



Reflections on the Stop Loss

The subject of this article is the “Stop Loss”. By this we mean the exit point for a trade if it goes wrong after it is initiated. Without a stop loss as part of your trading routine you are in danger of a huge capital and worse, psychological loss. Even if you have a very high hit rate of successful entries it only takes one unprotected trade to wipe you out.

Exercising a stop loss should be like brushing your teeth: good trading hygiene. Exercising a stop however has deeper psychological implications. It means the initial entry was incorrect. If you are trading for ego rather than profit this can be a blow. So much so that amateurs and beginners will be tempted to ignore the stop “in case the market comes back”. It usually doesn’t, so the one who lets the stop go is essentially in denial: he or she would prefer his or her view to prevail; even if the market reality presented to them is that the trade is not working and should be discontinued.

Now let’s delve deeper into the stop loss.

A vast improvement in outcomes occurs when the trader consistently uses the stop loss, but unfortunately this will not lead to superior profits. Relying on a rigid stop loss alone probably means the trader will break even or slightly better. Why is this so?

A stop loss is like house insurance. You pay the premium but you never want to use it. If you saw a small fire on the kitchen bench, you wouldn’t just say it doesn’t matter if the whole house burns down because I have insurance and I can just cash it in. No, you would put the fire out immediately if you could. (The amateur without a stop loss trades without house insurance and hopes the fire in the kitchen will go out of its own accord).

What I am saying here is that relying on a fixed stop loss is a passive approach to the market. It’s creating a worse case scenario defensive situation. The stop might be 2 ATR or 1% of capital away but watching as your stop is about to become hit means you are not prepared to take responsibility or act by putting the small fire out while you can.

I’m not saying that when you enter a trade you do not need a stop loss. It’s a must, just like insurance is for the home owner. But you shouldn’t just rely on the worst case scenario as the trade plays out.

The market pays you for your agreeing with it. It doesn’t have to agree with your view or position. It doesn’t have to go up just because you buy.



When you enter a trade it must be for a reason. If the market confirms your entry then you would hold the position with a view to working it as long as your trade was in accord with the market.

But what would happen if just after your entry the market contradicts rather than confirms the entry? Rather than let your insurance stop come into play, wouldn't you be better off to exit the position immediately. (Put out the fire when it is small!) This is what professional traders call a "Scratch" trade. Not only would you save some capital, but also you save yourself psychologically for a new entry as soon as it is indicated. This way you are aligned with the market with very small losses.

Let me give you an example using real data from my files.

A client came to me after a very bad experience in day trading the Australian SPI. He performed 312 consecutive trades in a 3 month period. His hit rate (Wins out of the total entries) was 37% and he lost 384 points. At \$25 a point this is a sizeable sum of money to lose. He was aggressive but not prepared to take control of his outcomes.

Basically he didn't employ a stop loss consistently although he was meant to have a 10 point stop. Let's see what would happen under these various scenarios applied to his data: same entries, but employing rigorous defence.

| Action | Outcome |
|---------------|----------------|
| No stop | -384 points |
| 10 point stop | +133 points |
| 8 point stop | +321 points |
| 5 point stop | +699 points |

Isn't this data striking?

It shows that a 10 point defensive stop avoids a calamity but a 5 point scratch stop enables very good profit. This data discounts the worry whether a scratched trade comes back after its execution. In the example above, on a few occasions the trade did come back after being scratched where it would have been advantageous not to scratch. But nevertheless it was not so often to make it worth ignoring the scratch rule for a couple of exceptions.



Lest you think that this idea applies only to day traders here is another data set. These are the actual results, juxtaposed with a scratch and \$200 stop of a position trader with \$100,000 and an \$800 stop (0.8 % of capital). This trader held the positions derived from chart patterns that could last for days.

| 2009 | Actual | Scratch | \$200 Stop |
|--------------|---------------|----------------|-------------------|
| January | -8021 | 124 | -2559 |
| February | 1231 | 4740 | 2992 |
| March | 11442 | 18662 | 15889 |
| April | -2015 | 4440 | 3372 |
| May | 8299 | 16839 | 13870 |
| June | 528 | 10182 | 7843 |
| July | -12171 | 173 | -2716 |
| August | 6409 | 14300 | 10807 |
| September | 4848 | 9219 | 8210 |
| October | 9241 | 18886 | 14978 |
| Total | 19771 | 97565 | 72596 |

By itself the \$800 stop gave a satisfactory return of 20% for the 10 months. It beats most superannuation funds for the period. But the results are quite unsatisfactory for what was possible if he traded out of the position when the market did not confirm it. His return applying the scratch rule was 97% for the period, some 5 times better than what he actually received. Even with some leeway on the scratch to the tune of -\$200, he achieved a 72% return for the period. Not bad!

The evidence from these 2 case studies should make you very aware of some of the drawbacks of the traditional inflexible worst case scenario initial stop loss. It is psychologically comfortable to have your stop in place and for investors it is probably a sound strategy. But for a trader it restricts profit.



A trader should know before initiating entry of a trade what information is required from the market to confirm the entry. If the market doesn't confirm the entry, then watching, waiting and hoping is not a strategy. There is only one thing a trader should do in this case and that is to terminate the trade and go on to the next opportunity to get into agreement with the market. Psychologically the scratch trade means that the trader is detached, objective and market aware, able to take decisive action if the market requires it. A trade is not scratched through fear or timidity. It is scratched because the trader has the courage to take responsibility for an action that is appropriate to the market conditions that prevail at the time.

Scratching is a dynamic, flexible and market focused stop loss strategy that really works as the data in this article shows. It is a new skill that every trader needs to learn. Through discipline and practice you can learn the skill and benefit from its application. When you ace it, you are on your way to becoming a trading professional.