, trading is about maximizing your winning trades and limiting your losers. I only see scaling out as minimizing a winner, and that is why I usually do not scale out.

I prefer to either take a predetermined 1:2 or 1:3 profit on a full position or IF the market is trending strongly like I discussed above in the diagrams, I will try to scale in. Either way I am not minimizing my winning trade like I would be if I were to scale out. So, to be clear, I either take profit on my full position at my predetermine target level, or I scale into a trade that’s in the context of a strong market trend. What I do not ever voluntarily do is minimize a winner by scaling out.

Final comments

Finally, I just want to stress again that you should not try to scale into every trade that goes into profit. You need to decide before you enter a trade if you think it has the potential to run in your favor; you need to decide before you enter if you are going to add positions to a trade by scaling in. You do not want to leave anything to chance, and you want to make as many decisions as possible before you enter the market, since that’s when you’ll be the most objective and logical.
Email us @ research@nusinvest.com if you have any questions!
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