Share Trading

Stop Loss — Why is it important?

Introduction

If you are a longer-term investor who believes in the "buy and hold" principle of investing, even when a bear market can tear aware huge amounts of your capital, then this article might not be very relevant for you. And let me wish you good luck with your investing.

However, you might feel that there can be times when a share market investment should be liquidated to protect your precious capital and to minimise losses. Some people would call this *sensible investing* (for more details on this topic, see: www.sensibleinvesting.com.au). This can apply to both traders and investors. It can be argued that it is not a good idea to watch the market fall, and to watch your stock holding fall in value, and do nothing about it.

The best way to protect your capital and maximise your profits is to sell out of a position once it is falling beyond a point that is considered "reasonable" (this sounds sensible). In share trading terms we call this our *Stop Loss* position. When entering an investment position, the first *Stop Loss position* is actually called our *Initial Stop*. Later on when the investment position has moved into profit, and we have lifted our *Stop Loss* position it can be called a *Protect Profit* stop, or a *Trailing Stop*. People tend to refer to all of these as *Stop positions*, or something similar.

This article in Brainy's series on Share Trading (number ST-4500) provides an introduction to the topic of *Stop Loss* positions. There are other articles in Brainy's series on Technical Analysis which provide more information from a Technical Analysis point of view (see articles TA-5020, "*Stop Basics*", and TA-5100, "*Indicators and tools for stops*").

Why use stop loss positions?

The first question to answer is "*why should we do this?*" And the answer is fairly straight forward.

Because of the nature of the share market, share prices rise and fall. They cycle up and down between extremes. Some of these extremes in price are only days apart, and some of the bigger extremes in price are months or years apart.

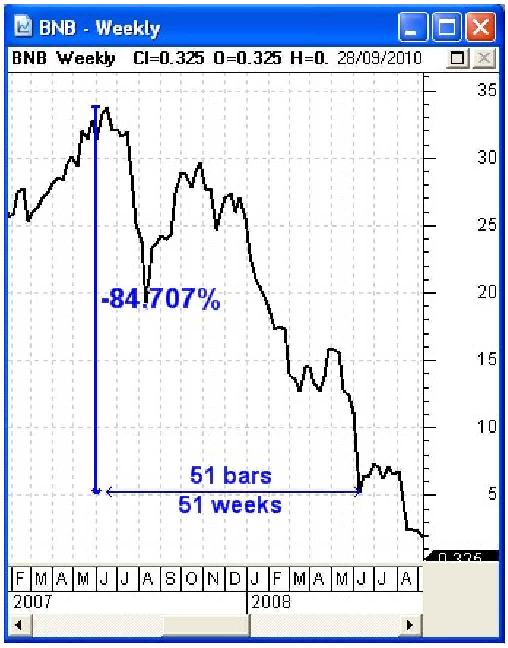

Figure 1: Babcock and Brown — massive price fall.

The weekly price chart in Figure 1 at right shows just one example of what can happen to some stocks. During the onset of the now infamous GFC of 2008, the Babcock and Brown share price fell significantly over several months. Some investors held on until the very end when the stock delisted and they subsequently lost everything. However, the more astute investors cut their losses early, and sold their holdings. This sort of price fall is not uncommon.

So, it makes sense that if share prices are falling, then before they fall too far it might be wise to cash in the shares. Then we can keep our money, and reinvest it when prices are on the up again.

One of the fundamental principles of investing is to trade with the trend (*The trend is your friend* — one of Brainy's Share Market GEMs[1]). While the trend is up it makes perfect sense to stick with it. But once the trend has turned, it also makes perfect sense to get out. That way we can protect our capital, and minimise any losses.

More information on how to do this is included on the following pages.

1 For a list of Brainy's Share Market GEMs, see: www.robertbrain.com/gems.
Also see Brainy's 3Ways Rule: www.robertbrain.com/3ways

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