

Taking a great Loss



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Putting great and loss in the same title seems like a contradiction, but in trading there are good and bad losses.

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There are probably not many traders that talk about great losses. Let's face it, big gains especially to the novice trader are like fire flies kept hostage in a jar. They need to get out in the open and shine for everyone to see and enjoy. Losses are better kept in secret hiding spaces, never to be spoken of or acknowledged. The less they are brought up or ever discussed the better.

No doubt you have heard the mantra from the trading prophets about taking losses for many of the reasons listed below:

- Protects your capital
- Keeps you in the game
- First loss is your best loss
- Like wins, they are simply part of trading
- Big losses require much larger gains (percentage wise) to recoup
- You will never make it until you learn to take losses

While all these statements are true, I believe it is hard to truly appreciate how important it is to take these continued small losses in your trading career without putting some hard numbers out there to digest. What do I mean? Let's take an actual losing trade, go through the process of what was lost or could have been lost in hard dollars and more importantly delve into the thinking process at each stage.

Trading psychology (having control of your emotions) is something that will probably never get the attention of new entry techniques or magic formulas for the latest and greatest indicator.

That is unfortunate, as despite the lack of sexiness involved with this subject, as you will **NEVER** be a successful trader (at least long term) if you cannot master your emotions. This includes taking signals, exiting trades, taking losses, taking appropriate risk and doing this on a consistent basis. Doing it 9 out of 10 times is not good enough; each and every time you have to be disciplined. Whether you use fundamental analysis, technical analysis or a combination of both, I don't believe taking small losses should be up for debate.

What I hope to do with this article is show the damage that can be done to your account visually and in real dollars. Just telling you to take small losses is not as effective for most new traders. Let's assume we have a \$100,000 account to trade. We are trading our own money, so we face no external pressure from other investors. We decide we will risk 3% per trade (though I don't suggest this to new traders initially and actually trade less myself). Our first trade triggers and we enter an order to buy. We decide we will use a mental stop, and exit our trade if we lose \$3,000.

Let's see how the trade sizes up and more importantly go through some of the thoughts that might enter your mind.

Trade Example - SPY



We have a break-out in the SPY above, but our trading style (system or approach) is break-out trading with a modified entry method. We don't buy the break-out, but wait until a retracement to the break-out and look for a reversal bar. I call it a "pin" bar (pinnocchio bar), but candle lovers will call it a hammer. This is meaningless in the grand scheme of things for this lesson, but play along for now. The high of the bar is \$130.60, so we enter a buy order of \$130.70 (\$.10 above the high) and put our mental stop at below the low by \$.10 as well. Let's assume we use a profit target of 4X our stop loss. Since the low is \$128.96, our mental stop will be \$128.86. Distance from our entry to our stop is \$1.84. Our profit target becomes \$7.36 above our entry, or \$138.06. We have a nice 4R potential trade lined up - all we need to do is let price make up its mind where it wants to go.



Our order is filled and it has a very strong bullish close on our entry day. Even though it has not hit our profit target, let's get out the calculator (or spreadsheet) and start spending our paper profits for fun. Since we are risking 3% of \$100,000, we purchased \$1,630 shares. Since we close at \$132.05, we are up \$2,201 in one day. About this time we probably consider one of the following actions as appropriate if we don't have our emotions under control:

- 1) Tell the wife or husband how easy we just made \$2,200 (and in one day)
- 2) Tell your coworkers or friends about your call on the SPY
- 3) If you system trade, remind yourself how great your trading system performs
- 4) Start planning that weekend getaway that you just "won" by trading

Let's continue on with the trade....it is now 7/22/2011 and we sit as follows:



A small red bar (no worries) is then followed by another strong bullish bar. Even better, the next bar after making a retracement towards \$132.00 closes the day near the high. Once again we pull up our account and look at that paper profit of \$5,200. The only natural thing to do is the following:

- 1) Might as well have the spouse start packing the bags for the weekend trip. Also let them know that you will be flying first class.
- 2) Start debating whether you even need a normal job if you can make \$5,000 in 4 days.
- 3) Remind your friends how well the trade is going.

I don't know many traders that would look at the above chart and not feel good about it. At this point I guarantee many of you could start thinking numerous thoughts....

Should I just sell now and book the profit?

Should I adjust or raise my profit target....it is moving so fast and easy

Maybe I should buy a call option to really bolster the return on this one

A traders mind can go through so many scenarios once in a trade. My advice is to always know your conditions for buying, selling, taking a loss or profit (or any other strategies) **BEFORE** the trade is put on. During a trade is usually the absolute worst time to start changing or second guessing your approach or strategy. There is no good reason to place mental anguish on your brain when trading. Following a trading plan for each trade is a simple and effective way to reduce trading stress. Regardless of the outcome (since we can't predict what will actually happen), if you followed your trading plan you did the right thing.

Let's move to 7/28/2011 now:



Not what we expected, and now we are even showing a small loss. Our mental stop loss is not far away, but we are probably hoping previous support holds up. Our frame of mind has turned to negative and our list of to-do items has changed:

- 1) Cancel the trip or put it on the credit card (smile when asked about the trade)
- 2) Don't bring up trade to friends or family, if asked just reply "It's going"
- 3) Downgrade to coach and explain that first class was booked
- 4) Question your trading system and start searching on the internet for a new system

I won't pretend the above chart is exciting.....it is never fun seeing profits disappear; however, the experienced trader understands he can't control the markets direction. All he can do is take his signals, protect his capital with proper risk management and if he has an edge over time the profits/return will come. It is part of doing business in the trading world.

The moment of truth arrives on 7/29/2011:



The correct option was to have taken our loss of 3% and moved on. Unfortunately if you did not have a hard stop in place, you may have been indecisive and just left it on. I know you are saying, no way I would have left it on – **NOT ME**. But if you did not use a hard stop, the voices and thoughts could easily have crept up in your mind and offered the following:

- That is really a neutral type bar, plus it closed higher than it opened
- Mr. X on CNBC just predicted a huge rally, he said it was just month-end selling by larger funds
- Let me see how tomorrow's price action plays out
- Indicator X now says it is oversold, this is the worst time to sell

Assuming you bought into any of your own sales presentation on keeping the trade, let's see how things played out:



Of course I used an extreme example here, but it doesn't change the risk of not taking the first loss. We are not down \$31,000 and change from one single trade. One single mistake has cost us a 31% loss. We need a 45% return to just get back to break-even. Assuming your trading strategy averages 20% per year, we are two years away from getting back to break-even. In six days time we lost two years.....please read that again, **IN SIX DAYS TIME WE LOST TWO YEARS OF POTENTIAL ACCOUNT GROWTH.**

Assuming we used a hard stop loss and exited as intended, would you now agree with me that initial loss would have been a **GREAT LOSS**?

I think seeing hard dollar numbers and the damage on the chart makes it much more real. The same results could have happened over a 2-year period vs. 6 days if you don't like my specific example.



If you are still in this trade you are “only” down roughly \$26,400. Along with the initial wound of not taking the loss, throw some salt in that wound as your capital has been tied up for 40 trading days.

Remember to always take the first loss.....if you want to brag, brag about your **GREAT LOSS** that saved your account \$27,000 on the SPY. In the big picture, which is more important for your account capital – taking a \$4,000 profitable trade or taking a great loss that saves \$27,000?