18 Smart Ways to Improve Your Trading

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SAMPLE

Chapter 1: How to Use Stop Loss Orders Effectively

Winning traders set their stop losses based on a proven successful system designed to both protect them, and allow them to select suitable trades and profit from the markets. Losing traders on the other hand, set their stop losses based on randomly selected price levels and random potential percentage losses and monetary amounts, as well as based on the fear of losing any money trading, and the hope that all things in the markets, including this particular trade, will work in their favour.

Let's look into this in more detail. Winning traders always select trades that suit their broader macro view of the markets, their view of a specific security (whether this is a stock, an index or a different asset class) their timeframe (time they are willing to stay with a trading position) and their personal risk tolerance.

So how do winning traders really select their stop loss levels in practice? It is easier to illustrate this through an example.

Let's assume that the trader's macro view of the UK stock market is bullish; that is, the trader expects that UK stock prices will continue rising, and he wants to take advantage of this uptrend continuation by buying into individual UK stocks in the FTSE 100 and 250. Now his broader asset universe has been determined, the trader proceeds with selecting the stock/stocks he will buy. In order to do so the trader looks for a combination of fundamental and technical characteristics in a stock. Starting with the fundamental side, he wants to buy into a company with a healthy balance sheet and good future profitability prospects. He realises that it is important to know the company's past, so as to understand why the stock price is at its current level, and be able to make out whether the company's future is bound to be profitable or not, so as to decide on whether to buy into this future. So let us assume for our example that the trader has looked into company X, understands the past events that have brought the share price to its current levels, and believes based on his research that the company's future will be bright, so from a fundamental viewpoint, he is happy to buy it.

Now the trader determines the price levels that he would be willing to buy this stock at. This is where technical analysis comes in. The trader looks at the stock's chart (I use a daily chart for this purpose) in order to determine support/resistance levels for the stock. Winning traders always buy against a support level, and place their stop loss for the trade accordingly. So let's assume that the particular stock in our example has a support level at 100p, is currently trading above this, and moving higher. When buying a stock, winning traders want to risk as little as possible, only risk an amount that will not endanger their whole trading account, and what is more, risk an amount that if lost, will not prevent them from continuing to trade and look to make money in subsequent investments. Winning traders know that in the markets, same as in life, there will be times when they will fall and lose, so they make sure that when this happens, they have the strength and in the case of trading the financial ability, to get up and fight another day.

So let's assume for our example that the monetary amount that ticks all of the aforementioned boxes is £1,000. This translates into a maximum 10% stop for a £10,000 position in the stock, a 5% stop for a £20,000 position, and so on and so forth. This is the maximum amount the trader is willing to risk, and it is non-negotiable.

Now all of these have been determined, the trader looks at the price the stock is currently trading at, wanting to buy £20,000 worth of shares with a maximum monetary risk of £1,000, so a 5% stop. Winning traders will only buy into the stock if the current price fulfils all of their aforementioned requirements. If they do buy Stock X, their stop will be placed at a level just below the support level they are buying against, and if triggered will lead to a loss no greater than the maximum £1,000 that they are willing to risk on this trade.

If the price is not right in this way, winning traders will do nothing. They will add the stock to their watch list, and wait to buy in when and if the stock price comes to the right level in the future. They will not just pull the trigger and buy the stock regardless. By contrast, losing traders will just jump in, buy a randomly selected amount at the current market price, use a randomly selected stop, and hope for the best.

Well, as an old market saying goes, "There are old traders, and there are bold traders, but there are no old bold traders". The markets are not a charitable or forgiving place, quite the opposite, and any trader or investor believing that they can make and keep money in the markets over time based on their hope for the best, and as such on pure lack and inadequate risk management, will just never see their dream come true. This may sound harsh, but the markets are only going to be as harsh to you, the individual trader/investor, as you allow them to be, and on the other side of your every trade there is likely to be a winning trader, who among other things, will set their own stops in the way that makes them the winner.

So to summarise, next time you decide how to set your stop loss order for a trade, start by determining whether this is the right trade for you to begin with. This implies that it is your personal risk tolerance among other things that determines whether a trade is suitable for you, and not your wish to trade a particular security regardless of its suitability for you and your trading system at its current price levels. If the trade is indeed suitable for you, set your stop loss against the support/resistance level you wish to trade against, and just go for it. In any other case, you are much better off going for a walk, and either keeping the money you would risk in this trade for your future investing, or if you find yourself unable to do this, spend your money on something different that is guaranteed to entertain you, or give it all to a charity.

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