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Technical Analysis Masterclass- Part 2

'Entering the trade'

Entering a trade without ascertaining a certain things is gambling.

In this masterclass we will learn the pre-requisites to enter a trade.

DON'T ENTER A TRADE WITHOUT DETERMINNG THE FOLLOWING.

Please share.

We understand what reward to risk (popularly called risk to reward) is.
It will be denoted by R:R.

We will also try to bust a few myths about R:R and how to avoid losing trades.

Before entering a trade, you need to determine 3 things.

1. Entry trigger
2. Stop loss
3. Target

1. Entry trigger = Reasons for entering a trade. There could be multiple reasons or a single reason for entry.

Generally a set of reasons AKA confluence is a higher probability trade and a generally a safer entry.

Example of an entry trigger.

Trend line re-test

Previous resistance broken.
Entry made.

2. Stop Loss.

The price in the opposite direction of the trade where the trade is exited, at a loss.

At this level, the reason for the entry becomes invalidated according to TA and the price can then move in the opposite direction, probabilistically.

Entry

Break-out invalidation level.
Stop Loss.

3. Target is the possible price level that the asset might touch based on previous trends or confluence AND where a possible reversal could occur.

Target is the next path of least resistance from where the price might reverse.

We will always ONLY use TA to determine all 3.

A combination of the three coming together forms R:R.

We will try to understand what really R:R in this thread.

R:R simply is the ratio of the distance between entry and target, and entry and the stop loss.

Here is an example of the R:R ratio

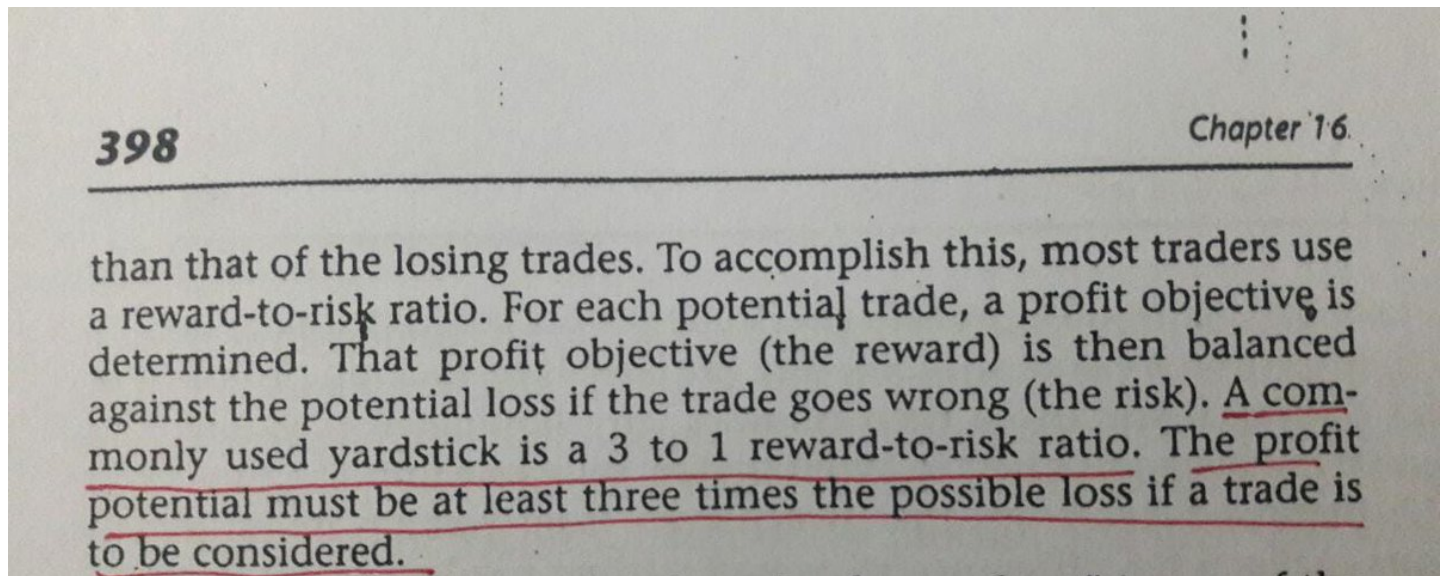R:R is generally denoted in ratio form such as 2:1 or 3:1.

If the target is 10% above the entry and the stop loss is 5% below the entry, the RR is 2:1

YOU SHOULD NOT BE ENTERING A TRADE UNLESS THE R:R IS KNOWN.

Myth.

A fixed minimum R:R is necessary for taking a trade.

Even Murphy in his book has advocated for the same but in my opinion it is a wrong benchmark to have.
Sticking to a fixed RR can prevent us from entering a high probability trade at times, eg at confluences.

than that of the losing trades. To accomplish this, most traders use a reward-to-risk ratio. For each potential trade, a profit objective is determined. That profit objective (the reward) is then balanced against the potential loss if the trade goes wrong (the risk). A commonly used yardstick is a 3 to 1 reward-to-risk ratio. The profit potential must be at least three times the possible loss if a trade is to be considered.

So what is the right way to use R:R and how do traders with low Win rate turn out to be profitable?

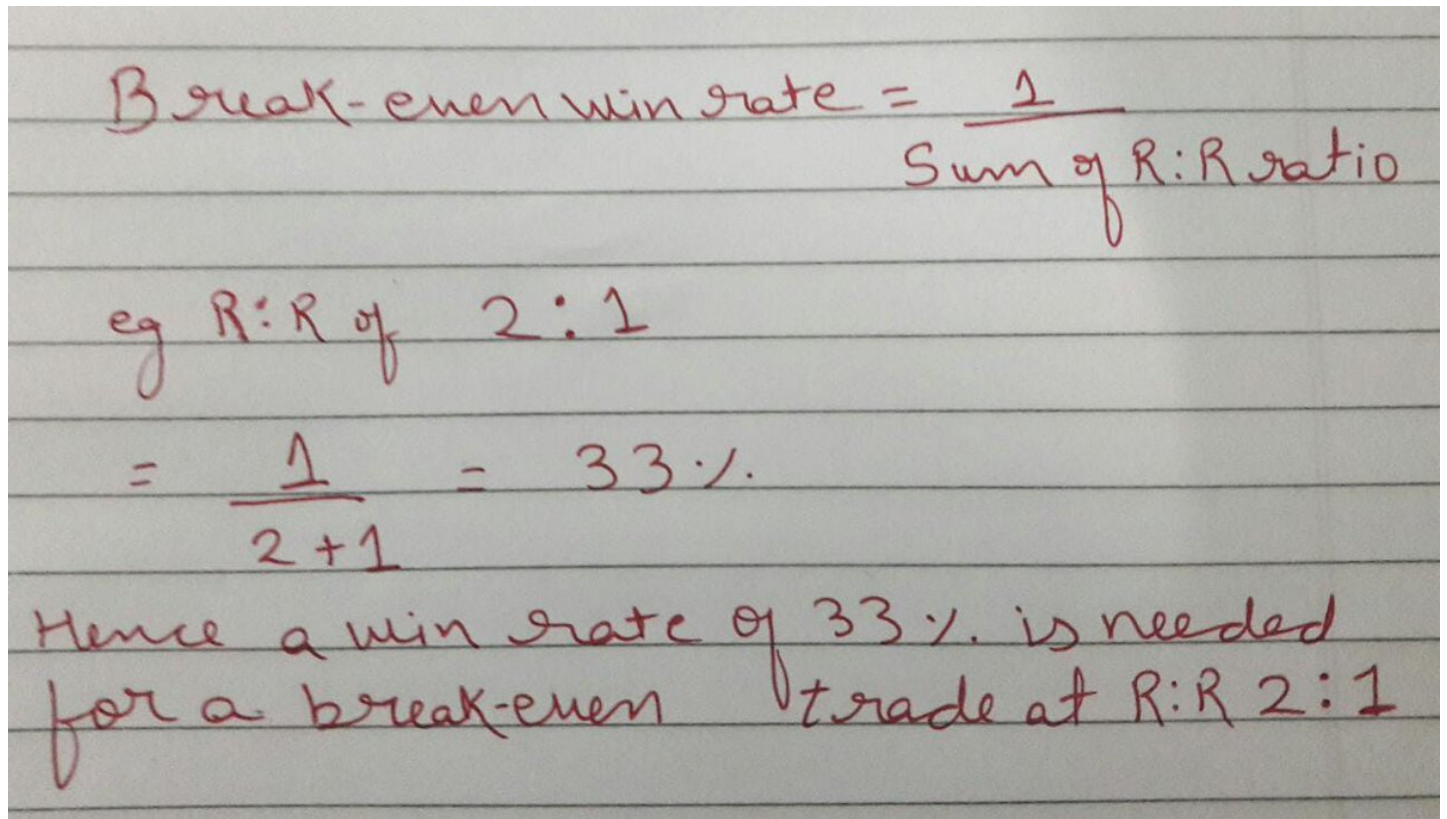Profitability depends on 2 factors. R:R and win rate.
Study the chart below.

Your historical winrate	Minimum reward:risk ratio
25%	3 : 1
33%	2 : 1
40%	1.5 : 1
50%	1 : 1
60%	0.7 : 1
75%	0.3 : 1

The above chart describes how much R:R is needed for a certain level of win rate.

Eg. If your win rate is 50%, you will be at breakeven at a R:R ratio of 1.

The formula to calculate the same is as below.

$$\text{Break-even win rate} = \frac{1}{\text{Sum of R:R ratio}}$$

eg R:R of 2:1

$$= \frac{1}{2+1} = 33\%$$

Hence a win rate of 33% is needed for a break-even trade at R:R 2:1

The above might seem confusing but the crux of the matter is,

-Test your strategy

-Find your win rate

-Use only the R:R setups which suits your win rate.

Eg. Always choose a trade with R:R greater than 2 if win rate is around 33%

Conclusion.

1. Find your win rate. Choose trades with R:R which suits your win rate.

2. Base the above only on TA.

3. Never enter a trade without knowing the target and SL.

4. Don't get stuck with a fixed R:R.

The completes the Risk to reward tutorial.

It is a must use to tool to avoid trades that don't suit our win rate. This gives a HUGE trading edge as most of the lower win probability trades can be avoided.

We will learn stop loss placement next.

Please share if this was useful.