

Planning Your Losses

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(April 14, 2002) – I received dozens of emails following my recent chatroom class with Linda Raschke. The question I heard most often concerned the setting of stops. Specifically, traders were interested in learning how I set my stops, especially with trades that lasted an average of less than 30 minutes.

I believe that a key to successful trading is learning how to become comfortable with taking a loss. We know that markets, while not perfectly efficient, are largely so; complete predictability is never going to be attained by mortal traders. That makes trading a bit like hitting in baseball, where one can achieve a high degree of expertise, even while making frequent outs.

Losing traders often bring a measure of perfectionism to their work. They equate a good trading day with a profitable day. No, no, no! A good trading day is one in which you have followed your well-researched plan with focus and discipline. Good trading days, over time, will generate profits. But the uncertainty of the markets means that even the best laid trading plans can go awry. *In the short-run, you cannot control your profitability.* You **can** control whether or not you have good trading days, which **will** generate profits over the long haul—**if** you have adequately researched your strategies.

Broken clocks are right twice daily and even unresearched strategies implemented impulsively can occasionally yield profits. Those might **seem** like good trading days, but in reality, they reinforce the very qualities associated with failure.

The perfectionistic trader equates taking a loss with experiencing failure. The loss thus sets up a rash of negative internal dialogues and subsequent trades born of frustration. A more realistic trader realizes that there is a degree of uncertainty built into the market and that losses are simply a cost of doing business. The goal is to limit these losses as effectively as possible, not will them away or becoming preoccupied with them.

Stop Loss Scheme #1: Price-Based

In this article, I will cover three basic stop-loss strategies: price-based, time-based, and indicator-based. All of these can be rehearsed in advance to make the taking of losses more automatic (i.e., less emotional).

Most traders are familiar with price-based stops (though not all adhere to them!). I utilize price-based stops as a last resort in losing situations, when time and indicators won't take me out of a trade.

As I indicated in the chatroom, I view every trade as a hypothesis. If I am buying the SP on a one-minute time frame, it is because I have identified a candidate low point in that market. Perhaps I have noticed that the Dow and NYSE Composite TICK values have dropped to significant negative values, but that price has held above its prior low. I

may place my order to buy with that prior low serving as my stop point. I have hypothesized that the prior low was an important low and that this pullback is the first in an upswing. If we return to that prior low, my hypothesis was not supported and I need to retrieve my remaining capital.

A key to making such price-based stops work is setting your entries near your hypothesized high and low points so that losses will not be excessive when your hypotheses fail to pan out. On short term trades, this means that I am examining one-minute and five minute charts along with my market-maker screen for bids and asks. Remember, if the patterns you are trading only historically test out with 50% winners, you must keep the size of the losers much smaller than the average winners to make your system profitable!

Stop Loss Scheme #2: Time-Based

The second stop-loss approach makes use of time. One system I trade was designed for a holding period of 21 minutes in order to capture 3 S&P points. If the desired profit has not been achieved in 21 minutes, I exit the trade—even if my price stop has not been hit.

The logic for such a time-based stop is as follows: I try to enter short-term trades where momentum is increasing in the direction of my trade. If I have been successful, the position should become profitable fairly quickly. If the market stays flat to slightly down when I have taken a long position in a market, it means that I did not read the momentum correctly. That, too, is an invalidated hypothesis. I have learned from hard experience that when a trade stays flat, I was probably **right** about the direction of the move, but that the flat move is all the direction is going to give me. That means the next move is likely to be one that will hit my price stops. The time-based stop thus allows me to scratch a trade rather than lose a point or two.

One of the few rigid laws in trading is that risk and reward per trade are proportional to the holding period. When designing your trading approach, I encourage you to factor holding period into account as a way of suiting your methods to your personality and risk-tolerance. I designed the 21 minute system by researching the best predictors of 3+point profits in the S&P over various brief time spans. I examined dozens of indicators—volatility, momentum, volume, intraday advances/declines, various TICK figures, sector indices, intraday new highs/new lows, index futures premiums, intraday put/call figures, intraday TRIN, etc.—to come up with something that tested well and held up against independent data. Once the system was built, the time-based stop was already built in, supplementing my price stops.

Stop Loss Scheme #3: Indicator-Based

The third stop-loss methodology is indicator based. As I suggested above, many of the predictors that I utilize in my trading are intraday versions of common stock market indicators, such as advances/declines, new highs/new lows, and volume. I spend

much time testing these indicators against prospective price action, since the relationships among the indicators—and between indicators and price—are always shifting. For example, the blending of the predictors in the 21 minute system that I utilize today may not be (and probably won't be) the blending I will be using next year. My goal is to identify what has been working in the market and keep doing it—until it degrades.

A large part of the research that goes into developing such trading approaches is determining what happens when the indicators that are candidate predictors hit extreme values. Will the extreme indicator reading produce a continuation of the trend or will it predict reversal? Such information can be helpful in setting stops.

For example, one of my trading frameworks utilizes a two hour average holding period. The NYSE Composite TICK is an important predictor for this approach. I recently researched what happens when the TICK breaks out of its two hour range. Interestingly, when the TICK significantly breaks above its range, the broad market averages move upward by .20% over the next several hours. When the TICK significantly breaks below its range, the averages decline a further -.11%. (This corresponds to an average gain of around 2 SP points versus a loss of a point).

Over my testing period, the market was up 148 times and down 184 times when the TICK made a downside breakout. It was up 205 times and down 121 times when the breakout was to the upside.

Armed with such research, I created an indicator-based stop. If the TICK breaks out to a significant new high or new low against me (i.e., a new high if I am short; a new low if I'm long), I exit the trade—even if my price stop has not been hit. (In certain situations I might even stop and reverse, given the bias for short-term continuation in the direction of the TICK breakout).

If you take the time to research intraday indicators at various time frames, you can create indicator-based stops to fit your trading style and approach.

Using Stops as a Psychological Tool

Once stops are set, they can be mentally rehearsed while the trade is on as a way of ensuring that they will be honored. A good loss is a planned one; the only true market failures are the ones that are unintended.

I have reviewed the writings of a number of trading mentors: Linda Raschke, Ken Wolff, Mark Cook, Ari Kiev, Alexander Elder, Mark Douglas, and the many others interviewed in Jack Schwager's wonderful Market Wizards books. To a person, these successful traders and coaches emphasize that discipline is at the heart of exemplary trading. When you set, rehearse, and honor stops, you are building that discipline and using your losses to reinforce the qualities needed for success.

It is an irony that successful traders plan for “failure”; unsuccessful ones fail to plan.

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