Stops – What are They?

A question that comes up all the time is the best way to set our stop-loss level. Stop-loss is a much abused term. For this discussion I will assume that we are investors, so our stop-loss will be a level where we protect capital and hopefully profit by selling our position; in other words a sell-stop. A stop of this kind might be an order placed with our broker, or it may simply be a level on which we have made our money management decision (our position size) and intend to activate manually if hit.

Before we get to the issue of the method of setting our stop, we must first have a clear idea of what a stop is. That is what I want to explore in this article, because I am continually surprised that investors and traders are going about their analysis and setting stops without a logical underpinning of what they are doing.

The correct logic is really simple. When we buy a stock, we should not simply be hoping for the best, although this is all many investors and traders do. No, we should have a clear idea of what we expect will happen. This is the essential first step and everything flows from that. Once we have a clear idea of what we expect to happen, we need to take the more difficult step of defining how we will be able to determine whether what we expect to happen is happening. This is not so simple; it requires a lot of careful thought. It should be thought through and written into our investment or trading plans. There are a great number of possibilities here, so there is no single best way.

The next step is slightly easier. From the definition of how we know whether our expectation is happening, we turn it on its head and define how we will know when it is not happening. This should flow logically from the previous step. This logic should enable us to set a stop at any time before and after we make the purchase. It is a price level that, if the market in the stock falls to or through it, will tell us that we were wrong about what we expected to happen when we bought the stock.

The big test is: can we write down our logic? Also, I want to stress that we must write it down in our investment plan before we put on the investment. In fact, it must be done before we can determine how many shares to buy in our position size calculation. Our definition must not be changed after we have bought the stock and are emotionally involved, no matter how calm and collected we might think we are. The market has a nasty habit of putting us under great pressure during an investment.

My investment plan is based on two models: the value model and the growth model that give me an edge in the market. For readers who are not familiar with my models, they are outlined in my book *Building Wealth in the Stock Market*. In both models, I am looking for a stock to break out upwards from an accumulation pattern (value model) or a consolidation pattern (growth model). I find these stocks primarily by scanning the market for stocks that are making new 52-week highs. If a stock has broken out of such a pattern, my expectation is that an upward trend will unfold.

I use the definition of a trend: that the weekly bar chart will form a series of higher peaks and higher troughs. I ignore the occasional failure to make a higher peak after each higher trough. However, my expectation is not unfolding if a stock breaks below the last trough in the trend. In that case I am wrong about what I expected to happen and that is my stop. I do not place it with a broker, but execute my stops manually. There are a few exceptions to this. At the breakout there may be an existing trend within the sideways pattern. If there is not, my stop will be under the lows of accumulation or consolidation pattern because, in that case, the breakout has failed. I also have two other sell signals that are outside this discussion, however, all of this is set out in detail in *Building Wealth in the Stock Market*.

It should be kept in mind that no method is perfect in the sense that it always leads to a profitable investment or that it does not sometimes stop us out prematurely. Also remember that there is no one single best way to define what we are expecting to happen. And even if we agreed on that point, we might reach different conclusions about how to define exactly when it is not happening.

The purpose of this article is to expose the logic that should be present in the way we determine where we are wrong about what we expected to happen after we buy a stock and thus where our stop will be.

Over fifty years of investing I have analysed thousands of charts of stock prices and tested my method on paper on them and in hundreds of real investments. There is no short-cut to developing faith in our method, be it stops or any other aspect of our investing. However, stops are critical to risk management and should be very high on our list of aspects of our investment plan to be tested extensively before risking our capital.

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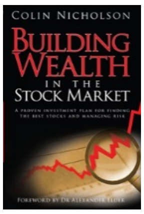

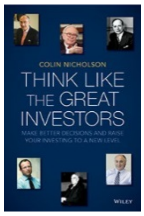

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