On Stops (part 2)

1 Attachment(s)
This is part 2 or the second post dealing with this chart (I'm actually doing this one first though). I wanted to begin by discussing stops, as I believe this is an area where most traders go wrong.

Whilst the chart is of the ES, for this post we will be using a fictional market as I hope that will make the subject more relatable. In this market, the minimum tick size is 1 and that's $1/tick.

Okay, again I am saving the price action/vsa analysis for the next post, but we need to look at our entry signal bar-the squat.

We see a narrow range up bar on increasing volume. Note that the close is well off the high and in the lower 1/3 of the range. We have to be able to see that supply swamped demand on this bar. If this bar had been strength, then the close would be high in the range. The other thing we need note is that the close is below the trigger level.

We place our entry 1 tick below the low of the entry signal bar (squat). Being the disciplined traders that we are, we want to place a stop. The question is, where do we want to place it?

As I have said before, the market does not care about the size of our account. The best place to put our stop is based on market generated information. In this case, a tick or two above the squat. We will pretend that that level is 20 ticks above our entry, or $20.

Why here? There are two things that we know about this level:

(1) Supply swamped this level before and therefore the BBs are likely to defend this level again. If they don't, then we don't want to be short.

(2) The move up on the squat bar was artificial and designed to suck in the retail trader. If it was marked up artificially, we would have to assume any move back into this level and above is NOT.

So we place our stop just above the high of the squat bar. The next bar brings us in and into the black. The next interval does not disappoint as price continues down. We want to reduce our exposure by moving our stop again. But where? Break Even (BE)? No. This is where most traders go wrong. Moving our stop to BE and then subsequently being stopped out, tells us nothing about the condition of the market. With our initial stop level, we knew something. If our stop was hit, we did not necessarily want to be long, but we did not want to be short.

At BE what do we know? Nothing. We don't even know if we are wrong on timing, because BE is not a time based stop. It's just a level where we can say we are in "free" trade. Yet the market is all about information and sometimes information comes with a cost.

Still, we want to reduce the cost of that information. Suppose we move our stop to just above the trigger level. In our hypothetical example, this level is 10 ticks above our entry. So what do we have here? We have reduced our risk from $20 to $10 but here's the rub. We are able to get roughly 2/3 the amount of information at the trigger level as we were able to get a the high of the squat. In other words, we can risk 1/2 as much and only get 1/3 less the information. Unlike a BE stop, we know what it means for the market to trade back above the trigger level.

Our next goal is to let the market tells us where the next stop level should be. In the case of this example, we have to recognize the wide spread down bar that closes near its middle on Ultra High Volume. This is the highest volume bar for some time. A clear exit signal.

In this example, it is true that a BE stop would have been hit while the trigger level stop was not. That, however, is of no importance. The concept is what matters here. BE almost never gives you any information about the condition of the market, so why place a stop there? The ideal stop level will minimize risk while maximizing market information.