

How to Use STOPS

Take Yours PROFITS?... or let them run!

By Chelsey Baker, Vince Stanzione and Mike Hein

Placing stops must be one of the most important and most controversial subjects in the whole of the spread betting and financial trading world.

More arguments and client conflicts have arisen from stops than on any other subject I know of, yet the other financial publications have on the whole brushed the matter under the carpet.

In the next few pages our aim is to share what we have found works and what doesn't. Notice that it has taken three of us to write this article, with a combined trading experience of over 30 years with more trades than we care to remember. This is a big subject, it is TRADING LIFE OR DEATH.

In future editions we will definitely be coming back to stops but as with a journey of a million miles we have to start somewhere and here is the first step.

Introduction by Vince Stanzione

When drawing a list of articles for the Financial Trader magazine we came up with many serious issues that need to be addressed, however, one issue which is the biggest and hardest to address is placing and using a stop-loss.

Of course other magazines and publications make it sound simple, "Yes, place a stop 50 points below your entry level."

What a load of rubbish, written by people who have never traded for real, because if they had they would

know that it's a psychological nightmare.

Anyone reading this who has attended my trading day knows that trading is all about PSYCHOLOGY and human behaviour. Charts, indicators, news and everything else means little, it is our PSYCHOLOGY that is important.

Jesse Livermore said it in 1920's, Nick Davas said it in the 1960's and I am saying it in 2001.

Opening a trade

Most people spend hours, days and months deciding where to enter a trade, yet entering a trade is the easy bit. The hard bit is exiting whether it be with a profit or a loss.

Exiting with a profit

If you've never traded you will be thinking exiting with a profit isn't that hard, Yeah, ask any real trader and he or she will tell you what a mind game this business is. I remember reading a quote by Oscar Wilde who said, "*The coward dies a thousand deaths, a brave man dies but once.*" He was wrong and if Oscar had ever traded the futures market he would have never said that.

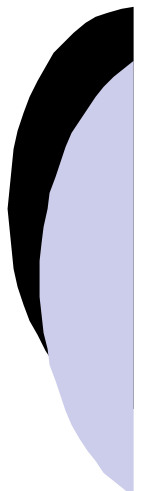
Believe me holding a profitable trade can in most cases be as hard as holding a losing one. Why? It's human psychology and our emotions of GREED and FEAR.



The Greed element says to run your profits, the Fear element says we need to take our profit. What happens if the market turns?

I remember two pieces of advice I had when starting my trading career,

"Son, you must let your profits run, you will never make money if you cut winning trades quickly." OK, I can understand



that. Second piece of advice, "Son, you will never go broke taking a profit, and you should cut losses quickly." Now is that a contradiction or what!

So what are you supposed to do?

Let's say you have found your share, index or whatever you want to trade, it doesn't matter if it is long or short. You decide to buy at £5.00. What's the very first thing that happens? You are in a losing trade because as soon as you buy or sell you have spread or commission factors to be considered.

The next point is an exit strategy if the trade goes wrong. In Spread Betting we have two types of stops, a Controlled Risk Stop or (Guaranteed Stop) and a normal stop.

A controlled risk stop is charged for, normally a few points are added to your quote which is like buying a small insurance policy. In return the bookmaker guarantees your exit at that price regardless.

Normal Stop-Loss

A stop is really a limit order which you have placed with your bookmaker which will be executed if the market hits that price. The futures broker or a financial bookmaker will endeavour to do their best to exit you at or as near as possible to that price. For example, if you buy the Dow at 10,500 so you are Long your Stop which is a sell order is at 10,400.

If the market trades at 10,400 your stop order now becomes a live sell order and is executed at that price.

In a fast market the dealer may not be able to fill your order at the price so your order could show at 10,380 or 10,350. Of course this causes many arguments especially out of hours, and while many may believe that bookmakers move prices just to stop your order out, I assure you that this is not the case. It's just not worth it.

If you are worried about this then make sure you always take a SCREEN price stop.

Remember a Stop was put in to protect you. Many newcomers phone bookmakers to move stops further away because they do not want to be stopped out. This is a crazy strategy and in 99% of cases you will end up losing more.

A stop is there to do a job, stop you from losing too much money on one trade or to lock in profits.

The other factor to consider in spread betting is SCREEN price or OUR price. I still prefer Screen price because then you have an outside record that the price was

quoted at that price by a 3rd party quote vendor such as Bloomberg or Reuters. If you accept OUR price which means if the bookmaker quotes that price you do not have an actual screen print to check.

The problem with stops normally happens overnight especially in markets such as the FTSE100 which does not have a Globex quote.

Let's look at some real examples of using stops:-

My experiences with stops by Chelsey Baker

When I first started trading with IG Index I had a limited risk account which meant that I had to place stops. At first I would keep stops fairly tight, my strategy was don't lose too much on one trade and I would be ok. For me it didn't work.

In many cases I had the correct trade but my timing would be a little out, so I would buy BT, it would dip down (as Vince already stated you are down because of costs the minute you trade), I would be stopped out and then BT would soar and I would be out of the trade, yet if I had not had a stop I would have been fine.

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In an article in The Times May 18th 2000 on Spread Betting, Simon Mansell the Managing Director of City Index cautions against the use of a stop loss in a highly volatile market for exactly the same reasons.

Six Continents PLC with a 200 day moving average (green line) and 20% stop loss line (red line) The stop is taken from the previous high. As the price advances so does the stop which would lock in profits. When prices fall or stay in a range the stop-loss line goes sideways.



So what did I do?

The first thing I did was bring my £ per point down, at that time Spread Betting firms worked on a minimum of £5 per point however, IG were sympathetic and allowed me to trade £2 per point. Of course now you can trade a 1p a point with Financial Spreads and all major bookmakers allow smaller minimum bet sizes. So I was able to make my bets last longer.

For example if I placed a bet at £5 with a 50 point stop I could now bet £2 with 125 point stop.

Once I did this my trading improved dramatically, it was far less stressful and I did not have to worry about being stopped out every five minutes.

I also added other rules and made the following observations:

1. Trade only markets and stocks that you can afford

In many cases I did not understand how volatile a share or market was intra day. For example the daily range (OHLC Open, High, Low, Close) is far bigger on a high flying technology stock than it is on a conservative property stock.

You can use various tools to help you read how volatile a market is, such as the Bookmakers NTR (Notional Trading Requirement). If you look at a bookmakers handbook and I am currently looking at the recent folder issued by City Index, you can see an NTR figure for the contract month on the Dow Jones is 500.

If you now look at the Swedish OMLX it is only 50. So the Dow is far more volatile than the OMLX. Another indicator for shares is the Volatility reading on Sharescope.

Press enter from any share graph and you will see the various financial information with a volatility box. The higher the number the more volatile it is.

2. Add to winning trades

If a trade went wrong and I was stopped out with £2 a point then it's no big deal, I was wrong but if a trade started to go my way it meant that my trade was correct and in many cases it would go further, so I would add to my winning trades. (Never average down.) So if I bought £2 at £5.00 and now the price was £5.50 I could buy another £2. Of course at some stage I had to close out or be stopped out.

3. Using a trailing stop

Most people place a stop and forget about it. What many successful traders do is to trail the stop. The chart below shows a trailing stop.

The stop is taken from the previous High. This chart was produced using Sharescope but most packages will do this or you can work it out by hand. The chart of Six continents PLC on the previous page shows how a stop loss line should be drawn.



You can move stops as many times as you like and if your bookmaker doesn't like it then change your bookmaker!



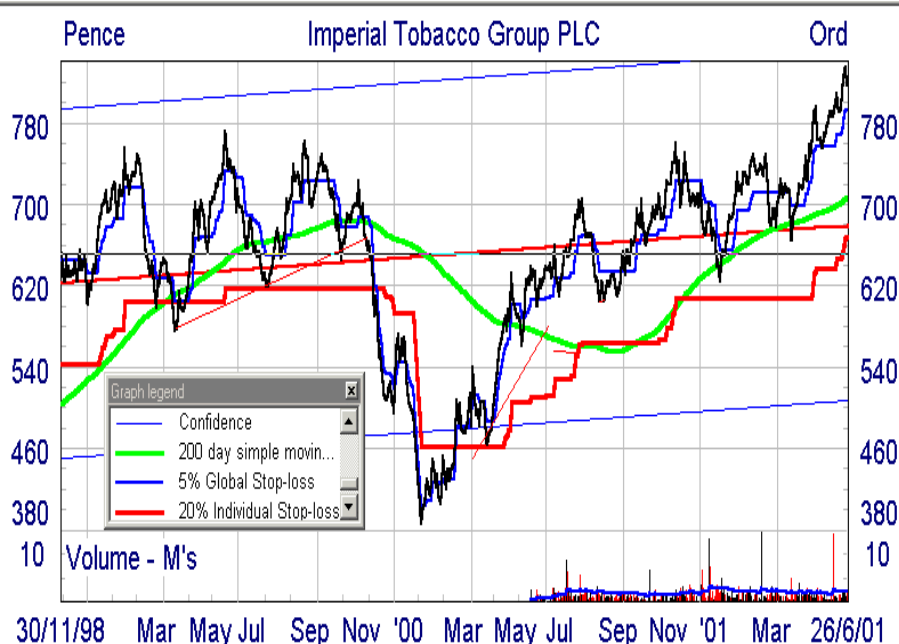
Looking for stop points by Mike Hein

If we look at any share or index you will find various points where the market finds support and resistance. (See article in this edition for more in depth information.)

A great example of this is the chart shown on the next page of the FTSE100. For months the 6,000 level continued to hold. Anyone long this market that had a stop around 100 points below 6,000 would have been fine.

Stop loss percentage values. Death by a thousand cuts!

The example below shows where a small stop loss fails. The blue line which is very close to the share price is 5%. While you would never lose much on one trade you are stopped out numerous times, this is what we call death by a thousand stop outs. Remember every time you enter and exit you have spread or commission on top. Using a 20% stop keeps you in the trade yet cuts you out during the major price fall at the end of 1999.



As with all trading ranges at some time the market breaks below, your stop catches you and you are taken out of your trade.

Using Moving Averages

Moving Averages have also been discussed in this edition. Many traders like to use moving averages as a buy signal, however, they can also be used as a Stop sell signal. If we look at the chart of Man Group Plc we can see a great upward trend and following a strategy as outlined by Chelsey Baker where you add on the way up would have paid off. Of course when Man Group does turn, you are holding a large position.

By using a trailing stop you would have locked in profit on the upside. The break of the 50 day moving average confirms that the trend has changed or has at least come to a halt for now. From my experience after a strong bull run it is normal to see some retracement or a consolidation before the next direction is decided.

For most of us we are better off staying out while the bulls and bears fight over the next direction. Once the winner looks clear we are happy to get back in.

Re-entering a trade

A big problem that many traders have is what to do if you are stopped out, whether it be with a profit or not. Take a look at the Man Group chart and you will see that you would have been stopped out. The share then continues to move back up. If you are stopped out and the share now continues to move back up you re enter and start again. In the Man Group case you would have lost around 20 points, but that did not matter as the share continues to rise.



Summary and conclusion to using stops

1. Don't place stops too close

While the text book may say to keep losing trades small, you have to realise that markets are far more volatile than they were 10 years ago. At the same time it is financial suicide to run a losing trade down to a massive loss. You can recover from a 10% or 20% loss but recovering from a 50% loss is very hard.

2. Have a stop loss strategy

Whatever strategy you do use make sure you stick to it. Don't keep moving stops because you do not want to take a loss, in most cases you will end up with a bigger loss that you will find hard to recover.

3. Trade stocks and markets you can afford

Don't trade the Nasdaq or a very volatile high technology stock when you are first starting out. Know what you are trading, look at the volatility or NTR for that market. Is the stock liquid, what is the spread, and what is the normal market size? All these factors will make a difference to your stop-loss levels. At the time of writing low volatility FTSE 100 stocks include: Land Securities, Boots, Scottish & Southern and Canary Wharf. Notice no telecoms or techs here.

In further editions we intend to return to stop-loss and exit strategies. One final word and this goes for trading and any business, you will never get in and out of every trade at the perfect time, it just doesn't happen. Understand that the key to successful trading is to balance the risk and reward and to profit from the main part of the trend.

