A Look at Exit Strategies

Money management is one of the most important (and least understood) aspects of trading. Many traders, for instance, enter a trade without any kind of exit strategy and are therefore more likely to take premature profits or, worse, run losses. Traders need to understand what exits are available to them and know how to create an exit strategy that will help minimize losses and lock in profits.

Making an Exit

There are obviously only two ways you can get out of a trade: by taking a loss or by making a gain. When talking about exit strategies, we use the terms take-profit and stop-loss orders to refer to the kind of exit being made. Sometimes these terms are abbreviated as "T/P" and "S/L" by traders.

Stop-Loss (S/L)

Stop-losses, or stops, are orders you can place with your broker to sell equities automatically at a certain point, or price. When this point is reached, the stop-loss will immediately be converted into a market order to sell. These can be helpful in minimizing losses if the market moves quickly against you.

There are several rules that apply to all stop-loss orders:

- Stop-losses are always set above the current asking price on a buy or below the current bid price on a sell.
- Nasdaq stop-losses become a market order once the stock is quoted at the stop-loss price.
- AMEX and NYSE stop-losses enable you to have rights to the next sale on the market when the price trades at the stop price.

There are three types of stop-loss orders:

- Good 'till canceled (GTC) - This type of order stands until an execution occurs or until you manually cancel the order.
- Day order - The stop-loss expires after one trading day.
- Trailing stop - This stop-loss follows at a set distance from the market price, but never moves downward.

Take-Profit (T/P)

Take-profit, or limit orders are similar to stop-losses in that they are converted into market orders to sell when the point is reached. Moreover, take-profit points adhere to the same rules as stop-loss points in terms of execution in the NYSE, Nasdaq, and AMEX exchanges.

There are, however, two differences:

- There is no "trailing" point. (Otherwise you would never be able to realize a profit!)
- The exit point must be set above the current market price, instead of below.

Developing an Exit Strategy

There are three things that must be considered when developing an exit strategy. The first question you should ask yourself is, "How long am I planning on being in this trade?" Secondly, "How much risk am I willing to take?" And finally, "Where do I want to get out?"

How long am I planning on being in this trade?

The answer to this question depends on what type of trader you are. If you are in it for the long-term (for more than one month), then you should focus on the following:

- Setting profit targets to be hit in several years, which will restrict your amount of trades.
- Developing trailing stop-loss points that allow for profits to be locked in every so often in order to limit your downside potential. Remember, often the primary goal of long-term investors is to preserve capital.
- Taking profit in increments over a period of time to reduce volatility while liquidating.
- Allowing for volatility so that you keep your trades to a minimum.
- Creating exit strategies based on fundamental factors geared towards the long term.

If, however, you are in a trade for the short-term, you should concern yourself with these things:

- Setting near-term profit targets that execute at opportune times to maximize profits. Here are some common execution points:
    - Pivot point levels.
    - Fibonacci/Gann levels.
    - Trend line breaks.
    - Any other technical points.
- Developing solid stop-loss points that immediately get rid of holdings that don't perform.
- Creating exit strategies based on technical or fundamental factors affecting the short-term.

How much risk am I willing to take?

Risk is an important factor when investing. When determining your risk level, you are determining how much you can afford to lose. This will determine the length of your trade and the type of stop-loss you will use. Those who want less risk tend to set tighter stops; and those who assume more risk give more generous downward room.

Another important thing to do is to set your stop-loss points so that they are kept from being set off by normal market volatility. This can be done several ways. The beta indicator can give you a good idea of how volatile the stock is relative to the market in general. If this number is within 0 and 2, then you will be safe with a stop-loss point at around 10-20% lower than where you bought. However, if the stock has a beta upwards of 3, you might want to consider setting a lower stop-loss, or finding an important level to rely on (such as a 52-week low, moving average, or other significant point).

Where do I want to get out?

Why, you may ask, would you want to set a take-profit point, where you sell when your stock is performing well? Well, many people become irrationally attached to their holdings and hold these equities when the underlying fundamentals of the trade have changed. On the flip side, traders sometimes worry and sell their holdings even when there has been no change in underlying fundamentals. Both of these situations can lead to losses and missed profit opportunities. Setting a point at which you will sell takes the emotion out of trading.

The exit point itself should be set at a critical price level. For long-term investors, this is often at a fundamental milestone--such as the company's yearly target. For short-term investors, this is often set at technical points such as certain Fibonacci levels, pivot points, or other such points.

Putting It into Action

Exit points are best entered immediately after the primary trade is placed. Traders can enter their exit points in one of two ways:

1. Most brokers' trading platforms have the functionality that allows for entering orders. Alternatively, many brokers allow you to call them to place entry points with them. There is one exception, however: trailing-stops are not supported by many brokers. As a result, you may have to recalculate and change your stop-loss at certain time intervals (for example, every week or month).
2. Those who do not have the functionality that allows for entering orders can use a different technique. Limit orders also execute at certain price levels. By putting in a limit order to sell the same amount of shares that you hold, you effectively place a stop-loss or take-profit point (because the two positions will cancel each other out).

Conclusion

Exit strategies and other money management techniques can greatly enhance your trading by eliminating emotion and reducing risk. Before you enter a trade, consider the three questions listed above and set a point at which you will sell for a loss, and a point at which you will sell for a gain.

by Justin Kuepper

Justin Kuepper has many years of experience in the market as an active trader and a personal retirement accounts manager. He spent a few years independently building and managing financial portals before obtaining his current position with Accelerized New Media, owner of SECFilings.com, ExecutiveDisclosure.com and other popular financial portals. Kuepper continues to write on a freelance basis, covering both finance and technology topics.