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TUTTLE
CAPITAL MANAGEMENT

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Risk Management for Retail Traders

Tuttle Capital Management

Introduction

The retail revolution that came out of Covid was a logical pushback against the traditional Wall Street dogma that generates large fees for Wall Street but tends to shortchange the investor. I saw a similar revolution in the late 90s around internet stocks. Unfortunately, many retail investors ended up getting crushed as many of their favorite stocks suffered massive losses. Fast forward to 2020 and we saw a second revolution. This time retail investors had tools they didn't have in the 90s. They were connected over social media, they could trade for free, and they had access to the same, or better, information than they pros. Unfortunately, for many the results were similar to the results in the 90s. This does not mean that retail investors should go back to Wall Street with their tails between their legs. I still believe that there are opportunities for retail investors to generate significantly better results than they can by just owning some index funds or a globally diversified portfolio. It just comes down to proper risk management.

In my opinion, **understanding risk management is the most important skill a retail trader can have.** No matter how good an investor is, they are not going to be correct 100% of the time. Without proper risk management, those times one is wrong could be devastating. We have all heard the saying, "Let your winners run and cut your losses short". That's an integral part of risk management, but there is much more to it than that. In this white paper we will break the concept of risk management down into several key tenants that we believe can help keep you safer out there.

BTFD: I am a huge fan of buying dips, but understand there is a huge difference between buying the dip during a bull market, when the Fed is easing, and buying the dip during a bear market, when the Fed is tightening. Dip buying can be an integral part of your investment strategy, but you need to be cognizant of the overall market environment.

HODL: It's one thing to have conviction in a stock, and it's another to have blind conviction. There is no such thing as too low. What is low, can go much lower. You need to consider having stops when you are trading. Yes, from time to time you will get stopped out and a stock will zoom back up. However, there are times when stops could save you from disaster. You can always get back into a stock, which is a lot easier than recovering from major losses.

Position Sizing: Position sizing is one of the most powerful tools you can use to potentially reduce or enhance risk. There is no "one size fits all" here—what keeps everyone up at night will inevitably vary. On social media I see people discuss portfolios that comprise a handful of 5 or so stocks. In my opinion, that's way too high a position size. Concerning a portfolio of this size, imagine that one of the stocks opens up down 20% on news. That's a 4% loss (assuming a 20% position size). Give position sizing a lot of thought. Just because someone you follow can be comfortable with a position size this high doesn't mean you are. On the other hand, maybe that type of position size is right for you, especially if you have a smaller account that you are looking to grow aggressively. Fear and Fear of Missing Out ("FOMO") can be two of the biggest enemies of traders because they are emotions that can cause one to do things they may regret. If your position sizes are too high, they may lead to fear. On the other hand, if they are too low, they may lead to FOMO.

One other factor to consider in position sizing is the volatility of the underlying name. I remember seeing a tweet from someone going after a FURU who recommends penny stocks. Penny stocks are as risky as you can get because, in my opinion, nothing trades under $1 without a reason. This particular stock got crushed, which is not what caught my eye. What got my attention was that this person had put his daughter's entire college savings plan into this stock and had wiped it out. If you are going to buy penny stocks, please consider position size accordingly.

Owning a Stock into Earnings: Every stock reports earnings quarterly. Wall Street analysts spend considerable time trying to figure out what those earnings are going to be, and, many times, they are consistently wrong. Often, stocks have large moves after earnings releases. These also come either after hours, or premarket, so if you get caught on the wrong side it can be harder to adjust. Stops don't work for risk management as companies often gap below the stop. Let's say you could figure out what a company's earnings are going to be. Can you also figure out what their guidance is going to be, and how the market will react to the earnings? Doubtful. We don't think you should own stocks into earnings. If you do, consider your position sizing. Also, consider what type of cushion you have in the stock. If you are already up 20% on something that gaps down 20%, all you did was lose your paper gains. For example, Funko, Inc. has been a retail favorite from time to time. They went down more than 50% on their earnings (see figure to the right). If you are going to hold something through earnings recognize that it is a gamble and size accordingly. I have seen some people also only hold stocks that they have a large profit cushion on.

Source: stockcharts.com

Be Aware of Correlations: Stocks tend to fall into broader groups than just sectors or industries. A coal stock is in an entirely different industry than an industrial metal stock, but there are frequently times when all commodity-based stocks move at once. So, you could have a bunch of different stocks in your portfolio, but you may not be diversified. Understand what is going on in the market. Interrogate what stocks are doing (e.g., are commodity stocks moving together, are growth stocks moving aggressively, is there some sort of theme?).

Trade Based on What you See, Not What You Think: There's an old saying that the plan goes out the window the moment that shots are fired. You should come into every trading day with a plan and be ready to scrap it if the market is doing something different. Forcing your idea into a market that is doing something different can be a great way to lose money.

Be Agnostic as to Being Long or Short: There is a common perception that Wall Street wants you to be fully invested at all times. They will try to convince you that shorting stocks or sectors is way too risky. I would argue otherwise. Yes, most of the time the overall market goes up, but even during a bull market there are stocks and sectors that experience declines. In a bear market, shorting can be the difference between making money and losing money.

Learn to Sit on Your Hands: Trading can be fun, and just watching the market without doing anything can be boring. However, sometimes that may be the best course of action. There are two types of days in the market: trend days and chop days. On a trend day, stocks pick a direction and then move. There are usually a lot of opportunities for traders. On a chop day, stocks will appear to be moving in a direction, only to move back. Traders can get chopped to bits trying to trade a chop day.

Learn to Fish: There's another old saying, "Give a man a fish and he eats for a day, but teach a man to fish and he eats for a lifetime". There are a lot of great traders on social media that provide varying levels of advice. You could choose to follow the picks of many of these people, however, regardless of their skill, I would advise caution. Someone else may have a great methodology that's right for them, but it may not be right for you. You are better off taking the time to develop your own methodology. That way, you can follow people and see if their picks fit your methodology, instead of just following them into plays that may be too risky for you.

Adapt your Methodology to the Environment: Having a well thought out methodology is key, but it has to be adapted to the market environment. For example, you may decide you are a breakout trader, that's fine, but trying to trade breakouts during a bear market may be silly. Stocks that attempt to break out just get slapped back down. A stock like Lantheus Holdings is a good example. Breakout traders loved it in September when it looked like it was breaking out to new highs. Now it is 30 points lower (see figure on next page).

Source: stockcharts.com

In a bull market, Lantheus could have kept on going and been a true market leader. In a bear market you should have been looking to fade the move and go short on a breakdown.

Conclusion

Risk Management is important for any trader looking to enter the market. By incorporating common-sense risk management strategies, retail traders can more safely navigate unpredictable market conditions.

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