PROP TRADING ESSENTIALS



Your Path to Success with Prop Firms

ENG.LUTANDULA

PROP TRADING ESSENTIALS

Eng.Lutandula

Copyright © 2024 Eng. Lutandula. All rights reserved.

This book is protected by copyright law and may not be reproduced in any form, in whole or in part, without the express written permission of the author. Unauthorized use or distribution of this material is prohibited.

For permissions or inquiries, please contact: lutamarkets@gmail.com.

CONTENTS

PROP FIRMS 8

Benefits of a Prop Firm Challenge 9

Conditions of a Prop Firm Challenge 11

DRAWDOWN LIMIT 12

What is Daily Drawdown? 14

Tips for Success in a Prop Firm Challenge 18

How to Choose the Right Prop Firm Challenge 19

DISCLAIMER: 24

General rules that apply across various firms: 25

EXAMPLE 27

PREFACE

In the fast-paced world of trading, opportunities abound, but so do challenges. As a trader, you are constantly navigating the complexities of the financial markets, where understanding the intricacies of proprietary trading firms (prop firms) can be a game-changer.

This book is a culmination of my extensive research and practical experiences in the realm of forex and trading methodologies. Over the years, I have delved deep into how prop firms operate, the rules that govern them, and the essential strategies for success. My journey has not only expanded my knowledge but also highlighted the common pitfalls that traders encounter, particularly concerning risk management and daily drawdown limits.

In the following chapters, you will find a comprehensive exploration of prop firms, the benefits they offer, and the critical conditions you must understand to thrive within their framework. We will dissect various types of drawdowns, emphasizing their significance in trading and the strategies to manage them effectively.

My aim is to provide you with practical insights and actionable strategies that can enhance your trading performance and empower you to make informed decisions. Whether you are a novice trader seeking guidance or an experienced trader looking to refine your skills, this book is designed to be a valuable resource on your journey.

DEDICATION

To all aspiring traders who dare to dream and strive for success in the financial markets. May this book inspire you to embrace the challenges ahead, seek knowledge relentlessly, and never lose sight of your goals.

To my family and friends, whose unwavering encouragement fuels my passion for sharing knowledge and helping others succeed.

PROP FIRMS

A proprietary trading firm, or prop firm, is a company that provides traders with capital to trade financial instruments, such as stocks, currencies, or commodities, in exchange for a share of the profits. Prop firms can be an excellent resource for traders aiming to elevate their skills and gain access to larger trading positions. Through these firms, traders can take advantage of advanced tools, training, and mentorship, which can enhance their overall trading performance.

As many of you might already know, the financial world is full of opportunities, and one that has caught the attention of traders globally is the concept of Proprietary Firms (Prop Firms). Over the years, I, Eng. Lutandula, have conducted extensive research on forex and trading methodologies, including how prop firms work and the rules surrounding them. Through practical research and firsthand experience, I've gathered valuable insights into prop firms and the common challenges traders face when managing risks, especially daily drawdown limits.

Prop firms typically have stringent rules to ensure that their capital is well-protected. One of the most critical rules involves managing the **daily drawdown limit** — the maximum loss you can incur in one trading day. If breached, the trader could lose access to the account. In this chapter, I will break down the two major methods prop firms use to calculate daily drawdown limits and how to avoid breaching them.

As part of my research, I also had the opportunity to participate in various challenges, successfully passing multiple phases, as evidenced by the certificate I earned (as shown below):



Benefits of a Prop Firm Challenge

1. **Access to Capital**

Prop firms allow traders to access significant capital to take larger positions and earn higher profits. This access is crucial for traders looking to scale their strategies without using personal funds.

2. **Improving Trading Abilities**

Participating in a Prop Firm Challenge pushes traders to sharpen their skills. The competitive environment forces you to adapt, improve strategies, and make better trading decisions. This experience is invaluable and helps traders build resilience and agility, qualities essential for long-term success.

3. **Increased Earnings**

Once funded, many firms offer profit-sharing models where traders keep a portion of their earnings. This aligns the interests of both the firm and the trader, motivating you to perform at your best.

4. **Mentorship and Guidance**

Prop firms often have experienced traders who provide mentorship. Being part of such a community accelerates your learning curve and helps you navigate complex markets with expert advice.

5. **Real Market Experience**

Prop Firm Challenges are designed to simulate real trading environments. This practical exposure, with actual market risks, surpasses the limitations of demo trading and provides you with invaluable, hands-on experience.

6. **Risk Reduction**

Trading with the firm's capital limits your financial exposure. You are not personally liable for losses beyond your initial investment, which allows you to take calculated risks without the fear of significant financial damage.

7. **Networking Opportunities**

Passing a Prop Firm Challenge opens up doors to connect with other traders and professionals. These relationships can lead to partnerships and career advancements, broadening your opportunities in the trading world.

Conditions of a Prop Firm Challenge

Before starting a Prop Firm Challenge, it's important to understand the rules. Though requirements vary between firms, some common conditions include:

1. **Drawdown Limits**

Firms typically impose drawdown limits to ensure traders manage risk responsibly. Exceeding these limits often results in disqualification, emphasizing the importance of disciplined risk management.

2. **Algo Trading Rules**

If you use automated strategies, be aware of the firm's rules on algorithmic trading. Some firms may have restrictions to ensure fairness.

3. **Winning Criteria**

Challenges often require traders to hit specific performance metrics, such as achieving a minimum profit or maintaining a favorable risk-reward ratio. Ensure you understand these benchmarks.

4. **Risk Management**

Effective risk management is key. Firms look for traders who can control losses while maintaining consistent profitability.

5. **Account Funding and Scaling**

After passing the challenge, you may be required to fund an account with an initial deposit. Many firms also have scaling plans, offering more capital as you demonstrate profitable performance.

DRAWDOWN LIMIT

Common types of drawdown

1. **Max Drawdown**

This is the **largest peak-to-trough decline** in equity during a specified period. It shows the maximum loss suffered before a recovery.

Example: If the account reaches $10,000 and then drops to $8,000, the max drawdown is 20%.

2. **Daily Drawdown**

This measures the **largest loss within a single day**. Prop firms often impose strict daily drawdown limits to control risk.

Example: If an account starts with $5,000 and drops to $4,500 by the end of the day, the daily drawdown is 10%.

3. **Relative Drawdown**

Also known as **percentage drawdown**, this type is calculated from the most recent peak and shows the **percentage decrease from that peak**.

Example: If the account peaks at $20,000 and falls to $16,000, the relative drawdown is 20%.

4. **Absolute Drawdown**

This measures the drop in equity relative to the **initial account balance**, regardless of profits made. It shows how much of the initial capital has been lost.

Example: If the starting balance is $10,000 and the account drops to $9,000, the absolute drawdown is $1,000 or 10%.

5. **Trailing Drawdown**

This is a dynamic form of drawdown that moves **in line with profits**. As the account balance increases, the trailing drawdown limit adjusts upward.

Example: If the drawdown limit is initially set at $1,000 from $10,000, and the balance grows to $12,000, the drawdown limit moves up, adjusting based on the new peak.

6. **Balance Drawdown**

This is calculated based on the **account's closing balance** after all positions are closed. It doesn't factor in the value of open trades.

Example: If you close all trades and the balance decreases from $10,000 to $8,000, the balance drawdown is $2,000 (20%).

7. **Equity Drawdown**

This type considers the current value of **open positions**, reflecting real-time changes in account value.

Example: If your balance is $10,000, but open trades cause equity to drop to $9,000, the equity drawdown is $1,000.

What is Daily Drawdown?

Daily drawdown represents the maximum allowable loss a trader can incur in a single trading day, usually expressed as a percentage (e.g., 5%). Prop firms strictly enforce this limit, and exceeding it typically results in an immediate account breach.

There are two primary ways to calculate daily drawdown:

- Balance-Based Drawdown
- Equity-Based Drawdown

1. Balance-Based Drawdown

Explanation:
In a balance-based drawdown, the daily loss is calculated based on a percentage of the starting balance at the beginning of the trading day. It remains constant throughout the day, unaffected by floating profits or losses.

Balance

Balance = Initial Deposit + Total Closed Trade Profit/Loss

Balance-Based Drawdown

Drawdown = Initial Balance − Current Balance

Example Calculation:

- Starting Balance: $100,000
- Daily Drawdown Limit: 5%
- Maximum Allowable Loss: $100,000 * 5% = $5,000

If your balance falls below $95,000, you breach the drawdown limit, regardless of unrealized gains or losses from open trades.

Example Scenario:
Starting the day with $100,000, you experience two trades:

- Trade 1: Loss of $3,000
- Trade 2: Floating loss of $1,500
  If you close Trade 2, leaving a final balance of $95,500, you remain within the limit. However, if a third trade causes your balance to drop to $94,500, you breach the drawdown limit.

Advantages:

- Easy to track and manage.
- Stable throughout the day.

Disadvantages:

- Doesn't account for floating losses, which might provide a false sense of security.

Best For:
Swing traders holding trades for longer periods

2. Equity-Based Drawdown

Explanation:
Equity-based drawdown factors in both realized and unrealized profits or losses, making it a dynamic calculation based on real-time equity. The drawdown limit adjusts throughout the day according to the open trades' performance.

Equity

$$\text{Equity} = \text{Balance} + \text{Unrealized Profit} - \text{Unrealized Loss}$$

Equity-Based Drawdown

$$\text{Drawdown} = \text{Highest Equity} - \text{Current Equity}$$

Example Calculation:

- Starting Equity: $100,000
- Daily Drawdown Limit: 5%
- Maximum Allowable Loss: $5,000
  If your equity drops to $95,000 due to floating losses, even if your balance stays at $100,000, you breach the drawdown.

Example Scenario:
With $100,000 equity at the start of the day:

- Trade 1: Loss of $1,500
- Trade 2: Floating loss of $3,500
  Your equity drops to $95,000, putting you at risk of breaching the drawdown, even if your balance hasn't changed significantly.

Advantages:

i) Provides real-time protection against large floating losses.
ii) Prevents open trades from spiraling out of control.

Disadvantages:

i) More challenging to track since it fluctuates with open trades.

Best For:

Day traders who close positions by the end of the day benefit from its simplicity and fixed nature

3. Trailing Drawdown (Special Case)

Explanation:
A trailing drawdown moves in tandem with your account's peak equity, locking in profits and adjusting the allowable loss. However, once the drawdown limit increases, it doesn't reset if your equity falls.

Example Calculation:

- Starting Equity: $100,000
- Trailing Drawdown: 5%
  If your equity rises to $105,000, the maximum allowable loss becomes $5,250. However, if your equity falls back to $100,000 or below, the limit remains fixed at $5,250.

Advantages:

1. Secures profits, ensuring you don't give back all gains.

Disadvantages:

2. Limits may become restrictive if the account's high equity trails too far.

Best For:
Traders who excel at growing equity while minimizing losses.

Tips for Success in a Prop Firm Challenge

1. **Understand the Rules**

Read and understand all the rules before you begin. Violating even one rule, such as exceeding drawdown limits, could lead to disqualification.

2. **Stick to Your Strategy**

Consistency is crucial. Deviating from your strategy due to emotions like fear or greed can lead to poor decisions. Stick to your plan throughout the challenge.

3. **Start Small**

If you're new to prop trading challenges, consider starting with a smaller one. This will give you experience without risking significant capital.

4. **Be Patient**

Don't rush to meet profit targets. Patience and calculated decisions are key to managing risk and increasing your chances of passing the

challenge.

5. **Focus on Long-Term Success**

Passing the challenge is just the beginning. Once funded, it's important to continue refining your strategies, learning, and maintaining consistent performance.

How to Choose the Right Prop Firm Challenge

Choosing the right Prop Firm Challenge is essential for your success. Here's what to consider:

1. **Compatibility with Your Style**

Make sure the firm's rules and trading philosophy align with your trading style. If you're a day trader, a firm focused on longer-term strategies may not be the best fit.

2. **Evaluation Process**

Understand the evaluation process, including how profits and losses are calculated, and the criteria for passing the challenge. This will help you prepare better.

3. **Fees and Costs**

Consider the fees and any costs involved. Ensure the potential rewards outweigh the investment.

4. **Firm Reputation**

Research the firm's credibility by reading reviews and testimonials. Align with a company that has a good reputation for fairness and transparency.

5. **Support and Resources**

Some firms offer educational resources, tools, or mentorship programs. These can significantly impact your learning and growth.

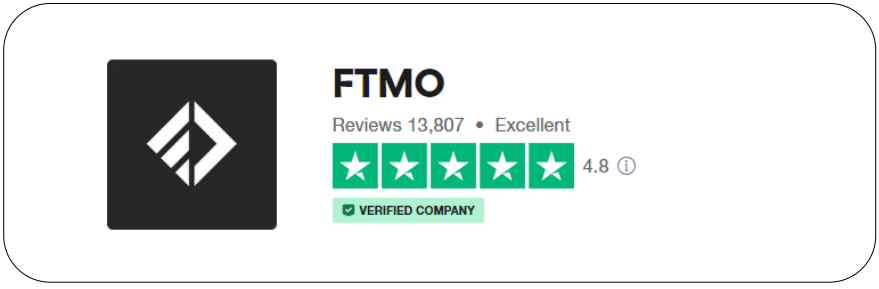
6. **Growth Opportunities**

Look into the firm's long-term growth plans. Some offer additional capital based on performance, allowing you to scale up and increase profits over time.

Top trusted prop trading firms based on recent reviews, featuring key differentiators, sources like Trustpilot, and industry rankings:

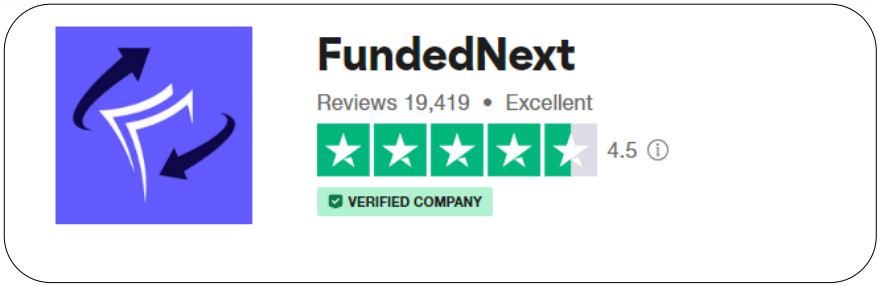
1. **FTMO**:

A widely recognized prop firm known for its flexible account options and favorable profit splits. FTMO provides traders with up to 90% profit shares and a smooth evaluation process. The firm allows trading forex, indices, commodities, and crypto, making it a top choice for both novice and experienced traders. FTMO also receives high ratings on Trustpilot for its reliable payouts and strong support.



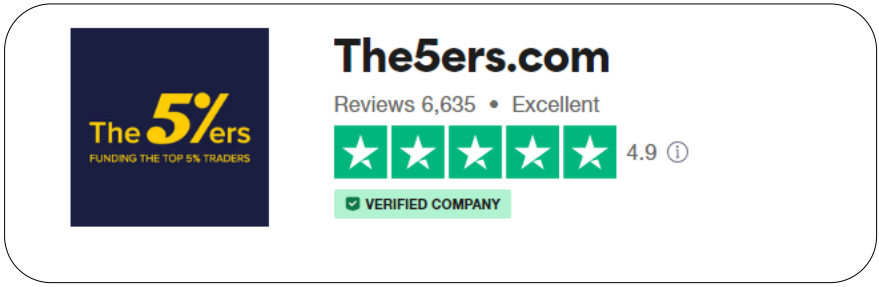
2. **FundedNext**:

FundedNext provides a straightforward evaluation process and a variety of account types, allowing traders to choose based on their risk tolerance. It is gaining popularity for its trader-friendly conditions and supportive community.



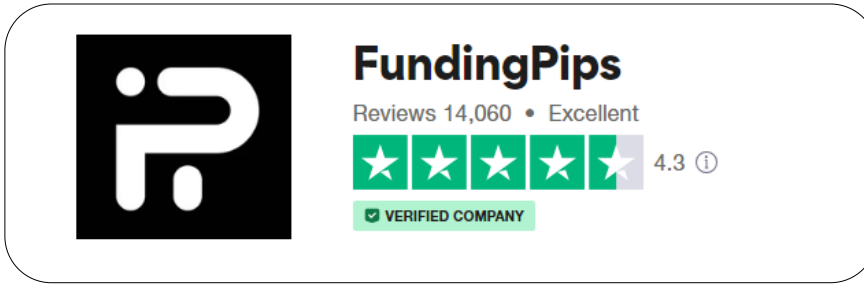
3. **The 5%ers**:

This firm caters to forex, indices, and metals traders, offering a profit split of up to 100%. The 5%ers is recognized for its robust risk management tools and is ideal for both beginner and experienced traders. It also supports traders worldwide, including those in the U.S., which sets it apart from other firms(Sources: Benzinga).



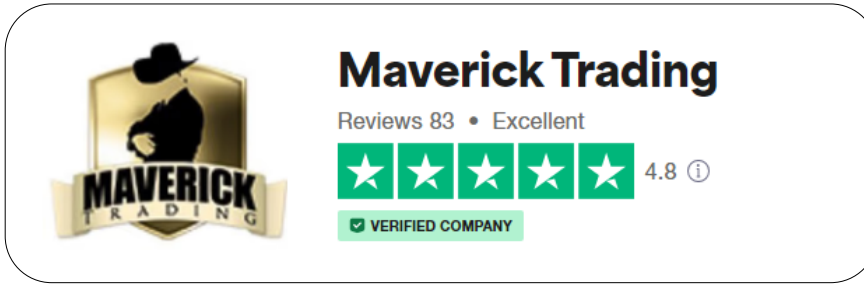
4. **FundingPips**:

This firm focuses on forex trading and offers a unique evaluation process suitable for both beginners and seasoned traders. FundingPips has received positive feedback for its flexible trading rules and supportive mentorship.



5. **Maverick Trading**:

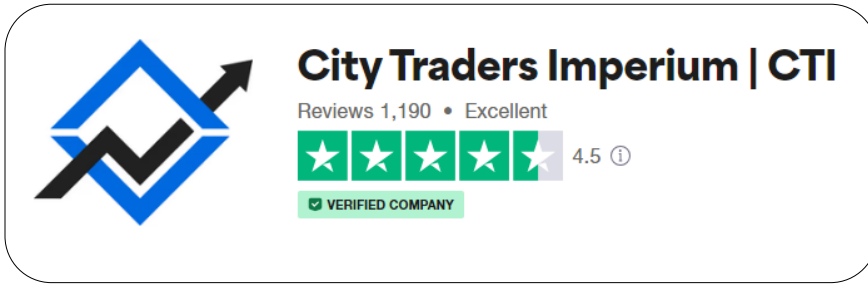
A highly rated proprietary trading firm with a focus on options, forex, and futures. Maverick offers a comprehensive training program and a solid community of traders. The profit split varies but can be highly rewarding for those who perform well. It has a strong reputation on Trustpilot for providing consistent support and education(Sources : Benzinga).



6. **City Traders Imperium (CTI)**:

City Traders Imperium (CTI) is a London-based prop firm offering funded accounts from $10,000 to $70,000 with a one-step evaluation process and no time limits.

Traders can earn up to 70% profit splits and benefit from a scaling plan. CTI allows weekend and news trading, making it a flexible option for various strategies. It also provides strong educational resources and a supportive community, ideal for traders seeking long-term growth.**Sources**: Benzinga, Trustpilot.



7. **Maven Trading**:

A proprietary trading firm that specializes in a range of asset classes, including options, forex, and futures. Maven Trading is known for its robust training programs and active community, making it an attractive choice for both beginner and experienced traders. The firm offers competitive profit splits, rewarding traders who demonstrate consistent performance. It has earned a strong reputation for its educational support and mentorship, receiving positive feedback across multiple review platforms (Sources: Benzinga).



DISCLAIMER:

The information provided about the proprietary trading firms, including FTMO, FundedNext, The 5%ers, FundingPips, Maverick Trading, and City Traders Imperium (CTI), is for general informational purposes only.

While these firms are currently well-regarded and trusted within the trading community, financial markets are inherently unpredictable, and business operations can change over time. These firms could face various challenges such as regulatory changes, financial difficulties, or other factors that may lead to their restructuring, closure, or insolvency.

As **Eng. Lutandula**, I advise that traders perform their own thorough due diligence and understand all associated risks before entering into agreements with any proprietary trading firm. The potential for loss of capital is significant, and the operational continuity of these firms cannot be guaranteed in the long term. It is essential to stay informed about any updates or changes in their policies and terms.

General rules that apply across various firms:

1. **Profit Splits**:

Most firms offer attractive profit splits, typically ranging from 75% to 90%, depending on performance and account growth. For example, FTMO offers an 80-90% profit split, while Topstep allows traders to keep their first $10,000 in profits before applying their 90% split.

2. **Drawdown Limits**:

Firms impose both daily and overall drawdown limits to manage risk. Daily drawdowns can range from 4% to 5%, while overall drawdowns can be between 5% and 10%. Exceeding these limits usually results in account termination or challenge failure.

3. **Challenge Phases**:

Many firms require traders to pass one or two phases of evaluation before gaining access to real capital. These challenges often require a profit target of around 8% to 10% while adhering to strict risk management rules, such as drawdown limits and position sizes.

4. **Leverage**:

Leverage varies depending on the firm and asset class but can range from 1:30 to 1:200 for Forex. This allows traders to manage larger positions relative to their account balance but requires careful risk management to avoid excessive losses.

5. **Fees**:

Most firms charge a one-time fee to enter their challenges. The good news is many firms, such as FTMO and Fidelcrest, refund the fee upon your first profit payout.

6. **Trading Time Limits**:

Depending on the firm, traders may have a limited amount of time to meet profit targets, typically 30-90 days. Some firms allow retries if you're in profit but haven't reached the target when the time expires.

7. **Account Rules**:

Many firms have restrictions on trading styles and strategies. For instance, some firms limit the use of Expert Advisors (EAs) and forbid high-frequency or grid trading systems to prevent excessive risk-taking.

EXAMPLE 1

Scenario 1

Mr. Obangajanga took a prop firm account with a balance of $10,000, and the maximum daily drawdown was set at 5%. He placed a buy trade on GBP/USD around 16:30 GMT+3 during the New York session. By midnight, he had made a profit of $800, bringing his account balance to $10,800.

However, at around 10:00 AM the following day, the price began to pull back. As you know, during the opening of a new trading day, prices often experience pullbacks before continuing their trend. This pullback was significant, and by the end of the trading session, Mr. Obangajanga's profit had decreased to just $200, resulting in a total account balance of $10,200.

Question

Using the rules for calculating risk, based on either equity or balance, which method did he violate, if any?

Solution

Balance-based drawdown calculation:

- Initial balance: $10,000
- Maximum drawdown (5%): $10,000 * 0.05 = $500
- At the end of day one, his account balance was $10,800, so there is no violation based on balance.

Equity-based drawdown calculation:

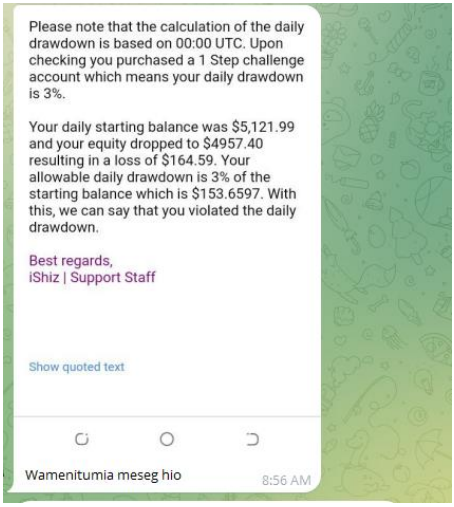
- Equity at the end of day one: $10,800
- Maximum drawdown (5% of the equity): $10,800 * 0.05 = $540
- When the account dropped to $10,200 after the pullback, the drawdown from the highest equity ($10,800) was:
- $10,800 - $10,200 = $600
- This exceeds the allowed drawdown of $540, indicating that Mr. Obangajanga violated the maximum daily drawdown rule based on equity.

EXAMPLE 2

NOTE

It is important to know the method used to calculate the daily drawdown of the prop firm you are using; this will help you avoid breaking the rules.

This is one of the messages I received from a trader via DM. They are asking why they were sent a message saying they breached the rules, even though they are still running a profit.



That prop firm calculates daily drawdown based on equity, which is why the maximum percentage for the day has been reached, even though there are trades still running in profit. This was caused by a pullback.

NOTE

To avoid breaching the rules, especially if your prop firm calculates daily drawdown based on equity, it's crucial to adopt a day trading approach. This means you should avoid holding trades for extended periods, as pullbacks that often occur during the Asian session or at the start of the London session can cause sudden drops in equity.

These pullbacks may reduce your equity enough to trigger the firm's daily drawdown limit, even if your trades are still in profit. By closing your positions within the day, you can minimize the risk of these unexpected fluctuations and stay within the firm's rules.

However, if you're a swing trader who prefers holding trades for longer periods, you should consider prop firms that calculate daily drawdown based on balance rather than equity. With a balance-based calculation, the drawdown is measured from your account balance rather than your fluctuating equity, which allows more flexibility to hold trades through pullbacks without risking an immediate breach of the firm's daily drawdown limits.