TRANSCRIPT

Trading basics part 4: Managing risk and creating an exit strategy

Presenters: Nicholas Delisse and Peter Jannsen

Nicholas Delisse: Welcome back, everyone, to our fourth part of our four part series on trading basics -- how to trade. We have a lot of great information planned for everyone today, so stick around while we'll go through everything on risk management and so forth. As I said, lot of really good information. That said, we will be talking about managing risk today we're going to be wrapping everything up we've been addressing the previous three weeks. We've been talking about managing risk -- different ways that you can plan your exit strategies. We'll be introducing concepts like stop-losses that we always get asked questions on stop-losses. And in two and in three of this four part session and we mentioned during those live classes, stick around for week four. We'll be addressing and talking about them during this particular class. In addition, we'll talk about some tips and tricks and simply monitoring your positions and keeping on top of your account. Now with that said, as I mentioned before, managing risk is very, very, very important to your portfolio. Peter, why don't you take us through some of the basics and things you need to keep in mind when you're managing risk?

Peter Jannsen: Of course, Nick. Thanks for that. As you had mentioned, when we talk about risk management it is an extremely important aspect that really I think should be front and center when we discuss trading or investing overall. Whether it's something completely new to you or even if you've been at trading for a number of years, there are a lot of things to consider. We're going to start here with the thought of diversification and I'm sure many of you are already familiar with this concept, it's the old saying of not putting all your eggs in one basket. And the thought is that through diversification and spreading your capital around, rather than being concentrated, it has the ability to provide growth potential but perhaps at a reduced risk profile. I'd say generating risk adjusted returns for everyone from retail investors up to professional money managers should be an important factor when making decisions. The overall goal, of course, is to generate returns but at a lower volatility to our account which sometimes can be more predictable. We honestly talked a little about this previously when we discussed different asset classes with different types of risk profiles that can make up your portfolio and that goes back to cash, bonds, stocks, different assets like that. And you can also diversify through different investments and different market capitalizations. As you see here, different sectors, different geographies, even regions of the world. And also different styles, which refers to as growth or value oriented companies. So we always want to keep that top of mind when constructing a well-rounded portfolio. We also want to consider how large our positions are in relation to our account. And that is what we mean by position sizing. It also is extremely important because it can work for or against us which can be enticing at times, but it can also lead to extremely unfavorable results when things don't go according to plan. In a moment I'll actually go into further detail on different ways to approach position sizing overall because it's going to be different for everyone depending on your own unique situation. The theme here though is that you want to have a system that's going to work for you, you want to strike a balance so that perhaps one or two positions don't make up the vast majority of your account. Rather, you may want to have a percentage or dollar amount of your portfolio spread more evenly across numerous investments. The main goal, of course, is planning your trades with an appropriate size that allows you to confidently put capital to work when you see opportunities and not keep you up at night. So however that translates to you is the goal that you're going to be after. Now, of course, once we know how much we want to allocate towards our trades, as you see we must also define our exit strategy -- and it says here at the time of entering a trade and I think that's fair, Nick, but at the same time I would almost say it should be thought of before you enter a trade. Ideally before you enter every single order you should always be able to answer the question of, "When am I going to get out? When will I exit this position? At a profit or at a loss?" And that's really the emphasis here, making sure that we know when to exit even if we don't make money at all. And I'll admit that that's easier said than done. We all invest to make money, not to lose it, so why really plan for that at all? I think as traders we can tend to downplay losses that we have. I know I have in the past and I'll tell you right now I wish someone would've told me sooner that if you can really turn the corner or even embrace the fact that in trading losses are going to happen. And rather than be hard on yourself or ignore it or hope that the situation turns around, accept that things didn't go according to plan and understand that given the current situation you need to act in order to potentially minimize further losses, perhaps protect profits that you have and your capital moving forward. So I guess what I'm saying here is have some guideline or framework to -– when to take action. As you see, it can come in a number of different ways. There's really not a -- I guess -- golden rule, so to speak. It could be a percentage or a dollar amount of a gain or loss. It could also be some type of technical level. Maybe you're incorporating technical analysis, maybe you have some indicators that you factor into your overall plan. Whatever it might be, create that exit plan because honestly in the heat of the moment if a position starts to go against you it could cloud your emotions. It could cloud your judgement and be very difficult to make a decision right then and there. That's why we feel that it's so important to plan ahead of time and know how you're going to act when certain scenarios take place and unfold. And lastly, as we see here, we want to be consist. Consistency and discipline on your process is going to allow you to take less of that emotional approach like we said, which is a huge piece of investing and trading. It's also going to allow you to identify potential strengths and weaknesses. And in turn that should allow you to isolate areas for improvement. It's going to allow you adjust your approach and make small changes over time. And that's definitely a key distinction I want to emphasize. When I speak with clients I say be consistent. I always want to reiterate the fact that it doesn't necessarily mean pick an approach of the bat and stick to it regardless of what the results are. I think that trading's going to boil down to learning from our mistakes, making adjustments and taking steps forward rather than backward so don't change your approach on winners versus losers or anything of that nature. We want to be more consistent so that we can make those adjustments and improve. I definitely can't say how difficult it can be at times. So much decision making goes into this but I can tell you the best traders I've worked with they do have these types of systems that mean something to them and their unique situation they review it periodically they make changes and they try to make improvements over time. So having that said, let's go ahead and take a look at the aspect of position sizing and how much we really want to put towards each trade. I think, like I mentioned before, it's going to be different for everyone and that's going to really come back to and depend on your risk tolerance, may depend on your time horizon, it may depend on the purpose of the trade. Is it shorter term, longer term, bigger gain, bigger, I guess, risk mitigation? What is it that I guess is going to be the thought process or thesis for that investment? There's different way that this can be done. Commonly it can be thought of as a percentage or maybe a dollar amount of your overall portfolio or account size. For those of you that maybe you're unsure of what I mean by that -- just as a pure example, let's say that you had a 100,000 dollar account and perhaps you feel comfortable putting two percent of your portfolio into a position. That would translate into 2,000 dollars that you have to allocate towards that trade. Now having that said, two percent may be what you allocate initially when you enter the trade, but of course what happens as time passes, or the price changes, or other things change in your portfolio? That concept is exactly why we need to review our concentration initially at the time of our trade but also over time. Do we need to reduce concentration? Are there any major outliers that we've identified and if there are those outliers is it by design or was it maybe on accident? There's nothing inherently wrong with being overweight or underweight a particular position maybe a sector or market cap for instance, but I would say over the past few decades we've actually observed that certain sectors have done tremendously well compared to others. The thought, though, is that we want to be able to recognize that that can get magnified over time as fluctuations take place so periodically you need to monitor your exposure and either be comfortable with the changes and be comfortable with that over or underweight that you have in certain positions, or you need to be able to take actions and rebalance to your intended portfolio composition. And this doesn't have to translate to making major changes either. I think that's a common misconception for many clients that we've worked with. It ties in to what we see here next which is sometimes keeping it small in proportion and making minor changes to keep things in line with your original goals. I think that's important for all investors, not just for those of you that might be newer to trading. I think another benefit is that this industry has really evolved in so many ways to make that easier than ever. I think that goes back to everything from reduced commissions, different fee structures, the ability to trade fractional shares, even the ability to buy stock on a dollar amount rather than a number of shares basis which could've been more restrictive depending on what the stock price may have been. So definitely keep those things in mind and take advantage of those benefits. Recognizing that you don't always have to put every last dollar towards a trade initially and likewise you don't always have to completely close out of positions that you may have a profit or loss in. So regardless of how you scale into or out of positions, and what is most helpful for your situation, just know how much you are willing to lose and that's what we see here next. That's not always going to be easy. Nick, you and I both know that, but it does go back to having an exit strategy and really knowing how to act when things don't work out according to plan. As we mentioned before, that could be some percentage or dollar amount of your investment. And it also can tie in to more of a risk reward analysis that I'm sure many of you have heard of before. That goes to that concept of maybe risking a dollar for every two dollars that you want to earn. Maybe risking one dollar for every three dollars that you want to earn on your trade. And there's no perfect ratio once again, that goes back to you and the analysis that you've done. But you do want to keep in mind, what is it that I'm willing to risk and what is that potential return that I'm after. And that can be a little bit difficult but honestly with those changes in technology once again you'd even find that Fidelity offers a tool that does this for us called Trade Armor. It actually will allow you to kind of dial in on a chart and visualize those different levels of risk and reward. It'll put it into percentage or dollar terms and I've actually firsthand been able to work with clients that have said that that has been extremely helpful for them. So also we want to think about this from the standpoint of if we're able to sleep at night. And that goes back to our position size potentially being out of line with our initial expectations. If you can't sleep at night on a trade it's more than likely that you're more concerned with the potential for loss than the potential for the gains that you might profit from. So if you recognize that, that loss potential is bigger than you're honestly okay with risking, you may need to go ahead and actually look to reduce some of that exposure and that can be done in a number of ways that we discussed previously, in bits and pieces or maybe portions at a time. I think what that'll do for many clients, I know it has for me in the past, is reduce the emotions behind that initial trade or that investment. And I know it's easier said than done but it will give you a lot more of a clear mind which will allow you to focus on other opportunities that you might have been blinded to in the past. And that's what so much of this is all about. I know we talk lots about the mental aspect of investing it's about staying disciplined I think it's about implementing some of these considerations so that you can alleviate many of those emotional challenges that you are going to face and that you need to be aware of. It's not going to guarantee a perfect outcome, believe me, but I think it's really going to provide a road map for how you can act in various situations and not let your emotions in the moment dictate that decision making process. So, aside from those types of thoughts that you have, I think that we probably want to look next, Nick, at different types of orders that you might want to implement in various scenarios that you encounter.

Nicholas Delisse: Absolutely and I can't stress that -- when it comes to position sizing what Peter was saying if you can't sleep at night because you're just worried about the market's going to crash, position might be large and it might be best off cutting down what you have invested in that particular position to a level that you're comfortable with. That said, as Peter was alluding to we do have several different types of orders you can place to help manage risk. These stop orders they are conditional orders. If you remember in previous sessions you know we talked about a market order versus a limit order and we stressed those differences significantly. Part of why we stress that is that plays in to the difference between a stop-loss and a stop-limit. One triggers a market order, one triggers a limit order. Now, that said, we do need to address what the stop part of the order is. That comes back to, like I was saying, conditional orders. What a stop order is, is you then specify that when the stock reaches a specific price, place an order. The condition is the stock reaching that particular price. So if you have a stock trading at 100 dollars that you've purchased at 100 dollars, well you can say, "Well, if the stock drops down to 95 place this order to get me out." What a stop-loss order does or simply just a stop order as many traders will call it, that will then trigger a market order. Stock drops to 95 trades at or below 95 and boom. You place a market order, you're out of the stock, you sold it. If you remember market orders, you're almost guaranteed an execution but you're not guaranteed a price. You're going to go through -- order's going to go through very, very quickly right away. With that said, what happens if the stock moves significantly over night? It was trading at 96 dollars the night before and earnings happen and it's now trading at 90. Well, is 90 at or below 95? Yes, it is. The condition of the stop is met -- triggers a market order. You then sell at the next available price -- is closer to 90 bucks a share. So again, you're not guaranteed price. In this particular example I mentioned this is called gapping risk where it could gap down and you're not guaranteed to get out at the 95 dollars. Now, a stop limit order, as opposed to triggering a market order, triggers a limit order. When the conditions been met, stock trades at or below that 95 dollars, limit order is placed. Now, there are some pros and cons to this that -- let's say you told our system when it trades at or below 95, place an order to sell your shares at 94 dollars or greater. So as it comes down -- 95.50, 95.25, 95.00. Boom, order's placed to sell at 94 or greater. The order goes through. If it then gaps down to 90 dollars a share. Well, the tradeoff is stop loss or goes through right away you sell at 90. But if you are expecting a balance if that happens, well a stop limit order will trigger a limit order, it won't sell at 90 because it's not at or above 94. The order -- the stock comes back to 94 then it will sell. The problem with this is, is if the stock gaps down to 90 and then goes to 85, 80, 70, 50 but never comes back up to 94, your limit order never fills, you never get out. So many traders look at this and go, "It's more important that my order is filled, that I get my particular price." So with this, they'll look to actually have that market order triggered with the stop instead of a limit order trigger. But that's the big difference between a stop or stop-loss and a stop limit orders, one triggers a market order, one triggers a limit order. Now, another type of stop order is a trailing stop order. What this does is you set how much you want it to trail and it then follows along based on a high watermark. So, in essence if you have a 100 dollar stock and you say trail by five dollars, well now the stop loss order is at 95. But if the stock goes up to 101 well now it's at 96, but if the stock drops down that order doesn't change. The way I like to think about this is picture a stop order being a brick. You set a brick down and you continue to walk. Well, if you've walked a long distance and you start to back up well you might have to back up a long distance before you finally hit the brick that you set down. Now, imagine instead of setting a brick down and walking, you set the brick down and you tied a string to it. As you walk you pull that string along with you. Well now if you back up, well you only have to back up the distance of the string. And that string, that's that trail amount that you're setting. We have a great chart that shows this particular concept here. Bought the shares of stock for 25 dollars. Stock goes up to 27. You want to protect your gains because you've made two dollars already, so the stop loss isn't just stopping additional loss it could also be protecting gains. So with this the trader then sets a one dollar trail. Well right now the stop would trigger at 26 bucks. Again, this is the difference between a one dollar trail and simply setting a stop loss at 26 bucks. Because then as the stock goes up we see the trail amount increases as it goes down just like you can't push that string backwards, the stop order doesn't go down. And as it then goes all the way up the stock goes up to 29 dollars on this particular example, well the stop order then gets lifted up to 28 and doesn't move. And then as the stock then turns back down, as soon as it hits at or below 28 dollars the stop orders triggered, then places your order. In the event of a stop loss, places a market order, you then sell at market. In the event of a stop limit it then places a limit order. This is a great order type for maybe a longer term trader. That they're trading a trend they see in the security. And maybe they want to trail by 10 percent because a 10 percent drop is dealing with a correction or they might trail by 20 percent because a 20 percent drop from those recent highs would be a bear market, so they're setting it up on those particular levels which might be more common levels that traders might use for a longer term time horizon. Other common levels might be eight percent. Investor Business Daily talks about using an eight percent trail instead of a 10 percent trail on their particular orders. Then what this does is if it goes up and then comes back down, if the stock goes from 100 to 120, back to 115, back to 130 it's going to trail by that particular amount. Now, with this talking about percentages. Trailing stop orders may be based on a dollar amount or a percentage amount. You could have a trail by five dollars in that 100 dollar example, or you could have a trail by five percent. Which this could be a big point that if you're using 10 dollars or 10 percent, well if the stock goes from

100 to 200, well 10 dollars is now at around 190 that's only five percent. Or if you're doing it on a percentage basis that trail amount is dynamic. Now, one other thing to think about though that we get asked frequently is stop orders are typically held on the exchange side, they're not held on Fidelity's side. So yes, those orders could be visible to other market participants. Trailing stop orders are held on Fidelity's side on a not held basis. And once the trigger is met, then they're sent on to the market. And so these types of orders are not visible to other market participants. Now, that said, we have a lot of different tools that are available to help you choose stop prices, to help you manage risk associated with that. Peter, why don't you kind of introduce to us some of those tools that we have?

Peter Jannsen: Yeah, absolutely and that's incredible. I agree with everything that you had said and more in being able to implement those. And what we see here is that technical analysis piece and we're going to look to try to keep this somewhat high level, but just know that in addition to risk reward analysis being done solely on that percentage or dollar amount that we were discussing earlier, some traders may want to incorporate some aspect of technical analysis also. Now we have numerous sessions and classes on technical analysis for those of you that want to learn more, but for now let's like I had mentioned keep it a little bit high level with this thought of support and resistance that we see here. And the thought is, is that there are potential levels where buyers may see value and make purchases supporting the price action and pushing it higher. Likewise, there are thought to be resistance levels where sellers may feel that a price is extended or potentially overvalued and they actually want to look to take profits and over time you can observe those patterns or levels in charts. So some traders will use these levels like this in combination with other analysis that we had discussed to try to determine where they potentially need to exit positions and protect gains or potentially prevent further losses. So as you see here, a stop could be placed under an area of support or even above resistance and the thought process is, is that if that price level is broken then the trade thesis is invalidated and at that time managing risk should really be the primary goal and the task at hand. So that's a really high level basic thought as far as technical analysis and at least how some traders will use support and resistance incorporating some of the other aspects that we had talked about in risk management, but once again for anyone that's interested in learning more, we definitely encourage you to join some of those additional sessions that we offer. For here and now, Nick, how about we go ahead and actually take a look at some of those tools that we discussed and different ways that we actually could actually look to incorporate some of what we have talked about so far today.

Nicholas Delisse: Absolutely, Peter. And keep in mind that we could literally spend hours just talking about the concept of support resistance without breaking into other different technical tools that traders will use. So I pulled up our Active Trader Pro platform. It's a fantastic tool to chart, to utilize technical analysis with. Within Active Trader Pro, once you pull up a chart if you come up here to technical analysis you can then add support and resistance. This is powered by Recognia these are algorithmically generated support resistances based on closing price information since it's based on closing price information it's based on the prior day close so you might see some time where prices above resistance or below support. With this you can of course click on this, you can modify it. You can go, instead of long term, you can take a look at intermediate term. Even short term to see some of those differences associated with that. Now, this is just looking at our algorithmically generated tools. Other traders might prefer to actually draw those lines themself and we talk about that in some of our other classes. We do have additional tools that are quite useful when determining those particular levels. It could even help you also place the order alongside the chart. Within Active Trader Pro we have Trade Armor, coming up to trade and then down to Trade Armor you'll see this pop up. I'm going to type in a symbol, we're using Apple on our chart. Pull up Apple here and we can see we have a chart, we have news, we have information, all in one particular spot. This also draws support and resistance lines here. Now, this is just showing within Active Trader Pro. We do also have Trade Armor on Fidelity.com. Pull back up our positions page on Fidelity.com if we have a position we're looking at we can click on a position, we can expand it. We have this link that says set exit plan. We click on set exit plan this'll actually pull up Trade Armor on Fidelity.com and so we can see this, looks very, very similar to what we had within Active Trader Pro we have this chart, we have this information out here to the right. Now, if we want to get to this particular page without clicking on this link we can come to accounts and trade and then trade. Or click on this trade button popping up the trade ticket that we previously talked about and from the dropdown here on this tool or the other page, click the dropdown, we come to Trade Armor that will load the Trade Armor tool for us. Of course, the first thing we need to do is we need to take a look at what symbol are we wanting our trade based on. We'll type in AAPL for Apple to pull up a chart for Apple. If we'd like to place a buy order, simply place trade, this'll pull up this particular order type. Now, I want to take a look at a specific example, our test account has shares of Bank of America in it so we'll come back over to this tab that has that looking at Bank of America. A very common, more complex conditional order that traders will look at is called a once cancels the other order or a bracket order. With this we'll come down to action, we'll do sell bracket OCO five shares because we have five shares in the account and what this has done is this has set up two orders for us. One is a sell limit at our price target. The other is a stop loss. Or maybe we can drag this down to at or below where we see a support level. We see Bank of America bottomed out down here. We might set a stop loss at that particular level. And then a sell limit right below the 52 week high. So what this'll do is if Bank of America goes up to this order this sell limit order would fill and then the stop order would get canceled. Or if it comes down to our order down here, our stop order will get filled exiting the position and a sell limit will get canceled. A third type of order the trader will let you place is let's say you don't have a position on the account, we come here to action and we can do a buy triggers a bracket order. Simply will put in the quantity of shares, maybe we're just doing one share. And now we see we have a buy order here, it's a market order. Maybe we want to move this down a little bit because we want to specify the price at which we're willing to pay for Apple. We can drag this up and down or even come over here to this order ticket on the right hand side and specify a price level. Maybe we say we're willing to buy shares of Apple only if Apple drops down to 170 dollars a share. We can say well if we purchase Apple we want to get out if Apple drops below the support level. You see I drug this down to visually see this. We can say well we also want to ring the cash register so to speak if Apple makes it back up to this 52 week high. So you see, this has all been pre-filled, the price, stop price based on where we drug the chart and it even shows percentages that if we place the order what our gain and our loss would be with that. Actually this flip these order types right here so add this buy right there at the 170. We'll drag our stop down here. Just visually everything we see that's at 170 now. These are our stop prices down here at 150 our sell limit is 180. We can see if it goes up. We're making that seven percent, comes down to this support level losing about five percent. We may look at that and go, we like those particular numbers. It's a great, powerful tool to make it easier to place conditional orders, easier to place a bracket order, easier to place a stop order and it shows support resistance information for you right on the chart to let you visually trade right here on the chart. Any last thoughts you have, Peter, before we wrap up our session?

Peter Jannsen: I think that's great, using that type of tool. If anything it will help you really visualize I think many of those thoughts that we had on that risk reward, whether it's that one for two. Whatever that case might be and will also help you I think look at really what could be realistic. And that's not to say we know exactly what's going to happen but when you look at these charts and also incorporate that well rounded thought I think those types of tools are extremely useful to many clients that are out there. But having that said, I think at this point it was a fantastic four weeks that we were able to go ahead and discuss everything as far as different types of strategies for investing, different types of asset classes, all the way up to once we have decided on which investments to make in our portfolios. How to manage those and not just the one rule of thumb but also numerous ways to manage them through different positions, through different types of orders. So that being said, I appreciate everyone's thoughts and engagement so far throughout this time period and we look forward to seeing you in some future sessions.

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