Using Multiple Lot Positions To Improve Trading FX

Though there are unlimited variations to trading styles and strategies, there is one broad commonality that most retail currency traders, be they novices or veterans, share - trading one lot at a time. When developing a strategy, most traders pay more attention to their indicators while giving little thought to money management. However, managing a position can limit losses and even turn a losing strategy into a winning one. And, while there are many facets to risk management, this article will focus on the significant improvement that trading multiple lots alone can provide.

The Standard Trade

When a trader goes about defining a money management strategy, they usually decide on what their risk/reward ratio will be, how wide to set stops, how many different trades can be floated at one time, and many otherwise important rules. However, one aspect seems to be overlooked and forever set in stone – each trade will be based on a single lot with one stop and one limit. There is an exception to this generality in those traders that pyramid in and out of positions; but this approach is very time consuming and can often lead to greater losses than taking a single lot alone. On the other hand, taking a trade based on two lots at the outset can offer a great deal more flexibility for a trader while at the same time keeping the downside well defined.

However, before delving into how a multiple lot trading system works, we should first establish a baseline trading strategy. We will use a simple and straightforward RSI breakout strategy. A trade is triggered when a 14-day RSI moves from an extreme region (below the standard 30 and below 70) and crosses back within these key levels towards the 50, mid-point. For an exit strategy we set both the profit target and stop equal (increasing the risk/reward merely decreased the ratio of winners to losers and in turn led to worse results). As an example, we have the GBPUSD November reversal seen in the chart below. After the RSI closes the day below the 70 overbought level after previously being outside the extreme boundary, we would look for a reversal and initiate a short trade at the open of the next bar with a wide, 300 points and an equivalent target. As we can see from the chart below, our target is met relatively quickly.

And, while this was a successful example, backtesting over 10-years of GBPUSD data shows that this profitable trade is in the minority. The best results come with a 100-point stop and target; and yet the statistics still show us that little more than 40 percent of our trades are profitable. What's more, the median size of the winners will equal the median loser, so there is no money making edge to this trading strategy. Overall we would end with a net loss of $6,609.00 on an initial balance of $50,000 (which we can see in the trade performance below).

Trading With Multiple Lots

Incorporating a two-lot system into a trading strategy actually requires few adjustments. With a single-lot system, a trader would take a position with one standard or mini lot and immediately set a stop loss and profit target. For our new system, a triggered entry would lead us to enter in the same way with two standard or mini lots. From there, we stagger the stop and target levels (setting both lots' targets and stops equal would effectively just double our leverage and offer no real benefit). There are advantages to inputting different stop levels, but we will keep them equal to make things simple. At any rate, the true value in a two lot system comes from the ability to set two profit objectives. The first should be set relatively close and the second will naturally look for follow through with a wider objective.

From here, we will apply the two-lot system with a modest 100-point stop and initial target and an aggressive second target of 300 points to see how this strategy performs. From the chart above, we can see that our short GBPUSD trade hits its first target very quickly. With a portion of our profit secured, we now have greater confidence in pursuing a more aggressive, second target.

The Benefits of Trading Multiple Lots

A first target that is set 'nearby' is essential to this strategy. It should make sense that the closer a target is to the entry price, the greater the probability that the objective will be hit. From a psychological standpoint, a trader will often times view this as a winning trade which leads to a better state of mind when considering subsequent positions. Practically, this first target can ‘pay for’ all or part of the trade. If the first target equals the total stop amount, the trade is essentially riskless when the first objective is met. Even if the first target is only a fraction of the total stop, the risk will be reduced significantly when the objective is met.

To better improve the risk/reward probabilities of this method of trading, we can trail the stop on the second lot. Therefore, when the first lot meets its first objective, the second lot’s stop is moved up to break even which locks in the gain and guarantees that profit. This one step can dramatically alter the performance of a strategy and boost a trader’s confidence. When the first target has been met, the worst that can happen from that point on is the second lot retraces to the breakeven point and the trade is closed out for the net profit on the first lot. For strategy performance this will naturally increase the ratio of winners (though it could also lower the average size of winners and increase the average size of losers depending on the size of the stops, first target and second target). Applying the two lot method, and the trailing stop for the second lot, to our RSI strategy; we can see a dramatic improvement in performance. Our percentage winners is boosted to 60 percent with a greater average winner to loser. The bottom line, this strategy turns a faulty trading strategy into to a profitable edge through a few money management adjustments.

The greater potential from adjustable stop is seen in trader psychology. Emotions often get in the way of a successful trade whether a strategy is discretionary and placed by hand or mechanical with orders automated. Often times, when a trader creates a strategy, they will either place a target too far (in compensation of high risk or to satiate greed) or too close (in fear of a reversal). When using a two-lot system, the burden of turning a profit or avoiding risk is lessened. After the first target is reached, the trader can be more aggressive on the second objective and choose that level more objectively.