



## >: Stop Losing Money in the Markets. Here's How

Thursday, October 29, 2009 / Bob De Dea

Novice skydivers who don't jump solo have an instructor with whom they dive, strapped to their backs.

That way, if panic (or overwhelming wonder) sets in and the new jumper forgets to pull the ripcord for the parachute, the instructor's got his or her back.

Likewise, investors have a means by which we can prevent our positions from going *splat* all over our bottom line.

The investing equivalent of a ripcord is called a stop-loss.

### **Know When to 'Say When'**

Learning how to establish and use stop-losses effectively has saved my shirt from being ripped from my back on more than one occasion. Today, I'll show you how you can use your brokerage to automatically pull the ripcord on unproductive trades.

[Teeka Tiwari](#) has very specific rules for controlling losses. (In fact, if you haven't set up your own rules to follow as an investor, you're playing with fire.)

Big T recommends, for example, [not risking more than 3% of your entire portfolio on any one trade](#).

So if I have a \$100,000 portfolio, does this mean that I can only invest \$3,000 in a position?

Well, yes and no.

### **It's Not What You Invest; It's How You Manage It**

Let's start with the **no.**

What it means is that I don't risk more than \$3,000 in any one trade. So if I buy 1,000 shares of LMN at \$20, I've established a \$20,000 position.

Not risking more than \$3,000 would mean that I set my sell stop-loss at \$17. So, if the security should fall, it will be sold at \$17, thus limiting my loss to \$3,000.

Another example: I buy 500 shares of OPQ for \$100 a share for a \$50,000 position. I would set my sell stop-loss at \$94 ( $\$3,000 / 500 \text{ shares} = \$6 \text{ per share}$ ;  $\$100 - \$6 = \$94$ ).

One more example in the reverse direction: I sell short 250 shares of CBA for \$90 a share. I would set my buy stop-loss at \$102 ( $\$3,000 / 250 \text{ shares} = \$12 \text{ per share}$ ;  $\$90 + \$12 = \$102$ ). That way, if the stock goes up when I expect it to go down, I'll cover my short before I lose more than \$3,000.

This is not a hard-and-fast percentage. You may feel more secure setting a tighter stop-loss than

3% -- say, 1.5% or 2%. It depends on the size of the trade and your own comfort level.

A couple of things to know:

### **1. There are different kinds of stop-losses.**

A plain vanilla **stop-loss order**

turns into a market order when the specified stop price is reached. And, as you may know, a **market order** doesn't mean you'll get your price, but executes at the next-*available* price.

*So, a simple stop-loss guarantees execution of the order, but not the price.*

On the other hand, you could use a **stop-limit order**.

A stop-limit order turns into an **open-limit order** when the specified stop price is at, or lower/higher than, the bid price.

In this case of a **sell-stop limit**

, for example, the security may dip below your stop price and never come back up to it. The same holds true for a **buy-stop limit** if the security's price rises higher than your stop price.

*So, a stop-limit guarantees your price, but not the execution of the order.*

In either case, it's also possible for your order to be *partially* executed.

### **2. There is also a creature called a trailing stop-loss.**

A trailing stop is a great way to take advantage of an upward trend when riding a wave (or a downward trend when shorting). Most full-service brokerages offer trailing stop-losses in a variety of flavors:

#### ***The Dollar Amount Trailing Stop-Loss***

In my first example above (1,000 shares of LMN @ \$20), I would want to limit my loss to \$3 per share, so I could set a trailing stop-loss of \$3.

If the stock goes from \$20 to \$17, it will trigger the stop-loss. But if the stock goes up to \$23.50 and then heads down again, the trailing stop-loss follows it up and resets, so it would then be triggered at \$20.50.

*(Important Note: The stop price always stays the trail dollar amount away from the last trade with positive movement. In other words, it doesn't adjust if the security moves against the order.)*

I would sell it at a 50-cents-per-share profit, minus my commission fees.

Remember, the trailing dollar amount stays the same, whether the stock doubles or triples. If LMN goes from \$20 to \$50 then descends, the trailing stop-loss will execute a trade at \$47.

#### ***The Percentage Trailing Stop-Loss***

This is similar to the dollar amount trailing stop, but is based on the current price -- not a dollar

amount.

You can set a trailing stop-loss percentage from 1% to 30% (whole numbers only). This gets a little tricky because it requires an upfront determination of risk.

If I hold to the \$3-per-share maximum loss for LMN I would set my trailing stop loss at 15% ( $\$3 / 20$ ). If it reaches \$17, it will trigger a trade. But if it goes up to \$23.50, the trailing stop-loss won't be triggered until it reaches \$19.98 ( $\$23.50 - \$3.52$  ( $15\% \times \$23.50$ ) rounded).

I would sell it at a loss of 2 cents per share plus commissions. If it reaches \$50 and topples, the percentage trailing stop-loss doesn't kick in until \$42.50.

### **Happy Trails...**

The difference between the two is that, during a violent market, you're more likely to get stopped out with the dollar amount trailing stop, whereas with the percentage, you're giving up potential profit for a little flexibility.

But wait, there's more!

The above trailing stop losses act as market orders when executed. ***A Dollar Amount or Percentage Trailing Stop-Limit Order***

works just like its brethren above, except that the order becomes a limit order instead of a market order.

The limit price is the last stop set before the order was triggered.

The same risks apply here as to stop-losses and stop limits. Note that you can base any trailing stop-loss or -limit on either the LAST price or the BID or ASK price.

And you can also set Dollar Amount Trailing Stop-Losses and -Limits for options.

### **About That '3% Rule'**

Speaking of options, it's about time I addressed the **'yes?'** part of the answer to my question above. ("So if I have a \$100,000 portfolio, does this mean that I can only invest \$3,000 in a position?")

If you are an options investor, you could spend the \$3,000 to buy calls or puts on LMN (or OPQ or CBA) and consider this your at-risk amount. In effect **the investment becomes your stop-loss** and you just ride the option out.

I'm sure this doesn't exhaust the possible strategies for stop-losses. I welcome you to share yours

below.



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