

Charting a Course to Sell Shares

An enduring saying about investing and trading is to “cut losses short and let profits run”. Experienced investors and traders know that this is the real secret to success in the stock market.

What is remarkable about cutting losses and letting profits run is that it is all about getting out of positions, rather than getting into them. Yet, most investors and traders put almost all their energy into selecting which stock to buy.

Investors will protest that they are not trading, so this article does not apply to them. However, it does. The return from an investment is the total of the dividends and the capital gain. The capital gain will often be the larger component of the total return. If capital gains are not actively sought, or if substantial capital losses are made, then returns to the investor will be disappointing. Traders focus almost exclusively on capital gain or loss and there is much that investors can learn from the accumulated wisdom of traders about this aspect of investing.

Technical analysis is the study of the *price* of shares. It is separate from fundamental analysis, which is the study of the *value* of shares and is very important in *selecting* which shares to buy or sell. Because it concentrates on identifying the balance of buyers and sellers in the market, technical analysis is important in deciding *when* to buy or sell those shares.

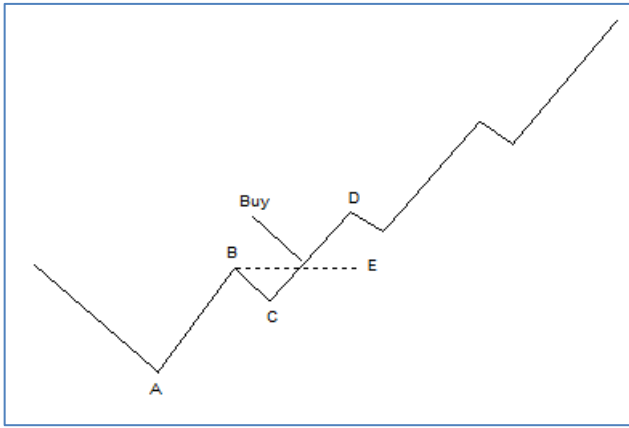
All investors have had the experience of seeing a share price fall, for no apparent reason. Only much later does the news come out. Technical analysis can allow us to see what those in the know are doing and act ahead of the news. Nowhere is this more important than in selling, because bad news tends to travel slowly.

There are two situations in which a share should be sold. One is to cut losses when a mistake has been made. The other is to capture profits once an investment has run its course. We will look at each of these in turn.

Cutting Losses

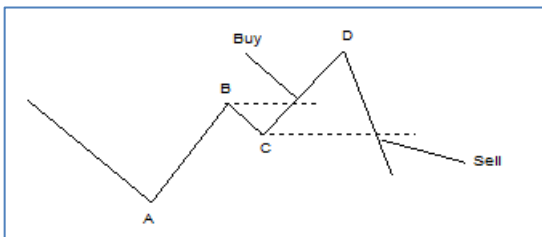
No investment should be made unless there are strong reasons to do so. However, there is also a down side. Something can go wrong with our assessment of the company or its fortunes. The technical analyst deals with this situation by using a model of how price action forms in a successful investment. A very basic model is the idea of a trend. Prices in the market move in waves, rather than moving straight up or down. An up trend is when each upward swing, or rally, in price carries further than the previous one and each downward swing, or correction, in price is arrested higher than the previous one.

The diagram below shows the basic model and the first point where a trend investor would buy:



This is the first time a trend is present: C is a correction which has terminated above the previous down move at A. Once price moves above level E, which is where the previous rally finished at B, the current up swing must end higher than B. The expectation of the model is that price will rise to D and each subsequent rally or correction will finish higher than its predecessor.

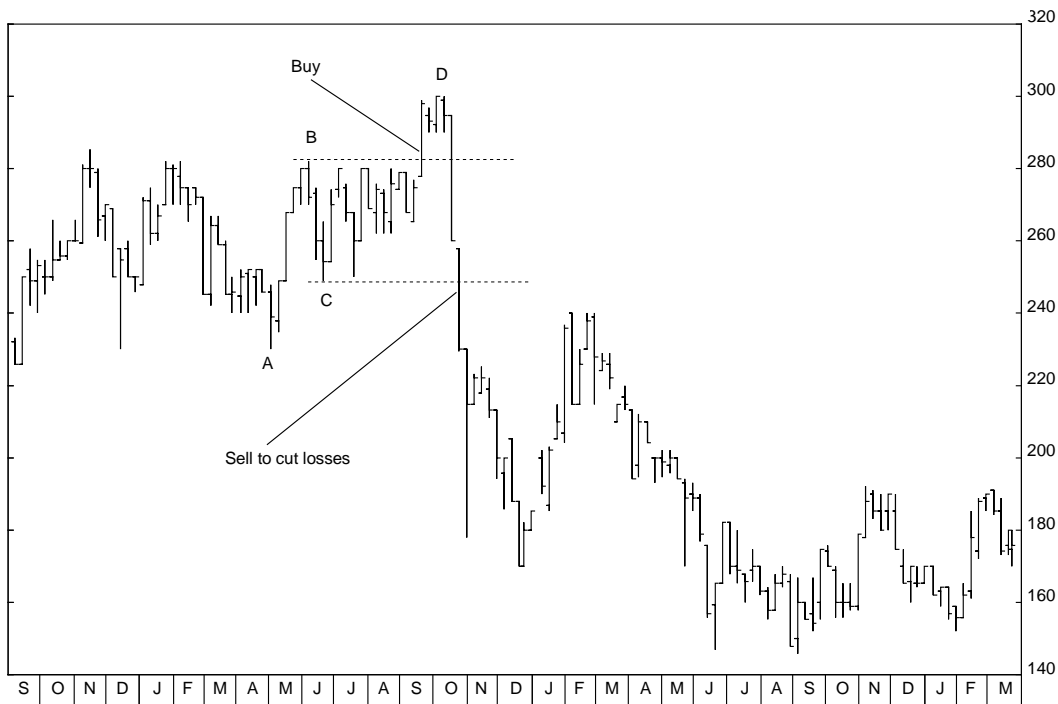
Using the model, we can identify when something has gone wrong. This is if the next correction were to fall below the level of the previous correction:



Once price falls below point C in the above diagram, there is no longer a trend, because the pattern in our model of each correction finishing above the previous one has been interrupted.

Technical analysts have found that this strategy has saved them from countless bad investments.

The chart below shows an example. After the price had been moving sideways for some time, it began to trend upward once the correction to C held above A and price moved above the top of rally B. A purchase at a price just above the level of B was initially successful as the price rose to D. However, price then rapidly fell below C, signalling that the trend had lost its integrity and losses should have been cut around \$2.40. Recent prices over a year later are under \$1.80. The loss cutting strategy would have afforded the opportunity to switch capital into a better investment in the ensuing period.



Of course, sometimes the trend will reassert itself. When this happens, the investment may be reconsidered.

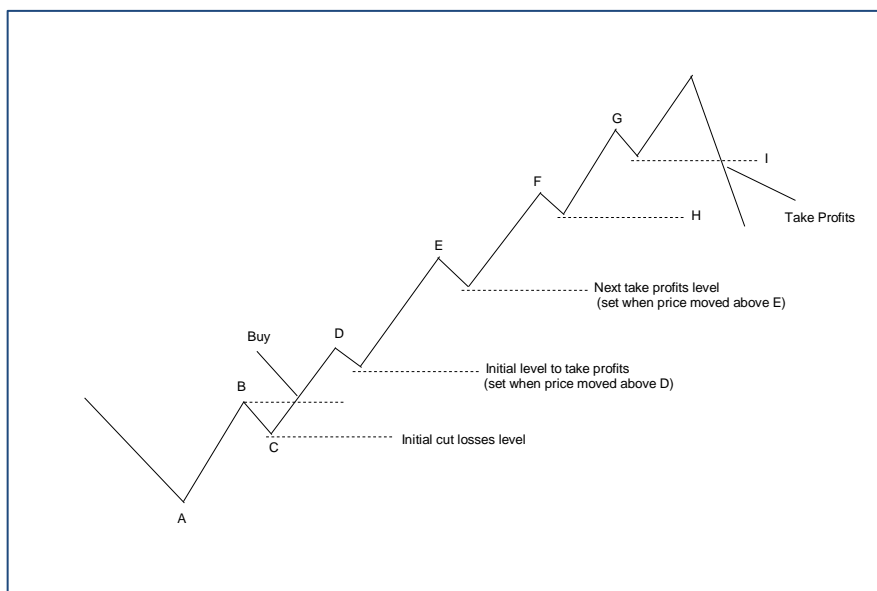
Taking Profits

Once an investment is made on the basis of our trend model, it should be held as long as the trend continues, which might be weeks, months or years. We let the market tell us when the trend has finished. Doing this requires patience and discipline.

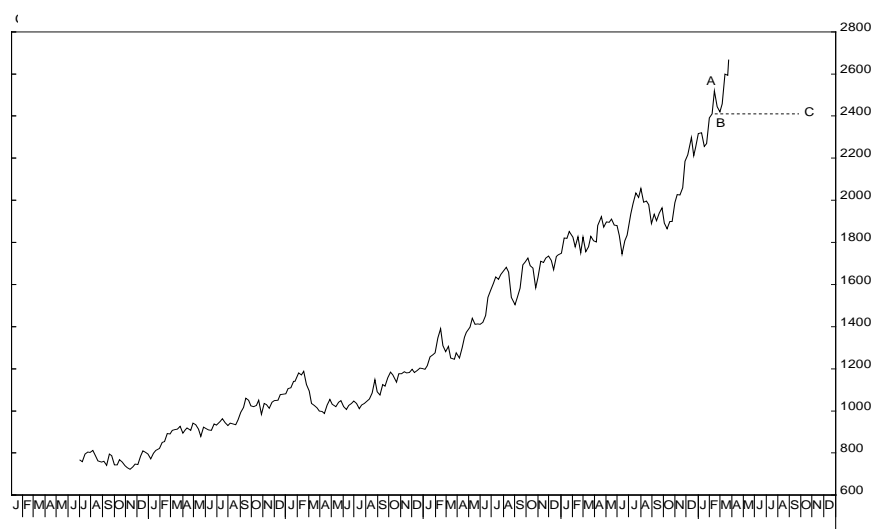
Using the trend model to take profits is based on the same principle used to cut losses. As the trend continues, each rally should take the price to a new high. As soon as the price moves above the top of the last rally, we can move the point at which we cut losses up to just under the bottom of the most recent correction. In a good trend, this will soon become, not a point to cut losses, but a point at which to take profits.

The process is shown in the diagram at the top of the next page.

Once price moves above the top of the rallies at D, E, F and G, the level at which profits would be taken is advanced to just under the last correction as shown. Eventually, the trend model is violated when price falls below level I, and the investment is sold at a profit.



An example is shown in the chart below, where we see the marvellous up trend in this stock. The current take profit level is just above \$24.00, marked C. This was set when price moved above the top of the rally marked A and was fixed just below the low of the correction to B.



There are other refinements on this basic trend trading idea and alternative methods of achieving the same ends, such as trend lines and moving averages.

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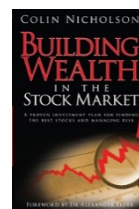
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