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Using Stops Effectively

Sunil Mangwani leads a discussion on methods to effectively use stops to preserve trading capital. In this article, he outlines ways to use the pivot point formulas as stop placement zones when trading Forex markets.

The first priority of a trader is to conserve trading capital.

The trader's capital is his bloodline. Without capital, it is not possible to trade, so preserving it becomes a matter of utmost importance.

It is only natural that when a trade is initiated, the focus tends to be on potential profits rather than on the possibility of loss. We are usually so convinced that a trade will be profitable, that we tend to ignore the possible losses that would occur should the trade go wrong. One must accept that losses in trading are inevitable, but a successful trader is one who manages and controls the losses.

Therefore, a trader must have a money management policy, which is nothing but a set of techniques to help minimize the risk of loss, while still enabling him to participate in major profitable trades.

Ironically, it is probably the most critical aspect of trading while also being the most overlooked. Money management becomes an absolute must in the Forex markets, due to the use of high leverage values. Hence entering a trade with a proper stop loss and exiting the trade with a sufficient profit, conserves and increases a trader's capital.

As the popular saying goes "take care of your losses, and the profits will come by itself."

This table illustrates this concept, and serves to illustrate the importance of controlling the loss of capital.

Loss Of Capital As A%	% Required To get Back to Break Even
10%	11.11%
20%	25%
30%	42.86%
40%	66.67%
50%	100%
60%	150%
70%	233%
80%	400%
90%	900%
100%	Blow Out/Broke

Without implementation of loss control techniques, a sudden large drawdown can shrink an account to such an extent, that the possibility of attaining profitability becomes remote.

This is probably the most important lesson in trading,

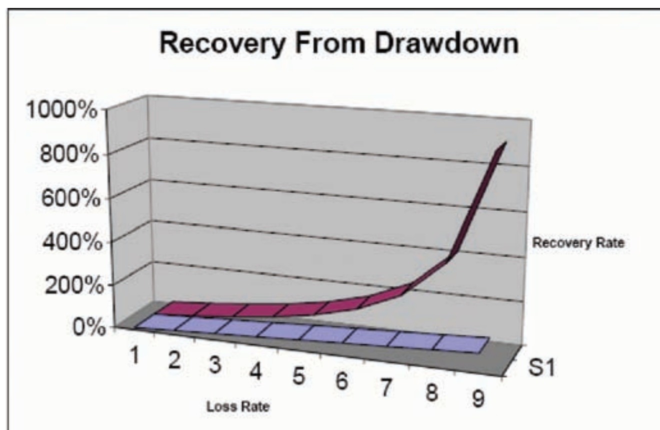
which should be well understood by any trader.

Taking the specific example of losses or drawdown, which are only to be expected in trading, controlling them is the first vital step in money management.

A single loss is not only a loss of capital; it also puts a trader two-steps behind in the quest for profitability.

The reason for this is that the percent gain needed to recover from a loss increases geometrically with every loss.

If we display this same principle as a chart (since technical traders rely more on charts), we get a visual picture of how the recovery rate becomes increasingly difficult with every single loss.



Based on this principle, let us have a look at some practical applications for the best use of stops.

The most important and basic principle to consider is that the stops should never be mere dollar value stops, but technically correct stops. This simply means that one cannot decide on the stop level based on his or her personal risk comfort level. A trader cannot decide the stop level by saying that "I am going to only risk $50 for the trade."

The market does not care about your personal risk level, but only respects the technical levels. Hence, a stop must be at a technical level that should contain the price … regardless of how far it is away from your entry.

Taking care of this one point within your trading plan is not always the sole deciding factor. Money management often encompasses a correct mix of multiple factors.

For example, there would be some situations when the technical stop level would be quite a distance from the entry point, which simply means a higher risk level.

In such cases, one must take into account the Risk-to-Reward Ratio.

If the potential profit of a trade out weighs the risk level by a 2 to 1 ratio at a minimum, then one can enter the trade … provided your capital exposure is within the decided parameters.

If a trader has determined that he or she is not going to risk more than 2% of the capital at any given time, and this high risk level fits within this parameter…and the Risk-to-Reward ratio is favorable, then the trade can be taken.

If either of the factors does not fall within the decided parameters, then the trade should not be taken.

Remember staying out of a trade is also a market position.

I would rather be out of a trade wishing that I was in it … than to be in a trade wishing I was out of it.

The bottom line is that the stop level should never be compromised to suit your convenience. If one cannot follow the rules of money management, then the trade should simply be ignored.

If one does not follow this simple rule, the "comfortable" dollar value stops would probably get taken out more often, which defeats the very purpose of placing a stop.

Here are a few suggestions on how to set stops for long (buy) positions.

1. Set the stop just under yesterday's low unless yesterday was a big up day. Then move the stop closer to today's open.

2. Set the stop just under a recent minor support level.

3. Use the daily Average True Range to determine the expected movement for the market and set the stop just beyond the range amount.

4. Move stops up as the price rises, first to break even, then to protect profits. On a long position when you use trailing stops, do not lower stops - only raise them.

5. As the price moves up and tends to 'top out' or when market conditions become unfavorable, 'tighten the stop.' In other words, move the stop closer to the current market price. Doing this will effectively employ an "'up or out' strategy" – either the price goes up, or you are out of the trade.

Practical Suggestions based on Technical Tools The Pivots Strategy

The Pivot Point system can be classified as a technical indicator derived by calculating the numerical average of the high, low and closing prices of any financial instrument.

It can also be classified as a technique to help ascertain where the price is relative to previous market action. In a very basic sense, it can be defined as a turning point. The pivot points work best on highly liquid markets, like the spot currency market, but they can be used in other markets as well.

They work simply because many individual traders and investors use and trust them, as well as bank and institutional traders. It is known to every trader that the pivot point is an important measure of strength and weakness of any market.

There is no big secret to trading with pivot points. Floor traders and dealing desks have been applying the methodology for decades in the financial markets. But what separates the profitable traders from the losing traders is the simple act of following the trend of the day, cutting losses short and letting profits run to the next pivot value.

There are different methods for calculating pivot points:

(a) The most common method is the five-point system.

This system uses the high, low and close of the previous day to derive the pivot point along with two support levels and two resistance levels (totaling five levels)

The equations are as follows:

$R2 = P + (R1 - S1)$
$R1 = (P \times 2) - L$
$P = (H + L + C) / 3$
$S1 = (P \times 2) - H$
$S2 = P - (R1 - S1)$

Here, "P" represents the pivot point,
"S" the support level,
"R" the resistance level and
"H", "L" and "C" represent the High, Low and Close respectively.

(b) Further calculation yields additional support and resistance levels to the basic pivots.

Price action, especially in the currency markets respects these levels quite frequently. This is very helpful, especially after a large range day when the basic support and resistance levels are far apart.

The calculations are as follows:

$R2 = P + (R1 - S1)$
$M4 = (R1 + R2) / 2$
$R1 = (P \times 2) - L$
$M3 = (P + R1) / 2$
$P = (H + L + C) / 3$
$M2 = (S1 + P) / 2$
$S1 = (P \times 2) - H$
$M1 = (S2 + S1) / 2$
$S2 = P - (R1 - S1)$

The advantage with this calculation is that additional levels are available to place stops, reducing the risk of a trade.

The pivots technique is very effective from the "risk" point of view, since the stop levels are very clearly defined…and are very effective.

For long positions, a trade is confirmed when price finds support on a pivot level. In this case, the pivot level below (the support pivot) acts as an effective support level. The probability of price dropping down to that level is very low; hence it becomes the safest technical level to place the stop.

Using Fibonacci Ratios

Price has an uncanny way of respecting Fibonacci ratios, often quite precisely. It is possible for a trade to use the Fibonacci ratios to ascertain the technical levels, which become the correct stop levels.

For price in an existing trend

When we are looking for a pullback to finish and we want to rejoin the existing trend.

In this example of an uptrend, we plot the Fibonacci retracement ratios on the existing up trend, before the pullback commenced. If the pullback is held within the Fibonacci retracements, then the indication is that price should resume the up move again.

Hence the break of the 23.6 level should be the entry, with the stop below the 61.8 level.

If price has broken the 23.6 level, but has gathered sufficient momentum to resume the move in the direction of the existing trend. Hence, the probability of price moving back down to the 61.8 level is quite remote, making it the correct technical level for the stop.

Triangle breakouts.

In case of a breakout from a triangle formation, extend the triangle lines forward until they cross. This intersection level, which is also the apex of the triangle, becomes the correct technical level for a stop.

This is because the 'apex' level often forms a strong level of support/resistance, which contains price action. And it is possible for this technique to be applied to all kinds of triangle formations like the symmetrical triangle, the ascending or descending triangle, the wedge, pennant etc.

In spite of following the correct procedures, if your stops are taken out…accept the fact that you had a losing trade and move on to the next one.

The bottom line is that you had a fixed plan when you entered a trade.

That fact alone puts you in the top 20% of all traders.

Sunil Mangwani is a Physics graduate with a Diploma in Financial Management.

He has been trading the Forex market for the last 6 years and devises simple trading strategies based on his vast knowledge and in-depth study in the field of technical analysis.

He has worked as content providers and article writers with different websites such as www.surefire-trading.com; www.trading-strategies.info and www.guppytraders.com.

He has also developed video modules on specialized topics and has contributed technical articles to different magazines like Traders and The Trader's Journal and to the educational sections of websites like Trade2Win etc. He has been the "Director of Education" at www.fxinstructor.com, where he conducts 'Live trading room' webinars, where the price action was analyzed in real time and trades taken in real time based on the techniques taught.

In his years of trading and experience of teaching technical analysis, he realized that applying technical analysis is not enough to be a successful trader. One can be successful in this exciting, fulfilling and yet demanding business, if and only if, one has a definite plan on how to approach the market.

If a trader has an iron clad "Trading Plan" with the 3M's Method, Money, and Mind, it automatically puts the trader into the top 15% bracket of the winners. He now conducts special coaching for developing specific trade plans at www.fibforex123.com.

His vast repertoire of services on this website also includes Live Trading room training, special webinars on educational topics & advanced trading strategies.

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