

Trailing Stops: How To Capture Big Trends by Turning Shorter-Term Trades Into Longer-Term Winners

When I first began this series of articles in mid-September, I stressed the importance of trading with the trend. At that time, the S&P 500 remained in a longer-term (and shorter-term) downtrend. Since then, the US market has dropped over 25 percent (and is trading even lower at the time this is being submitted for publication!).

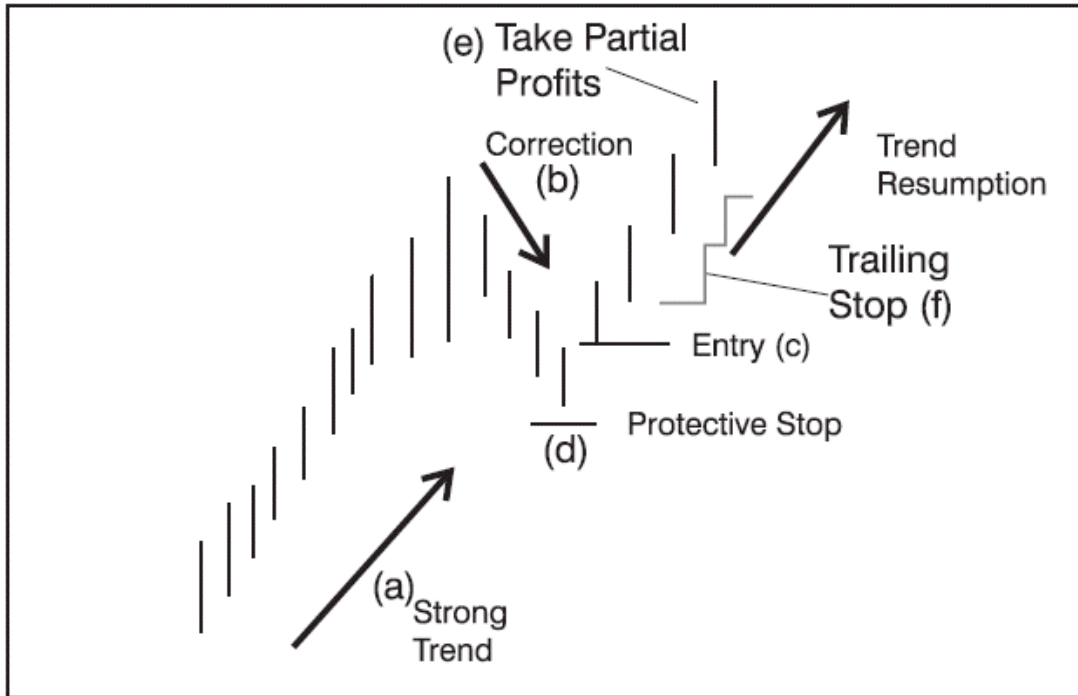


Of course, there's no guarantee that the trend will always resume (that's why I recommend using protective stops!). However, as you can see, it pays to follow the longer-term trend for when it does.

This week, we'll get back to basics. As previously mentioned, all of my patterns are based on identifying trend and then entering that trend on a pullback.

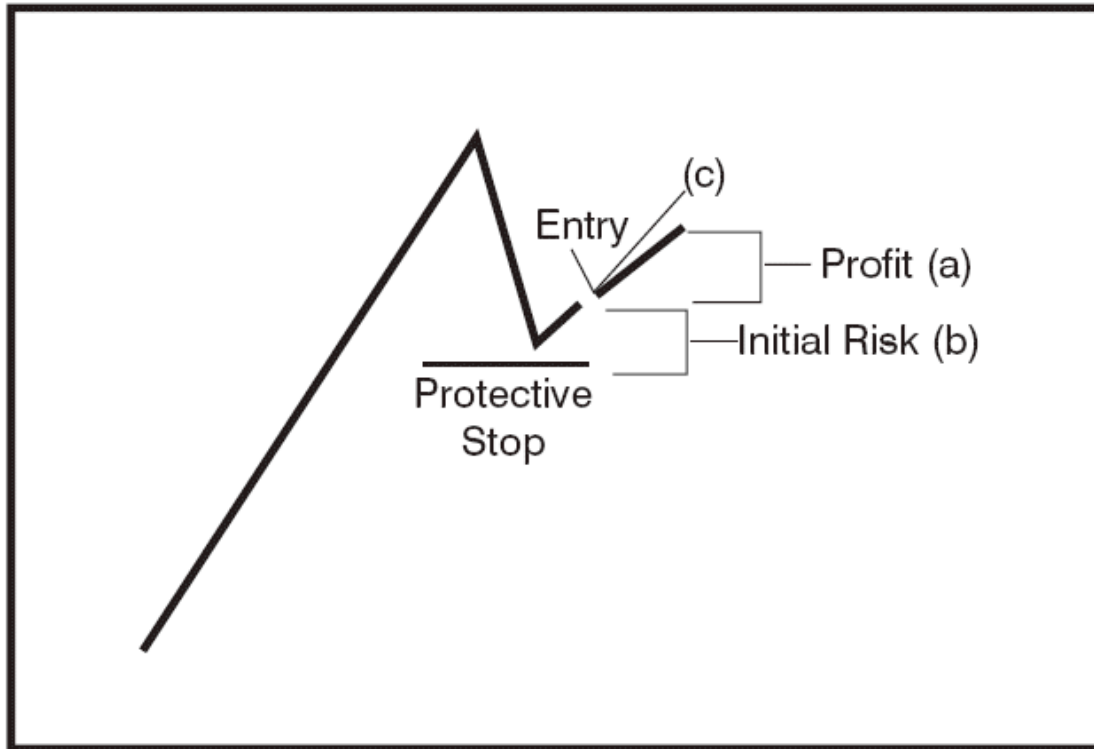
To review, here is the pullback figure. A pullback consists a market in a strong trend (a) that has begun to correct (b). An entry is triggered when the trend begins to resume (c) and a protective stop is placed just in case the trend does not resume (d). As the trend continues, partial profits should be taken (e) and the stop on the remaining shares should be trailed higher (f).

In this article, I'm going to talk about how to attempt to capture a longer-term trend with a trailing stop (f). I'm also going to cover the basic money management system.



The *basic* money management system that I use is to sell half of the position when the gains are at least equal to the initial risk. I use the term “basic” because there are tips and tricks that one can use to improve upon this system. We can explore these in future articles (or for those of you who speak English, see my webcasts at www.davelandry.com). For now, let's just stick to the basics.

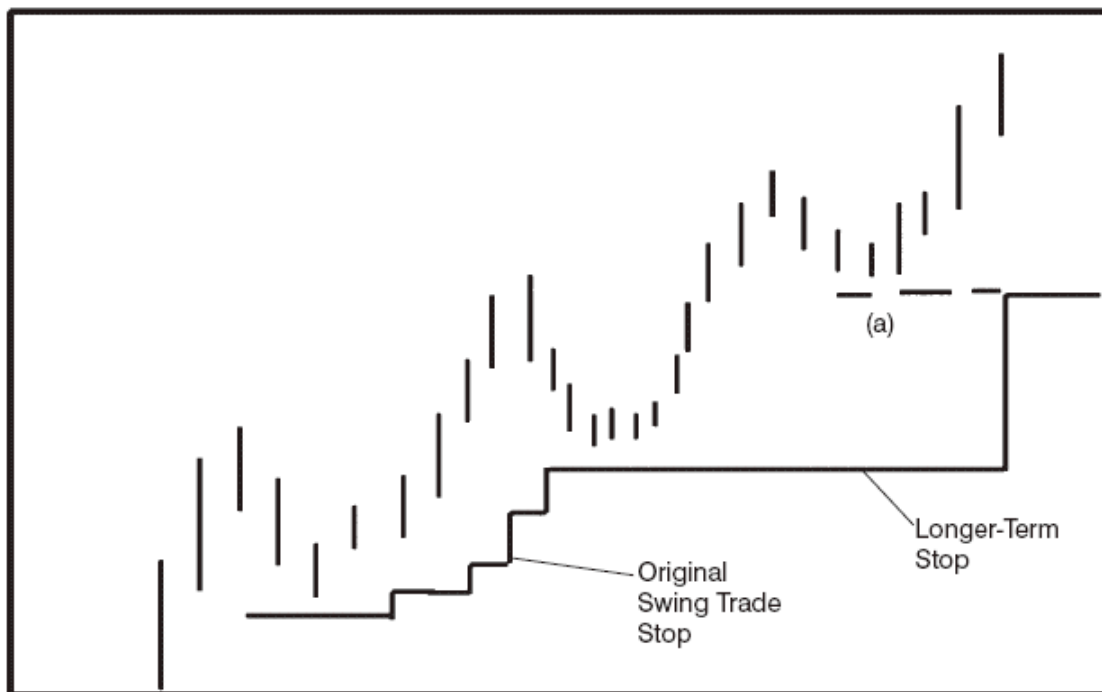
Considering the above, suppose the initial risk, from the entry (c) to the protective stop (d) is 5 points. Referring to the figure below, I am then looking for at least a 5 point profit--(a) \geq (b)--before I will begin to scale out of the trade. At this point, I will exit half of my position and then move my protective stop on the remaining shares to breakeven. This way, the remainder of my position has the potential to turn into a “homerun” (a large gain). And, the worst I can do, barring overnight gaps, is a scratch trade (breakeven) on those remaining shares.



Although I'm known as a swing trader, I will stay with a position via trailing stops as long as it moves in my favor. In fact, my goal on *every* trade is to capture a longer-term move. I let the market decide for me when it's time to exit.

Initially, the trailing stop is equal to the initial risk (b) described above. Therefore, for instance, if I am risking 5 points, then I will trail the stop higher to 5 points below the *closing* price. Once the initial profit target is hit and I have exited half of my shares, I will then move my trailing stop to breakeven. On a sustained favorable move, I will begin to trail more loosely (e.g. more than 5 points away from the closing price) in effort to help ensure that I capture a longer-term move. Therefore, the initial fairly tight "swing trade" stop becomes a wider stop that one would normally associate with a longer-term type of trade. This helps me to "ride out" corrections than are normal in longer-term stock moves.

I have illustrated this below. Notice the "swing trade" stop is trailed more loosely (i.e. I don't tighten it as much) as the stock continues to move in my favor. As the open profits grow, I might continue to loosen my stop even further (within reason).



Another way of accomplishing the above is through pattern based trailing stops. You adjust the stop higher *after* the market corrects and then begins to resume its longer-term trend. Notice above that what originally started out as a swing trade with fairly tight stops becomes a longer-term trade with a looser stop. This stop is then raised to below each subsequent correction (a) *after* the trend resumes from that correction. This allows you to participate in a longer-term trend should a stock continue to “stair step” higher.

Keep in mind that when I trail stops more loosely as the stock moves in my favor, my “point based” stops often eventually become similar to the pattern based stops described above.

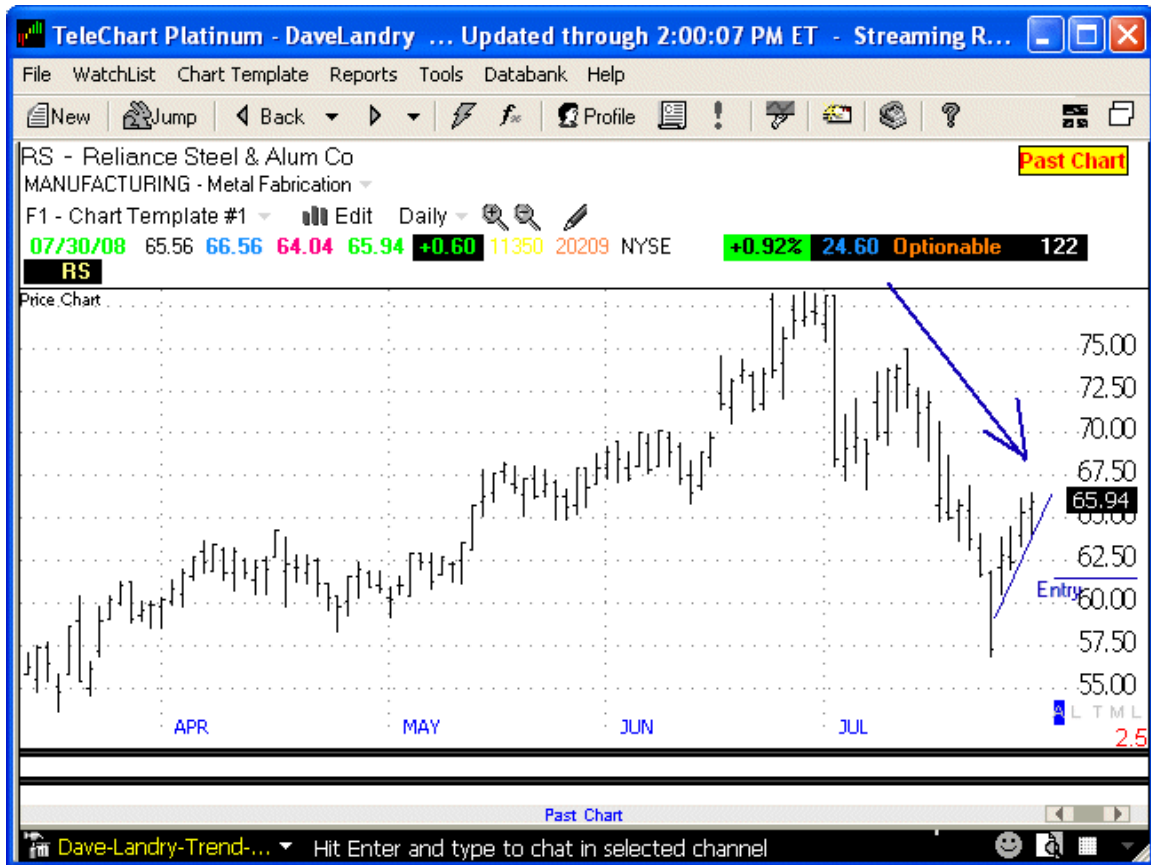
Now let’s look at a “real world” example. Below is the original recommendation published on 07/30/08 (email me if you need access to the archives):

Setups/Actionable Items

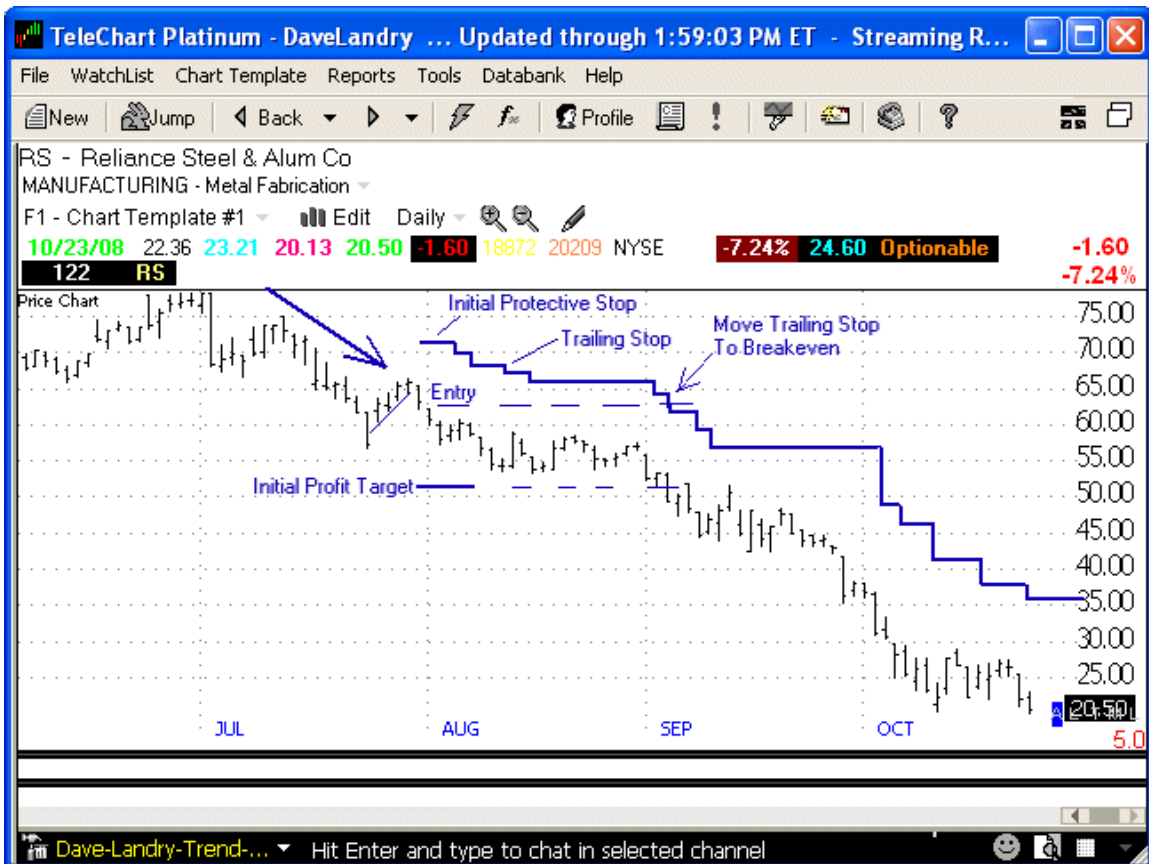
RS-Sell Short
 Reliance Steel & Aluminum
 Pattern: Pullback
 Entry: 62
 Protective Stop: 72
 Initial Profit Target: 52

See recent articles on entries and protective stops for more insight on how I determined the above. Notice that the distance from the entry to the initial profit target (62 – 52=10) is the same as the distance from the entry to the protective stop (72-62).

This is what the pullback setup looked like:



Now let's look at what happened (below). The stock triggered and initially moved in our favor. We tightened the stop as the market continued lower. Then, notice that after a fairly lengthy consolidation, the stock resumes its slide and hits the initial profit target. At this juncture, we take profits (half) and then tighten the stop on the remaining shares to breakeven. As mentioned above, the worst that can now happen to us is a scratch (breakeven) on the remaining shares (barring overnight gaps). And, best case, it sets us up for a potential longer-term gain.



Notice above that as the stock continues to move in our favor, we begin to trail the stop more loosely on the remaining shares. So far, this has allowed us to capture what has turned into a longer-term trend. I'll follow up on the above in coming articles.

As you can see, this very basic money management plan with the use of trailing stops can help you turn a swing trade into a longer-term winner.