

Some Thoughts on Stop-Loss Levels

By Colin Nicholson

One of the questions most often asked by investors and traders who are learning to use technical analysis is where they should place their stop-loss level. This is a question the answer to which is best prefaced by the caution that it all depends on what the investor or trader is trying to do.

In the broadest terms, a stop-loss level should be the price at which investors or traders are wrong about their investment or trade. However, before this is useful, investors or traders must be clear about what they are trying to do and be able to define where their expectations have gone awry. Experience suggests that many investors and traders are far from clear as to what they are trying to do. Even when they are, they do not always have a clear understanding of the logic behind their plan, such that they can pinpoint a level at which it can be said that an investment or trade has failed.

Before we investigate this a bit further, it is necessary to step back a bit and look at a more general problem. This is that when most investors and traders start out, they tend to be subconsciously seeking a perfect method. In terms of stop-loss levels, what they would like to discover is where to put their stop-loss level such that if it is taken out, the investment or trade would always have ultimately failed.

It is important to recognise that such certainty is not a realistic expectation. No matter what method is used to situate a stop-loss level, there will always be some investments or trades that are closed out at the stop-loss level only to reverse later and succeed, sometimes spectacularly. With hindsight it is possible to see where the stop-loss might have been placed to avoid missing the success story. The reality is that investment and trading does not lend itself to such consistency. There will always be situations where sound decisions result in missed opportunities. Hindsight is a useful tool for learning, but is inappropriate as a method of evaluating decisions. Even sound decisions will sometimes result in adverse outcomes.

One could envisage a method where most of the time a stop-loss level was effective in getting us out of a bad investment or trade. Yet there might be a small number of cases where it would have been better in hindsight to have held the position through an adverse move against it. It is quite possible that by adjusting the stop-loss level we could have avoided all the premature exits. However, we would have had to apply this looser stop-loss policy to all of our positions, because there is no way to know in advance which ones will subsequently recover and succeed. When applying the looser stop-loss policy to all of our positions, we will have taken a bigger loss on each failed position and may have run up a totality of losses on the majority of situations that outweighed the profits on the minority of situations that turned around and led on to profits.

The conclusion from this discussion is that it is important to focus on the universe of investments or trades, rather than be tempted into just trying to correct a few that hindsight shows might have been handled better with a wider stop-loss level. There are always new opportunities coming along and nobody has enough money to take them all. In addition, there will always have been an opportunity to have re-established those stopped-out investments or trades that recovered after triggering the stop-loss level.

So, there is no such thing as a perfect stop-loss level that will guarantee to close out only investments and trades that would have ultimately failed. Some ultimate winners will also be caught. However, having reached this point, many investors and traders fall into another trap. If they cannot always get it right, why not use tighter stop-loss levels? Overall losses would be less, and the good ones would be re-established as soon as it is clear the temporary setback is finished.

This thinking exposes a grim irony in placing stop-loss levels. By thinking that tighter stop-loss levels reduce overall risk, they may actually be increasing their overall risk. This can happen when the tight stop-loss is set arbitrarily or without reference to the logic of the investment or trading plan.

Suppose that our plan is to buy upward breakouts from trading ranges. Our stop-loss level is set 1% below the bottom of the trading range. The logic of our plan is that upward breakouts mostly lead to new uptrends. The logic to placing our stop-loss level under the trading range is that the bottom of a trading range represents a support level. A support level is where buyers emerged repeatedly in the past with sufficient conviction that they overcame supply at that level. Their expectation was therefore inferred to be that they saw this as an attractive level to buy based on their expectations. It follows that if the price falls back through this support level, then something has changed to affect the expectations of buyers. In that case, the assumption underlying our plan that upward breakouts from trading ranges leads to new uptrends is quite possibly wrong in this case. Hence it is a logical place to suppose that our plan is not going to work in this case and we should cut our losses.

Now suppose that our purchase price was \$2.57 and that the bottom of the trading range was at \$2.30. If our stop-loss is at \$2.28, we are risking 30c, or 12% of our cost. Now suppose that we think 12% is a bit too much to risk and that we will reduce our risk to 10%, or 26c. We tighten our stop-loss to \$2.31.

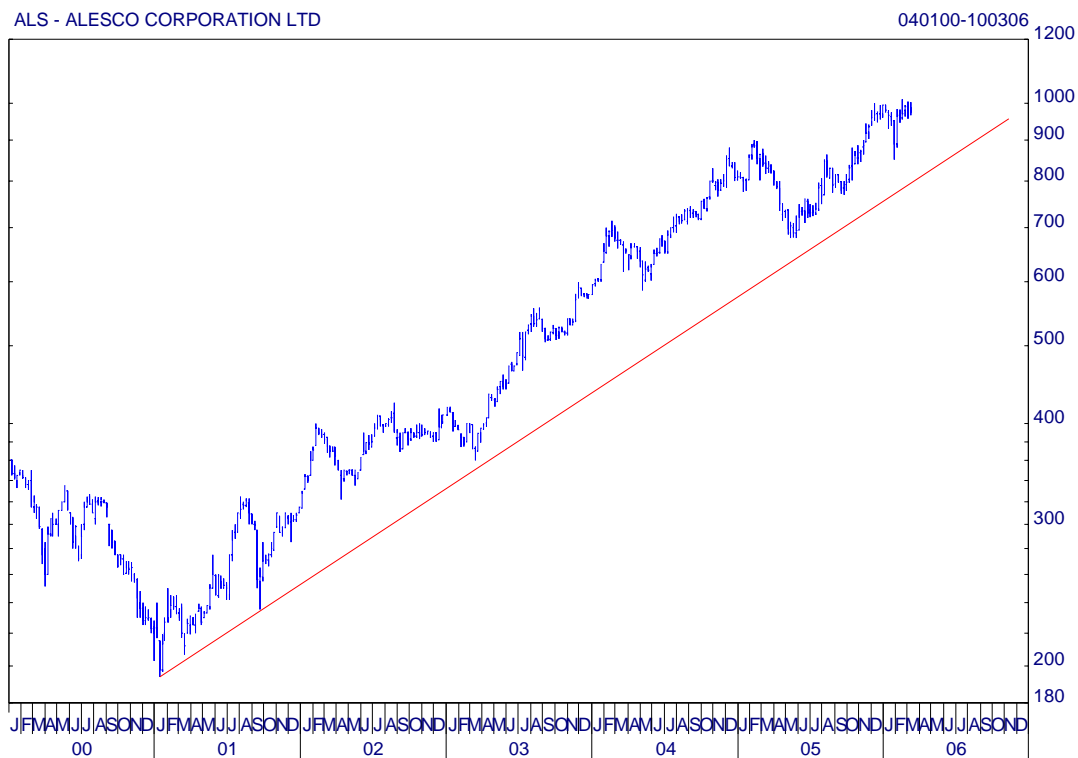
The irony is that in trying to reduce risk in this way, by acting arbitrarily outside the logic of our plan, we may actually be increasing our risk. To understand this, remember that the bottom of our trading range at \$2.30 was an established support level. If the price falls back into the trading range because the initial breakout was premature, it is to be expected that buyers will take the opportunity to buy more at \$2.30. The logic of a support level is that it will continue to hold unless there is a change in expectations. However, our arbitrary stop-loss is at \$2.31. It is therefore quite likely that our stop-loss

could be triggered on the way to \$2.30, which level holds again with expected support and the expected uptrend unfolds after this final set-back.

By setting the stop-loss level tighter than the logic of our plan suggested, we may have actually increased the likelihood of being stopped out at a loss. In other words we have increased the risk of being forced to take the loss and maybe entering the trade again later at an even higher price than originally paid.

Now I know that many readers will want to argue with this. They will say their logic for trading breakouts from trading ranges is different. This would be missing the point. I defined the logic and argued that setting a stop outside the logic defined by the plan may actually increase the risk of being stopped out. If readers' logic for a breakout trade is different, then everything needs to be re-stated in terms of the logic of their plan. It will still follow that, no matter what their plan is, by tightening their stop-loss level against the logic of their plan my actually increase their risk of being stopped out prematurely.

To see how the same point may apply when the plan has a different logic, consider this weekly chart of Alesco (ALS):



Now suppose that our investment plan here is to identify and uptrend and buy. The logic that underlies our plan this time is that strong trends will respect a trend line. Our logical sell-stop strategy therefore is to situate the sell-stop level just under the trend line.

Suppose further that we decided to buy into this trend on the move up from the 2004 dip. It might have been tempting to situate our stop-loss level under

the lows of the 2004 trough. On a plan with a different logic to it that may be quite a defensible place to put the stop-loss there. However, since our plan is based on the logic of riding the trend while it is above the trend line, placing a stop-loss above the trend line would invite it being hit while the trend defined by our plan was still intact. Again, we might only have invited a higher risk of taking a loss on the investment.

The conclusion from this discussion is that we must have a clear understanding of what we are trying to do. We then place our stop-loss level at the failure point for our trade or investment, based on the logic of the investment or trading plan. To place the stop loss closer to the price action in an attempt to reduce risk may actually succeed in producing a higher risk of being stopped out at a loss.

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