Take Profits or Wait for the Stop-Loss?

With such a bearish outlook, do we wait for your individual stocks to follow the overall market and turn south to hit your stop-loss positions or do we exit earlier on market signals and pocket more money in the bank?

Everyone struggles with this problem when they start out investing or trading.

On one hand, it is good that we never completely rest in re-examining and testing our investment plan. Much of the thought and testing can be done away from the market. However, that only ever takes us so far. Investing is an inherently emotional experience. It is not possible to create the exact circumstances of the art of investing without actually investing real money. Thus, on our journey from beginner to good investor, it is inevitable that our ideas be tested 'under fire', because otherwise we are not testing how robust our plan is in a real way. Another way of expressing this idea is to recognise that a plan on a piece of paper is only part of the act of investing. Investing is a dual act in the sense that we are involved. We have to execute our plan and make the decisions and take the action that the plan requires of us. In most cases, the plan is not the weak partner in the investing act, it is the investor: us. Just as we have to work on the plan over time to fine tune it, we must also work on ourselves and our performance in executing the plan. Most beginners will be naturally in denial of this. We are talking now about the way we think and decide under pressure. This is also called our psychology. In order to become a good investor the acceptance of this is an important initial step.

On the other hand, one of the truths of investing is that once an investment is under way, our task is to stick to our plan. The worst possible time to start revising our plan is when we are under pressure in a specific investment. Investment plans are not made based on a single situation. The sound way to develop and to modify our investment plan is to write it down after giving it deep consideration over time. Then be slow to change the plan. We should not change a plan until a weakness in it is exposed many times. Otherwise, to change it because of one or a small number of investments is akin to curve-fitting our plan to that narrow selection of stocks and time. We should be looking to find a defect in the plan that occurs many times in different market conditions. Then we should leave the issue to bubble away in our unconscious and conscious minds over some time until we develop a feeling that we have a better way to structure that element in our investment plan. In my experience, this cannot be hurried. If you read some of my case studies on specific investments, you may notice that I sometimes expose an issue in my own plan, but say that I need more time to think about it before changing the plan. This is the process I am describing in action. Problems are often far more complex than we initially think. Many competing elements in our investment plan have to be balanced. It simply takes time to get it all into proper perspective in our minds until what seems like the best solution becomes apparent to us. This is the really hard work in investing. It is much more difficult than just following the plan faultlessly and that is difficult enough as is described in the question I posed at the start of the article.

What can be of assistance in the thinking process involved in considering modifications to our investment plan is to maintain a focus on three of the key principles of investing that are applicable to the issue:

- Protection of capital
- Cut losses quickly
- Let profits build

Quite clearly, the second principle above is one of the major ways in which the first principle is carried out. However, it is less obvious that so also is the third principle. In order to protect the quantum of our capital, we must avoid big losses (the second principle). In order to protect the real purchasing power of our capital, we must make it grow in real terms, rather than simply remain static. To do that, when we make a good investment, we must keep it in place so that we enjoy a growing income stream and we must let the market value of the investment grow (the third principle). No matter how good we are at cutting losing investments quickly while they are small, if we also snatch profits on good investments quickly before they have had a chance to grow, we will be left with a history of small losses and small gains and we will not have achieved the growth in capital necessary to maintain and grow its real purchasing power over time. I am not saying this is easy or simple. This proposition takes us to the heart of the craft of investing and why it is different to trading.

The two activities have different modus operandi:

Investors

Purchase part ownership of a business in order to enjoy a growing income stream. If successful, there will also be growth in the market value of the stock holding over time.

Traders

Buy or sell stocks in order to grow their capital over time by exploiting changes in the price of the stocks. Note this can involve going either long or short or both.

Once we see this, it becomes obvious that investing and trading are very different. They both involve growth in capital. Traders can be successful if many small profits are made consistently and allowed to compound. This is not easy. Investors cannot be successful using that approach. Taking quick, small capital gains continuously will cut the investor off from enjoying an income stream, which is part of the total return from investing. To maximise both elements of the total return that is sought, the investor must let capital profits build and allow the income stream to flow. This is not easy either, which goes to the heart of the question.

Clearly, the type of stocks in which investors must operate is a smaller population of listed stocks than may be appropriate for traders. The trader is after price change and nothing else. However, the investor is after total return which means an income stream plus capital growth. It follows from this that the investor must focus only on stocks that have a history of making growing profits and paying increasing dividends and franking credits.

What traders have in common with investors is to cut losing positions quickly.

On the one hand, traders can be very successful in quickly taking many small profits on short-term moves. To understand one way of doing this, I suggest studying Dr Alexander Elder's great books *Come into my Trading Room* and *The New Trading for a Living*. One of his key strategies is to buy at fair value in a trend and sell at extremes of short term moves within that trend. There is a great deal more to Dr Elder's work than this, but for the moment this element is relevant to this discussion.

However, on the other hand, investors must be looking for a specific type of stock and to be looking, if possible, to hold through many of Dr Elder's short term rallies in a trend and then sit through the inevitable corrections, so that in an uptrend, a growing stream of dividends and franking credits flow into their investment capital and the market value of the investment grows over time.

Now we come to the big difficulty in investing. Unlike Dr Elder, who can get set near fair value and exit near the extremes of short term moves, an investor is unlikely to be able to do the same for a complete upward trend over several years except by sheer luck. The aim of an investor is to detect an upward trend once it has started (higher peaks and higher troughs), or to buy into a breakout from a sideways pattern (accumulation or consolidation) that should lead to the unfolding of an upward trend. Then the investor will be looking to hold until such time as the upward trend fails. The inevitable consequence of this is that the best the investor can do is to take a large chunk out of the trend. This also means that the investor will miss the early part of the trend and will give back some capital growth from the top of the trend to the sell signal.

The source of most frustration in investors is that they are expecting the impossible. They want to sell at the top. I repeat that it simply cannot be done except by sheer luck. Indeed, I will go further – it is not possible to sell at the highest high in the trend, or anywhere near it, without acting contrary to the trend. This is because an upward trend will always be still in place at or near the top, so the investor who sells there will be selling a rising trend. The investor is therefore terminating the investment before the trend has demonstrated to have run its course.

This, I think, is at the heart of the question with which I began the article, except with a twist. To explain this, I must step back a bit.

An investor will buy with the expectation that an upward trend will unfold. Otherwise there is no rational reason to buy part ownership of a business that will throw off a growing income stream and see its market value grow over time. Yes, there can be special situations like expecting takeovers, but I class these as trading, not investing.

There is only one way to define a trend in the time frame of an investor: there must be a series of higher peaks and higher troughs. My investment plan is based directly on this definition of what I am expecting to happen when I buy a stock. There is either an existing trend which I envisage continuing to unfold, or there is a breakout from a sideways pattern which I expect will lead to the unfolding of an upward trend. I sell when the price action indicates that the trend has failed.

However, while that is the only real definition of a trend, the definition of existence and failure of a trend is not the only way to manage an investment. There are a number of techniques that may be adopted legitimately based in general terms on trend lines or indicators of various kinds. The only way to test whether these methods are effective is by testing them over many stocks over several bull and bear market cycles.

To illustrate what I mean here, suppose that our method of managing an investment in a trend is that the price bars remain wholly above a 52-week exponential moving average. This is chosen purely as an aid to explanation, it is not something that I have tested. It should be noted that this is not an alternative definition of a trend.

What my definition of a trend and the stipulation that the price bars remain above a moving average describe are what the expectation of the investor is when the investment is undertaken.

This is of critical importance in investing. What our investment plan should set out in writing, amongst many other aspects, are:

- The definition of the trigger for our investment.
- The expectation as to what will unfold from that point.

This is important in the definition of our stop-loss level. Our stop-loss level should be defined in the investment plan as the price at which the expectation when we initiated the investment is no longer present. In short, the price level which, if violated, we are wrong about our expectation of what will unfold after the trigger to undertake the investment.

Now we come full circle to the question posed at the start. The simple answer to the question is to be totally clear in the investment plan as to what was expected to happen if the investment was still on course.

If that expectation was that the price bars would always remain above a 52-week exponential moving average, then the stop-loss level on that investment plan will always be the last level of the moving average. Thus, on any day when a price is transacted on the market below the moving average, something has happened contrary to the explicit requirement in the investment plan. This, by definition, is a violation of the stop-loss level.

The anguish expressed in the question that began this article was that our paper profits were slipping away, but the price was still above our stop-loss. My simple answer then is that the investment is still unfolding as was expected in our investment plan. To close it out prematurely is to take an action contrary to our investment plan.

Of course, this assumes that the plan has been tested and is robust in most stocks and in many market conditions. If that is so, the simple answer holds.

However, there is another answer. This is based on an old Wall Street story, probably apocryphal, about a trader who could not sleep for worry about a large paper profit. The advice in the story was to sell down to the sleeping point. I think this is the alternative answer, especially for beginners.

If the investment plan has not been thoroughly tested, we are gambling on the basis of the plan. We should therefore take the view that the plan is not proven to be sound. In that case, if it were me, I would sell all positions and go back to the drawing board to test the plan before making more investments.

I am sorry if this sounds harsh and unfeeling, but investing on the basis of an untested plan is sheer speculation which contravenes the first principle of investing: preservation of capital.

I hope that my discussion of the issues is of help to many readers.

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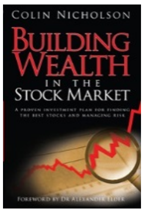

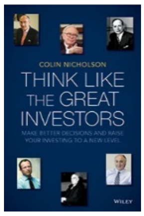

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