AMBALAL's KNOWLEDGE SHARING

STOPLOSS (30/11/2013)

SHARES & STOCKS PRIVATE LIMITED

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Stop-Loss Order

Definition of 'Stop-Loss Order':

An order placed with a broker/investor to sell a security when it reaches a certain price. A stop-loss order is designed to limit an investor's loss on a security position.

Stop loss placement for a couple of important reasons. One, you always should think about risk before reward and you should be at least two times more focused on risk per trade than you are on reward. Two, we need to determine our stop loss to then determine our position size (No of lots/stocks) on the trade, This will all become clearer as you read.

The purpose of a stop loss

The purpose of a stop loss is to help you stay in a trade until the trade setup and original near-term directional bias are no longer valid. The goal of a professional trader when placing their stop loss, is to place their stop at a level that both gives the trade room to move in their favor or room to 'breathe', but not unnecessarily so. Basically, when you are determining the best place to put your stop loss you want to think about the closest logical level that the market would have to hit to prove your trade signal wrong. So**, we don't want to put our stop loss unnecessarily far away, but we don't want it to close to our entry point either**. We want to give the market room to breathe but also keep our stop close enough so that we get taken out of the trade as soon as possible if the market doesn't agree with our analysis. So, you can see there is a 'fine line' that we need to walk when determining stop placement, and indeed we consider stop placement one of the most important aspects of placing a trade.

Many traders cut themselves short by placing their stop loss too close to their entry point solely because they want to trade a bigger position size. This is what we call as "trading account suicide. When you place your stop too close because you want to trade a bigger position size, you are basically nullifying your trading edge, because you need to place your stop loss based on your trading signal and the surrounding market conditions, not on how much money you want to make.

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Not Just for Preventing Losses

Stop-loss orders are traditionally thought of as a way to prevent losses thus it's name sake. Another use of this tool, though, is to lock in profits, in which case it is sometimes referred to as a "trailing stop". Here, the stop-loss order is set at a percentage level below, not the price at which you bought it, but the current market price. The price of the stop loss adjusts as the stock price fluctuates. Remember, if a stock goes up, what you have is an unrealized gain, which means you don't have the cash in hand until you sell. Using a trailing stop allows you to let profits run while at the same time guaranteeing at least some realized capital gain.

A trailing stop is a type of stop loss order that combines elements of both risk management and trade management. Trailing stops are also known as profits protecting stops, because they are used to keep a particular amount of profit in addition to preventing a loss. Trailing stops are supported by most trading software, and are usually implemented by the trading software as opposed to a brokerage or the exchange.

How a trailing stop loss works

A trailing stop is initially placed in the same manner as a regular stop loss order. For example, a trailing stop for a long trade would be a sell order, and would be placed at a price that was below the trade entry (and the exact opposite for a short trade).

For example, if a long trade is entered in NIFTY at 6000, a ten points trailing stop might be placed at 5990. If the price then moved up to 6010, the trailing stop would move to 6000. If the price continued up to 6020, the trailing stop would move to 6010. If the price then moved back down to 6015, the trailing stop would stay at 6010. If the price continued down and reached 6010, the trailing stop would exit the trade at 6010, having protected ten points of profit.

How not to Use a trailing stop loss

A mistake that is often made by new traders is to place a trailing stop that is too close to the current price (e.g. one or two points trailing stop). When a trailing stop is too close, the market does not have enough room to breath (i.e. make its usual fluctuations), and it is very likely to reach the trailing stop prematurely.

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Trailing stops should be placed at a distance from the current price that you do not expect to be reached unless the market changes its direction. Some traders use trailing stops with every trade that they make, and some traders never use trailing stops. If you do decide to use a trailing stop, it should probably not be your only way of exiting a trade, because most trailing stops are not based upon market dynamics (i.e. they are just an arbitrary stop loss). The only exception to this would be a system trader that has specifically tested and proven this to be the most profitable trade exit for their trading system.

Conclusion

Deciding how to determine the exit points of your positions depends on how conservative you are as a trader. If you tend to be aggressive, you may determine your profitability levels and acceptable losses by means of a less precise approach like the setting of trailing stops according to fundamental/technical criteria. The reliability of both the techniques, however, are affected by market conditions, so do take care to be aware of this when using the strategies.

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