TRADING ACADEMY

LEVEL-1: COMPLETE GUIDE TO
TRADING FOREX & CFDs

MODULE-1
MECHANICS OF TRADING

SECTION-8

STOP LOSSES

TRADING ACADEMY LIMITED

MODULE-1: SETUP PHASE / THE MECHANICS OF TRADING

SECTION-8: STOP LOSSES

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PREVIEW

ABOUT THIS SECTION

This section will cover the topic of stop losses in greater detail and the use of them in their variety of capacities. Stop losses encompass a critical element of money management and risk management tactics when trading, and are therefore extremely important to implement when accessing the markets. In essence stop losses are a necessity as they work to protect you from further losses and to protect capital as your trades progress.

This section will also cover the concept of slippage and weekend gaps and how allowing for these variables should be part of your trade management and trade plan, as a result covering what is good practice and good habit trading.

SECTION OBJECTIVES

At the end of this section you should:

- Have an understanding of the use of stop losses

- Have practiced the use of stop losses

- Be able to explain the purpose of risk management

- Be able to describe a hard stop loss

- Be able to describe a break even stop loss

- Be able to explain the use of trailing stop losses

- Be able to explain slippage and the weekend gap

8. OVERVIEW OF STOP LOSSES

8.1: STOP LOSSES FOR RISK MANAGEMENT

Trading involves a certain element of probability, and whilst calculative analysis should be employed before the execution of any trade, stop losses are a critical aspect of trade management because they allow you to protect and manage your capital by essentially stopping further losses than already exposed on open market positions. Stop losses represent the risk component to the trade.

An investor inherently takes on an investment with a long term prospect in mind, anticipating a possible downturn in performance for sometime before the investment potentially turns in ones long term favour. A trader however, enters a trade with protection in the form of a stop loss as an exit strategy to protect his or her trading capital should the trade take a turn in performance contrary to the trader's desired result.

Typically forex traders generally enter the markets frequently with relatively short-term positions in quest of smaller, short-term gains, using stop losses as a money management mechanism to protect trading capital, by providing an exit clause typically with a small percentage of capital as risk exposure relative to ones trading account.

Stop losses provide a pre-determined exit price should the trade go against the initial trade analysis and they work in a capacity to protect further loss than the initial exposure placed, subject to any slippage that can be experienced by the broker depending on the liquidity provider used or bank backing the broker.

Stop losses can be used to free the risk of a trade when the trade moves into profit through modifying the stop loss by moving it to the entry price or beyond to secure what profit is available.

Stop losses can also be used to protect profits as a trade continues to move in the desired direction. Exiting a trade effectively is paramount to the learning experience to ensure profits are either captured when available, risk is cleared during a trade or trades are exited with minimal loss. The stop loss helps automate this part of trading and can essentially provide a safer and better trading experience when adequately used.

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8.2: STOP LOSSES

Stop losses are ultimately used as an exit strategy to get of a trade when it turns in the negative. Yet there are so many components to a trade that stop losses can also be used to control your trade in the positive and are therefore one of the most vital and used functions of the order ticket. Stops once placed, protect your trade from going further into loss and then as the trade progresses the stop loss is used to lessen the amount of risk exposed and eventually start to protect the available profits.

The first rule of thumb when trading is risk management and capital protection by ensuring a stop loss is implemented correctly. The second rule of thumb is referred to as freeing the risk of the trade. This occurs when the stop loss is moved from the preset price to the original entry price once the trade moves a significant way into profit therefore removing any of the risk of the open position.

This technique is commonly used when the trade has moved a certain amount of pips or points in profit and confidence is present that the trade has left the station and is venturing on its way towards the take profit value. The value of risk initially put up for the trade in the stop loss component has been removed and the trade is now running risk free.

In the event the trade turns against the desired direction and comes back to touch the entry price the trade will be will be stopped out on zero and no loss is experienced resulting in a zero trade. As a trader you move on and continue to look for better setups.

As the trade moves further into profit the stop loss is used as a tool to capture and protect more profit along the way still maintaining its functionality as a way to exit a trade, but only once the risk is cleared the stop loss is now looked at as a way to protect further profit and close the gap between the stop loss and the take profit value. *(Fig 8.1)*

FIG 8.1: STOP LOSS - BASIC OVERVIEW
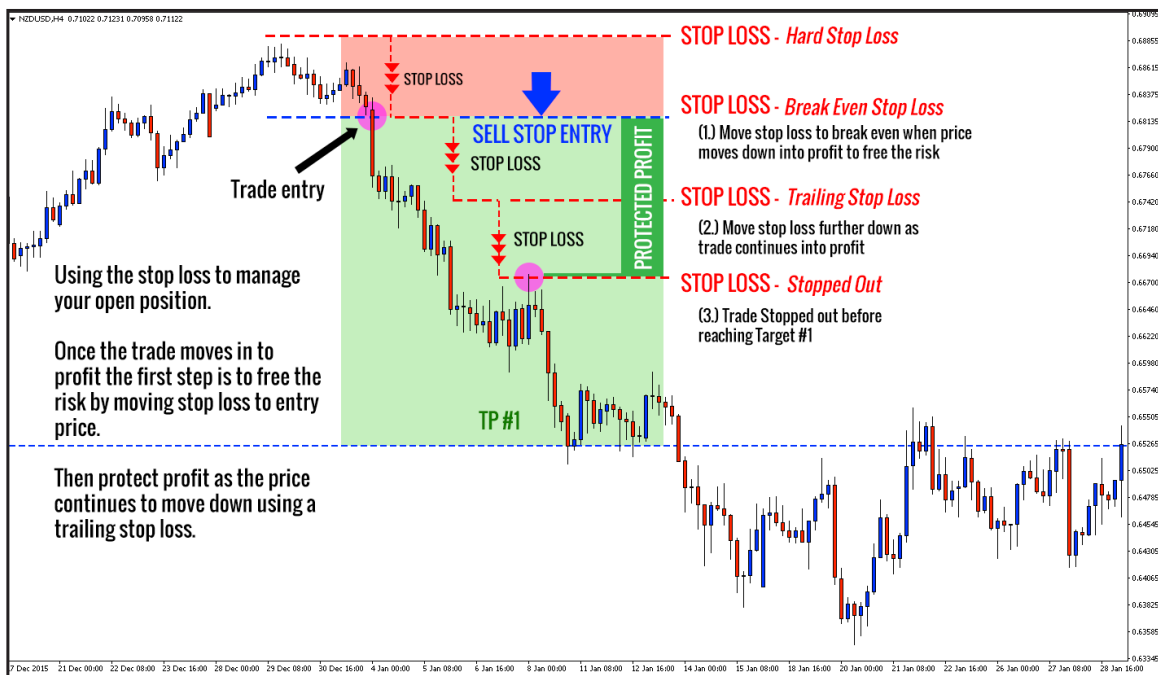
It is important to note with MT4 and other trading platforms that run scripts and automated programing such as trailing stops that when the platform closes or goes offline the automated script may not be honoured and could cease from working due to the offline status. This is why hard stop losses are safest to use when you are unable to monitor the markets as they are secure and will remain in place.

8.3: HARD STOP LOSS

Typically used for equities, a hard stop loss is a price level that, if reached, will trigger an order to sell an underlying financial instrument and is set at a constant price that are inherently good until cancelled. A hard stop is used to protect the downside of holding an investment by always being active, and is only triggered once the price reaches the specified stop level.

A hard stop loss is a bottom price that an investor is prepared to hold on to the stock for, once that price is reached the investor has a pre-arranged order in place to sell the stock off if it gets that low.

A hard stop loss or regular stop loss in regards to Forex is a level that a trader is not willing to hold on to the trade for any longer and if the trade continues to plummet the trader will exit the trade at that level.

8.4: BREAK EVEN STOP LOSS

A break-even stop loss refers to a preset price at which a trader exits a position in a financial market. Usually this price covers the trader's costs and includes a certain level of profit over and above the break-even point. A break-even stop loss is often implemented once a trade moves some way into profit and then the stop loss is moved a specific level in order to free the risk and clear a small amount of profit to cover the trade and brokerage fees. *(Fig 8.1)*

Once executed most trade plans will require the stop losses to be manually moved to entry or beyond to free the risk of the trade and secure profit, this break-even stop loss strategy is a vital component of money management and minimizing risk whilst trading.

FIG 8.2: STOP LOSS - BREAKEVEN

When trade is in profit 30-40 points look to move the Stop Loss price to entry price to free the risk.
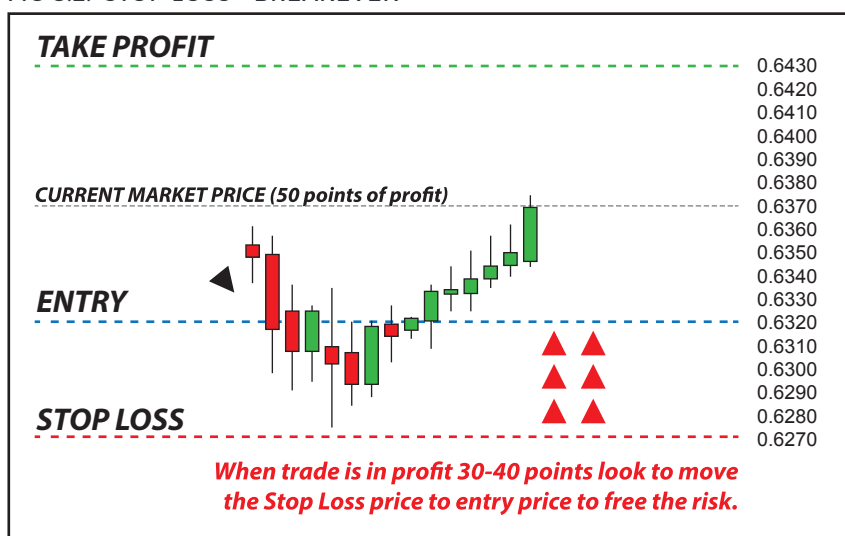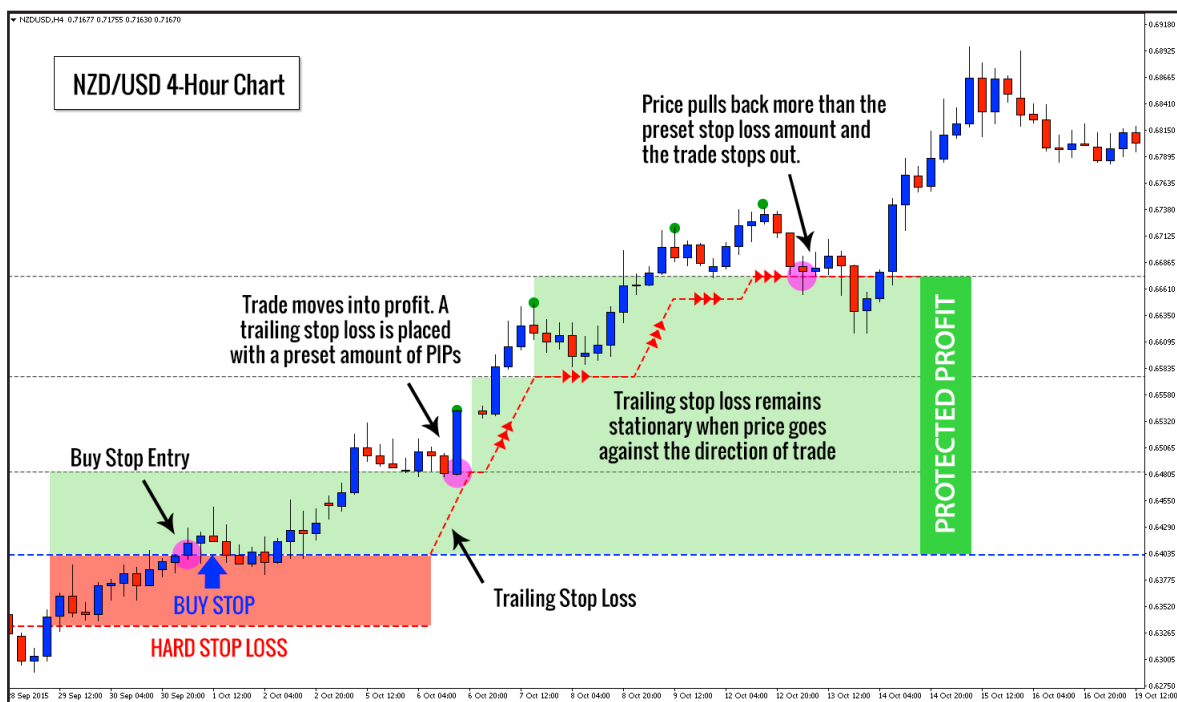
8.5: TRAILING STOP LOSS

A trailing stop is a type of stop loss order attached to a trade that moves forward as the price progresses into profit and remains still when the price retracts towards the trailing stop loss.

Trailing stops can be difficult to use unless there is an obvious direction on the market place, as natural volatility can easily collect a trailing stop and close a trade prematurely hindering potential profits should the trade complete the pre-analyzed move. Trailing stops can however be a positive tool to use if the trade is in significant profit and can be used to collect any further profit that may be available before a price reversal. *(Fig 8.3)*

FIG 8.3: TRAILING STOP LOSS - EXAMPLE

A way to combat premature stop out due to volatility with a trailing stop is to decrease the distance over the course of the trade as the trade progresses into greater profits. Traditionally traders will commence with a trailing stop of a greater distance away from the market price and as the trade progresses over time manually shift the trailing stop closer, until ultimately it gets collected after a reasonable move has been made.

This could work in the following way:

- Trade analysis sets a trade with a profit target of 400 PIPs and a stop loss of 80 PIPs
- The trade moves 70 PIPs into profit
- A trailing stop of 70 PIPs is used to break-even on the trade
- As the trade progresses into profit the trailing stop follows behind by 70 PIPs

- When the trade reaches 150 PIPs profit the trailing stop is adjusted to 50 PIPs

- At 220 PIPs the 50 PIP trailing stop is adjusted to 40 PIPs

- At 270 PIPs the 40 PIP trailing stop is decreased to 30 PIPs

- The trade maxes out at 330 PIPs before retracing and collecting the trailing stop at 300 PIPs profit closing out the trade at this level

Below is another example. If a buy trade was entered for the NZD/USD at 0.6310, with a trailing stop loss of 50 PIPs and the price moved in the desired direction the trailing stop would follow behind the market price by 50 PIPs. If the price retraces back toward the trailing stop the stop would stand still and only progress forwards again once the price moves off in the buy direction by more than 50 PIPs, the trailing stop would then venture forward once more following behind the market price.

The stop loss distance will remain at this preset lagging price and will not widen as the market moves the trade into profit. When the market turns against the trade the gap between the market price and the trailing stop will tighten until it is either reached and the trade stops out or the trade moves off in the correct direction again and the gap widens until it reaches 50 PIPS or more with the trailing stop resuming its journey following the market price. *(Fig 8.4)*

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FIG 8.4: TRAILING STOP LOSS - ILLUSTRATION
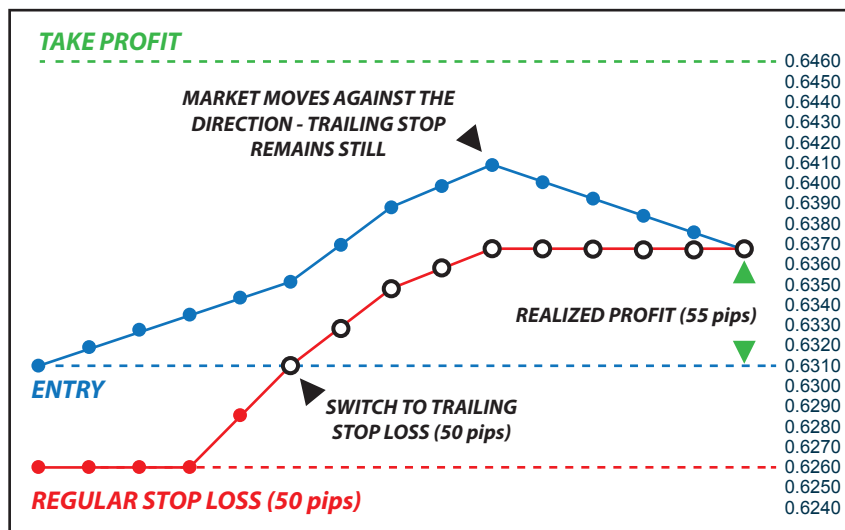
8.6: PROTECTING PROFIT

Another key reason to use a stop loss is to protect available profit as a trade moves into profit traveling towards the final take profit value. It is good practice to move the stop loss up close behind a trade within 25-35 PIPs and set it there before retiring for the evening, protecting what profit is available, hoping for a price continuation toward the final take profit value by morning. *(Fig 8.5)*

When using this technique be sure to keep the stop loss value a certain amount from the current market price otherwise if the price is set too close normal price fluctuation or volatility will potentially touch the stop loss and close the trade. A good rule of thumb is to set the stop loss approximately 20-30 PIPs from the market price allowing the market breathing space to move up and down.

FIG 8.5: USING STOP LOSS TO PROTECT PROFIT
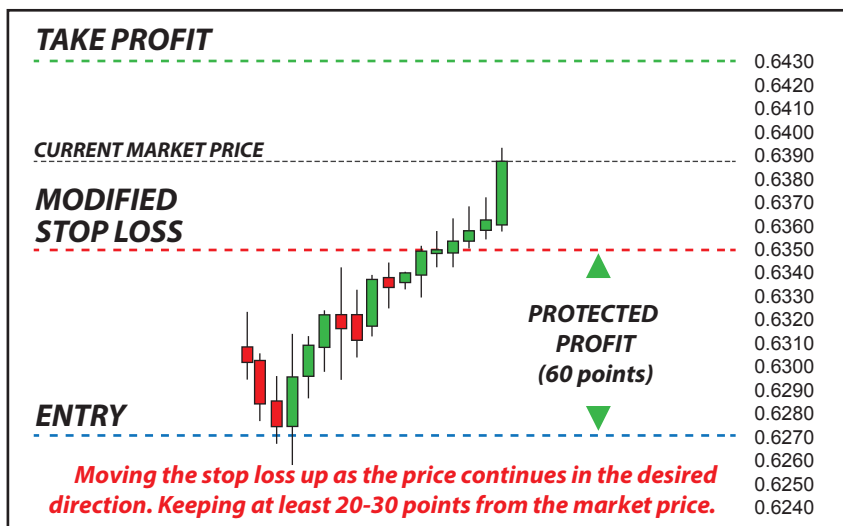
8.7: TRADE MANAGEMENT

Trades need to be monitored manually to ensure trade adaptation occurs as the landscape of the charts change, and there are key components to the trading landscape that can adversely affect your trades, such as slippage or weekend gaps. *(Fig 8.6)*

It is good practice to close out all trades prior to weekends and especially long weekends. There is no point keeping trades open when the banks are closed and market hours are over, as anything can happen during these times to result in a disadvantageous outcome.

Weekend gaps can see the markets jumping significant amounts and in these cases if the market moves against your open positions the stops will not be honoured at the price level set, but rather the trade will close out at the next available price when the market reopens, which can sometimes be a significant move. US data can often be dangerous due to its volatile nature and during closed periods such as weekends you are unable to exit a trade when the markets are closed.

Slippage is also an aspect to take into consideration as part of your trade plan and trade management. If you are trading a pair that often has slippage or trading with a broker whose liquidity provider has poor data integrity then this will also result in the negative. So it is wise to check the liquidity providers to ensure their integrity is complimentary to your expectations of a reliable data source and allow a buffer zone for entries and exits to compensate for this subtle unknown quantity. Incorporating buffer zones into your trade plan is also good trade management practice and will be covered in greater detail in the next module.

FIG 8.6: TRADE MANAGEMENT & SLIPPAGE
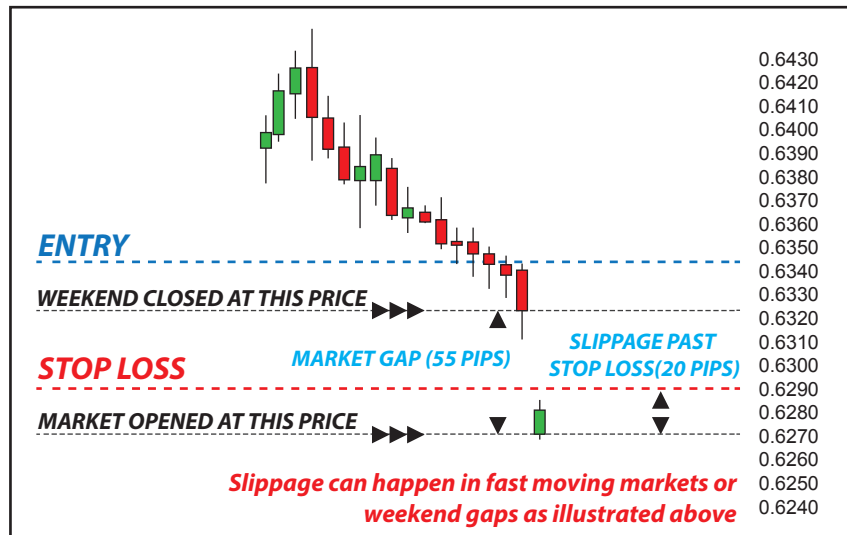
> *Because of the rapidly changing nature of the forex market, the executed price (stop loss) may differ from the last price viewed on the trading platform. This is referred to as slippage. Sometimes slippage works in a trader's favour, and sometimes to a disadvantage.*

REVIEW

SUMMARY

This section explored the use of stop losses and analyzed their necessity as a crucial element to good trade practice and individual trade plans. The various types of stop losses were looked at and the reason they are used as a vital component of risk and trade management.

The role of hard stops, trailing stops and break-even stops were covered for their incorporation of trade management as well as the function stop losses and trade management has to play in protecting yourself from weekend gaps and slippage.

QUESTIONS

1. What does risk management refer to?

2. What is a stop loss?

3. What is a break-even stop loss?

4. What is a hard stop loss?

5. What is a trailing stop loss?

6. How can a stop loss be used to protect profit?

7. What is slippage?

8. What is a gap or weekend gap?

ANSWERS

1. Risk management refers to the concept of using stop losses as part of a trading strategy to govern how much capital is exposed on the markets in a particular trade, also in conjunction with the component of profit or reward being sought. Using stop losses with correct position sizing will protect ones capital and minimize exposure resulting in potential loss.

2. A stop loss is a feature used to automatically cease a position once the price level of the stop loss value is reached. The trade will automatically stop at that point, subject to market gaps and slippage, debiting the amount that was exposed within the stop loss component and protecting the traders trading capital from dwindling down any further as a result of the contrary trade outcome.

3. A break-even stop loss, is when the stop loss is moved to entry or beyond to compensate for broker fees, once the trade progresses into profit, therefore creating a break-even trade should the trade turn and reach the stop loss

4. A hard stop loss, typically used with equity trading, is a stop order used to initiate a sell-off of an underlying financial instrument once the price level reaches a pre-determined level set by the investor that he or she no longer wants to maintain ownership of.

5. A trailing stop is a type of stop loss used to track behind the momentum of the trade by a set distance securing whatever profit is available at that distance and continues to move with the trade as the trade progresses. Should the trade turn around and move toward the stop the trailing stop will stay still until it is either reached and the trade exited of the market moves off again in the previous continued direction, taking with it the trailing stop.

6.   A stop loss can be used to protect profit by manually moving it behind the trade as it progresses into profit, securing a certain amount of profit should the trade turn against the chosen direction. A trailing stop can also be used for this purpose.

7.   Slippage occurs when market volatility increases resulting in price movement spikes dramatically up or down, making it difficult for the liquidity provider or broker to honour an exact price and therefore they have to take the next available price that can be offered. Slippage is more common in volatile and uncertain markets. It can also be a result of poor and intermittent data feeds.

8.   A weekend gap is the space between the week's close of the market session and the new weeks opening of the next market session. The difference in price that takes place between these two time frames is known as the weekend gap and whilst the weekend gap can be favourable to ones trading it can also move against ones favour, so it is safer and good practice to get into the habit of closing out trades before the close of the market session.

CHECKLIST

Below is a checklist of the main points covered in this section.

☐   Stop losses and their use is a vital component of trading forex due to the markets volatile and unpredictable nature.

☐   Stop losses limit risk exposure by protecting any further loss, subject to slippage, should the markets turn against you.

☐   Stop losses can also be used to protect profit by manually moving the stop loss some way behind the trades current market price, protecting a level of available profit should the market turn against you.

☐   Trailing stops can be used to follow the market price by continually creeping forward behind the market price as the trade tracks further into profit, and is there to protect that level of available profit should the market turn and stop the trade out upon reaching the trailing stop.

☐   Stop losses can also be used to free the risk of a trade by manually moving the stop to entry or just beyond. This is also referred to as a break-even stop on a trade if either the desired momentum is not accomplished on a trade or a trade has moved far enough into profit to clear natural volatility and warrant moving the stop to entry.

☐   Gaps in the market can occur anytime due to extreme volatility and intermittent data feeds, however they are a relatively common occurrence during the market closing hours and therefore it is good practice to close out trades over the weekend period and especially during long weekends or bank holiday periods.

☐   Slippage in pricing can occur due to rapid moving volatile markets with high volume where the broker and liquidity provider must take the next available market price, therefore a vital part of trade management is to allow for slippage by using a buffer zone for entries and stops to accommodate the spread and perhaps a small amount more in these markets.

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NOTES

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SETTING THE STANDARD

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