Stop-Prices: Are They For You?

by
Dr. Bart DiLiddo

A Stop Price is like a pane of glass. Once it gets hit, it's broken. The use of Stop-Prices is one of the most controversial and misunderstood methods of selling stocks. Stop-Prices are double-edged swords. They can cut losses and protect profits, or result in high turnover and lost opportunities. Are they for you?

Selling is a crucial part of successful investing. Yet, it is avoided like the plague. The reasons are clear. Buying a stock is fun, a positive event. It's the beginning of a hopeful relationship.

Selling is a negative experience, the end of the relationship. Hope of future profits is gone and losses become reality. Tax consequences must be addressed and the proceeds need to be re-deployed. Selling is not fun, but it must be done.

While there are no hard and fast rules for selling stocks, each investor eventually makes decisions to sell. The need for funds, tax considerations and a myriad of other factors enter into these decisions. Whatever the reasons, the primary purposes of selling are:

1. To control losses, and
2. To protect profits.

Stop-Prices are ideally suited to do both.

STOP-PRICES. The term "Stop-Price" comes from the practice of selling stocks falling to specified prices. For example, if one of your stocks were at $27 a share, and you were concerned that it was going to go down in price, you could place a "stop-loss" order to sell the stock at a specified price, say $25. In this case, the Stop-Price is 25. Your broker would enter a "stop-loss" order to sell the stock if it fell to 25.

A "stop-loss" order does not guarantee that your order will be executed at the Stop-Price. The price at which your stock is sold depends upon market conditions. In severe downturns, stocks may be sold well below Stop-Prices. It is also important to know that "stop-loss" orders can be executed on exchange-traded stocks, e.g., New York and American stock exchanges, but may or may not be executed on over-the-counter (OTC) stocks, depending upon your broker.

Many advisors suggest that Stop-Prices be set at 10% below purchase prices. I have found that the Stop-Price of a stock should be based upon its safety, fundamentals and price trend. Safe stocks with solid fundamentals should have "looser" Stop-Prices than those with weak fundamentals. These considerations allow investors to stay with solid stocks longer and get out of weak stocks faster.

One of the major arguments against using Stop-Prices is that they result in excessive trading and expose one's positions to "whip-sawing." The likelihood of experiencing these events depends upon the type of stocks one owns. Safe, steady performers rarely hit their Stop-Prices, while risky, highly volatile stocks often break their Stops.

Table I., shows the relationship between portfolio turnover rate in percent and stock safety.

Table I. Portfolio Turnover Rate in Percent per Year as a Function of Relative Safety.

Percent Turnover	**Relative Safety**
10	1.50
25	1.25
50	1.00
100	0.75
200	0.50

In the VectorVest system of analysis, stocks with a Relative Safety rating of 1.00 or higher are above average in safety. Prudent and Conservative investors dealing in safe stocks would experience lower turnover while Aggressive and Speculative investors would have much higher turnover rates.

VectorVest analyzes over 8,000 U.S. stocks each day for Value, Safety and Timing and calculates a Stop-Price for each stock. These Stop-Prices are based upon 13 week moving averages of closing prices and they are fine-tuned according to each stock's safety, fundamentals and price trend.

A stock's price behavior and future performance can become vividly clear by observing the difference between a stock's price and its Stop-Price. If a stock's price is above its Stop-Price, and the price difference is getting wider on a day-to-day or week-to-week basis, the stock is behaving favorably and will likely continue to perform well. If the reverse is true, the stock is heading for trouble. This is when you need to be on guard.

VectorVest alerts its users to these conditions by adjusting its Buy, Sell, Hold ratings in the following manner:

- A stock gets a "B" or an "H" rating if its price is above its Stop-Price and it gets an "S" rating if its price is below its Stop-Price.

- The distinction between a "B" and "H" rating is made on the basis of safety, fundamentals and price trend. Strong stocks receive "B" ratings much more readily than weak stocks.

With this background in mind, let's see how Stop-Prices can be used to control losses and protect profits.

USING STOP-PRICES TO CONTROL LOSSES. The cardinal rule of investing is to keep your losses small. This goal may be achieved by virtue of the stock market's tremendous liquidity. It allows

investors to specify both a buying price and a selling price at the same time. The best time to make these decisions is before buying a stock.

Investors should be aware that the period of highest risk is at the time of purchasing a stock. Taking commissions into account, you're already starting with a loss. If the stock heads down in price, the loss increases. The name of the game, at this point, is to control further losses. Stops provide the discipline to do this.

Let's consider our old friend, Disney. Suppose we wanted to buy Disney and it closed at $104.17 on February 13, 2015. VectorVest gave it a "B" rating and a Stop-Price of $91.87. If we were to buy this stock at $104.17, we could also place a "stop-loss" order to sell it at $91.87. This would limit our downside risk to $12.30, or 11.8% of our purchase price, not counting commissions. There are very few investments in which both a buying price and a selling price may be specified in advance.

The Stop-Price should be raised if the price of the stock goes up. Once the Stop-Price is above the purchase price, your risk of a loss virtually has been eliminated. Isn't that nice?

USING STOP-PRICES TO PROTECT PROFITS. As the price of a stock rises or falls, VectorVest automatically raises or lowers its Stop-Price. This is called a "Trailing Stop" and it is commonly used to protect profits in a variety of ways.

1. THE RATCHET STOP. The most conservative and, perhaps, the most common use of Stop-Prices, is to raise the Stop-Price as the price of a stock goes up. If one never lowers the Stop-Price, it moves only in one direction like a Ratchet. This system ensures that most of the profits gained from a price rise will be captured. It is, however, susceptible to premature selling and "whip-sawing." Consequently, the "Ratchet System" of using Stop-Prices does not necessarily lead to the best overall profit performance. This is the price one pays for reducing risk.

2. THE TRAILING STOP. A slightly less conservative method of using Stop-Prices is that of allowing the Stop-Price to float up and down as the price of the stock fluctuates. This is very easy to do with VectorVest since new Stop-Prices are calculated every day. While this approach allows a Stop-Price to drift downward, it reduces turnover, commission costs, and the probability of getting "whip-sawed." While it may or may not provide higher profit performance than the Ratchet-Stop System, I prefer this method of using Stop-Prices.

When using the Trailing Stop, one should never let the Stop-Price go below their purchase price once it has gone above the purchase price. Why encounter a loss when you had a profit?

3. THE GUIDANCE SYSTEM. Many investors prefer to use Stop-Prices as a guide to selling, rather than a trigger for selling. They feel that Stop-Prices are too mechanical.

This approach to using Stop-Prices is perfectly satisfactory for investors who follow their stocks closely. Investors who work full-time or are traveling, however, are vulnerable to bad news. In today's age of instantaneous communication and electronic trading, a stock may drop 30% in an afternoon. The guidance system of using Stops is the least conservative method of managing one's portfolio. For the right investors, it may be the most profitable.

USING MENTAL STOP-PRICES. Many investors use Stop-Prices, but do not use stop-loss orders. They want more control over deciding when a stock is sold. This practice, called using “mental stops,” is not the same as using the Guidance System of setting Stop-prices. For example, one may use the Ratchet Stop as a method of setting mental Stop-Prices, and decide to use closing prices to trigger sell orders. This approach provides close rein over their portfolios, yet reduces excessive trading due to intra-day volatility.

Other investors use mental Trailing Stops on a week-to-week basis. They generally have a long-term view of the market, but are also concerned about controlling losses and protecting profits.

Whether you are a Prudent investor seeking an extra margin of safety or a Speculative investor looking for trading profits, Stop-Prices can help control losses and protect profits. Are they for you?

Click Here or call **1-888-658-7638** to order a Special 5-Week Trial to VectorVest.

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