STOP ORDERS

<u>The first rule in successful trading and investing is: Cut losses short.</u>

E. H. Harriman, who was once a broker on the floor of the Stock Exchange, said: "If you would be a successful trader in stocks, kill your losses." As a floor trader he used to close out a trade if it went 1/2 to 1 point against him. You, who pay full commissions and are not on the floor, cannot cut your losses as closely as this but you <u>can</u> limit them. You can safeguard your investment and trading commitments against crippling losses, against the tragic consequences of riding stocks up and down through one intermediate market cycle after another until eventually you have nothing but a collection of "has been" performers whose only last remaining solace to your damaged bank account is your hope that they "might some day come back."

The way to do this is: First, never make a commitment whether for investment or speculation until you have decided, in advance, where the danger point exists in that stock. Second, calculate the possibilities for profit if the stock should confirm your judgment by moving in your favor. Third, determine whether the indicated probable profit outbalances the indicated risk by at least three to one. Fourth, place a stop order (under the danger point on a long commitment and above it on a short sale) the moment your buying or selling order is consummated.

Should you have a stock under observation and believe it affords a logical buying or selling opportunity, have patience to wait until it works into a position where it meets the first three conditions above named before you make your purchase, (or sale if you contemplate selling it short). Or, if these conditions cannot be met, look around for another opportunity where they do exist. In other words, test the validity of any proposed commitment by noting, in advance, where your stop order must be placed so that you will always be operating with the odds at least 3 (or more) to 1 in your favor. It pays to wait for these opportunities.

In the stock market you must be constantly on your guard: Always be expecting something to happen. Danger is present in every trade, whether it be for investment or speculation.

But when you place a stop order on every commitment, you limit this risk. You insure yourself against letting a little loss run into a big one. In short, you "kill your losses." Also, you are always "Foot loose and fancy free." Your capital is never tied up in losing ventures; you are not waiting for soured performers to come back. You are always set and ready to swing into new opportunities because your investment and trading accounts will not become restricted by impaired margins. Your funds will not become frozen assets.

You decide in advance that you will risk just so much on your judgment that a commitment will be profitable, and you are out automatically when you are wrong. With good judgment, you are not likely to be wrong three times in a row. But assume this does happen and you are using stops which cut your losses to an average of 2 points on each trade. You still have capital intact to take the fourth position on which you will need to make only 8 points to come out ahead of the game. But if, on your first trade you let a loss run to 10 points or more because you failed to use a stop order, it may take only the one venture to tie up your account and put you out of business; or at best, you will be a long time getting back on your feet.

No one can trade (or invest) without losses, which are a part of the operating expenses of trading, along with the broker's commission, the transfer taxes and interest charges. Instead of becoming irritated when your stops are caught, you should be thankful. Say to yourself: My judgment was wrong when I started this trade and a few points lost is better than the 10 or 20 points I might have lost had I not placed a stop order.

There is nothing mysterious or complicated about a stop, order. A Stop Order, or a Stop Loss Order as it, is generally called, is simply an order, given to a broker, to be executed whenever a 100 share lot (or more) of that stock sells at a stipulated price. If you buy a stock at 50 and wish to limit your risk to, say, 2 points, you give your broker an order: "Sell 100 shares XYZ at 47 7/8 Stop." (See Pg. 12, Par. 2.) This means that if and when the price, touches 47 7/8, he is to close out (sell) that 100 shares of XYZ at the market so as to stop your loss. Or, if you sell XYZ short at 50 and wish to limit your loss to 2 points, you give the broker an order: "Buy 100 XYZ at 52 1/8 Stop." This means that if and when the price rises to 52 1/8, he is to cover (buy back) that 100 shares at the best price obtainable after the stipulated figure has been reached. Thus, the addition of the word "Stop" to your order distinguishes it from an ordinary "Buy" or "Sell" order.

Stop orders are usually considered "Good till cancelled," which means good till cancelled or executed, and the technical term is GTC. If your broker does not make it a rule to keep all stop orders GTC, specify that you wish your stop orders so considered. You do this because you want to protect your commitments so long as they are outstanding.

You may, if you prefer, mark your stop orders "Good this week" (GTW) or "Good this month" (GTM), instead of GTC. The advantage in limiting open orders (that is, orders that cannot, be executed except at or when a stipulated price is reached) is that you might forget to cancel a GTC order and later find to your chagrin that the GTC order is still standing after you have changed your position. If you make it a practice to limit your orders to a week or a month, they must be renewed by you at or before the beginning of the next week or month — provided, of course, they have not been executed previously. This will reduce the possibility that a forgotten GTC order may turn up unexpectedly when it is no longer wanted. However, you must not fail to renew such GTW or GTM stop orders on stocks in which you are still committed, long or short.

<u>The stop order is the greatest protection against danger.</u>

Stop orders are a form of insurance against large losses; against errors of judgment; and unforeseen contingencies. You pay insurance premiums on policies protecting your home against fire. Of course, you can take a chance that your house will not burn down, but to save a small premium you would risk a large loss. It is the same with stop orders. Trace back all your large losses in past years and you will see that they have resulted from your failure to place stop orders.

Many people say: I do not believe in stops. Probably this is because a number of their stops have been caught from time to time. That is chiefly because they do not understand the market, have never studied it properly, and so do not know how or when to begin their trades at the point of least risk; neither do they know how to handle stops judiciously. Of course, even with the best of judgment some stops are bound to be caught; without good judgment the majority very likely will be caught.

Other people fail to use stops because they think the specialists influence the market so their stops will be executed. This happens only in stocks having very thin markets; or in dull, professional markets; or when a lot of stops are bunched around the same levels so that it pays the floor traders to gun for these stops. In active stocks in which there is a large volume of trading, this is no ground for failing to use stops.

We cannot too strongly urge you: (1) To enter stop orders, "Good till countermanded" (or as suggested on the previous page), immediately upon making every commitment; (2) to move these stops to cover commissions and taxes as soon as you can safely do so; (3) to protect profits to the utmost by moving these stops judiciously as the market goes in your favor, as explained in preceding chart studies.

The closer you can get your stop, the more you reduce your risk. But there is another point about this: The smaller your stop, the greater the percentage of your profit compared with the amount of your risk. To illustrate: If a stock should indicate a decline of 10 points and you can play it on the short side by selling close to the danger point (Sect. 7M, Pg. 4, Par. 2, and Pg. 10, 5th Line) with a 1 point stop, your possible profit is ten times your risk. That is much better than making a trade with a 2 point stop in which the probable profit is 5 points; for in such a case your expected profit is only 2 1/2 times the risk.

By making both a rule and a habit of placing stop orders invariably as soon as a commitment is made, you can operate with much loss, concern. You need not feel that you must hang over a ticker to see what your stock is doing. You can go about your regular business. The moment your broker receives that order he becomes personally responsible for its execution. If for any reason he fails to execute the order, he must make good to you any loss occasioned by reason of his failing to carry out your instructions.

If you file with your broker, when you begin trading with him, a letter instructing him to consider all of your stop orders good until countermanded and if you receive from him a letter in reply, acknowledging and accepting these instructions, he can never claim that he "thought your stop was good for the day only." Of course, you will not do this if you follow the plan of renewing your open orders weekly or monthly.

The use of stop orders will increase your mental poise. This is a very great requisite (Sect. 25M, Pg. 1, Pars 1 & 2). Dixon G. Watts, one of the most successful cotton operators of half a century ago, wrote this among the fundamental principles which lead to success in speculation:

"Act so as to keep the mind clear, its judgment trustworthy."

Your mind will be clear if you decide on the amount of your risk when you start to operate. But if you neglect to place a stop, and leave yourself open to a loss out of proportion to your possible profit, your mind is apt to become confused and you are likely to do the wrong thing at a critical time.

Therefore: <u>Never abandon the use of stop orders.</u>

You may think you have so much money you cannot lose it.

Thirty million people thought that in 1929. Very few used stop orders.

I know, or know of, several who lost $100,000,000. They did not use stop orders.

Do not let <u>anyone</u> dissuade you from the use of stop orders. Now and then, well meaning brokers may imply disapproval of stops. This is because they have been so long accustomed to dealing with the haphazard operations of the untrained public that they are apt to think in the" same terms as the mass.

Stop orders are used:

(1) To limit risk
(2) To reduce risk
(3) To insure profits
(4) To begin new trades at prices above or below the present market.

<u>Stop orders are used to limit risk</u>, as already explained, by placing a stop order immediately, as soon as a commitment is made.

<u>Stop orders are used to reduce risk</u> when the action of the stock enables you to move the stop closer to the market price than it was originally. If you have an opportunity to do this without jeopardizing your trade, it should be done. It is better to risk 1 point than 2 or 3, but do not be too hasty in moving the stop up or down. Watch for the support and resistance points to develop so that you can use these as a guide when placing or changing your stop orders.

Of course when you can move your stop order to cover cost or selling price and commissions, there is no risk; your expectancy is then 100$ of the indicated profit.

A good rule is to move your stop on a long trade if you can do it with safety 1/2 or 3/4 point <u>above</u> your cost price as soon as the market permits, or, in the case of a short trade, a half or three-quarters point <u>below</u> your selling price. The 1/2 point is usually sufficient to cover the commissions on a round (100) share lot and 3/4 point on an odd (less than 100 shares) lot.

Stop orders cannot always be executed exactly at the stop price, especially in the case of round lots. If a stop stands at 58 on a long trade, the broker must sell your stock the moment the first trade is made at 58. If at the time the best bid is 57 3/4, he must sell your round lot at 57 3/4 if he cannot induce the bidder to pay 57 7/8. In the case of an odd lot, if the stop stands at 58 and a round lot sells at that figure, your stop will be executed on the basis of the round lot price, that is, at 57 7/8 (the round lot price less the odd lot dealer's differential). Bear this in mind: A stop order is an order to buy or sell <u>at the market</u> when the stop price is reached (see Par. 1, Pg. 3). So never blame your broker if he cannot get you out exactly at the price at which you have placed your stop.

Stop orders cannot always be executed satisfactorily in stocks which have a small floating supply, or in those having thin markets. This is evidenced by their wide swings, their skipping large fractions or points between sales, combined with a very small number of shares traded in. In such stocks you are more or less at the mercy of the sponsors and the specialist in the stock. The latter is employed by your broker because the broker cannot himself stand in one crowd (i.e., at one post on the Exchange) just to watch your stop order; therefore, you may find in thin market issues your stops at 70 executed at 69 or 68; in very bad markets perhaps at 65.

The large swings in these stocks make them look inviting because, above all things, most people like to get action. However, you will find in the long run it is more satisfactory to deal in the leading stocks where stop orders can be executed exactly at your price or very close to it. These stocks are very much less inclined to skip large fractions or points, and, therefore, you can get in and out at a figure close to the last sale.

Stop orders are used to insure profits. One can never tell when a contrary move in the market will wipe out a paper profit. Rarely should a profit of even 3 points be allowed to run into a loss. This applies to investment, as well as to trading commitments.

Remember: The element of risk is present in every commitment. There is no such thing as a "permanent" investment. Failure to recognize this fact is one of the most productive sources of loss to investors who annually lose more in vanished paper profits and shrinkage of capital than they gain in the form of dividends. The worst offenders in this respect are those who allow profits of 10 to 30 points to shrink from one to two-thirds because they neglected to safeguard their commitments. When the market turns they hesitate to get out because they think "it is only a reaction." As profits shrink, they hold on because they think of what they might have made by getting out sooner and this leads them to hoping that the market will come back. Later on, they fear to sell because stocks have declined so far they "are due for a recovery" and they "hate to get out at the bottom," or the financial writers, still dazzled by the hangover effects of the late bull movement, mislead them into believing "this is only a healthy intermediate reaction in a major bull market."

Eventually, the paper profits become paper losses. And then the investor consoles himself with the dangerously comforting thought that "it is only a paper loss." How many people do you know who were not ultimately driven to converting just such "paper" losses into actual ones, in the aftermath of every big bull market?

How much better it is to recognize that 10 points profit on most stocks is more than you can take out of those stocks by holding for a full year's dividends. If you take 15 or 20 points, you can afford to close out your holding's and remain out of the market for three years, if necessary, before the dividend return can catch up with the profits you have taken.

Therefore, protect your profits with stop orders.

An initial move of 10 points in your favor, if it started from the point of accumulation or distribution, will usually be followed by a contrary movement of 3 to 5 points (Sect. 14M, Pg. 4, Par. 2). You must allow for that contrary-movement in judging where to place your stop. The greater the initial move, the greater the expected rally or reaction. Even though you expect a probable move of 20 points in your favor, make sure that you nail some of the 10 points you have on paper. The move may have been just a flash in the pan. A rise from 60 to 70 is no guarantee that the next move will not be down to 50.

<u>Stop orders may be used to begin new trades</u> above but not below the present market. However, it is best that you do not undertake to employ stop orders for this purpose unless you have had a great deal of experience and know exactly what you are about. Otherwise, there is danger you will be whipsawed.

A buy stop would be used to begin a new trade on the long side above the present market. Such stops can be placed on the floor, through your broker, in the regular way.

A sell stop would be used to begin a new trade on the short side below the present market. Owing to a ruling of the Stock Exchange, selling stops cannot be used to open new trades under the market. Therefore, if you desire to take a short position "on stop" it will be necessary to use an office stop: That is, instruct your broker or your customers' man to watch the stock and sell it short at the market when he sees that the price on the tape has touched the figure you have specified. Thus the Stock Exchange requirement will be met, as this will be a market order on the short side, and not a stop order placed on the floor to begin a new short trade. In following this procedure, you, of course, must rely upon the alertness of your broker to see that the stock is sold immediately after it touches the price you have instructed him to act upon.

A buying stop is used under conditions where you have reasons to believe that the fulfillment of a required rally indication would be likely to initiate a further rise or the beginning of an important advance with no further material reaction; and where it appears that unless you catch the initial move immediately on the day the required indication appears, you might miss it or be compelled to pay a higher price by waiting (Sect. 17, Pg. 9, Par. 2). These conditions may prevail: (1) When a stock is near the end of a period of accumulation or absorption and seems ready to step on the springboard. (2) When a stock is on the hinge, that is, at a dead center. (3) When a stock has been in a trading range and it appears that if it can overcome previous resistance it will go into a definite mark up.

You reason that if the stock touches a certain figure on the up side, it will be ready to go, whereas, if it fails to reach that figure, you prefer to stand aside waiting until it does give the up signal. For instance, suppose you have seen the accumulation in the hypothetical stock charted on Page 9, Sect. 9M. You observe that whenever the price dips to around 30, it is strongly supported. You believe that at M a quick rise to 32 would be an indication that it is on the springboard for an immediate further rise, whereas a break to 29 or 28 on increasing volume would result in a further immediate sharp decline. You are undecided which it will do and you cannot watch the market to see how it will behave. Believing it is more likely to rise than fall, you instruct your broker: "Buy 10 ZYX at 32 1/8 Stop." If the price does not touch 32 1/8 your order will not be executed. But if it reaches that figure, whether you are watching the market or not, you will be long of the stock at or about that figure. Hence, if it should continue on up to 33 or 34 the same day, you would be in near the inception of the move and would avoid buying on a further bulge.

The disadvantage of this procedure is that since your risk begins the moment a new trade is made for you, you must place* a new stop order immediately to protect your purchase, just as you place a fire insurance policy on a house when you buy it. This second stop, which is to limit your risk, would have to be under 28 and since your buy stop necessarily must be executed on an up wave, you have increased your risk, as compared with the first procedure of buying at 30, etc, (as explained on Pg. 4, Sect. 10M). Thus, if the move to 32 1/8 should prove to be a flash in the pan and the stock fail to fulfill all its previous indications by turning downward, your trade would be closed out with a relatively large loss on the execution of your protective sell stop under 28.

A selling stop is the reverse of a buy stop and is used to begin a new trade on the short side when you have reason to believe that a reaction to a certain price would be likely to signal the beginning of a further down swing or the beginning of a large decline, with no further material rally.

The advantage of a selling stop is the same as in the case of a buying stop. You use it under conditions where you believe that the indicated down move is not likely to start unless and until a certain price is reached. And, when that price is reached, you figure that the decline will continue rapidly so that it is better to act on what is the equivalent of an automatic selling order than to risk a chance that you .might miss catching the beginning of the move, or risk having the price slide rapidly away from you if you should wait, for the required indication to be fulfilled.

The disadvantage of such a stop is the same as in the case of the buy stop, namely, you may be whipsawed by having your protective buy stop (which must be placed immediately to limit risk on the short sale you have just made) caught in the event you have misjudged the indications.

Sometimes when you are long of a stock close to a danger point, you reason that if it should break through that danger point you wish to be short instead of long. Say you are long 100 at 61 and the danger point is 59 3/4; it is your opinion that if it breaks through the latter figure you must get out of your long stock and go short. You instruct your broker: "Sell 200 XYZ at 59 3/4 Stop, and when sold, put a 2 point stop on the 100 shares I will then be short."

The reverse of the above procedure might be followed if you are <u>short</u> of a stock close to a danger point (on the up side) and you reason that you wish to be long instead of short if it should break through the resistance point. Say you are short 100 at 73 and the resistance point is 75. In that event you would give your order to: "Buy 200 XYZ at 75 1/8 Stop, and when bought, put a 2 point stop on the 100 shares I will then be long."

<u>It is better not to place stop orders at even figures</u> such as 90, 83, 72, 41, etc., because there is usually an accumulation of orders at the even figures, and when it is to their advantage, sponsors, specialists and floor traders try to get a stock up or down to these even figures so that these orders will be filled. Therefore, if you are long of a stock at 65, do not place your stop at 64 or 63, but at 63 5/8 or 62 7/8 instead. Then if the stock declines say to 64 there may be quite a lot wanted at that figure; more in fact than is offered for sale, and so long as the demand at 64 is greater than the supply, your trade is protected. Only when all the buyers are supplied at 64 and at least 100 shares dealt in at 63 5/8 will your stop be caught.

This technical point is based on an analysis of a large number of orders placed by the public. Full figures are the most used in the placing of orders. Next to the full figures, the half points are most often stated, such as 25 1/2, 50 1/2, etc. Next to the half points, the quarter points. Least of all, the fractions 3/8 and 5/8.

From the above we observe why it is to our advantage to place stops on long trades at the so-called odd fractions below the full figure, and on short trades at the odd fractions above the full figure.

The proper methods of placing stops to protect commitments when first made, and of moving stops to reduce risk and then to protect profits have been fully exemplified in the chart studies presented in preceding sections. From these practical illustrations, it will be noted that it is unwise to follow arbitrary rules, such as placing a stop 2 or 3 points away from the price at which a commitment is made.

Arbitrary stops of 2, 3 or more points should be used only when the tape or the chart does not show a support or resistance level, or a support or resistance point, nor otherwise give an indication as to where your stop might logically be placed.

Remember, your object should be to place your stops as close to the danger point as you can get it with reasonable safety. In the case of very high priced stocks, this may be 3 to 5 points under a supporting point or level, or 3 to 5 points above a resistance point or level, or it may be the same number of points under or above the level of a part way (50%) reaction or rally mark; or the same (approximate) number of points under a clearly defined trend support line or above a clearly defined trend supply line. In the case of moderately priced stocks it may be approximately 2 to 3 points and in the case of low priced stocks, say in the ranges under $50, approximately 1 to 2 points.

The number of points you will risk in placing a stop should also be governed by the type of operation you are engaged in. Thus, in short swing trading operations where you may be trying for the 3 to 5 point moves, your initial stop ; must be placed much closer to the danger points and should be moved to reduce risk more quickly than in the case of commitments made for the intermediate, swings of 10 to 20 or more points. The difference is that in the case of short swing trades, you are trying for smaller indicated profits and a more rapid turnover of capital; hence to keep the proper limitation of risk you must crowd your stops closer than in the case of long swing operations where you wish to allow for normal corrective rallies and reactions, or changes of stride, without being kicked out of your position on minor reversals of an established trend. All of which sums up into saying: In handling stops, be influenced by the purpose for which you made your commitment originally, and adjust your stops thereafter in accordance with the subsequent behavior of the stock and the market as a whole.

Always keep in mind that: Stop orders should NEVER be changed so that your risk is increased. All changes should be made for the purpose of reducing risk or eliminating risk or making sure of part of your paper profits.

Nowadays so many traders make a practice of placing stops exactly 1 point above or below an old resistance or support level on the even (full) figures that it is better to place your stops from 1 3/8 to 2 5/8 points away, from these levels and at the odd fractions, as already stated. Thus you will, in many cases, be out of range of specialists and floor traders who "gun" for these stop orders.

After a stock has moved well away from the point at which you took a long or a short position, you must remember that the further it moves, the nearer it is coming to the reactionary or rallying point, or the turning point for a swing in the opposite direction. The more it goes in your favor and the more it approaches the point (objective) where, you estimate, it should rally or react or turn completely, the closer your stop order should be to the market price.

If you calculate that there should be a 15 point move in your favor, do not hold out for the last point. If you are 10 or 12 points to the good on paper, crowd the stop order right behind the price when you see indications of hesitation or preliminary signs of a reversal. The more the stock hesitates and seems ready to reverse, the closer your stop should be.

In some cases, such as the above, it may be better to be stopped out on a close stop than to close it out yourself, for when you close a trade you shut off the possibility of further profit. But if you move your stop within a point or so of the market price, or to whatever figure the action of the stock itself indicates is best, the way is open for more profit and you have assured yourself most of what has already accrued.

However, the handling of stops efficiently is like everything else in the stock market, it is a matter of developing good judgment. Generally speaking, you will find it more satisfactory to close out your trades yourself, on your judgment of behavior, in preference to letting your stops take you out. This is because a stop on a long trade must necessarily be executed on a down wave, that is, on weakness and a stop on a short trade necessarily must be caught on an up wave, that is, on strength. With good judgment, you aim to begin long trades and cover short sales on down waves and to close out short trades or close out long commitments on up waves. The difference between what you get in using good judgment to begin and close out positions and all owing them to be closed out on stop, nevertheless, should not be counted as a loss. Rather, it is merely another item in the operating expenses of an investor or trader, namely, the insurance premium paid to guard against greater losses — a very small premium and a very convenient insurance which is available in few other lines of merchandising.

Of course, even the very best judgment in making commitments and the best logic in handling stops cannot prevent having them caught at awkward places. In such instances, that is, where you see you have been stopped out prematurely, it pays to reestablish your original position if you find that the action of your stock subsequently justifies going right back into it. But you must set your stop on the reestablished commitment just as if it were an entirely new position and without regard to the price at which you previously went in or were stopped out.

There are three reasons for the too frequent catching of .stops:-

(1) Starting trades too soon. This may be the result of impatience — hence poor timing or failure to wait for reasonably conclusive indications — or failure to observe the principles set forth in Paragraphs 2 and 3, Page 1.

(2) Bucking the trend.

(3) Improperly placing and adjusting your stops.

If you find your stops are being caught frequently, go over your trades carefully to determine whether the fault may be attributed to any or all of the above causes. Then review the instructions herein and all preceding references to stop orders so you may discover your errors and thus avoid repeating the same mistakes in the future.

Should it appear that your commitments are started right and your stops reasonably well placed, then the frequent catching of stops should be taken as a warning that you are not operating in harmony with the trend of the market. Thus, if you persist in selling stocks short in a rising market you are bound to expose your stops to the danger of being touched off on bulges. Conversely, if you repeatedly buy on what you believe are reactions only to discover that your stops are consistently caught, this should be taken as an indication that you are operating on the wrong side of the market — the trend is down and those presumed "reactions" in reality are waves of liquidation. Such errors of judgment sometimes lead students to abandon the use of stops. Nothing could be more dangerous.

Some active traders prefer to use mental stops. We suspect that many of them do not watch the market continuously; they forget that the market may go badly against them when they are not studying the tape. And on occasions the tape is many minutes behind the market. A mental stop is of no use under such conditions. Do not use mental stops unless you are watching the market continuously. If you cannot do this, leave instructions with your order clerk to close out your trade "at the market" when a certain price appears on the ticker tape. You may get more or less than that price; but if you will follow this plan you will not sustain a large loss if you are wrong. And everyone must expect to be wrong a considerable percentage of the time, especially when he is learning to trade.

<u>NEVER</u> abandon the use of stops. Instead, if your stops are too frequently

caught, close out all your commitments. Get out of the market entirely and stay out until your judgment clears, until you have located the cause of your difficulty through consultation with our Coaching Staff and know how to correct it: In brief, until you <u>understand</u> the market and are able to apply the instructions contained in this Course.

Not to use stop orders is to discard one of the most vital parts of this Method. The secret of success in any business is the limitation of losses. Not to use stop orders is to express such confidence in your judgment as to indicate that you cannot be wrong.