The Value of a Stop-Loss Strategy

Why you may want to have one in place in any market climate.

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What is a stop-loss strategy, and how can it potentially aid an investor? Savvy investors use stop-loss orders as a kind of "insurance" against stock market losses. Simply explained, a stop-loss order is an order you give to a brokerage to sell a stock when the share price falls to a certain level.

A stop-loss strategy may be used to preserve gains and alleviate downside risk. Say you buy 10 shares at $60 a share, and eight months later the price is at $68 a share. You place a stop-loss order with your broker, telling your broker you want to sell if the share price dips to $66. One day, the share price falls to that level, and the stop-loss order becomes a market order authorizing a trade. If the market (or market sector) dives quickly, you may not be able to sell your shares for $66, but you will likely be able to sell them near that price.[1]

You can also employ trailing stops as part of a stop-loss strategy. This can be useful with a growth stock. As an example, suppose you buy into a company at $20 a share, and two years later, the share price stands at $35 and seems poised to rise further. Is it time for profit-taking, or should you hang on to those shares a bit longer?

A trailing stop may provide an answer to this dilemma. When you put a trailing stop in place, you authorize your broker to sell the stock when the price dips a certain percentage below the current market value – say, 10% under market price. So if shares move up to $50, then fall to $45, you are able to sell at or near $45, and you profit more than you would had you sold at $35.[2]

The trailing stop moves up as the share price moves up. Obviously, you do not want to set the trailing stop only a handful of percentage points below the current price, because that could mean activating the stop too soon.

Profit targets are also part of stop-loss strategies. When the price of a stock reaches a certain level – a target price – you sell. In setting a profit target, you know when to get out, and you know your degree of profit as you close the trade.

How much gain do you need to break even or profit? Here is the key question in a stop-loss strategy. Reaching a price target represents a win, and a stop-loss represents a loss. At a glance, it seems easy to gauge whether your stop-loss strategy is a success: the wins merely have to exceed the losses. The evaluation is not quite that simple. You can use relatively simple math to figure out your break-even percentage: (Stop Loss ÷ (Target + Stop Loss)) x 100.[3]

For the sake of simplicity, say your average loss is $100 and your average target $200. The calculation becomes: (100 ÷ (200 + 100)) x 100, or 0.33 x 100 = 33%. Commissions aside, you

need to win on 33% of your trades to break even. Win more trades than that and you are profiting.

When exactly will you break even or profit? Time will tell, but the answer may directly relate to the difference in your loss level and your target level. If your target level is way above your loss level, in theory you will have to win very few trades to profit – but in reality, you may have a hard time winning any trades, and your strategy could fail. When your target level is closer to your loss level, you must win more often to break even, but winning may become easier for you.

A stop-loss strategy could help you sustain the income stream from your portfolio. A little reflection will reveal why. When Wall Street slumps, a buy-and-hold investor can become a buy-and-fold investor, hanging onto losers too long and then selling them at or near a market bottom. Alternately, an investor may fall in love with a winner so much that no profit is ever taken – he or she learns a tough lesson when its share price falls and the opportunity to sell high is lost. Having price targets and stop orders in place takes some of the emotion out of trading in these circumstances, helping to mitigate losses and lock in gains.

Sure, there are potential drawbacks to a stop-loss strategy. Some people prefer price alerts to automatic stop-losses, because they want to stay hands-on and not cede control of trades to software and algorithms – and in a steep market drop, those algorithms may quickly drive a stock's price well under a stop in the blink of an eye. An opportunity cost can also be paid with the use of price targets – maybe this or that stock clearly has more upside, and it really feels like you are selling too soon when the target is reached. These points aside, a well-considered stop-loss strategy may have real value for an investor, especially one who does not actively trade stocks on a day-to-day basis.

Citations.

1 - investopedia.com/ask/answers/06/stoplossorderdetails.asp [1/4/18]
2 - thebalance.com/trailing-stop-1031394 [7/25/17]
3 - thebalance.com/calculating-your-break-even-percentage-1031085 [10/14/16]

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