Brainy's Articles on

Share Trading**

Strategies for entry and exit

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Introduction

In the main, many investors invest in the share market with some sort of strategy in mind. But in reality, the strategies are often somewhat incomplete, and to some degree rather haphazard. Even if they follow the advice of a finance industry professional, there tends to be areas for improvement with the investing approach.

Many industry professionals recommend that whenever investors put money into the share market, that they do so with the intention of investing for the long term. This is because the long-term returns are claimed to be superior to alternative investment options.

However, this is arguable depending on which convenient time period is considered, as the markets endure significant cyclical upheavals which can be largely avoided for much better financial returns (despite what some of the industry professionals tell us).

Those investors who acknowledge that shorter-term and more nimble investing is a better or smarter approach tend to adopt the proven philosophies of using sound money and risk management methods such as the “2% Rule”, and the proven “Stop Loss” approach, and they have a planned exit strategy in place ***before*** they proceed with the investment.

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This Article in Brainy's series on Share Trading and Investing (number ST-6115) provides some introductory comment on the topic of *entry strategies* and *exit strategies* for share market investing. []

Markets move in cycles

Those who have participated in the markets for a number of years will already know that the markets move in cycles.

The property market has peaks (or booms, or bubbles) followed by troughs that result in many bricks-and-mortar properties losing up to 20% or more of their value for periods up to about 5 years. The old adage that investing in bricks-and-mortar is sound, and that they never lose value, is totally false. And property is not a liquid investment that can be easily sold short term when required. But that's digressing...

The share market itself moves in cycles, and periodically suffers from short-term “corrections” of at least 10%, and sometimes bear market periods with falls of more than 20%. And something that many investors don't realise (or refuse to accept) is that about every 20 years a bear market can pull the market index down by as much as 50% in value, and result in new sustained highs only after as many as some 9 years.

Another often ignored fact is that many blue chip stocks under perform over some time periods. In these instances an investor might have been better investing their money in a different company's shares, or even a different asset class.

Armed with this basic information, it seems to make sense to avoid the traditional long-term buy-and-hold approach which benefits the fund managers who continue to receive their management fees regardless of a fund's performance. It can be seen that a somewhat more nimble approach can be very beneficial. That is, be prepared to sell out of some investments if times are looking down, and park the cash in a more stable and secure investment.

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

Sound investment strategies

To be able to hop into, and out of, the market at appropriate times requires a clear and tested strategy. The entries and exits don't have to be frequent, and the portfolio doesn't need constant monitoring. But the right tools make it so much easier to do.

A sound investment strategy for investing in the share market will incorporate a number of key features including relevant consideration of money and risk management aspects as outlined below, plus a defined approach to trigger and manage the entry into the position, and another approach to trigger and manage the exit from the position.

Entry strategies

In the world of share market investing and trading there are literally thousands of different approaches that can be taken to select which shares to buy. Some of these are discussed in other eBook Articles in this series. Some experts suggest that it often doesn't matter which shares we buy, because it is the *exit* from the position that is more important — that is, the *exit strategy*. There is more on this in the notes below.

Some people choose stocks based on gut feeling, or a whim, or because the taxi driver gave them a hot tip. Others utilise fundamental analysis to identify those stocks which might be theoretically under valued, and which therefore ought to increase in value over time. Others select stocks based on the dividend return, looking for a reasonable income stream. Then there are others who use some form of technical analysis to identify those stocks which are more likely to out-perform.

More information and ideas about strategies for entry are included in other eBook Articles in this series. However, an important part of a sound entry strategy will include consideration of some key money and risk management principles which can also influence the exit strategy, as discussed in the next section.

Money and risk management

In the introductory notes above there is mention of the “2% Rule”, and of the “Stop Loss” approach. These are inter-related, and ought to be considered in conjunction with other key aspects of money and risk management.

Following is a brief introduction to these topics, with more details in other eBook Articles in this series.

Stop Loss (CBA example)

The idea of a *Stop Loss* means that when we are about to enter a position in shares (or similar) we adopt the approach that if the price of our investment falls to a pre-determined price level, then we will sell it without hesitation. The pre-determined sell level is the *Stop Loss* value. It is so-named because it is intended to stop any further loss.

A simple example of this could be that we might have considered buying CBA shares (Commonwealth Bank) for about $62 per share in December 2007 (they reached this value before falling to $25 in 2009). After our purchase, if they then fell to below $56, for example, then we could have sold the share parcel because they might have fallen further. Remembering that *“the trend is your friend”*, and we prefer to invest in rising share prices, not falling prices (the notion of a *trend* is very useful to understand here). Why choose $56 as the Stop Loss?

Refer to Figure 1 below to visualise the CBA price chart which shows the weekly close price each week through the period 2008 to 2012 (it shows the weekly close price but not the highs nor lows in each week).

In this example a technical analyst might have looked at the chart and seen a support level on the chart at about $56-$57 in November 2007. The value of $56 could have been set as the *Stop Loss* level, such that any trading below this support level would mean that price support had gone (ie. no more willing buyers at that level).

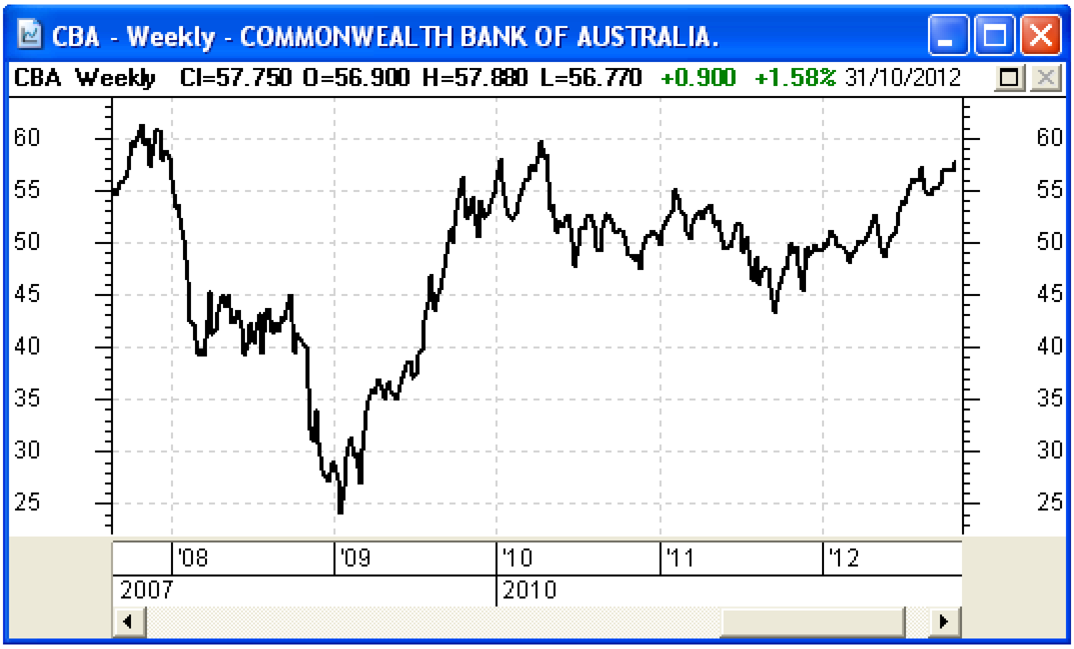

Figure 1: CBA share price from 2007 to 2012 (weekly price chart).

With reference to Figure 1, we can see that CBA shares went on to fall into a range of $40-$45 in mid-2008, then to below $25 in January 2009, then jumped up to touch $60 in April 2010 before falling away again, and by late 2012 were still trading in the $55 to $58 range. If we had have adopted the *Stop Loss* approach we could have sold our parcel for about $56 each share in early 2008, and put the cash into the bank to earn bank interest over the several years since. If we had have needed the cash for something else, it would have been readily available.

But exactly how do we determine the best *Stop Loss* level? Well, there are many possible methods, and further discussion is outside the scope of this particular Article. Readers are referred to other Articles in this series for more details. Refer to the list at the end of this Article.

The Two Percent Rule

The *Two Percent Rule* (2% Rule) basically says that we are prepared to lose no more than 2% of our total investment capital on any one investment. To do this, we might invest 5% or 10% or even more of our capital into one share market position, with a portion of that investment considered “at risk”. That is, we adopt the approach that if the value of the position falls to a pre-determined level then we will liquidate the position and lose only the 2% “at risk” component of our capital.

For example, in the discussion above about CBA shares, if we could have purchased them for $62, with the intention of selling at $56 if the shares fell that far, then the risk per share is $62 minus $56, or $6 per share. Now if we had $50,000 of investment capital available, then the *2% Rule* says that we won't “risk” more than 2% of the $50,000, which equates to $1,000. That is, we won't risk losing more than $1,000 if we need to sell out at the *Stop Loss* level of $56. With an anticipated share purchase price of $62, this means we could purchase a parcel of shares equal to 166 shares. This is the $1,000 of capital at risk divided by the $6 “at risk per share”.

This approach means that our investment capital is potentially spread across a number of investments, such that the failure of any one of them still means that we can rest easy and sleep at night. But it does require that we accept and adopt a money management and risk management approach with the determination to liquidate a position if it falls in value.

The 2 Percent Rule is discussed in more detail in eBook **Article ST-4100, *“The 2 Percent Rule”***.

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Exit strategies

One simple approach to exiting a position is to simply sell when in profit, because the experts say *"you can't go broke taking a profit"*. However, this is a fallacy. No one can achieve an investing success rate of 100%, so the losses that we do suffer must be small enough, and the profits large enough, so that the overall level of profit wins. If the profits are too small, then the losses might outweigh the profits and send us broke.

When we exit from a position it will be for one of a number of reasons including the following:

- For a new investment position, the price has fallen and our investment decision on this occasion was not a good one, so we sell based on our pre-determined *Stop Loss* approach.
- The money is needed elsewhere, so we liquidate in order to redeploy the cash.
- The investment value has risen significantly, making it somewhat sensible to liquidate some or all of the position, perhaps to re-balance the allocation of our funds or to reduce the risks of this particular investment (eg. the portfolio weighting risk).
- The investment has risen to a pre-determined price target, so we want to lock in the profits and exit the position.
- The investment position is not going anywhere and our money is not working hard enough (opportunity cost), so we liquidate in order to redeploy the capital elsewhere for a better performance.

Exit considerations

There are some general considerations that apply to the selection and use of exit strategies, as follows.

Profit-taking — We would all hope that the majority of our investment decisions are successful, resulting in a good profit. And if the profit is significant, then the particular share holding can become a lot more valuable than the initial position. Let's say that the share price for shares in a large bank doubled over a period of time. If we used sensible position sizing for the original position, then it might now constitute too much of our overall investments, in which case we should consider selling down a portion of the holding. This would return the position size to a more reasonable level, and capture some of the profits.

Beware the spike lows — When planning an exit strategy, and considering a stop loss approach, we need to be careful of the price spikes. Figure 2 at right shows a sample spike low — the share price spiked down during the day by about 10 percent below the eventual closing price. This would have caught out many investors who had stop loss positions implemented as sell orders in the market. Any investors who wait until end of day (or end of week) before committing to sell would not have been caught out by this.

Figure 2: Sample spike low.

In some cases these spikes are caused intentionally by traders who are looking for an end to the sellers that produced the down trend that ended with that spike. With the exhaustion of sellers, it is likely that the only way left for the price to move is upwards (as in this example).

Actioning a protective stop — Our pre-defined investing strategy document which records how we intend to enter and exit positions ought to have a description of exactly how we intend to implement the exit strategy, once the exit condition is met. But this is easier said than done.

There are basically three approaches from which to choose to implement a protective stop:

- Sell the position immediately the price level is breached, utilising a conditional sell order already placed in the market.
- Wait until the end of day, and sell if the price has closed the day below the price level.
- Wait for two consecutive days with the daily close below the price level. This is basically waiting for confirmation that the price has failed to hold up.

Hard stops versus soft stops — A *hard stop* is a stop loss position that is intended to be rigidly actioned, with a sell order already placed into the market. A *soft stop* is a flexible approach where we intend to use discretion and decide later exactly where the stop position should be. The experts say that a hard stop is mandatory for inexperienced investors and traders, whereas a soft stop is only safe to be used by experienced and seasoned investors and traders.

The (common) percentage fall exit

A very commonly used exit strategy deserves a special mention. It is in use by many investors and is the simple approach to sell if the share price falls by a certain percentage amount. This might be something in the range of 5 percent to 15 percent (or even as high as 25 percent). Now if you are after a somewhat random way to try to protect capital, then this approach might be okay. But technical analysts know very well that there will be some price levels on the price chart that might be prone to a sell-off, and other price levels where a sell-off is very unlikely. This means that any stop loss calculation should consider these price levels, and that a rather arbitrary percentage fall in price is very much hit and miss. Therefore this author strongly recommends against this *percentage fall* approach.

Exit strategy options

Regarding the detail for an exit strategy, there are many different approaches that can be considered, and they tend to fall into the following categories:

(a) Time, clock or calendar-based exits;

(b) Price target exits;

(c) Money-based exits (based on the share price value);

(d) Price chart feature exits;

(e) Chart indicator exits.

Note that the first of these categories has nothing to do with the price chart, while the others are all dependant on elements of a price chart. Each of these categories are briefly explained in the following notes, with more details in other eBook Articles.

(a) Time, clock or calendar-based exits

There are a number of possible considerations regarding the time of day or day of the week that tend to be a little easier for decision-making regarding exits, or even entries.

Time-based stop — It can often happen that a good looking investment is identified, and all the proper planning and money management is undertaken, only to enter the position and then find the share price trade sideways for days or even weeks. In this situation, many people will have a set number of trading days after which they will close the position and look for a more profitable opportunity.

Clock-based — With a lot of experience many investors and traders find that some times of some days are not good for opening or closing positions. This is more relevant to opening a position than closing; but it is still an option that ought to be considered in our own exit (and entry) strategies.

Calendar-based — Again, many investors and traders have found with experience that some days of the week, or weeks of the month, or even months of the year, tend to be different to other times, so they vary their strategy accordingly. For instance, many people will avoid Mondays and Fridays for opening new positions, and will be careful toward the close on the last day of a week (especially prior to a holiday period or long weekend).

(b) Price target exits

Many investors and traders have the view that as the share price rises there will be an upper price level where a rising share price might pause, or even sell off. Assuming that this will pan out, the intention is to take some profit by closing a part of the position, or even the whole position. In some cases they will close the position at this price level regardless, and then feel good about holding the profits, while others will be cautious as the price approaches that level and will be quick to sell only if the price hesitates.

There is another situation where investors utilise a *price target*. And that is in consideration of the Risk/Reward Ratio. Many investors consider this ratio before entering an investment so that they can avoid those positions that might have a low reward for the amount of money being put at risk.

But how do they identify the price target levels for an exit strategy? Consider the following options, all of which are based on price chart features or tools, except the first one:-

Overhead resistance — For any one company's shares, there will often be a higher share price than current, where current holders of the stock will have purchased some time ago. Since their purchase the share price has fallen, so they want to get their money back at the first available opportunity. This upper resistance level can often be spotted on the price chart because the price hovered there for a number of days or weeks while market participants fought about whether the share was worth more or less. Once the price rises back towards this level there can be an excess of sellers cashing in (just in case the price falls again).

Measure rule — A share price can spend some time in a trading range fluctuating between two extremes of price in some form of chart pattern (eg. Rectangle pattern, Triangle, Double Top, or Head and Shoulders, etc.). After breaking out of that trading range, it is then common for the price to move a predictable distance before stalling. This distance can be estimated in advance using the Measure Rule (see notes below for references).

Round price value — It can often happen that a share price will stumble at a whole dollar value (such as $1, $2, $5, or $10, etc., etc.), or for lower priced stocks at a multiple of 10 cents. In anticipation of this many investors set a price target at this level.

Elliott Wave and Gann — A number of traders follow the ideas and principles of Elliott Wave and of W.D.Gann. These approaches can give potential price levels, or potential dates, for turning points. A discussion of these topics is by far outside the scope of this Article.

(c) Money-based exits

There are several methods that can be used to set an exit price based on the recent price action.

Percentage of price — See the notes on this above.

Stop loss at recent support level — It often happens that a specific price level is actually a support level. Price can be observed to fall down to this level, and then rebound as though the support level is a floor which is stopping the price from falling further. This is much easier to identify on a price chart as in the sample chart of BHP in Figure 3 at right. Note that in late June 2013 the share price fell to close within a few cents of $31 on four days over a 2 week period. Once all the sellers at

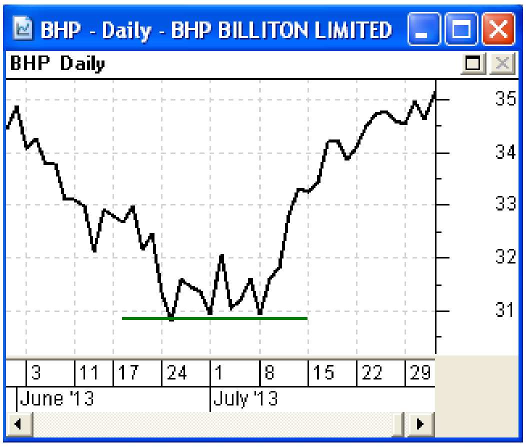

Figure 3: Price support under BHP's share price.

this level were satisfied, a shortage of sellers (a shortage of supply) caused the price to rally upwards. If the price had have fallen below this level then a continuation of the earlier downtrend would be assumed in which case an exit could have been the wisest action. That is, setting a Stop Loss just below $31.

Fibonacci extension — Many investors and traders follow the use of Fibonacci tools, believing that the swings and cycles in the shares are in tune with nature and cyclical behaviours. These investors often utilise a Fibonacci tool on the price chart to identify price levels that are likely to undergo heavy selling. For example, with a rally under way, some investors will be watching for an advance that is 161.8% of a recent swing (this is one of several Fibonacci levels). And when the price is retracing, they might look for a simple retracement of 50% of a recent price move to anticipate another reversal to the upside which might fail and actually produce further selling.

(d) Price chart feature exits

There are a number of ways that an exit strategy can be determined based on features of the price chart that may result in the stop loss changing from day to day. These include the following:

- ***Break of trend line*** — With a rising trend in place, and a valid uptrend line on a price chart, any price action below the trend line implies the trend is weakening, and that it might fail. This can be used as a warning that an exit might soon be prudent, or short-term traders might use this as a signal to exit forthwith.
- ***Change of trend*** — As with the previous item, once the price breaks a rising trend line, it suggests the trend is weakening. However, if the price action falls far enough it can signal that the trend is over. This can be used as a signal to exit.
- ***Lowest Low of last "n" bars*** — If the price falls back to the lows of recent price action (a few bars ago) it could be assumed that the price is weakening and that an exit might be suitable.
- ***Count Back Line (CBL)*** — This is very similar to the previous item in that it considers the most recent significant high, and then the lowest low of the last "n" candles (usually two).
- ***Pivot Point Reversal pattern*** — The study of several adjacent bars or candles can sometimes reveal a so called "pivot point reversal" pattern developing, which can be used to warn of a possible exit.
- ***Reversal candlestick pattern*** — A number of candlestick patterns (and bar patterns) are considered reversal patterns which can be used to warn of an exit.

Each of these methods are utilising technical analysis, and more details are included in separate eBook Articles to allow a proper discussion.

(e) Chart indicator exits

Many people like to follow the action of a Moving Average (MA) on a price chart, and note whether the price is above or below the MA. Even though this is an application of technical analysis, many people use it without considering that it is technical analysis.

Some of the possible technical analysis chart indicators that can be utilised to help identify a potential exit include the following:

- **Moving Average (MA)** — Note whether the price is above or below a particular MA. The 50day and 200day Moving Averages are commonly used. Also notice whether the MA itself is rising, or falling.
- ***Parabolic Stop and Reverse (P-SAR)*** — This is a simple but somewhat effective chart indicator for use with an exit strategy.
- ***MA Cross-over*** — The point at which two Moving Averages cross is considered by some people as a possible entry and exit strategy (or a part of a strategy in conjunction with another signal). If using a 5day and a 10day MA, then when the slower 10day MA crosses up to

above the faster 5day MA, then this is the relevant buy trigger, while the converse is the relevant sell signal.

- ***Bollinger Bands*** — This chart indicator can be used to assist with buy and sell trigger conditions.
- ***ATR-based indicators*** — There are several chart indicators that are considered ATR-based indicators (ATR = Average True Range). For a discussion of these, refer to the relevant eBook Articles. Some sample indicators include: Chandelier Stop, and Wilson ATR Trailing Stop.
- ***Hull Range indicator*** — The Alan Hull Range indicator is one that has a sell signal built in, with one of four zones on the price chart indicating "sell" territory.
- ***Jim Berg Volatility Profit Taker indicator*** — This is another chart indicator that includes a specific sell trigger.

Each of these chart indicators are discussed in more detail in separate eBook Articles.

Monitoring the position

Once we have decided on the details for an exit strategy, and it is recorded, how do we monitor the position and know that the exit needs to be actioned? This is discussed in eBook ***Article ST-5510, "Monitor your positions"***.

Summary

In this article in Brainy's series on Share Trading and Investing (number ST-6115) we have taken a look at *exit strategies*, to put them into perspective and help explain why they are not just useful, but very important. And we have looked briefly at a number of different possible approaches.

For more details on Exit Strategies, refer to:

- eBook Article **TA-6030, *"Exit strategies — introduction"***.

For more details on Stop Loss, refer to:

- eBook Article **ST-4500, *"Stop Loss (introduction)"***;
- eBook Article **TA-5020, *"Stop Loss Basics"***;
- eBook Article **TA-5100, *"Indicators and tools for stops"***;
- eBook Article **TA-6250, *"Daryl Guppy — Count Back Line (CBL)"***;
- eBook Article **BC-08-300, *"Wilson ATR Trailing Stop"***.

Also see:

- eBook Article **TA-5420, *"Measure rule"***.

Your own notes and comments: ....

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