Spread bets and CFDs are complex instruments and come with a high risk of losing money rapidly due to leverage. **71% of retail investor accounts lose money when trading spread bets and CFDs with this provider**. You should consider whether you understand how spread bets and CFDs work and whether you can afford to take the high risk of losing your money.

How to trade with risk reward ratio in focus

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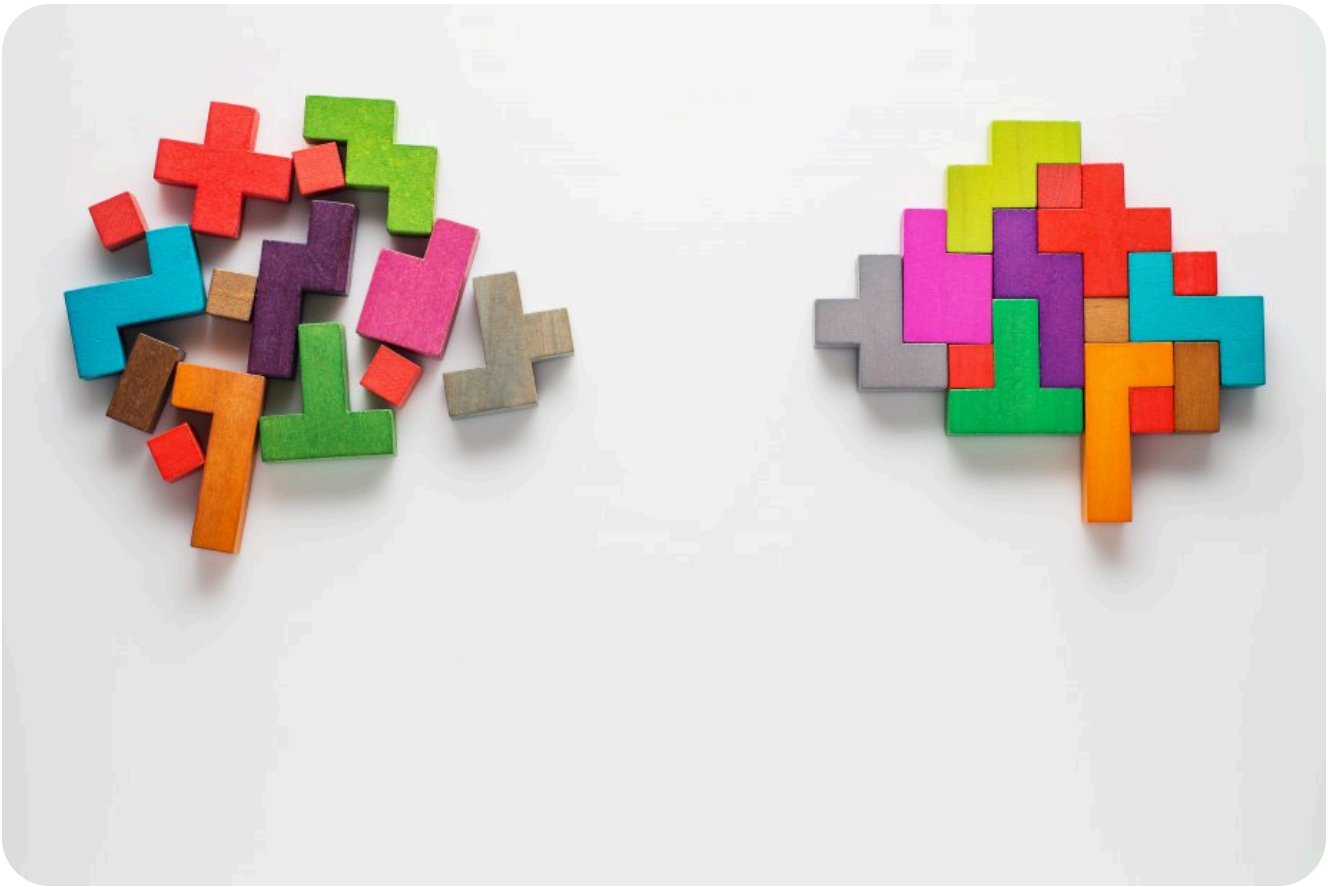

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There may be a lot of potentially lucrative trading opportunities, but how do you know which work and which will fail? The truth is you don't as all trading contains the risk of loss. As a trade

all you can do is choose positions where the potential reward justifies the high risks associated with trading. This is where the risk reward ratio comes in.

What is the risk reward ratio and why is it important?

The risk reward ratio is a tool that traders use to assess the potential risk and reward of a trade. The ratio defines the potential reward a trader can earn for every dollar they risk on a trade. It helps them determine whether the potential reward justifies the potential risk.

It is important to remember that the risk reward ratio is not a guarantee of success. Even if the ratio is high, there is still a possibility that the trade could lose money. The risk reward ratio can be a part of risk-management strategy.

How to calculate risk reward ratio

Before learning how to trade with risk reward, you should first be able to calculate the ratio. In its most basic sense, the risk reward ratio in trading is determined by taking the potential profit of a trade and dividing it by the potential loss. This will leave you with a risk reward ratio calculation of the amount of reward relative to the amount of risk.

The risk is usually left as '1'. The reward is a multiple of the risk.

Risk reward ratio formula = Potential profit / potential loss

The first step is to calculate your potential profit or loss on a trade. These are determined by:

- The price that you will buy or sell an instrument or asset at
- The price where you will take profits
- The price where you plan to cut your losses
- The number of assets or instruments you are buying

For example, a trader decides to buy 10 shares of Microsoft (MSFT) for $100 each. If the price rises to $120, they can close the trade for a profit but if it drops to $90 they are facing a loss.

$120 - $100 = $20 (Potential profit)

$100 - $90 = $10 (Potential loss)

$20 / $10 = 2

This means a risk: reward ratio of 2:1

The potential profit and loss are determined by the following factors.

- The price you will buy an asset at
- The price you will take profit at
- The price where you set your stop loss

In derivatives trading, such as futures and options contracts, as well as contracts for difference (CFDs), two more factors are important to determine potential profit and loss:

- The size of the contract
- The number of contracts you will trade

For example, say Brent crude oil is trading at $100 a barrel. Each Brent crude oil futures contract is for 100 barrels. An investor decides to buy two contracts. If the price rises to $120 they will take profits but if the oil price drops to $90 they will accept the loss.

$100 (oil price) x 100 (contract size) x 2 = $20,000 (size of position)

$120 (oil price) x 100 (contract size) x 2 = $24,000 (size of position) – a $4,000 profit

$90 (oil price) x 100 (contract size) x 2 = $18,000 (size of position) – a $2,000 loss

$4000 / $2000 = a 2:1 risk reward ratio

For those looking to avoid the maths, another way to calculate the risk reward ratio is to use a risk reward calculator, which you can find online.

What's the preferred risk reward ratio?

When you're considering a trade, it's important to look at the risk reward ratio and decide whether it's worth taking the risk. If the potential rewards are high and the risk is low, then a trade might be worth considering. However, if the potential rewards are low and the risk is high, you may want to rethink the trade.

Industry professionals often cite 2:1 as the optimal risk reward ratio for beginners. The truth is that the ratio by itself is not enough information to base a trade on.

Instead, the risk to reward ratio should be evaluated alongside other variables such as the win loss ratio (the probability of success of the trade) to create 'trade expectancy'.

Win ratio calculation = Number of wins / Total number of trades

Loss ratio calculation = Number of losses / Total number of trades

The expectancy ratio is calculated by multiplying the reward to risk ratio by the win ratio and subtracting it from the loss ratio.

Expectancy Ratio = (Reward-to-Risk Ratio X Win Ratio) - (Loss Ratio)

An expectancy ratio over zero means that, in theory, the trading strategy could be profitable, while an expectancy ratio under zero means it could be a losing strategy.

Why should we look at the expectancy rather than the risk reward ratio alone? Consider which of the following trades is better to take:

1. A trade with a risk:reward ratio of 10:1 with a win loss ratio of 5%
2. A trade with a risk:reward ratio of 5:1 with a win loss ratio of 90%

Trade A has a high risk reward ratio but only a 5% chance of being profitable. Trade B has a smaller risk reward ratio but has a much better chance of being a winner at 90%.

How to trade with risk reward ratio

You can use the ratio as a filter for trades that fit (or don't fit) into your trading strategy.

Let's assume you follow a swing trading strategy that involves buying securities after a dip in price. The strategy works half the time (50% or 0.5), but you only take trades where the win loss

ratio is at least 2:1. This means the strategy has an expectancy ratio of 0.5 and could be profitable. The calculation is as follows:

Risk/reward ratio = expected win / expected loss = 2/1 = 2

Expectancy ratio as per formula above = (2 x 0.5) - 0.5 = 0.5

You see a potential trade setup to buy Brent crude oil at $100. There is support at $95 and resistance at $113. You want to exit the trade if the price falls under the support at a loss or before the price reaches resistance for a profit.

potential trade setup

Let's say you set a buy order at $100, a stop loss at $95 and a take profit order at $110. Then the potential profit is $10, the risk is $5 and the risk reward is 2:1.

But what if you wish to 'add some breathing room' to the stop loss and place it at $94? Then the risk is now $6, taking the risk to reward ratio under 2:1. In this case you may decide to move the take profit order to $112, making the reward is $12, and taking the trade back to a 2:1 risk reward ratio.

If you take a trade that has a lower risk reward ratio than your strategy dictates, it affects the expectancy and is in effect a different strategy, which may have different expected results.

Final thoughts

Note that markets may be volatile and your decision to trade should depend on your risk tolerance, trading goals, the size of your trading account and how experienced you are in the markets.

Trading tools such as risk-reward ratio are helpful in enhancing your trading strategy and risk-management plan. They should not be used as a substitute for your own research.

FAQs

What is a good risk reward trading ratio?

How do you read the risk reward ratio?

Is risk reward important in trading?

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Most traded

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2500.81

-0.390%

US100
19898.0

Oil - Crude
72.247

J225
38422.5

US30
40949.5

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The difference between trading assets and CFDs

The main difference between CFD trading and trading assets, such as commodities and stocks, is that you don't own the underlying asset when you trade on a CFD.

You can still benefit if the market moves in your favour, or make a loss if it moves against you. However, with traditional trading you enter a contract to exchange the legal ownership of the individual shares or the commodities for money, and you own this until you sell it again.

CFDs are leveraged products, which means that you only need to deposit a percentage of the full value of the CFD trade in order to open a position. But with traditional trading, you buy the assets for the full amount. In the UK, there is no stamp duty on CFD trading, but there is when you buy stocks, for example.

CFDs attract overnight costs to hold the trades (unless you use 1-1 leverage), which makes them more suited to short-term trading opportunities. Stocks and commodities are more normally bought and held for longer. You might also pay a broker commission or fees when buying and selling assets direct and you'd need somewhere to store them safely.

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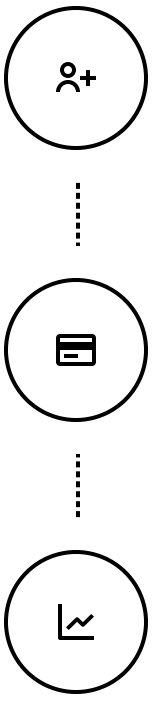

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