

Excerpt from **Life, Death & Rebirth: A Simple Guide to Outrageous Stock Market Profits** by Timothy C Schewe
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Stop Loss Orders (“Stops”)

At Confident Trader we almost *never* use stop loss orders. The rationale for employing stop loss orders is that when it comes to cutting/limiting your losses, they protect you from inopportune timing and insulate you from the vagaries of emotion. While we understand this train of thought we reject it.

Why?

A stop loss order is no guarantee that the pain you experience from a trade gone bad will be limited to that which was expected. Even under orderly and rational market conditions, there is generally a time lag between the triggering of a stop loss order and its actual execution. Thus, you might place a stop order around an obvious point of resistance and support, only to see the price fall even lower before the order goes through. Even under orderly and rational market conditions you are virtually guaranteed to sell at an even lower price than that intended. And market conditions are rarely orderly and rational, particularly when prices are falling through support.

Setting a stop loss order provides no room to consider the possibility of recovery. Stop orders consider only the aspect of price, ignoring volume. This oversimplifies things to the point of absurdity. Einstein once said, “Everything should be made as simple as possible, but not more so”. In this regard, setting stop losses is akin to setting your car’s cruise control when driving in precarious conditions. When things get dicey you don’t want to be turning control over to a mindless system, you want to be in control!

Failed breakouts and mistimed entries occur regularly. We are by nature emotional creatures. In order to become successful investors, one of the things we have to learn is how to make and execute decisions impassively. This ability comes with experience, which is gained only through practice. Setting mechanical stop losses only hinders this process.

Stop orders can tip your hand. There are thousands of professionals (mainly floor specialists and market makers) who have access to software that precisely logs each stop loss order. In the game of poker any kind of behavior that tips off your opponent as to the cards in your hand is known as a “tell”. In the stock

market a stop loss order is a “tell”, and if you are foolish enough to use one there is a high likelihood that you’ll get taken out.

Stop orders that look well-conceived may be premature. Another of the core reasons for employing stop loss orders is the preservation of capital. To accomplish this many people choose to execute what is known as a *trailing stop*. A trailing stop is based on a fixed percentage of change in a stocks price, typically 10% to 20% at any point in time. (For example: if you owned a stock valued at \$10.00 per share and placed your stop at \$9.00 you are guarding against a drop of more than 10 %.) However, the base for trailing stop orders travels with the stock’s peak high. (For example, if your \$10.00 stock rises to \$12.00, the trigger for a conventional stop loss order would remain at \$9.00, but with a trailing stop order it would now re-set to \$10.80.) As you study charts you will notice that many retracements and corrections easily pull back more than 10% and frequently more than 20% from the peak high. You will also note that occasionally toward the bottom of the trough or the end of the consolidation there will be a day or two when the price spikes down well below the previous lows, then recovers and closes near or at the days high. The most reasonable explanation for this is a stop running exercise pulled off by the pros to shake loose shares before the next leg up.

Don’t be lazy. Don’t be stupid. Don’t be a chump.

The only times that we use stops at Confident Trader are on those rare occasions (perhaps once or twice a year) when after taking the fourth 20% in profits off the table things are so ambiguous that we can’t decide what to do with the last 20%. In these cases only we’ll put in a trailing stop order at whatever percentage seems reasonable depending on recent price and volume action, and let it ride. If we get lucky, fine. If not, so what? We’ve already profited handsomely and if we’re stopped out at the low it’s still for a nice gain.

Cash preservation techniques are essential to excellent gains in the stock market over the long term. These techniques, in order to be effective need to be mindful, not mindless. While using stop loss orders may seem on the surface to be a prudent means of providing a safety net, in the long run they inevitably cost more than the benefit they presume to provide.