Trailing-Stop Techniques

In all forms of long-term investing and short-term trading, deciding the appropriate time to exit a position is just as (if not more) important as determining the best time to enter into your position. Buying (or selling, in the case of a short position) is a relatively less emotional action than selling (or buying, in the case of a short position). When it comes time to exit the position your profits are staring you directly in the face, but perhaps you are tempted to ride the tide a little longer, or in the unthinkable case of paper losses, your heart tells you to hold tight, to wait until your losses reverse.

But such emotional responses are hardly the best means by which to make your selling (or buying) decisions. They are unscientific and undisciplined. Many overarching systems of trading have their own techniques for determining the best time to exit a trade. But there some general techniques that will help you identify the optimal moment of exit, which ensures acceptable profits while guarding against unacceptable losses.

Momentum-Based Trailing Stop

The most basic technique for establishing an appropriate exit point is the trailing-stop technique. Very simply, the trailing stop maintains a stop-loss order at a precise percentage below the market price (or above, in the case of a short position). The stop-loss order is adjusted continually based on fluctuations in the market price, always maintaining the same percentage below (or above) the market price. The trader is then "guaranteed" to know the exact minimum profit that his or her position will garner. This level of profitability the trader will have previously determined based on his or her predilection toward aggressive or conservative trading.

Deciding what constitutes appropriate profits (or acceptable losses) is perhaps the most difficult aspect of establishing a trailing-stop system for your disciplined trading decisions. Setting your trailing-stop percentage can be done using a relatively vague approach (which is closer to emotion) rather than precise precepts.

A vague consideration, for example, might maintain that you wait for certain technical or fundamental criteria to be met before setting your stops. For example, a trader might wait for a breakout of a three to four-week consolidation and then place stops below the low of that consolidation after entering the position. The technique requires the patience to wait for the first quarter of a move (perhaps 50 bars) before setting your stops.

In addition to necessitating patience, this technique throws fundamental analysis into the picture by introducing the concept of 'being overvalued' (a rather relative concept if I have ever heard of one) into your trailing stops. When a stock begins to exhibit a P/E that is higher than its historical P/E and above its forward one to three-year projected growth rate, the trailing stops are to be tightened to a smaller percentage - the stock's apparent state of being overvalued may indicate a reduced likelihood of additional realized profits.

The overvalued situation is muddied even further when a stock enters a "blow-off" period, wherein the overvaluation can become extreme (certainly defying any sense of rationality) and can last for many weeks or even months. By rolling with a blow-off, aggressive traders can continue to ride the train to extreme profits while still using trailing stops to protect against losses. Unfortunately, momentum is notoriously immune to technical analysis, and the further the trader enters into a "rolling stop" system, the further removed from a strict system of discipline he or she becomes.

The Parabolic Stop and Reverse (SAR)

While the momentum-based stop-loss technique described above is undeniably sexy for its potential for massive ongoing profits, some traders prefer a more disciplined approach suited for a more orderly market (the preferred market for the conservative-minded trader). The parabolic stop and reverse (SAR) technique provides stop-loss levels for both sides of the market, moving incrementally each day with changes in price.

The SAR is a technical indicator plotted on a price chart that will occasionally intersect with price due to a reversal or loss of momentum in the security in question. When this intersection occurs, the trade is considered to be stopped out, and the opportunity exists to take the other side of the market.

For example, if your long position is stopped out, which means the security is sold and the position is thereby closed, you may then sell short with a trailing stop immediately set opposite (parabolic) to the level at which you stopped out your position on the other side of the market. The SAR technique allows one to capture both sides of the market as the security fluctuates up and down over time.

The major proviso on the SAR system relates to its use in an erratically moving security. If the security should fluctuate up and down quickly, your trailing stops will always be triggered too soon before you have opportunity to achieve sufficient profits. In other words, in a choppy market, your trading commissions and other costs will overwhelm your profitability, as meager as it will be.

The second proviso relates to the use of SAR on a security that is not exhibiting a significant trend. If the trend is too weak, your stop will never be reached, and your profits will not be locked in. So the SAR is really inappropriate for securities that lack trends or whose trends fluctuate back-and-forth too quickly. If you are able to identify an opportunity somewhere between these two extremes, the SAR may just be exactly what you are looking for in determining your levels of trailing stops.

Conclusion

Deciding how to determine the exit points of your positions depends on how conservative you are as a trader. If you tend to be aggressive, you may determine your profitability levels and acceptable losses by means of a less precise approach like the setting of trailing stops according to a fundamental criteria. On the other hand, if you like to stay conservative, the SAR may provide a more definite strategy by giving stop loss levels for both sides of the market. The reliability of both the techniques, however, are affected by market conditions, so do take care to be aware of this when using the strategies.

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