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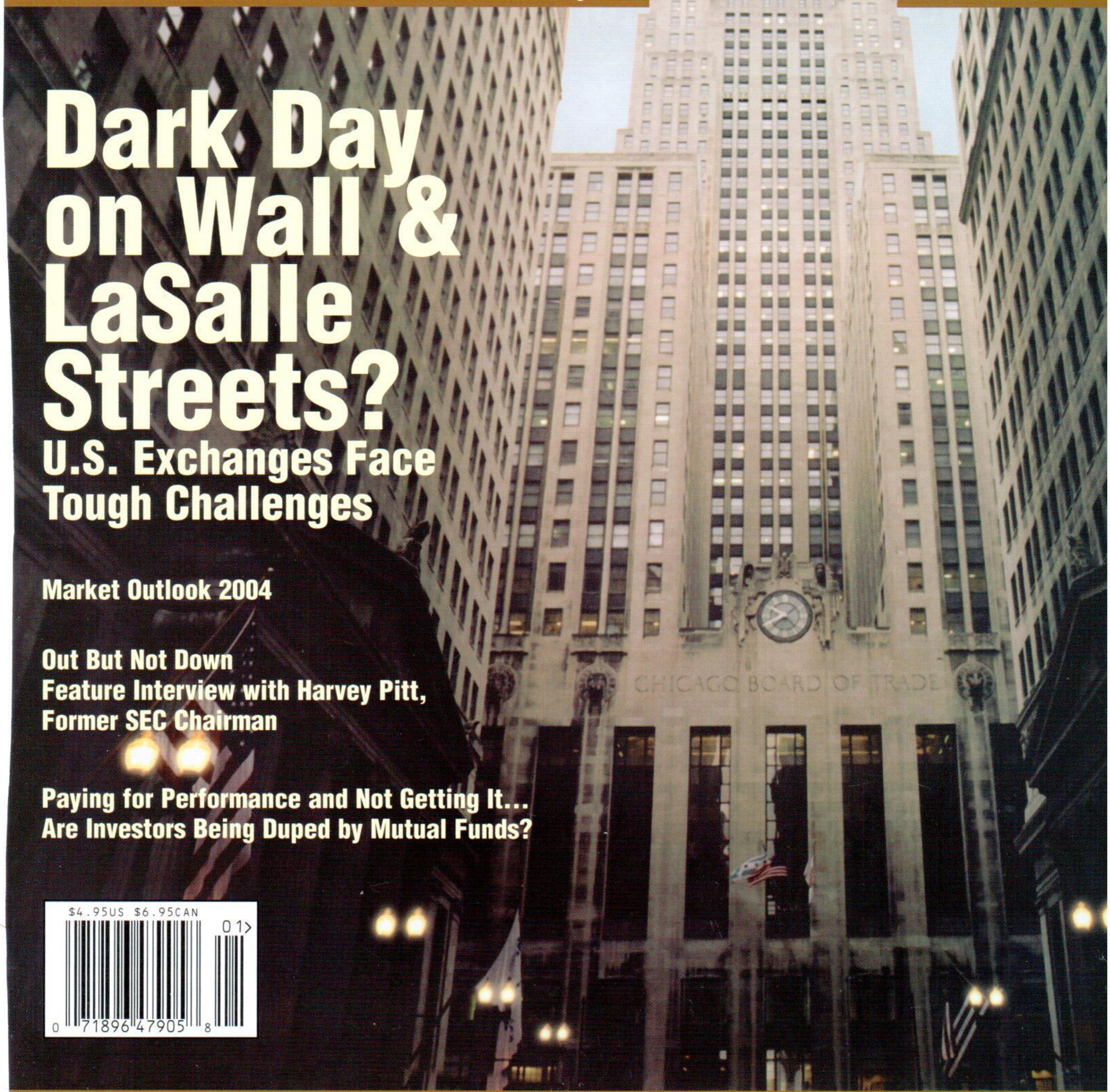

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Saying good-bye is never easy. And, traders often are confronted with challenges of knowing when to get out of a loser and also when to book profits on a winner. In the July 2003 issue of ***SFO***, I wrote an article that explored the dynamics of a short squeeze and the factors that should be considered when entering a stock trade from the long side. Now, it's time to look at the other side.

In this article we'll examine the elements that should be considered when exiting a trade across several different timeframes. It is often said that entering a stock is easy, but knowing when to sell (or cover a short) is what separates the best traders from those who just scrape by. Any successful trader knows that having an exit strategy is the true key to consistent success in the markets. As with any decision in the market, it is easy to let emotions creep into the decision-making process. If a trader allows feelings to become a factor in making decisions, he will find the emotional battle from within paralyzing at times. Some of the questions that will creep into his mind include, "Do I sell now and take a small loss, or do I buy more to average my price lower?" and "Should I sell for a small profit, or should I hold out for bigger gains?"

Clearly these emotions are going to get in the way of making objective decisions, so we must have a disciplined and consistent plan of action that cuts losses at an early stage and allows profits to run. This plan of action is based on the single most important factor – price action. Traders must recognize early on that the market does not care what any of us think a stock should do. Our opinion does not count. Buying or selling a stock casts a vote of confidence for that security, and in the market one person's opinion is about as relevant as if he had voted for Al Gore for President.

Plan Ahead

With that in mind, when should a position be covered? Professionals trade according to a plan that is thought out in advance and based on market action. The only accurate way to measure whether a stock is behaving as it should is by studying technical analysis. Technical analysis allows traders to be completely objective in their assessment of price action and to leave emotion out of the decision-making process. Knowing when to cover a trade is accomplished by letting the stock tell us when to get out.

You might be thinking "How the heck is the stock going to 'tell me' when to cover?" The answer to this question is more straightforward than you would imagine, and it relies on simple technical concepts.

SEVEN Ways to Say Good-Bye

Exit Strategies: A Critical Element in Trading Success

Before getting to those, it's important to consider the futile nature of trying to find the single best way of exiting a position. Recognize that there is no single best way to do anything in the market because everyone has different objectives in terms of time in a trade, different risk tolerances, as well as funds within an account. Certainly, the objectives of someone who is a pure day trader will be vastly different than those of a more patient individual who may be comfortable holding a position for months at a time.

With that in mind, let's examine seven good reasons and strategies to exit a position. By having a solid understanding of them, we can sell based on an objective interpretation of the message the market relays to us in the form of a price chart. For simplicity, we're referring to the long side of the market in all of the examples; of course, these events are valid on the short side simply by reversing the rules.

By Brian Shannon

There are seven events that should motivate an investor/trader to sell. These events can be best described as:

1. Initial protective stop
2. Gaps against the prevailing trend
3. Price targets
4. Hard trailing stops
5. RealTick® trailing stops
6. Moving average crossovers
7. Time stops

Keep Your Cash

Initial protective stops give us our first decision to sell because their use is based on preservation of capital. Before even thinking about taking profits, we obviously have to ensure that we are in a profitable position. The nature of short-term trading is to be in a position only while the stock is showing positive momentum. Once a stock shows signs of reversing its momentum, swing traders should be out of that position and in cash, or in another stock where their money is working for them.

Technical analysis allows traders to be completely objective in their assessment of price action and to leave emotion out of the decision-making process. Knowing when to cover a trade is accomplished by letting the stock tell us when to get out.

The final judge as to the success or failure of a trade is price, and it is the most important consideration in when to exit a position. Price action is the building block upon which support and resistance are formed, becoming the bedrock of trends. The goal of a trader is to capture as much of a trend as the market allows, and this is why price is the most important source of information. The first time that price plays a role in our decision-making process is in setting an initial protective stop on the position. Before thinking about how much money a trade will make, we need to consider where we will exit if the trade does not go according to plan.

When initially entering the trade, the first technical consideration is the location and price levels of support and resistance. Besides making sure we are entering a position that is not too far extended from a decent level of support, the reason to immediately look for support and resistance is to set a protective stop. We place the initial stop to make sure that if the stock does not act the way we expected, our accounts are not exposed to a catastrophic loss. For longs, stops should be placed just below the most recent support, and for shorts, just above a recent resistance level. Obviously, if it is not a swing trade, a shorter timeframe should be utilized to determine this protective level.

In the case of ODSY, seen in ***Chart 1***, the stock was shown after it broke out to all-time highs on May 6, with the price at the time $17.60 (adjusted for a 3/2 split on August 12). At that time, the highest preceding low was found at the April 30 low of $15.73, coinciding with the location of the rising 50-day moving average. Whenever we have more than one technical reason for being involved in a trade, it adds significance to the level. In this case, we had what appeared to be the beginnings of a new uptrend with the prior low and the rising 50-day moving average in the same location. Just below the prior higher low is often the ideal point to place the initial stop, because breaking below that level would nullify the trend. In essence, we are exploiting the definition of an uptrend (higher highs and higher lows) to remove the dangerous emotions that might enter the decision-making process.

CHART 1 Odyssey HealthCare (ODSY)

SOURCE: RealTick

Another Reason to Get Out

Gaps against the prevailing trend occur when a stock in an uptrend suddenly gaps lower while an investor has a long position in the stock. Luckily, these gaps in trading, caused by an imbalance to the sell side while the stock is in a solid uptrend, are not that common. Remember, here we are not discussing common gaps of one to two percent, but rather, a gap down by more than five percent.

When we do find ourselves in the unfortunate situation of being caught in this predicament, it often is best to sell the entire position. A gap of this magnitude (five percent plus) typically will not occur unless there is a serious fundamental development at the company, and because our entry may not have taken fundamentals into consideration, we are now in a position that was not anticipated.

But as they say, "When in doubt, get out!" As a general rule of thumb for gaps, liquidate the position if a hard stop (sell event #4) has been violated. If the stock gaps down five percent but does not violate a hard stop, we need to monitor the stock closely for further signs of weakness. If it looks like liquidity may be an issue for exiting a larger position, it is a good idea to consider selling half of the position. Thus, if the weakness continues, you will not feel trapped in the stock as it declines and grow reluctant to sell, waiting for a bounce that may never arrive.

CHART 2 RSA Security

SOURCE: RealTick

We see in ***Chart 2*** of RSA Security that the stock gapped lower on October 17 and did not bounce. Although it would have been a tough decision to liquidate the position on such a gap, it clearly was better to have sold at the first sign of trouble than to continue to hold and hope. Sometimes it is best to get the pain over all at once by selling the entire position rather than prolonging the agony of a loser.

Price Targets

Always have a reasonable expectation as to where you think the stock might rally, thus determining at least an estimated area where selling may occur. If a stock is in a solid uptrend that may be approaching a prior level of support, there is the potential for that past area of buying to offer resistance. Assuming you started with a good theoretical risk/reward ratio in the original purchase, taking some of the profits makes sense at the target area.

Then again, also be careful not to sell too much of a stock that continues to have strong upward momentum – because the biggest gains are still likely to be ahead in this situation. Selling a little at the target helps make it easier to let go of the stock later, because it shows less emotional attachment to the stock. Also, admit it – it feels good to take a profit and reward yourself a little. For the rest of the position, hold on tight, and allow yourself to have a big winner.

Hard Trailing Stops

This type of stop requires the most skill on the part of a trader. However, by the time we get to this point, the stock is doing the work while our job is to monitor and adjust our risk levels as the stock moves higher. A hard trailing stop is based on the very definition of the trends from which we are trying to take money.

The definition of an uptrend, of course, is "a series of higher highs and higher lows." This implies that breaking the series of higher lows is a violation of the trend, and that is a reason to sell. ***Chart 3*** encompasses 17 days of trading utilizing 15-minute time increments, and we can see how shares of Netflix Inc. (NFLX) ascended over the course of nine days in a perfect stair-step pattern of higher highs and higher lows.

Assuming the purchase of the stock at $36.50 on October 2, we would have an unrealized profit of $4.41 per share based on the close at $40.91. This gain is definitely worth protecting. Chart 3 shows how the trader would have raised the stop up under the rising lows with an exit being made on October 8, as the stock traded below the prior low of $42.85. This stop would have allowed the trader to lock in a gain of $6.35 over the course of five trading days. Indeed this stop takes some work because it requires the cancel and replace of orders; yet this is fun work, because it means that profits are being locked in.

To capture the occasional windfall profits in a stock that exceeds the profit objectives, market participants can use a simple methodology that has proven very effective for holding stocks that are showing positive momentum. This method involves the use of a trailing stop-loss based on the higher lows that the stock is making. Holding a long stock that is moving higher is done by using the daily chart and placing the stop just below the level of the last higher low. If the stock does not trade below the previous day's low, then it is showing positive momentum and should be held overnight again.

CHART 3 NetFlix, Inc.

SOURCE: RealTick

Best for Day Trading

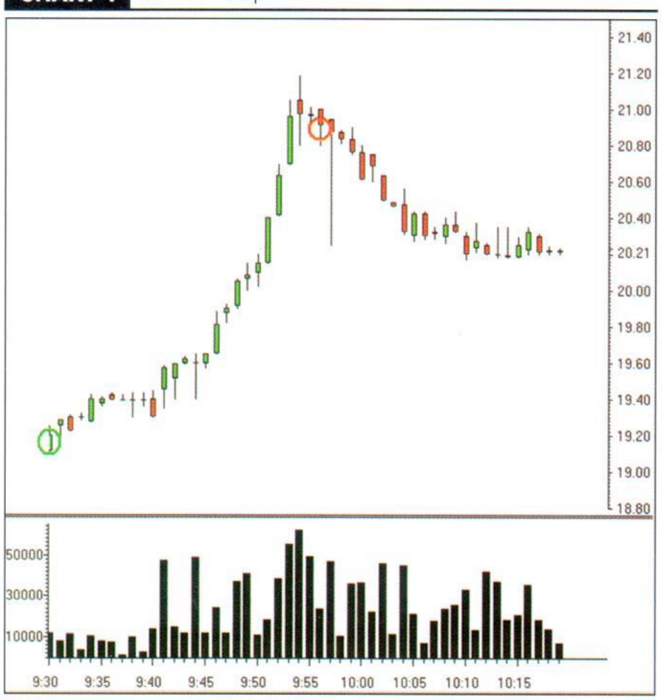
RealTick® Trailing Stops are my personal favorite stops to use on a day trade. This unique stop actually gives control of your order to the algorithm built into the RealTick trading platform. The ideal situation for this type of stop is when buying a stock that finds rapid upside velocity, pushing the stock quickly away from your hard stop. In the situation where the stock may run $1.00 or more in just a few minutes, traders are faced with the dilemma of deciding whether to sell the position and lock in the gains or to allow it to run further. We've all seen the stocks that can run $2.00-$3.00 in the course of an hour or less, and we certainly don't want to allow a nice winner to turn into a loser. The emotions that can be dredged up from this experience tempt even the most disciplined traders to exit with the profit rather than allowing it to run further.

Fortunately, technology has given us the opportunity to mitigate the emotional decision process with the Real Tick trailing stop. Let's look at an example of how it works, using ***Chart 4*** to illustrate. On August 21, Semtech started to rally late in the afternoon, and I bought 1,000 shares for a quick day trade. The stock continued to progress nicely higher, and because it was showing strong positive momentum and displayed a strong technical pattern, I locked in partial profits on half of the position. I allowed the rest of the position to be transitioned into an overnight hold. The stock closed that day at $18.58. The next morning, the stock gapped higher at $19.11, at which point I was tempted to sell the stock for a quick profit of $265. However, I instead decided to allow the profits to run a little. When the stock was at a price of $19.28, I entered a trailing stop of $0.15, which was read as a stop market order at $19.13.

As the stock exhibited further strength, the stop automatically adjusted higher, but would never get adjusted lower. The trailing stop sets an actual stop of $0.15 (or whatever increment you choose) below every new high the stock makes. Keep in mind that this will turn into a market order upon the stop being activated and can cause slippage in illiquid or fast-moving markets.

From the time the stop was set, over the next 23 minutes the stop was automatically adjusted 157 times until the trade was

CHART 4 Semtech Corp.



SOURCE: RealTick

finally stopped out $1.79 higher than the original stop. That is an extra $895 made on the trade without any further intervention on my part – a total profit for the day of $1,160. And to think that I was tempted to sell at the open for just $265! Ideally, I would love to use a trailing stop on all my trades, because it means I have gotten into a stock at a time of maximum upside velocity.

The most difficult decision for a trailing stop is how much room to allow the stock to have. It is similar to fishing. Any fisherman knows that if you tighten the line too much when there's a big fish on the hook, the fish is sure to break off and you never get to taste your reward. In trading, setting the stop too tight might mean getting shaken out of the position before the stock runs its course. How much room to give a trailing stop depends a great deal on historical volatility and the price of the stock. The more volatile and higher priced stocks will need to be given extra room to wiggle, while less-volatile, lower-priced issues usually can be kept on a tight leash with just a $0.10-0.15 stop.

The goal of a trader is to capture as much of a trend as the market allows, and this is why price is the most important source of information.

Moving Average Crossovers

These technical readings often signal the end of a prevailing trend, and that is a good time to take profits on a position. Refer back to Chart 3 of Odyssey HealthCare (ODSY). Referring to the July article, the stock was purchased in early May for a position trade near $17.50 (adjusted for a 3/2 stock split on August 12).

Trending stocks tend to stay above the rising moving averages, and ODSY remained in a healthy uptrend that would pause briefly at the 10- and 20-day moving averages, where it would find fresh buyers to bring the stock higher. On September 22, the stock broke hard down to the rising 50-day moving average. This swift sell off was reason for concern but not yet a reason to sell, as stocks often find support at the rising 50-day moving average. Three days later, the stock experienced another wave of selling and that brought the 10-day moving average down through the 20-day moving average. This action tells us that the short-term trend was now heading lower while the intermediate-term was trending higher; this indecision tells us it is time to book profits. The stock was at $28.50, well off the high near $36, but still 62 percent higher than the purchase just four months earlier. That is how this type of stop can get us out of a position, but now let's examine why.

Moving averages are simple, but often misunderstood, technical indicators. Many people like moving averages because they allow traders to objectively identify trends on all timeframes with incredible accuracy. One of the common misconceptions about moving averages is that moving average crossovers are a reason to enter a position. But usually a moving average crossover occurs after a trend has exhausted itself. As trend followers, there should be no clearer sign that it is time to exit gracefully with our profits before the market relieves us of them.

The Last Way to Say Good-Bye

Time stops are another way of exiting a position that is stagnant. As traders, we encounter two forms of risk. The previous six reasons to sell addressed the risk of price. This stop addresses the other form of market risk – time. Time can be our biggest enemy in a trade – the quiet killer of our equity.

How many times have you neglected a stock in your account because it wasn't doing anything? Even a day trader will sometimes find himself complacent with a stock that doesn't show any movement. Then suddenly a sell order comes into the stock and moves it lower by a dollar without the trader having the ability to react. The time stop takes care of getting out of a position if it is not working as quickly as we would have expected.

The general guideline I personally use as time stops for day trades is 15-30 minutes. For a swing trade, I typically will give the stock two to three hours before I consider selling the position out near my cost basis. For position trades, my patience gets stretched easily, and I will give the stock no more than one to two days to get moving before starting to think my timing is off. When I get stopped out because of time, I often will re-enter the stock if it exhibits signs that it may be ready to move later on.

These seven reasons to sell are not meant to be the only reasons to exit a position but, hopefully, it does give traders something to think about when looking at closing out positions. There are many different situations that present themselves to us in the markets. The more strategies we have to deal with them, the more likely we are to attain our goals of being in the elite group of traders who consistently take money from the market.

Brian Shannon is the director of research and an instructor at MarketWise Trading School in Broomfield, CO. In addition to instructing, Shannon is an active and successful trader. More of his work can be found at www.marketwise.com, where he writes daily market commentary and provides readers of "The WiseGuide" with actionable short-term trading ideas. He can be reached at b.shannon@marketwise.com.

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