STOP LOSS

What is Stop Loss?

A stop loss is an order to buy (or sell) a security once the price of the security climbed above (or dropped below) a specified stop price. When the specified stop price is reached, the stop order is entered as a market order (no limit) or a limit order (fixed or pre-determined price).

With a stop order, the trader does not have to actively monitor how a stock is performing. However because the order is triggered automatically when the stop price is reached, the stop price could be activated by a short-term fluctuation in a security's price. Once the stop price is reached, the stop order becomes a market order or a limit order.

In a fast-moving volatile market, the price at which the trade is executed may be much different from the stop price in the case of a market order. Alternatively in the case of a limit order the trade may or may not get executed at all. This happens when there are no buyers or sellers available at the limit price.

Types of Stop Loss order

1) Stop Loss Limit Order

A stop loss limit order is an order to buy a security at no more (or sell at no less) than a specified limit price. This gives the trader some control over the price at which the trade is executed, but may prevent the order from being executed.

A ***stop loss buy limit order*** can only be executed by the exchange at the limit price or lower. For example, if an trader is short and wants to protect his short position but doesn't want to pay more than Rs.100 for the stock, the investor can place a stop loss buy limit order to buy the stock at any price up to Rs.100. By entering a limit order rather than a market order, the investor will not be caught buying the stock at Rs.110 if the price rises sharply.

Alternatively a ***stop loss sell limit order*** can only be executed at the limit price or higher.

Advantages and disadvantages of the stop loss limit order

The main advantage of a stop loss limit order is that the trader has total control over the price at which the order is executed. The main disadvantage of the stop loss limit order is that in a fast moving volatile market your stop loss order may not get executed if there are no buyers/ sellers at the limit price.

2) Stop Loss Market Order

A stop loss market order is an order to buy (or sell) a security once the price of the security climbed above (or dropped below) a specified stop price. When the specified stop price is reached, the stop order is entered as a market order (no limit). In other words a stop loss market order is a order to buy or sell a security at the current market price prevailing at the time the stop order is triggered. This type of stop loss order gives the trader no control over the price at which the trade will be executed.

A ***sell stop market order*** is a order to sell at the best available price after the price goes below the stop price. A sell stop price is always below the current market price. For example, if an trader holds a stock currently valued at Rs.100 and is worried that the value may drop, he/she can place a sell stop order at Rs.90. If the share price drops to Rs.90, the exchange will sell the order at the next available price. This can limit the traders losses (if the stop price is at or below the purchase price) or lock in some of the profits.

A ***buy stop market order*** is typically used to limit a loss (or to protect an existing profit) on a short sale. A buy stop price is always above the current market price. For example, if an trader sells a stock short hoping the stock price goes down in order to book profits at a lower price, the trader may use a buy stop order to protect himself against losses if the price goes too high.

Advantages and disadvantages of the stop loss market order

The main advantage of a stop loss market order is that the stop loss order will always get executed. The main disadvantage of the stop loss market is that the trader has no control over the price at which the transaction is executed.

Conclusion

Stop loss orders are great insurance policies that cost you nothing and can save you a fortune. Unless you plan to hold a stock forever, you should consider using them to protect yourself.

A 2% Limit of Loss

A common level of acceptable loss for one's trading account is 2% of equity in the trading account. The capital in your trading account is your risk capital, the capital that you employ (that you risk) on a day-to-day basis to try to garner profits for your enterprise.

The loss-limit system can even be implemented before entering a trade. When you are deciding how much of a particular trading instrument to purchase, you would simultaneously calculate how much in losses you could sustain on that trade without breaching your 2% rule.
When establishing your position, you would also place a stop order within a maximum of 2% loss of the total equity in your account. Of course, your stop can be anywhere from a 0% to 2%

total loss. A lower level of risk is perfectly acceptable if the individual trade or philosophy demands it.

Every trader has a different reaction to the 2% rule of thumb. Many traders think that a 2% risk limit is too small and that it stifles their ability to engage in riskier trading decisions with a larger portion of their trading accounts. On the other hand, most professionals think that 2% is a ridiculously high level of risk and prefer losses to be limited to around half or one-quarter of a percent of their portfolios. Granted, the pros would naturally be more risk averse than those with smaller accounts--a 2% loss on a large portfolio is a devastating blow. Regardless of the size of your capital, it is wise to be conservative rather than aggressive when first devising your trading strategy.

Monthly Loss Limit of 6%

So, you have now established a system whereby your loss from each individual trade is limited to 2% of your risk capital. But it doesn't take a rocket scientist to realize that even losing a moderate 1% of your account's value in ten days within a month results in a rather devastating 10% of your account's value within that month (notwithstanding any profits that you might have made in the other twelve-odd trading days within the month). In addition to limiting losses from individual trades, we must establish a circuit breaker that prevents extensive overall losses during a period of time.

A useful rule of thumb for overall monthly losses is a maximum of 6% of your portfolio. As soon as your account equity dips to 6% below that which it registered on the last day of the previous month, stop trading! Yes, you heard me correctly. When you have hit your 6% loss limit, cease trading entirely for the rest of the month. In fact, when your 6% circuit breaker is tripped, go even further and close all of your outstanding positions, and spend the rest of the month on the sidelines. Take the last days of the month to regroup, analyze the problems, observe the markets, and prepare for re-entry when you are confident that you can prevent a similar occurrence in the following month.

How do you go about instituting the 6% loss-limiting system? You have to calculate your equity each and every day. This includes all of the cash in your trading account, cash equivalents, and the current market value of all open positions in your account. Compare this daily total with your equity total on the last trading day of the previous month and, if you are approaching the 6% threshold, prepare to cease trading.

Employing a 6% monthly loss limit allows the trader to hold three open positions with potential for 2% losses each, or six open positions with a potential for 1% losses each, and so forth.

Making Necessary Adjustments

Of course, the fluid nature of both the 2% single trade limit and the 6% monthly loss limit means that you must re-calibrate your trading positions every month. If, for example, you enter a new month having realized significant profits the previous month, you will adjust your stops and the sizes of your orders so that no more than 2% of the newly calculated total equity is exposed to a risk of losses. At the same time, when your account rises in value by the end of the month, the 6% rule of thumb will allow you to trade with larger positions the following month. Unfortunately, the reverse is also true: if you lose money in a month, the smaller capital base the following month will ensure that your trading positions are smaller.

Both the 2% and the 6% rule allow you to pyramid, or add to your winning positions when you are on a roll. If your position runs into positive territory, you can move your stop above break-even and then buy more of the same stock--as long as the risk on the new aggregate position is no more than 2% of your account equity, and your total account risk is less than 6%. Adding a system of pyramiding into the equation allows you to extend profitable positions with absolutely no commensurate increase in your risk thresholds.

Why Do We Recommend the Stop Loss Order?

First of all, the beauty of the stop-loss order is that it costs nothing to implement. Your regular commission is charged only once the stop-loss price has been reached and the stock must be sold. It's like a free insurance policy!

Secondly, but most importantly, a stop-loss allows decision making to be free from any emotional influences. People tend to fall in love with stocks; we believe that if we give a stock another chance, it will come around. This causes us to procrastinate and delay, giving the stock yet another chance and then yet another. In the meantime, the losses mount....

No matter what type of investor you are, you should know why you own a stock. A value investor's criteria will be different from that of a growth investor, which will be different still from an active trader. Any one strategy may work, but only if you stick to the strategy. This also means that if you are a hardcore buy and hold investor, your stop-loss orders are next to useless. If you plan on holding a stock for the next decade there is no reason to place a stop. The point here is to be confident in your strategy and carry through with your plan. Stop-loss orders help us stay on track without clouding our judgment with emotion.

Finally, it's important to realize that stop-loss orders do not guarantee you'll make money in the stock market; you still have to make intelligent investment or trading decisions. If you don't, you'll lose just as much money as you would without a stop-loss, only at a much slower rate.

Conclusion

The 2% and the 6% rules of thumb are highly recommended for all traders, especially those who are prone to the emotional pain of experienced losses. If you are more risk averse, by all means, adjust the percentage loss limiters to lower numbers than 2% and 6%. It is not recommended, however, that you increase your thresholds--the pros rarely stray above such potential for losses, so do think twice before you increase your risk thresholds.

A stop loss order is such a simple little tool, yet so many traders fail to use it. Whether to prevent excessive losses or to lock-in profits, nearly all investing styles can benefit from this trade. Think of a stop loss as an insurance policy: you hope you never have to use it, but it's good to know you have the protection if you need it.