

# **Van Tharp's Definitive Guide to Position Sizing<sup>SM</sup>**

**How to Evaluate Your System and Use  
Position Sizing<sup>SM</sup> to Meet Your Objectives**

**by  
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## Preface

Perhaps the greatest secret to top trading and investing success is appropriate money management or what we now call **position sizing**. I call it 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 top trading and investing simply refers to the algorithm that tells you “how much” with respect to any particular position in the market. And because the topic of money management is so conflicting, I’ve elected to call it position sizing throughout this book.

I’ve written this book to give you an overall understanding of the topic and show you various models of position sizing. Enjoy the journey; it’s potentially the most profitable journey you will ever take as a trader. The material is quite complex, despite my attempt to make it simple. However, you’ll find it well worth your while to go through all the examples until you have mastered it.

One of the fundamental concepts that you will learn in this book is that position sizing is the key to meeting your objectives as a trader. Most people assume that there is just one objective to trading—their own—and thus their view is biased by their objective. **As a result, they never realize that the purpose of position sizing is to meet your objectives.**

**The purpose of position sizing is to meet your objectives.**

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

- There are probably an infinite number of objectives that you could have and thus, an infinite number of ways for you to use position sizing.
- It is important for you to define your objectives before you develop a system and before you develop your position sizing routine.
- 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<sup>SM</sup> or SQN<sup>SM</sup> for short.
- **We’ve discovered that the higher your System Quality Number<sup>SM</sup>, the easier it is to use position sizing to meet your objectives.**
- You might even think of position sizing as a separate system, overlaid upon your primary system, which is designed to meet your objectives.

These key ideas are the foundation that you need to understand to make position sizing useful to you.

This book is one of the most important books you could ever read if you want to be a professional investor or trader. The material in this book provides the foundation for everything you do as a trader or investor. Only your personal psychological work is more important because you are the source of your trading success. In fact, there are many psychological biases that keep people from practicing sound position sizing. In addition, there are also practical considerations, such as not understanding position sizing or not having sufficient funds to practice sound position sizing.

**The higher your System Quality Number<sup>SM</sup>, the easier it is to use position sizing to meet your objectives.**

Let's look at the facts. The entry price to being an investor or trader is fairly low. All you have to do is have enough money to open an account. Your brokerage company doesn't care whether you understand expectancy. Your brokerage company doesn't care whether you know your objectives. Your brokerage company doesn't care whether or not you understand that position sizing is the key to meeting your objectives. And your brokerage company certainly doesn't care that you must have your personal psychology together in order for any of this to matter. They simply don't care.

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 described in this book 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. And if you make too many mistakes, you can never be an engineer. You cannot do brain surgery without going through medical school, doing an internship, and then going through 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. But the material you must study 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 there is absolutely nothing in that exam that tests your knowledge of material related to trading success—NOTHING.

To be a trader or investor, you don't have to know anything about what it takes to be "safe" as an investor and you certainly don't have to know what it takes to be profitable as an investor. All you need is enough money to open an account and to sign a statement that you understand the risks involved. In fact, your brokerage company, when they make you sign that statement, probably doesn't understand the fundamental basis behind that risk, which is the material in this book. Furthermore, most people who open a brokerage account lose money.

Here's the bottom line: if you want to safely master the art of trading or investing, you must thoroughly understand all of the material in this book. If it seems too complex, it

doesn't matter—it's still core material you must master. It is necessary if you want to be successful as a trader. In fact, Chapter 19 contains a mini-test on the topics contained in this book. 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 primary sections. The first section is on understanding the golden rules of trading and how to evaluate the quality of your system. The second section is on position sizing basics, including an introduction to basic position sizing models. The third section is on how to use position sizing to meet your objectives. And the last section is on miscellaneous topics related to position sizing, including what not to do, software, and information on putting it all together. This book contains the most important technical information that you will ever be exposed to as an investor/trader and probably the least understood. However, you must master this material if you want to meet your objectives as a trader/investor.

Here's what you need to do to get started. First, have an open mind. Second, make sure that you understand everything you read. If you have questions about what some particular word means, go to the glossary of this book and look it up. We also have a glossary at our web site, [www.iitm.com](http://www.iitm.com). Third, be sure you can do all of the exercises in this book when they come up. If you have problems, keep working until you have mastered the 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.