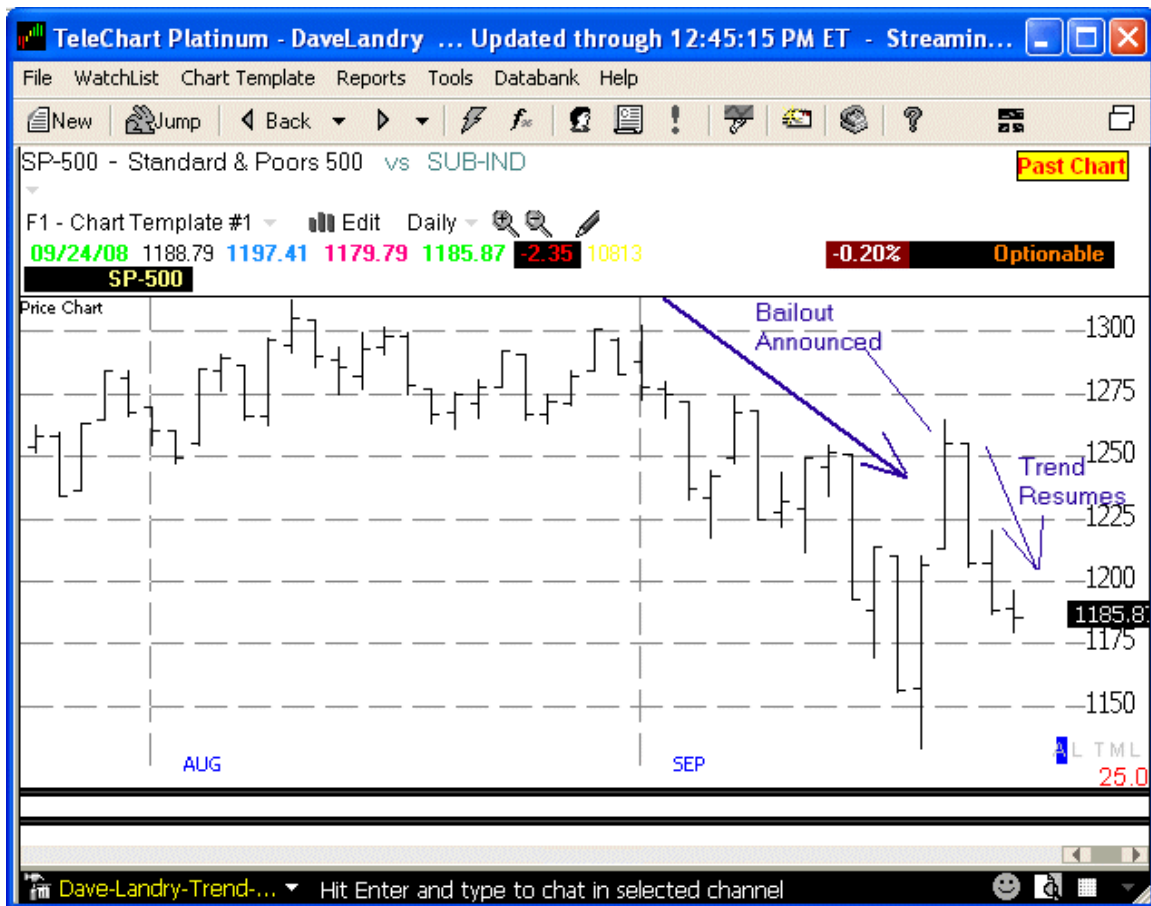


Over the last 2 weeks we discussed the importance of trading trend. Let's take a quick look at the trend of the US stock market. The market has been in a longer-term downtrend since October of 2007. In more recent times, it has been in a sharp slide.

Then, on Friday 09/19/08, in effort to stop the bear market, the US Government announced nearly a trillion dollar bail out plan along with making it illegal to short nearly 800 financial stocks. The market responded with a "knee jerk" reaction higher. However, notice, just 1-day later, all of those gains were erased as the longer-term trend resumed.

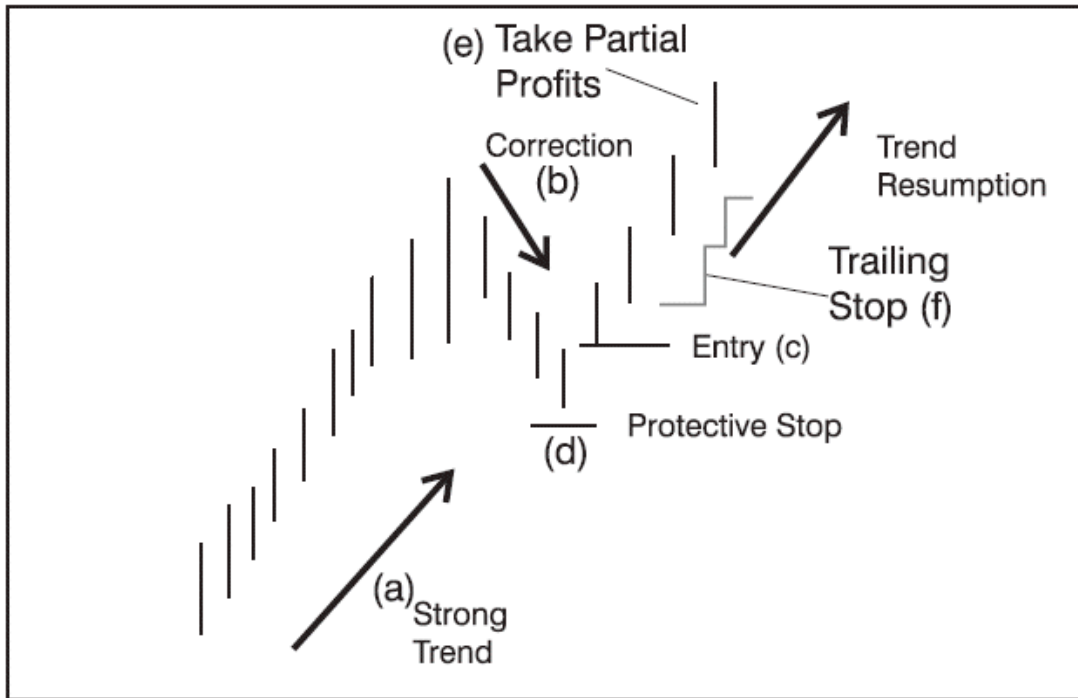


This is a great example of how trends can often continue in spite of massive efforts to stop them.

Of course, there's no guarantee that a trend will continue (and ironically, stocks are rallying as I write this!), that's why protective stops are necessary. *Every* trade has a chance to be a losing trade. This week, we'll look at where to place protective stops. In coming weeks, we'll break down the other aspects of the pullback and look at some of my favorite patterns for trading the 3 phases of trend.

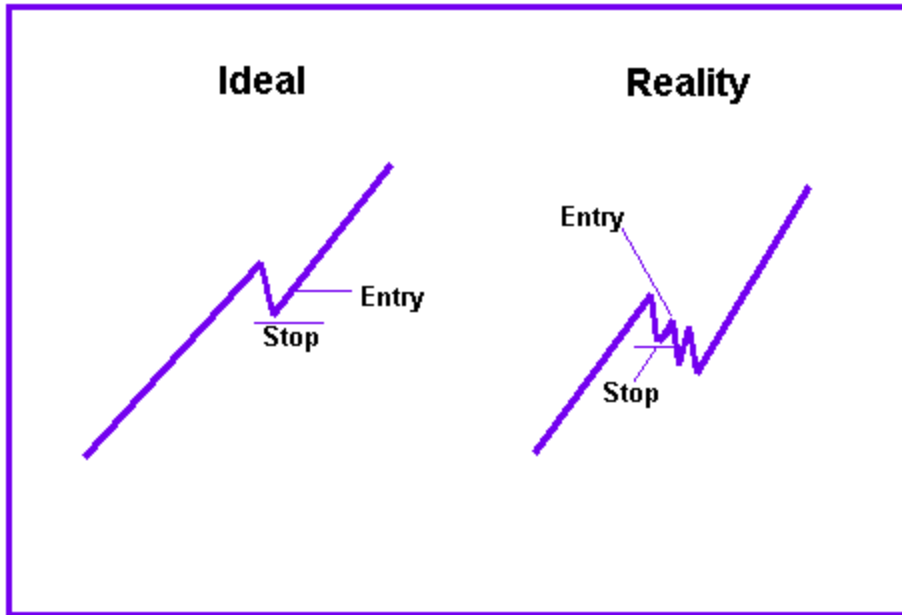
Last week, we looked at the elements of the pullback. To review, a pullback consists

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).



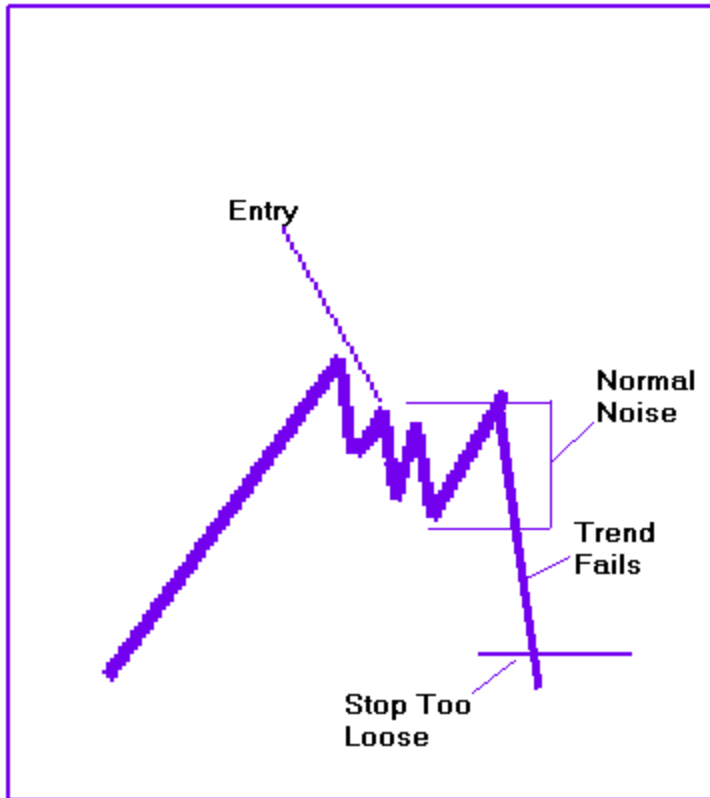
The Art Of Protective Stops

In an ideal world, a tight stop could be placed right below the low of the pullback (as inferred above). Unfortunately, very seldom does a market do exactly as we desire. Markets often continue in the obvious direction but not without trading back and forth first. Therefore, a tight stop would likely be hit on this normal “noise” alone. The “ideal” vs. “reality” of the real world is illustrated below:

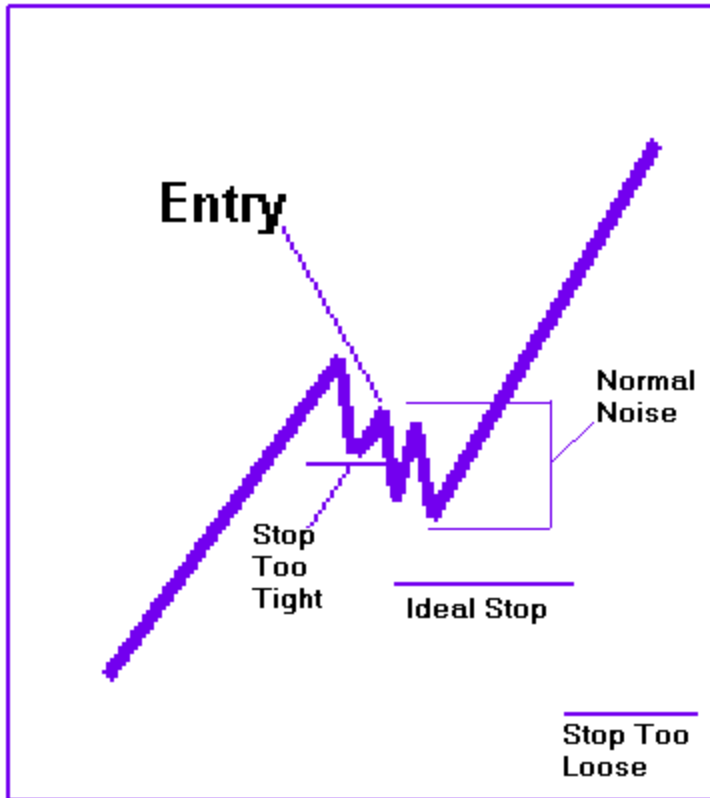


As mentioned last week, stops are a bit of a science and a bit of an art. There's no precise area they should be placed. As illustrated above, tight stops help to mitigate large losses but they almost guarantee that you will lose (on virtually every trade) since they are likely to get hit on noise (normal market fluctuations) alone. This can be frustrating as you watch a market that you were just in, take off without you.

Loose stops help to ensure you stay in a market long enough to capture a resumption of the trend. However, when the trend does not resume, the losses are too large. This is illustrated below.



The ideal stop would be far enough away to survive normal noise but not so far away that the risks are not too great. By now you're probably wondering, how do you define "normal noise." Unfortunately, no one knows exactly how far a market will go before resuming its uptrend, or, as mentioned above, if it will even resume the uptrend at all. Therefore, "normal noise" is *somewhat* arbitrary.



Statically measurements such as average true range, historical volatility, etc.. can be useful to gauge how far a market will likely to continue to fluctuate. However, these are based on the premise that all things will remain constant. And, as you know, in markets, seldom do things remain constant. Also, statistical measurements can often be quite large—outside of what one would ever consider using for a protective stop.

The good news is that it doesn't have to be complicated. Simply look at the charts notice how much a stock (or market) moves on a day to day basis. If a stock moves 5 to 10 points a day, you can't use a 1 or 2 point stop. Otherwise, you'll almost guaranteed that you'll get stopped out on noise alone. My point is that common sense is your best ally when placing stops.

Your own trading can be a good gauge for where to place stops. If you're constantly getting stopped out right before markets make a big move, then your stops are probably too tight. If you're catching some winners but giving up all the profits on a few bad trades, your stops are probably too loose.

One last point, if a market does require a fairly loose stop, make sure you are compensating for risk by trading fewer shares/contracts. This way, the point loss might be large but the percentage loss to the portfolio would remain minimal. Usually, you do not want to risk more than 1-2% per position *if* the stop is hit. Therefore, regardless of where the stop is placed, the losses should be minimal should they occur.

In coming articles, I show real world examples of where stops were placed and how they were trailed. I'll also show some instances where a fairly tight stop *can* be used. For now, in general, just know that they should be placed outside of the normal volatility. And, the *best* gauge of volatility is simply looking at the chart to see how much the stock has fluctuated in recent times.

For more information:

Email me directly at dave@davelandry.com My Italiano is not very good but I am getting a little better each day. See my website www.davelandry.com where I publish articles, daily market commentary, have a weekly webcasts, and a have a daily trading service.