Tips for Traders | 9/7/2007

Do You Have a Love Hate Relationship With Stops?

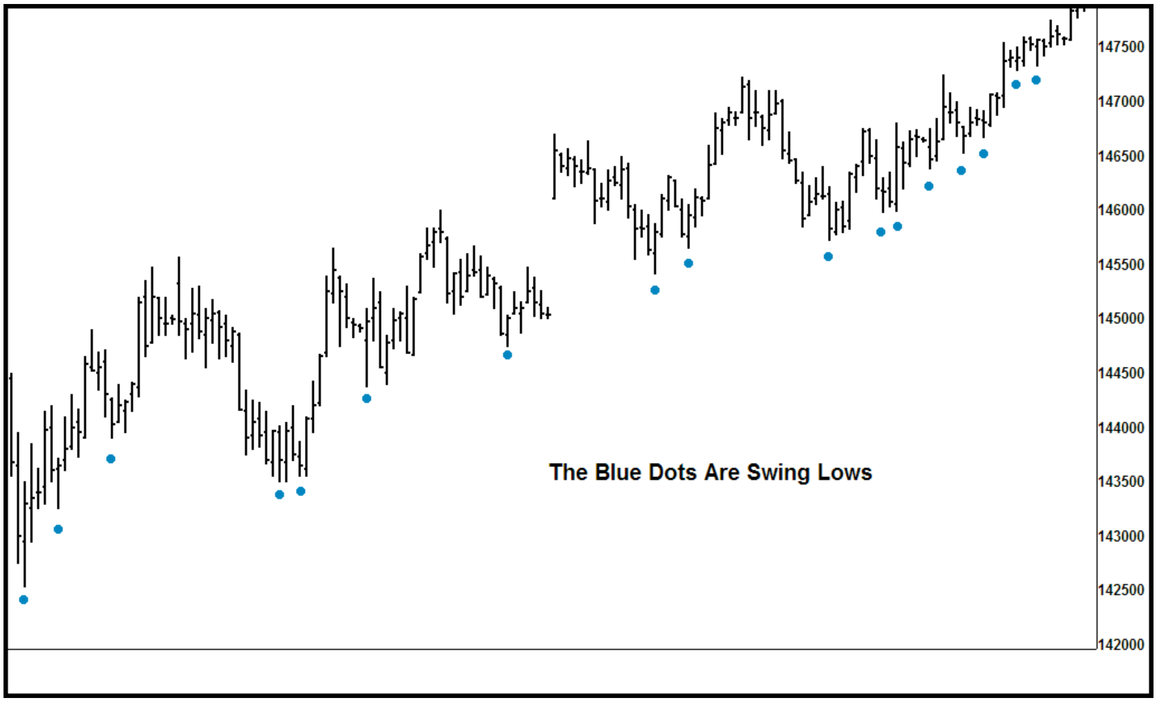
Money management is the most important part of your trading, like it or not. If you are weak on money management skills, no entry system or set up will be profitable over a long period of time. Correct stop loss placement, order management and risk reward selectivity are rarely the topics of popular seminars, because many traders go out of their way to ignore these important topics!

Let's cut the list down to make this discussion more manageable: How do you feel about your own use of stop loss orders? Do you dread placing stop loss orders because you just know that the market will 'run your order' and then head back in the original direction of the trend, leaving you with a loss while the market does exactly what you thought it would do?

Let me tell you about the very first seminar I gave for professional traders making the transition from floor traders to 'screen' or 'off-floor' traders at the Chicago Mercantile Exchange: A high profile floor trader from the S&P futures pit interrupted my explanation of where I was placing my stop loss order during a live trading demonstration by saying, "Stops are for losers." There was a nervous laugh around the room and I looked at him to try to judge if he was being serious. I asked him if he used stops in his trading. He said, quite proud, "I never use stops. I know when it's time to get out. But leaving stops in the market.that's just stupid. The stop will get run! That's giving money away!"

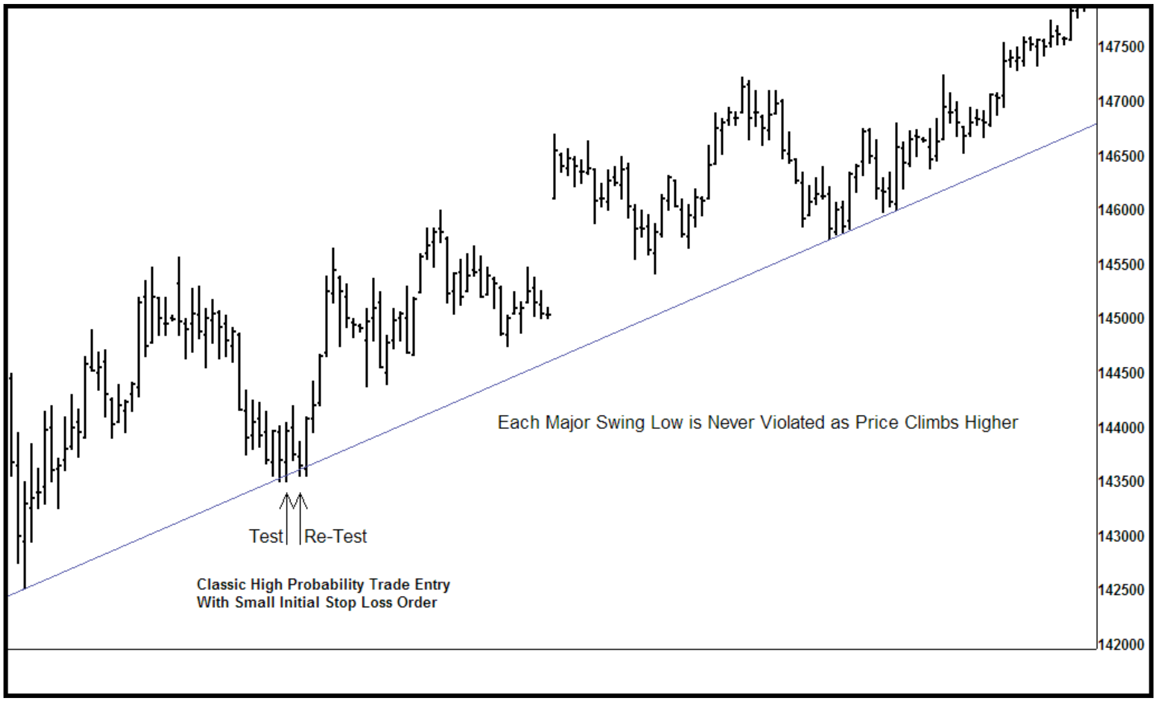
I gave three live trade examples during that seminar and each time, I'd ask him after I placed my stop loss order if he'd use a stop and if so, where? Each time, he said the same thing: "Stops are for losers!" I finally said to him that he should take all the money in his trading account and give it to his wife-or if he wasn't married, give it to me, so someone would still love him when he went bankrupt. There was another nervous laugh around the room and he gave me a blink and then a glaring look. You can guess the end of this story: He started trading 'off floor' and within three months, he had lost his entire trading account.

Here's a simple method I use to determine where to place my stops: Using thorough statistical analysis, I've gone back and tested each commodity, cash currency, futures contract and stock to find out just how 'noisy' each is. I want to know just how far price can move against the current trend and yet still 'return' to the direction of the trend. More important, I want to know on average, how far does price violate important areas like swing highs and lows and then return to the trend? Look at the following chart. You can see price is in a strong up trend and I have marked the swing lows with blue dots.



Now look closely at the swing lows and note that price rarely violates a major swing low. This is a day session only 15-minute chart of the S&P 500 futures market. You can see that by simply trading with the trend, finding a repeatable entry set up and most important, placing your stops underneath the swing lows in the case of an up trending market, your stops will protect you, not hinder you! If you keep moving the stops up under the next swing low as it is confirmed by new highs, you'll soon be 'boxing in profits' and find yourself working stop *profit* orders on a consistent basis. Let's see that chart again, in a trade context:

Let's not forget the 'noise' factor, though. My statistical testing tells me that in the E-Mini S&P futures market, for example, I need to place my orders at least three ticks below a swing low to stay away from the noise at those key levels. If I place my stop loss orders closer than that to the swing low, they are more likely to get 'run' and then price may return to the direction of the trend. I want my stop loss orders to protect me, but I also want to give the trade enough room to develop and mature as it unfolds.



Here's the 'noise factor' from some other popular markets:

US 30 year Bond Futures: 3 ticks
Euro Currency Futures: 5 ticks
E-Mini Russell Futures: 10 ticks [One full point]

It's time to embrace stops. Don't cringe when you place a stop loss order into the marketplace! Just use stop loss orders more effectively by hiding them underneath swing lows or above swing highs by an amount equal to or greater than the noise factor in that market. If you follow this simple idea for placing stops, you'll be in the market when it is trending and your stops will protect you when the trend has been truly violated.

I wish you all good trading!

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