Capital Preservation Using Stops

Any experienced investor will know that the most important single objective in investing is capital preservation. It is even more important that making a profit by investing our capital, important as that objective is. This is because if we lose too much of our capital, we are likely to find it very difficult to recover by investing. We will need to save more capital before we can get back in the game of investing. The importance of not losing too much can be highlighted with the following table:

% Loss of Capital	% Gain on Remaining Capital Needed to Recover
10	11
20	**25**
30	43
40	67
50	100
60	150
70	233
80	400
90	900

The danger level is in red above: lose more than 20% of our capital and we need a gain of 25% on the remaining capital to start again where we began. Once we lose 30% of our capital the road back becomes very steep, requiring a 43% return on capital to start again. Below that on the table it becomes increasingly unlikely that we can recover.

What this means is that instead of doing what most inexperienced investors do: concentrate on the dividends and capital growth, our prime focus at all times should be safety of our investment capital. The mantra for good investors should be to watch and limit the losses and let the dividends and capital growth take a secondary focus.

What is a Stop?

In the stock market, a stop is a conditional order or an alert to buy or to sell a stock holding.

When stops are price-based and determined in advance, as they should be, many brokers will allow the investor to enter their stop in the market as a conditional order – an order to buy or sell if the price reaches a certain level. Conditional orders can be tricky, so make sure you know the rules or you may not have the protection you think you have – especially if there is some corporate action, like a dividend, that calls for all existing orders to be purged from the system. Conditional stop orders are particularly hazardous in smaller stocks. Conditional stop orders are intended for big liquid stocks.

Of course, stops do not have to be placed in the market as conditional orders; they can simply be levels we set in advance to trigger an automated alert or that we check prices against at the end of each day to alert us that our stop has been triggered. We then need to manually execute the transaction in the market.

There are two basic types of stop:

1. A Buy stop – is used to open a long position or to close a short position
2. A Sell stop – is used to open a short position or to close a long position

Since I am writing primarily for investors, who will buy stocks rather than sell them short, I will not deal in this article with stops as used for short positions.

So, for an investor the two types of stop can be simplified, using a price-based stop as an example:

1. A Buy stop – is used to open a new investment if the price of a stock reaches a certain level, which may be higher or lower than the current price.
2. A Sell stop – is used to close an existing investment if the price of a stock we own falls to a certain level.

Since this article is about protecting capital, I will not deal with buy stops, which do not have that objective. I will focus on sell stops, because they are the stops that protect capital. We use sell stops to protect capital in two situations:

- If we find that we have made a mistake and the investment fails to perform as we hoped. The objective here is to preserve capital by limiting a loss. Max Gunter sums this up in his book *The Zurich Axioms* as the third axiom: *When the ship starts to sink, don't pray… jump!*

- If the investment has been successful, but begins to fail, so that the price begins to fall. The objective here is to preserve capital by locking in a profit. The objective here is to preserve capital by limiting a loss. George Classon sums this up in his book *The Richest Man in Babylon* as the fourth cure: *Guard thy treasures from loss*.

Successful Investing involves Assuming Risk

Investing in the stock market means buying part ownership of a business. Ideally, that business will produce a growing stream of profits. These profits come to the investor in three forms:

- The business will pay part or all of its profits to its owners in the form of dividends.

- Where the company has paid tax on its profits, the owners will also receive franking credits, which represent the tax the company has paid on the profits that were distributed as dividends. Franking credits are income in the sense that they are a credit against tax the investor must pay. In the situation where the investor does not need to pay any tax, the franking credits are refunded by the taxation authorities.

- Most businesses do not pay out all their profits as dividends to shareholders. Instead, these retained earnings are reinvested in the business. If this is done successfully, then the value of the company will rise and this will be reflected in its share price. This will also allow payments of growing dividends. The increase in share price is an unrealised profit until the investor sells their shares. However, it can be treated as a fluctuating increase in return from the investment.

All investments in stocks involve risk that the company's profits may decline. This may mean dividends and franking credits are lower and the stock price may decline. This risk arises in two ways:

1. **We make a bad decision**
   This can be because there was some information of which we were not aware or did not fully understand its implications.

   It may also be because there was some new development that we did not anticipate.

   It may simply be that we exercised poor judgement that caused us to buy at too high a price or at the wrong time.

2. **A successful investment deteriorates over time**
   This may be because of a decline in the performance of management of the company.

   It may also be because of new competition or new technologies which reduce the profitability of the company we have invested in.

Setting a Sell Stop: General Description

There are many ways to set sell stops. However, regardless of the method, the process should fit this general scheme:

- We should have a clear idea of what we expect to happen after we buy a stock.

- We should make an effort to define when what we expect to happen is actually happening.

- From that we should invert the definition into a definition of when what we expect to happen is NOT happening.

- That is our signal to execute our sell stop to protect our investment capital.

We may in fact have more than one trigger for a sell stop.

Thus, the key to successful use of sell stops is that we should know very clearly what will cause us to sell before we buy. It may be that our investment slips under water right from the start. It may also be that we have made a good gain in terms of dividends and franking credits, but the situation changes and our unrealised capital gains start to slip away from us.

Example of a Fundamental Stop

The idea of stops is very prevalent in the world of trading. In that world, stops are driven by price or some derivative of price and volume. However, in the world of investing, we have available to us a host of other information, called fundamental analysis of the business. Any change in the fundamental analysis of a stock might be the trigger for a stop. Here is one example, following our general schema for a stop from the previous section:

- We buy a business that is conservatively financed and we expect it to remain so.

- We define conservative financing as the business carrying long term debt that is no more than 2.5 times Earnings Before Interest, Depreciation and Amortisation (EBITDA).

- So, our business would not be conservatively financed if long term debt exceeded EBITDA. We may allow some fudge room here – say 2.7 times EBITDA.

- If debt grew to 2.7 times EBITDA, that would be our sell stop signal.

Other fundamental sell stop definitions may be based on sales growth, levels of profitability as measured by gross and net margins and so on. More generally, some triggers for stops may include:

- Generally, our reason for buying does not eventuate

- The company makes unwise mergers or acquisitions

- The founder or significant directors sell out

- The company stops growing because of new competition or threats from new technology

- The shares become significantly over-valued

- The share price trend is violated

- Some disaster strikes the business

The penultimate point above is a sell stop or stops based on the share price. This is my primary method and is based on the logic that when I buy into a business I expect its market price to trend upward rather than fall. Price is often a leading indicator of changes in fundamentals because smart money senses changes and acts before news becomes public. In this regard, smart money may be acting on legal inside information.

I have actually two sell stops on each stock – a soft stop that allows me some discretion and a hard stop which is compulsory for me to act on without hesitation.

I also have two other price-based sell signals.

I have also been known to sell stocks that have become overvalued, or stocks with declining fundamentals of any significant nature for the business.

What I do is set out in detail in my book *Building Wealth in the Stock Market* and there are many examples on the members website.

A final word is that stops are one of the most potent tools that we can take from the world of trading and use in investing. If our capital slips away from us we are sliding out of the game. Capital protection is the number one objective in investing.

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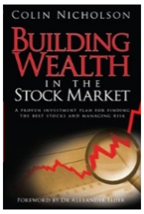

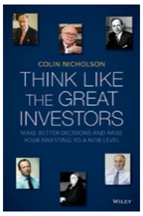

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