Brainy's Articles on

Share Trading**

Capital protection

Introduction

When investing (or trading) in the share market, the activity might be a part of a larger investing strategy, including investment in fixed income products, or property, and/or other asset classes.

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Many investors don't like to see their capital whittled away by falling asset prices. With some asset types (such as property) it can be difficult to quickly liquidate a position in order to prevent further declines in the capital value. However, the share market is a very different animal, and positions can normally be liquidated readily (provided the stock is not amongst the many illiquid ones).

Long term investors in the share market are often convinced that they need to be in the market for the long-term, because it is not possible to "time the market". This author strongly refutes this assertion. Many finance industry professionals stand by their recommendations and advice so that they can continue to receive management fees or commission income from your investment, even if the capital value falls. Contrary to popular opinion, the real truth is that we can "time the market". It's just that many industry professionals don't want us to accept this fact.

In the share market, the honest to goodness truth is that any company in which you invest might want to look after their shareholders, but at the end of the day, the company directors need to make decisions in the best interests of the company for both the short and long term. And sometimes their decisions do impact adversely on the company's share price. And a depressed share price can languish for months or even years. Unfortunately, the shareholder's interest does not always come absolutely first. Therefore, when a shareholder invests in a company and lends their capital to the company, there is no need to feel obliged to maintain the shareholding for the benefit of the company. If the company has to make decisions that are not in the best interests of the shareholder, then that is just unfortunate. So the shareholder ought to respond with a similar lack of emotion and affection, and sell the shares if they feel they need to in order to protect their own investment capital. This is a simple commercial reality.

There are a number of events which can cause a severe reduction in the capital value of an investment. It is important to be on guard against any and all of these possible outcomes, and to have an exit strategy prepared so that if the worst does happen, the exit strategy explains what to do about it in order to minimise the losses.

This Article in Brainy's series on Share Trading and Investing (number ST-3200) discusses these issues in more detail, and offers some suggestions to assist with ***capital protection***. Of course, this Article does not include any financial advice[1] nor recommendations — it is for information and education only.

Potential losses

The potential for losses in the stock market are enormous. As a bare minimum, if we buy shares in a poorly-managed company, or even a well-managed company that is struck with bad luck, it is possible for the company to suffer from any sort of bad news, impacting on factory production, or on the provision of services, or on the forecast earnings. Or the company might simply be over-leveraged at the wrong point in the economic cycle, resulting in financial difficulties.

Any of the above situations might result in the company incurring some form of financial impact, with a

1 **Important disclaimer** — This document is not advice of any sort. It is not personal financial advice. It is general information only, and is offered for educational purposes to raise the awareness of the reader to the broader issues regarding the topic. There is no consideration of anyone's personal financial circumstances, and no recommendations of any sort.

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share price that is heavily impacted as a result and which trades in the doldrums for months or years. The company's share price can reduce to a tenth of it's value, or worse, and not recover for a very long time.

At the worst extreme a company can suffer from a major calamity such as a natural disaster, a major accident or adverse weather, which may result in a very severe financial impact to the company. The worst result might be a suspension from trading on the stock exchange, and eventual liquidation with no return of capital to shareholders.

Then there are the risks of leveraged investing, using a margin loan, or a derivative product such as Contracts For Difference (CFDs). A relatively small adverse change in share price can result in a major loss for the leveraged investor.

The potential for losses is huge, so investors ought to be prepared, informed, and on guard to counter any eventuality. Otherwise, the impact on investment capital can be very significant.

Capital protection in the stock market

There are a number of ways that an investor (or trader) can protect investment capital in the stock market. The simplest method is to simply sell the position — moving it to cash.

Now some investors won't want to do this, and will prefer to hold on to their investment. In this situation, there are hedging strategies available to "counter" any potential losses. This includes the financial product known as an options contract (often referred to as an insurance product), or perhaps Inverse ETFs (which are designed to increase in value when the market falls), or short selling an index futures contract to profit from falls in the index. There are a number of ways to tackle this, all of which are beyond the scope of this eBook Article.

An effective hedging strategy can be very useful for those engaged in the handling of real commodities, or products that are transacted in an alternative currency. However, many (or most) share market hedging strategies can be argued to be too complex, or too expensive, or too time consuming for the average retail investor. If the investor does not have very large sums of money invested in the market, then perhaps the simplest and most effective approach is to simply reduce the size of a position, or even liquidate it completely.

Remember that bear markets and corrections are relatively frequent events in the markets, and the term "roller coaster" is often a very apt description. And not only that, the effects of a bear market can last for many, many months. So moving to cash can sometimes be the quickest, simplest and most effective way to protect share market investment capital.

Exit strategies

Okay, so we are thinking that perhaps we should be exiting a share market position to protect capital. So, how do we decide ***when*** to do it?

The simplest and crudest approach is to sell the position if the share price falls by more than a fixed percentage amount from a recent closing price high. Now this approach is NOT recommended by this writer, as it is too crude, haphazard, and ignores a number of key aspects regarding investor herd mentality and behaviour.

A technical analyst will typically study a price chart, and identify a price level on the chart below which the stock should not be trading. The reasoning for this is based on the general consensus of the investors in the stock which is reflected in the price chart in the form of chart features such as Support levels, and chart patterns (like a triangle pattern, or a double top, or a head and shoulders pattern, and looking for a breach of the pattern); and chart indicator divergence that can be spotted on a price chart before the price fall is evident, just to name a couple. Readers should refer to the relevant Articles on technical analysis for more details on these topics, including references to applicable tools, in other eBook Articles in Brainy's series of Articles (see the *Further reading* list at the end of this Article).

One simple approach is to do with "opportunity cost". If a company's share price languishes for too long, then it could be argued that the funds could be better spent in an alternative investment — by

** - The two words *trading* and *investing* are often used somewhat interchangeably.

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either investing in a different stock, or investing in a different asset class (such as cash or bonds).

Another complication here is that if a position is so large that liquidating the entire position is not reasonably feasible, then we might want to reduce the position by liquidating just a portion of it. The factors to consider in this scenario are outside the scope of this Article.

Stop Loss

A basic principle employed by many successful technical analysts is to utilise a Stop Loss. This is briefly mentioned in the discussion above on exit strategies; but there are technical analysis chart tools that can be deployed to scientifically estimate a reasonable share price value below which the stock should not be trading. See discussions on this topic, including references to applicable Stop Loss tools, in other eBook Articles (see the *Further reading* list at the end of this Article).

Price Alerts

Having decided on an exit strategy, or a stop loss method, the next challenge for many investors is to decide how to know when the exit price level has been reached. That is, if we are watching company XYZ's share price and we want to exit the position if it falls to $9.90 per share (for example), how will we know that this has happened? If we don't want to watch the share price every day, it might be both a challenge and a worry to keep tabs on the share price.

It is fine to have the approach all worked out, but if we are not made aware of the breach in share price, the stock might continue to fall while we continue to hold it.

One effective method for the more casual retail investor who doesn't watch the markets every day is to utilise a “price alert” method. There are a number of ways in which this can be done, including:

- Broker alert tools;
- Third party alert tools; and
- Trading platform and price chart alert tools.

Broker alert tools

Firstly, we should point out that some of the full service brokers do not actively support the notion of a stop loss, and selling down a position to preserve capital. So an investor might need to have strong discussions with a broker, or switch brokers.

Online brokers do tend to have alert tools including the following:

- SMS message alerts — The investor can set their own price level for each stock held (and even for stocks in which a position is not held). Then if the price level is reached, an SMS text message is sent to the investor's mobile phone.
- Email message alerts — Much like the SMS message alert, the resulting action can be an email message sent to an email address of the investor's choosing.
- Both alert types — If an investor so desires, it is normally possible to set up both an SMS message alert and an email message alert.

Third party alert services

As technology develops, and more organisations strive to attract business and clients, third party organisations are tending to offer the same sort of service as described above. It is suggested that anyone wanting to explore this option should do some research and proceed carefully.

Trading platform and price chart alert tools

Many of the more active investors and traders utilise either a charting software tool, or a trading platform, to assist with study of the price charts, and the search for share market investment opportunities. These charting tools usually include appropriate price alert tools, and sometimes

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volume alert tools.

This author's choice of tool is the BullCharts charting software, which does include these tools. Readers are encouraged to refer to the relevant eBook Articles on this topic (see the *Further reading* list below).

Summary

In this article in Brainy's series on Share Trading and Investing (number ST-3200) we have looked at the issues to do with capital protection, and considered a number of options. We have also considered the ramifications of failing to implement a reasonable capital protection strategy.

Further reading

In the material above there are a number of references to additional material on several topics, including the following eBook Articles in Brainy's series:

- Article ST-6210, “Strategy considerations, volume and liquidity”;
- Article ST-6215, “Strategy considerations — finding liquid stocks”;
- Article TA-3300, “Support and resistance”;
- Article TA-3410, “Chart patterns — introduction”
- Article TA-3500, “Chart patterns — triangles”
- Article TA-3600, “Megaphone chart pattern”
- Article ST-4500, “Stop loss”
- Article TA-5020, “Stop loss basics”
- Article TA-5100, “Indicators and tools for stops”
- Article TA-5210, “Divergence”
- Article TA-6030, “Exit strategies”
- Article BC-08-300, “Wilson ATR Trailing Stop”
- Article BC-4-0-300, “Alert Manager”.

Your own notes and comments: ....

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