



# The stop trap

In thinly traded instruments, leaving a standing stop order in the market can be an invitation to get taken out of a trade unnecessarily.

BY ACTIVE TRADER STAFF

It's happened to everyone. You put on a long trade and place a stop-loss order to protect your position. The market is initially moving in your favor, and you move on to other business.

When you go back to check your trade a little later, the trade is turning against you. You watch the market approach your stop price, and you fight the urge to cancel your order. Then the market makes a sudden drop — precisely to your stop, taking you out of the market — and then just as suddenly jumps back to the upside. And it keeps going up.

You would have a nice profit in hand if you were still in the market, but here you are, on the sidelines, sitting with a loss and wondering what happened. *They got you again.* Those sharks, those slimy insider market makers, specialists, brokers — whatever — who share information and pick off regular traders like you.

No, they didn't. Not really. Well, maybe they did. But it's not what you think. One of three quite mundane things probably happened.

## Don't be paranoid

First, getting stopped out on the high or low of a price move can simply be a coincidence. That might not put money back in your pocket, but it might save you the mental anguish of nursing a persecution complex. It just happens.

Second, you might have placed your stop at a very "obvious" level. For example, if you enter a stop order a small amount below a notable recent low or a "round-number" price (i.e., one ending in .00), you increase the odds of getting stopped out unnecessarily because many inexperienced traders use such conspicuous levels, and professional traders can and will try to flush them out.

## Just because you're paranoid doesn't mean you're not being followed

So, yes, you might have been victimized by the proverbial "stop hunter."

There are a lot of clever, highly capitalized people in the markets, and when there's low-hanging fruit available, they don't hesitate to pick it.

It is most convenient for professional traders to pick off stop orders in thin (low-volume) market conditions, when bids and asks are small. Today's electronic quote systems routinely display multiple levels of bids and offers, and this makes it easy for quick, seasoned traders in these situations to go on search-

and-destroy missions, plowing through multiple bids or offers until they hit pay dirt in the form of resting stop orders.

For example, consider the following quote screen, which shows the first five levels of bids and offers (and the size of those bids and offers) in a hypothetical market:

Bid	Size	Ask	Size
51	3	52	5
49	4	53	8
48	2	54	10
46	1	55	10
43	1	56	8

Assume that after trading higher most of the day — as high as 60 — this market has been moving sideways in a range between approximately 48 and 52 for the better part of an hour. Trading has been very quiet during this period and the bids and offers have gotten progressively smaller.

You went long at 49 when the market was first moving up, and you initially placed a sell stop order at 45 to protect your position. After the market sold off, you were less confident the overall uptrend would continue, so you raised your stop to 47.

At the moment shown on the quote window, the available bids are small — much smaller than the first five offers. Typical bid or offer size in this market is usually 15 to 20, so trading is thin right now in general, but the buying interest is especially weak (something that is also evident in the gaps between some of the bid prices).

In this kind of situation, a well-capitalized trader who notices the abnormally low buying interest might sell into the small bids on the assumption there are sell-stop orders below this level. The fact the market was up earlier in the day and has recently been moving sideways for a while leads him to believe there are many traders with long positions still in the market, and many of them have placed protective stops not too far below this trading range; many traders would see a "breakout" out of the downside of the range as a sell signal and would exit long positions or get short.

By selling into the small bids down to 43, the stop hunter's goal is to trigger one or more sell-stop orders below this level and to be able to buy at a lower price — thus earning an immediate profit on the small short position — and possibly creating a new long position that will profit when the market, predictably, jumps back up after the stop orders have been filled. If the trader is wrong, he has (for him) a relatively small short position he has to get out of.

If he's right, it's easy — and quick — money.

### What can you do about it?

It depends. The easiest way to avoid these situations is to avoid thinly traded markets. Instruments with tight bid-ask spreads and high volume are much less susceptible to this kind of manipulation — which is, by the way, entirely legal and an inescapable reality of trading.

However, even some normal high-volume markets will become thin at times. Given the scenario outlined in the previous section, one school of thought is to use a “mental” stop — that is, know the price (or approximate price level) at which you will exit the market at a loss, but do not enter your stop order in the market. By doing this, you can evaluate the market in real-time — taking yourself out of the market if necessary, but possibly giving yourself the opportunity to stay in your position when the market flushes out a stop area and then reverses back in your direction.

The catch, of course, is that this approach requires tremendous discipline. Many traders who profess to use “mental stops” are simply incapable of taking small losses, and so they end up taking larger losses. Also, it is very difficult to know when to apply this kind of discretion. There is the chance the market will continue to move quickly against you, and you would have been better off getting stopped out as soon as possible.

In general, discretion is something that should correspond with experience. Novice to intermediate traders are better off sticking to detailed trade plans that include “hard” (entered in the market) stops, and then learning from trading successes and failures.

In addition to avoiding placing your stops at obvious levels, it can also be helpful to avoid placing a stop by a round-number increment above or below a certain price. For example, if you're long and you're using the recent low of 23.20 as the basis of your stop, don't place it .50 or 1.00 beneath this level. You're better off placing your stop, say, .57 or 1.09 below the low (except in an instance when this would make the stop price a round number), because seasoned traders know how many inexperienced traders like to use convenient price increments such as .25, .50, and 1.00 when placing stops.

### Much more to learn

Finally, keep in mind these stop amounts are just hypothetical examples. Stop placement should be based on thorough analysis that takes into account the market's historical behavior and the performance of the trade signal you are using. The ideas outlined here are general principles that can help you better understand certain market risks and realities, and thus avoid making basic mistakes. 📌

## Related reading

The following articles provide more in-depth and advanced discussions of stop placement, especially in regard to trading system design.

### “Principles of risk control and money management”

by Active Trader Staff (*Active Trader*, January 2003).

While some traders argue various aspects of trading are more art than science, that's not the case with basic risk control and money-management concepts. Learn three rules of position sizing, capital allocation, and stop placement.

### “Taking the guesswork out of stop orders”

by Thom Hartle (*Active Trader*, October 2001).

Stops work best when they are based on a thorough understanding of market conditions. MAE/MFE analysis you can use to make your stops more effective.

### “Finding price targets and risk points”

by Thom Hartle (*Currency Trader*, July 2005).

To get the most out of a trading approach, you have to move beyond the obvious. Find out how to analyze trades to determine the best places to set stops and take profits.

### “Balancing stop size and trade length”

by Thomas Stridsman (*Active Trader*, April 2002).

How long you're in a trade and how much you risk on a stop loss are not unrelated elements of your strategy — they're inextricably linked. Here's a way to discover the relationship between these two elements, and how they can help you manage your trades.

### “Happy trails”

by Thomas Stridsman (*Active Trader*, June 2002).

This strategy explains how to determine trailing stops for basic swing trading systems.

### “Exit, trade left”

by Thomas Stridsman (*Active Trader*, May 2000).

Trailing stops can help lock in profits and reduce trading risk, but they can also take money out of your pocket if you don't use them correctly.

### “Putting stops to the test”

by Thomas Stridsman (*Active Trader*, March 2002).

Placing stops effectively requires understanding how your strategy, trade size, and account equity interact. Here's an approach that allows you to systematically find the best stop for your trading system.

### “Forex Trade Journal”

by *Currency Trader* Staff (*Currency Trader*, January 2006).

This analysis of a currency trade raises the question of whether to use a “mental” stop rather than entering a stop order in the market.

Note: Some of these articles are also part of the “Risk control and money management” article collection, which is a discounted set of 22 past *Active Trader* articles that cover a variety of strategies for limiting risk, maximizing profit, and managing trades. Topics range from position sizing and stop placement to more advanced concepts such as diversification between multiple trading systems, MAE-MFE analysis, Optimal f, and Monte Carlo simulations.

More information about these articles is available through the Active Trader store ([www.activetradermag.com/purchase\\_articles.htm](http://www.activetradermag.com/purchase_articles.htm)), where you can purchase and download articles in PDF format.

Article copyright 2011 by Active Trader Magazine. Reprinted from the June 2006 issue with permission from Active Trader Magazine.

The statements and opinions expressed in this article are those of the author. Fidelity Investments cannot guarantee the accuracy or completeness of any statements or data.

601825.2.0