

## A Little Discretion Goes A Long Ways

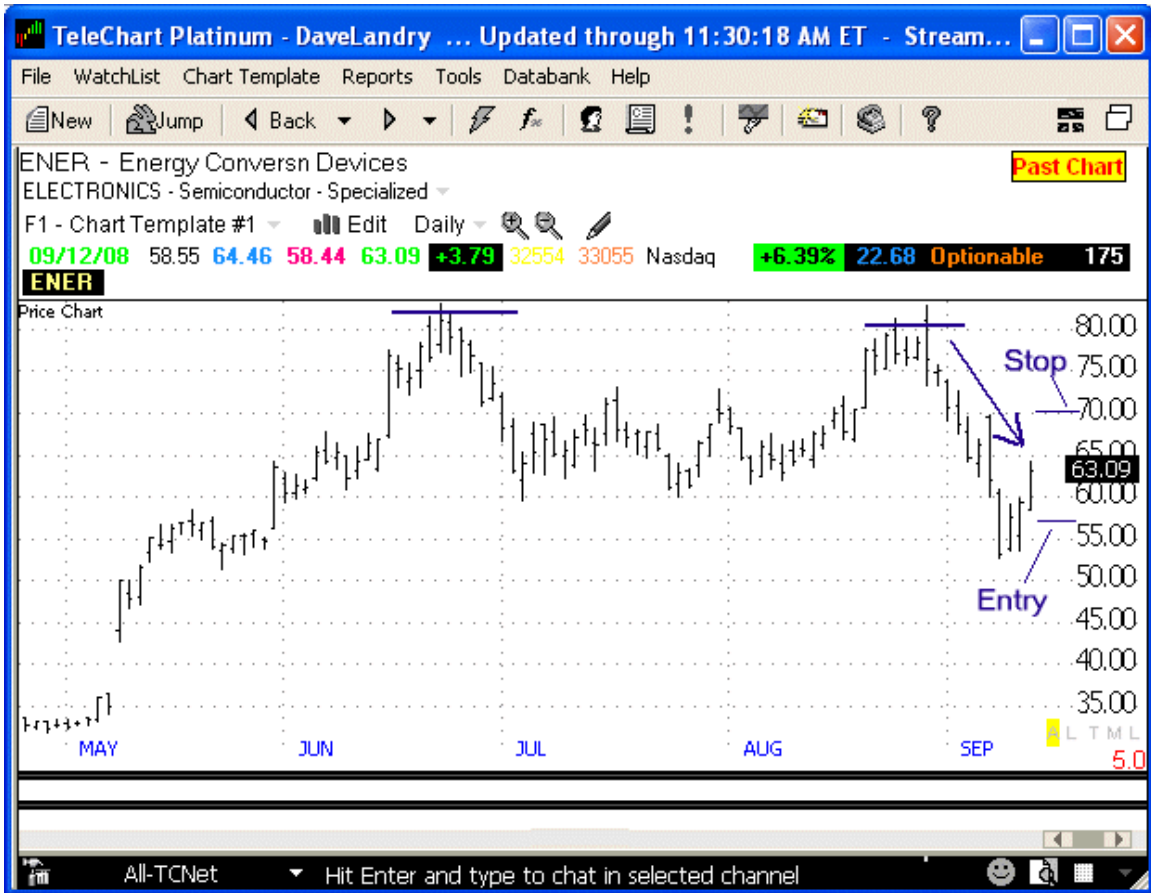
In a previous article, I talked about how the placement of protective stops is as much of an art as it is a science. Ideally, stops should be outside of “normal volatility” or noise of the market. Since the market usually doesn’t operate on “exacts”, a little discretion can go a long ways towards increasing your profitability. I’m going to demonstrate this concept using a recent example.

Before we get into the technique of applying discretion with stops, let’s look at the original setup. This was first published on Friday 09/12/08 for Monday 09/15/08. Email me if you need the archives.

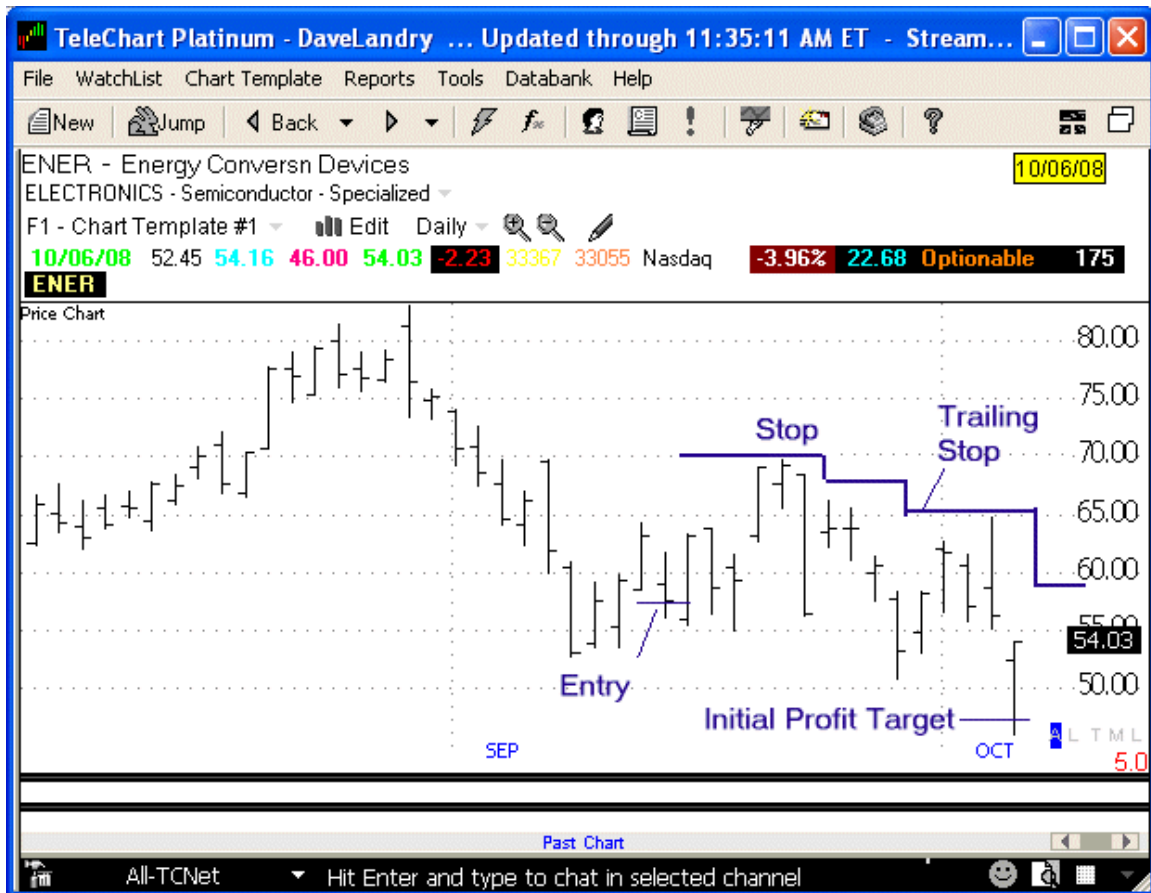
ENER-Sell Short  
Energy Conversion Devices  
Pattern: First Thrust  
Entry: 58  
Protective Stop: 70  
Initial Profit Target: 46

Notice the stop of 12 points/over 20% is *fairly* loose. However, when “eyeball” the stock, we see that it bounces around 5-10 points in a single day alone!

Here’s the chart. We’ll cover the First Thrust pattern in an upcoming article. For now, just know that it’s an early trend “transitional” type of setup (see recent article on trend). Also notice the stock had formed a big picture double top.

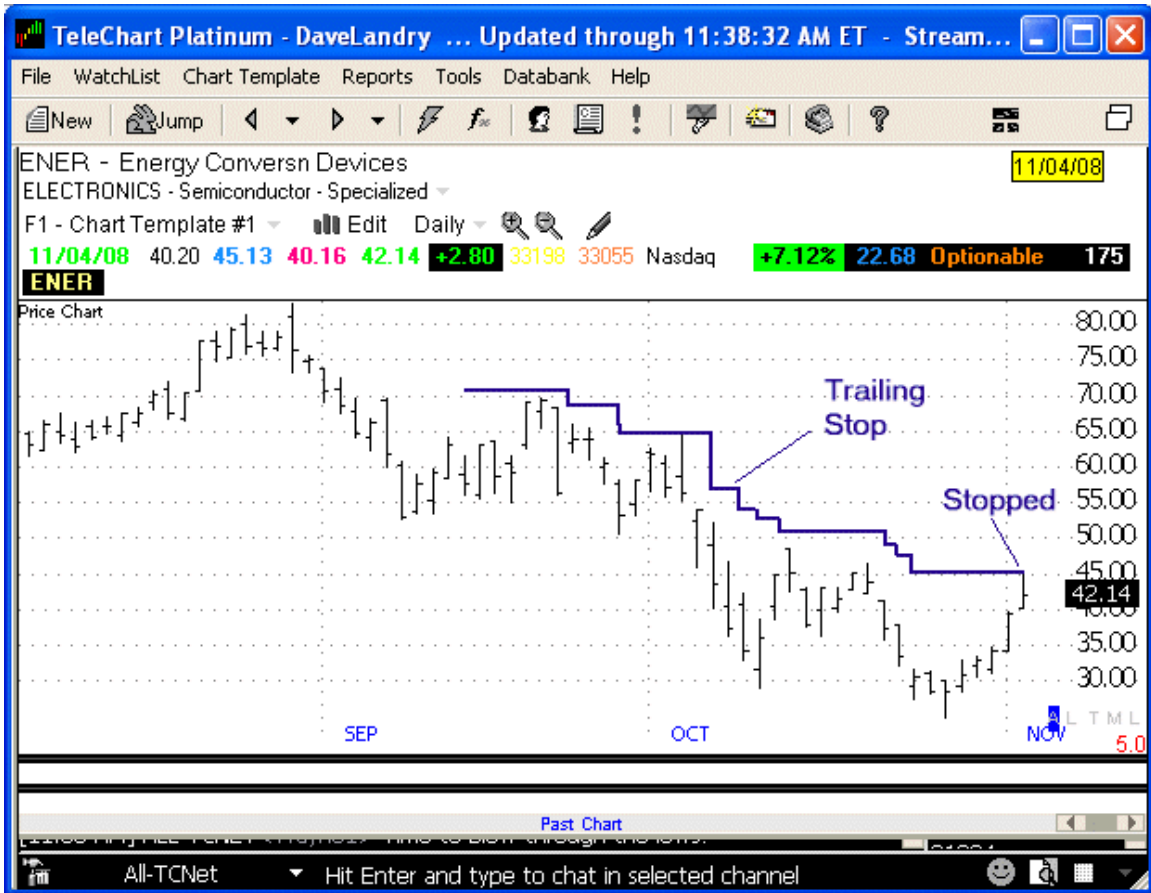


Now let's look at what happened.

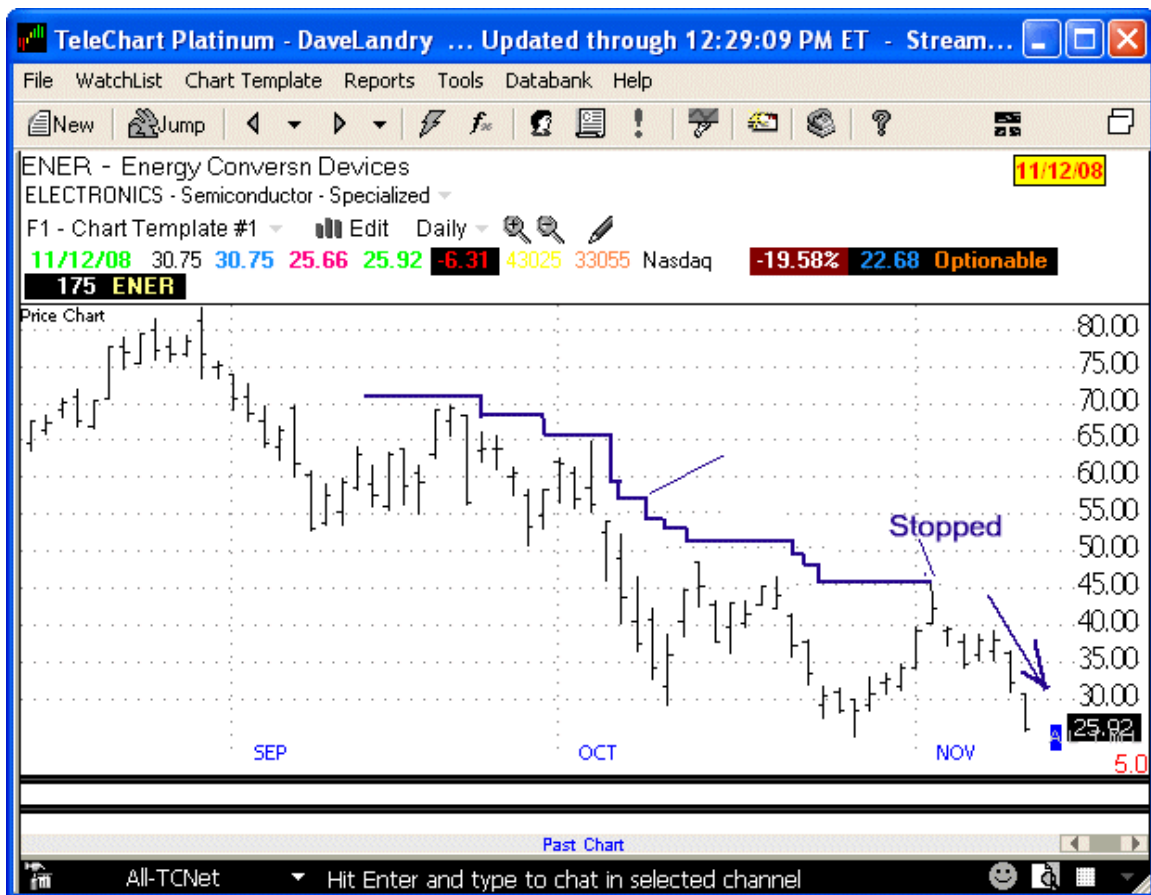


The entry triggers but the stock immediately reverses to come dangerously close to the initial protective stop. Luckily, it promptly reversed and begins to sell off. Whew! I told you it was volatile! After some gyrations, it resumes its sell off to hit the initial profit target. At this point the stop is moved to breakeven, the same as the entry (see prior articles for more on position/money management). This puts us in a good position--we have the chance for a homerun and the worst we can do, barring overnight gaps, is a scratch (breakeven) on the remaining shares.

Below is what happened over the next few weeks. Notice that we continue to trail the stop lower in effort to capture a longer-term trend (see recent article for more on this). Unfortunately, the stop is just hit.



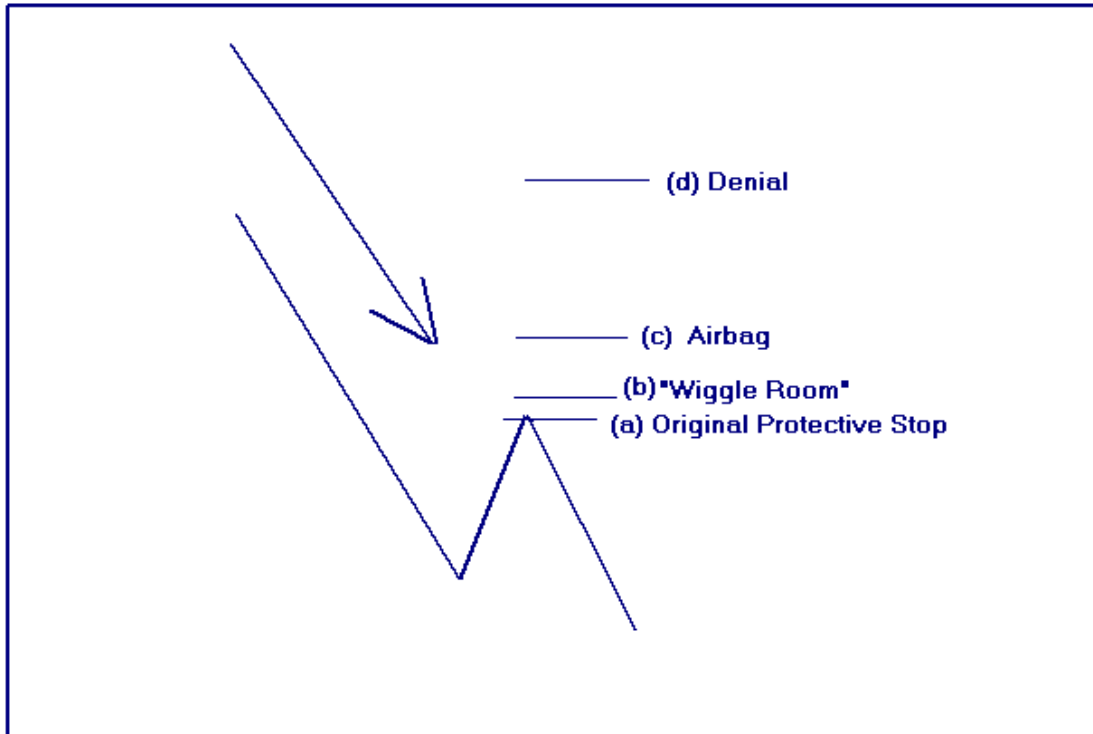
What's worse is, the longer-term downtrend promptly resumes.



Trading isn't an exact science. No matter how you determine your stop, the market always has the potential to take out that stop---and then turn back into the intended direction (as you watch in anguish!). Therefore, it's okay to give them a *little* wiggle room around the stop. This is provided of course, you're disciplined enough to exit if the market does not turn around

Referring to the figure below, notice at point (a) the original protective stop is "officially" hit. However, the stock reverses back into the intended direction. Of course, at the time the stop being hit, you don't know that the stock will reverse. Therefore, at this juncture, you can watch the stock (using a mental stop of course) and give it a little "wiggle room" (b) just in case the stock reverses.

Again, this takes discipline you *must* honor some sort of stop if you are obviously wrong. You cannot live in denial (d) and finally throw in the towel---taking a huge loss when the trend has obviously turned against you.



### Implementing Discretion With Stops

As mentioned above, to implement discretion with stops, you will have to watch the screen. Or, if you can't, you can set an alarm at your original stop. You might also consider having an actual "airbag" stop in place (c) just in case something happens and you're not able to implement the plan. This is a stop placed well outside of the normal volatility. It will help you survive reversals when you're not around. Obviously though, when it doesn't and the stop is hit, you're going to get hurt much worse than you would on your original stop. The good news is, you will "live to fight another day."

I'm not familiar with brokerages in Italy (yet!) but some brokers in the states allow "contingent" type orders. For instance, suppose you are short, you could require that the sock has to have multiple trades ABOVE stop and be bidding ABOVE stop before the stock. This can help keep you in trades (without having to watch a screen) where the stop is barely "nicked."

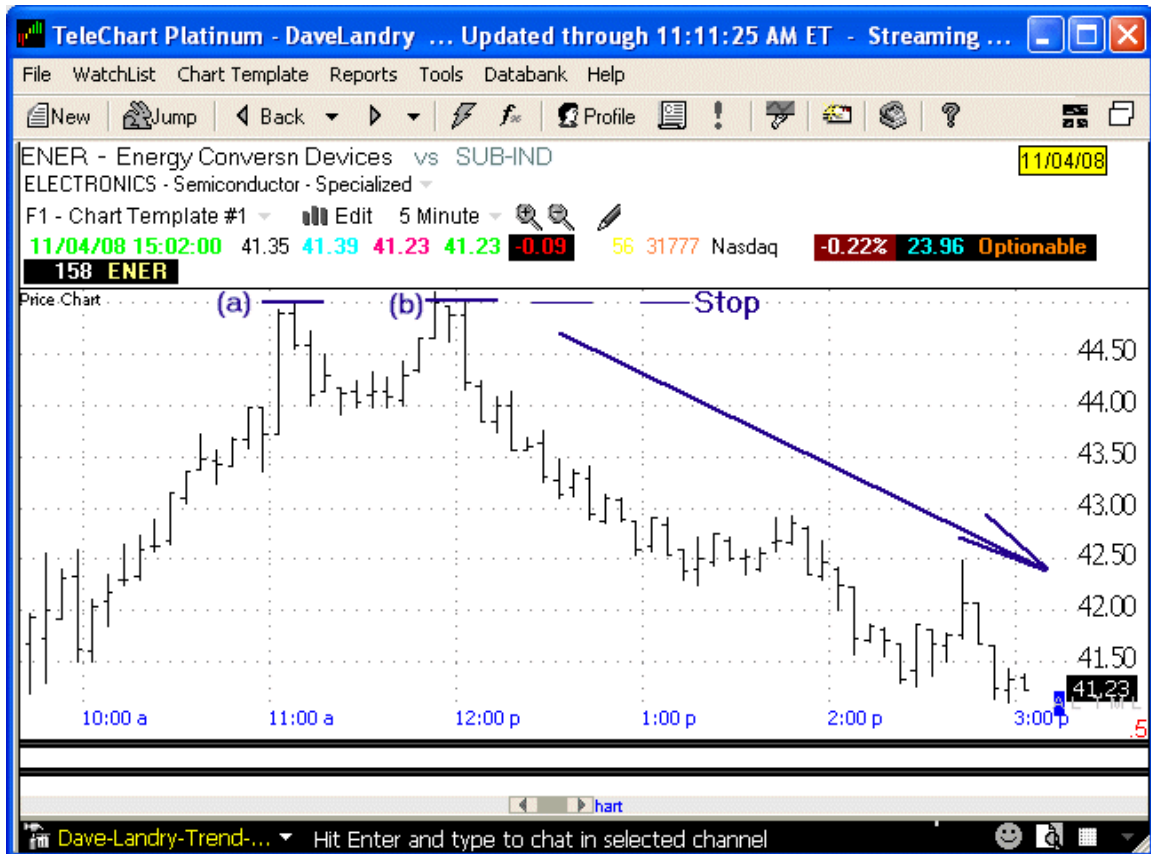
Market conditions should also be taken into consideration. For instance, suppose the market is up huge, overbought, and bumping up against resistance. *Chances* are pretty good that it will reverse (but of course, there's no guarantee!). Another example would be an opening gap reversal or early morning reversal off a fast move on the open.

Now, let's take a look at the market conditions on the day the trailing stop was "hit" on ENER. On 11/04/08, notice that the S&P remained in a longer-term downtrend but had been trading sideways over the past few weeks. Also notice on a short-term basis, it was overbought by rallying nearly 20% in a week. Further, it was bumping up against

resistance near the top of its trading range. Again, there's no guarantee that it would reverse but chances were pretty good that it could. This helps to make the decision of giving stops some additional room much easier.



Now, let's get back to our original example. Below is the intra-day chart, on the day the trailing stop was hit. Notice that the stock just hit (a) the stop (which was at 45). At this juncture, the stock only had several trades just barely above the stop. However, there were not *any* bids above the stop. Therefore, this is “no brainer”—it's obvious that you should stay with the trade. Nearly an hour later, it begins to approach the stop again. This time though, it requires a little more mental energy. It actually was *bidding* above the stop and *trading* above the stop. However, we see that it was not getting too far past the recent peak (a). This suggested that a *potential* double top was forming. Further, it only traded 13 cents above the original stop before beginning to reverse. By only risking a few cents more (than the original stop), you're able to stay with a longer-term winning trade.



As you can see, exercising a little discretion would have kept you in a longer-term winning trade. Of course, they don't always work this well. That's why you will have to be disciplined enough to exit when you are obviously wrong. Further, with any added decisions, there comes a consequence. Any trade you do not exit has the potential to turn into a loser. The good news is, being able to stay with one or two longer-term big winners will pay for many losing trades.