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STRATEGIES FOR SUCCESSFUL INVESTING

MARKET WISDOM

Beware Of

THE FORCE

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I AM FREQUENTLY ASKED WHETHER we at ValueTrend use "stop loss orders" to limit our downside on a trade gone badly. After all, the tagline for ValueTrend Wealth Management is "Limit your risk. Keep your money". You'd think that we'd be all over the concept of preventing losses by using stop's, wouldn't you?

In theory, setting a stop loss on a stock should work to reduce losses. Let's say you buy a stock at $10, and have a stop loss order sit just under your price –let's say you want to contain your loss to 10 per cent. So you enter the stop loss order to trigger at $9 – which theoretically limits your loss to 10 per cent. After all, the trader / the computer has to immediately trigger a sell on the stock if as and when the stock hits $9. If it stays above $9 – you keep the stock, and hopefully realizes its ultimate upside. A perfect world!

Not so fast! I'm going to condense 30 years of trading stocks professionally into one succinct discussion on why I don't use stop losses. I've used them in the past, and learned some valuable lessons. Here is why I've learned not to use stop loss orders:

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There *is* volatility!

Fact is, stocks gap down for negative breaking news, lousy earnings reports, false news, rumors, computerized trading, institutional selling, and many other reasons. Let's say such a news event hits your stock. Suddenly, your stop loss is triggered. But it won't necessarily be sold at your $9 stop price. Instead, it will be triggered at the next available market price. In a fast moving market, you will often see your stock sold into a knee-jerk overreaction to the news. A few days later, the stock is back to your old price. But you aren't in it any longer.

To put it bluntly, your stock will very often be automatically sold at the lowest price in such situations. Instead of limiting your loss to 10 per cent, it may be substantially more. And, you may regret the sale later.

Below is a stop loss failure that might have happened to a short-term trader on Blackberry. Yeah, I know–most of us trade a bit longer termed than this example, but let's just use this for easy illustration. Green arrows mark the trades. The stop was set at $13.00 having bought at $13.80 on a breakout. It triggered with a rapid markdown finishing the day at $12.50 – but I assume the trader got out a dime over that at $12.60. Three weeks later, the trader was found in a bar, drinking heavily. There are hundreds of such failed examples of computer-entered stops you will spot on charts.

But wait, there's more….

The dark side of the force

Did you know that when you place a stop loss order, that order is transparent? Market-makers on the stock see your order and often "run the stops." This occurs when the stock is forced low enough to trigger a large cluster of stop loss orders . Market makers, and other pro's, know that round numbers or obvious support levels are popular with amateurs using stop loss orders. Computers recognize these retail stop loss patterns and can execute in a heartbeat. Your stock gets popped out with the rest of the less informed investors holding stops at this well-represented, stop-price. Then, the stock reverses direction and rallies.

Humans still matter

Stop losses are like self-driving cars. Yes, they are convenient, but you are relying on a machine to look after you. Seems that Google and Uber have discovered that auto-pilot technology is great …. EXCEPT at busy intersections with jaywalking passengers, complex traffic patterns, bicycle traffic, etc. Yup – humans can outdrive a robot in these conditions. Similarly, stop losses seem like a good idea…. until the above situations occur, and human judgement would have prevented trading losses.

Technical analysis allows us to set mental stop losses. By using my "3 bar rule" per my book Sideways – you will hold the stock for at least 3 days after a support level is breached (or 3 weeks if you have a longer horizon). You are in control. No pro trader is taking advantage of you. No whipsaw news item will sell you out at a deep loss – only to watch the stock rise again. ▼

Keith Richards, CMT, CIM, FCSI Keith has been in the securities industry since 1990 . As portfolio manager and founder of ValueTrend Wealth Management, he manages $150 million in assets and runs a discretionary investment service for high-net-worth clients. ValueTrend Wealth Management was recently selected to receive the 2019 Canadian Business Excellence Award for Private Businesses - having received it in 2017 as well. Mr. Richards' articles and interviews appear regularly in Investors Digest, The Moneyletter, MoneySaver, the Globe and Mail and the Toronto Star newspapers. His appearances on Bloomberg/BNN Television have inspired producers to acknowledge him as "one of [our] most accurate technical analysts." Mr. Richards' books, SmartBounce: 3 Action Steps to Portfolio Recovery and Sideways: Using the Power of Technical Analysis to Profit in Uncertain Times, are available in bookstores.