Stop loss setting, one of the most crucial aspects of money management.

The most important rule to remember is to set a stop loss of each order to max. 3% of trading capital. Losses, that should be considered as normal costs of business activity, are part of trader's routine. Using the Stop Loss (SL) makes sure, that trader has enough capital to continue, even after a longer losing streak.

In Basics-section reader has been introduced to terms leverage, margin and margin call. I will now give a brief example of how the SL is connected to those. In the beginning of my trading career I read from various sources how dangerous high leverage can be. I then understood the fact, that even if you have a high 1:500 leverage, you should use only fraction of it. In other words, not taking big risks and using the SL setting correctly. Actually, 1:500 leverage just opens a possibility to take huge risk and because of that it is dangerous for excited yet uneducated beginner, who wants to multiply the capital in one trade. The ability to take unnecessary risks reduces with lower leverages.

Let's assume that you have a smallest possible order size of 0.01 lot (volume is then 1000), €-account and EUR/USD pair to trade on. Calculation for 1:200 leverage case, where currency price on €-account is 1:

$$(\text{Currency price} \times \text{volume}) / \text{leverage} = \text{Margin}$$

$$(1 \times 1000) / 200 = 5€$$

And so, to open 0.01 lot order you need to have only 5€ on your account. With higher leverage you need even less. Therefore, with very small capital you could open huge order and, potentially, lose all your funds during one losing trade and only a few price ticks. You could calculate margin requirements for different lot size, in order to fully understand the aspect.

When the order gets far on the losing side, brokers gives a Margin Call (a request to transfer more funds to trading account). If the loss becomes reaches certain value, and no addition funds are transferred, the position is closed automatically. An example of broker's trading conditions:

Margin call 150%, Stop out 100%

If, for example, you have 500€ on your trading account and, 50€ of margin is used, in hope for fast capital growth. Margin call would come when there is 50€ × 150% = 75€ left in your account, meaning that the trade is losing as much as 425€. The order will be closed automatically by broker (Stop out) when the respective figure is 50€ × 100% = 50€, which is also the originally used margin. In this case, the loss of the trade would have been already 500€-50€ = 450€. Loss to capital ratio is huge: 450€ / 500€ = 90%. As you might notice, there is a "tiny difference" between that and a proper risk management value of 3%.

The moral of the story is to always primarily consider the stop loss limit while planning a trade. Not matter the capital size (100 or 100'000€), the rule of max. 3% risk remains! When you have mastered the basics and selected own trading strategy, you could use a handy lot-size calculator for that 3% risk. Required ”Stop Loss in Pips” value is defined by your strategy setup, but for testing purpose you could enter 25 pips.