

Van Tharp's Definitive Guide to Position SizingSM Strategies

**How to Evaluate Your System and Use
Position SizingSM Strategies to Meet Your
Objectives**

**by
Van K. Tharp, Ph.D.**

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The Van Tharp Institute
102A Commonwealth Ct., Cary, NC 27511
(919) 466-0043
<http://www.vantharp.com>

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The following phrases are a trademark of the International Institute of Trading Mastery: “System Quality Number,” “SQN,” and “Position Sizing.”

This book is dedicated to Melita Hunt, former CEO of the Van Tharp Institute. This book would not have been possible without Melita's inspiration. Melita, you will always be in my heart.

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Preface

Perhaps the greatest secret in trading and investing success is appropriate money management or what I now call position sizingSM strategies. I say it is a secret because few people seem to understand it, including people who've written books on the topic. Some people call it risk control; others call it diversification. Money managers call it managing other people's money and still others call it how to "wisely" invest or spend your money. However, the money management that is the key to profitable trading and investing simply refers to an algorithm that calculates "how much" with respect to any particular position in the market.

I've written this book to give you an overall understanding of position sizing strategies and show you various position sizing models. This is potentially the most profitable journey you will ever take as a trader. Only your personal psychological work is more important because you are the source of your trading success. The material provided in this book is the foundation for everything you do as a trader or investor. The subject matter is quite complex; however, you'll find it well worth your time and effort to master the concepts in this book.

People frequently ask me, "What position sizing strategy should I use with this system?" Or, "Which position sizing strategy do you like best?" However, those questions show a lack of understanding of position sizing. The question you really need to ask is "What do I want to accomplish with this system?" When you understand your objectives, then you can use position sizing strategies to meet them. And there are as many objectives as there are traders, so you must know what your objectives are.

There are many other key concepts that stem from this primary one:

- An infinite number of objectives, as well as an infinite number of position sizing methods exist.
- It is important for you to define your objectives before developing a system and a position sizing method.
- Although your system has very little to do with meeting your objectives, we have developed a method to quantify the quality of your system, which we call the System Quality Number calculation or SQN calculation for short.
- We've discovered that the higher your System Quality Number calculation, the easier it is to use position sizing algorithms to meet your objectives.

- You might even think of a position sizing strategy as a separate system, overlaid upon your primary system.
- The best system is not the system with the highest SQN® score. Instead, it is the system with the highest SQN score that also fits you so that you can trade it well and thus meet your objectives.

In addition to a general understanding of position sizing strategies and sufficient funds to execute position sizing algorithms successfully, these ideas are the foundation that you need to make position sizing strategies useful to you.

The entry price to being an investor or trader is fairly low. You only need enough money to open an account. Your brokerage company doesn't care whether you understand expectancy, know your objectives, or understand that position sizing strategies are the key to meeting your objectives. And your brokerage company certainly doesn't care whether or not your personal psychology is together.

Your brokerage company cares about three things: 1) that you have enough money to open an account, 2) that you don't do things that might cause you to lose many times the value of your account so that you get your broker into trouble, and 3) that you generate a lot of commissions through your trading. That's it. You can make every mistake possible and it's still okay with your brokerage for you to open an account.

This is not true of most professions. You cannot become an engineer without understanding calculus. You cannot do brain surgery without going through medical school, an internship, and residency. You cannot hold a research job without a basic understanding of statistics. You cannot practice law without attending law school and passing a rigorous bar examination. To get a doctorate in finance, economics, or business, you must pass many exams. However, the material covered in these courses is almost the antithesis of what it takes to be successful in the markets. You even have to pass exams to become a broker, but absolutely nothing in that exam tests your knowledge of material related to trading success.

To be a trader or investor, you don't have to know anything about what it takes to be "safe" or profitable as an investor.

If you want to safely master the art of trading or investing, you must thoroughly understand all of the material in this book. We have created a self-evaluation test that will allow you to gauge your knowledge on the topics contained in this book. You can find the test, along with other supplemental material at www.vantharp.com/definitive-guide.asp. Answering all of the

questions correctly doesn't necessarily mean that you will apply this material because that means that you have mastered yourself as well, but it at least means that you have enough understanding to have a reasonable chance of success.

I've divided this book into four sections. The first section deals with understanding the golden rules of trading and how to evaluate the quality of your system. The second section includes position sizing basics, including an introduction to basic position sizing models. The third section covers how to use position sizing strategies to meet your objectives. And the last section encompasses miscellaneous topics related to position sizing methods, including what not to do and information on putting it all together.

Here's what you need to do to get started. First, have an open mind. Second, endeavor to understand everything you read. There is a glossary at the back of the book for you to reference. We also have a glossary on our web site, which you can find at www.vantharp.com/definitive-guide.asp. Third, be sure you can complete all of the exercises in this book correctly. Keep working until you have mastered these exercises. Fourth, you must develop a plan to put all of this material together. And finally, you must master yourself so that you can apply this material without making significant mistakes.