

Exit Strategies for Stocks and Futures

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Exits are important because your exit strategy will determine:

Size of your profits

Size of your losses

Length of your trades

Amount of your risk

Size of your position

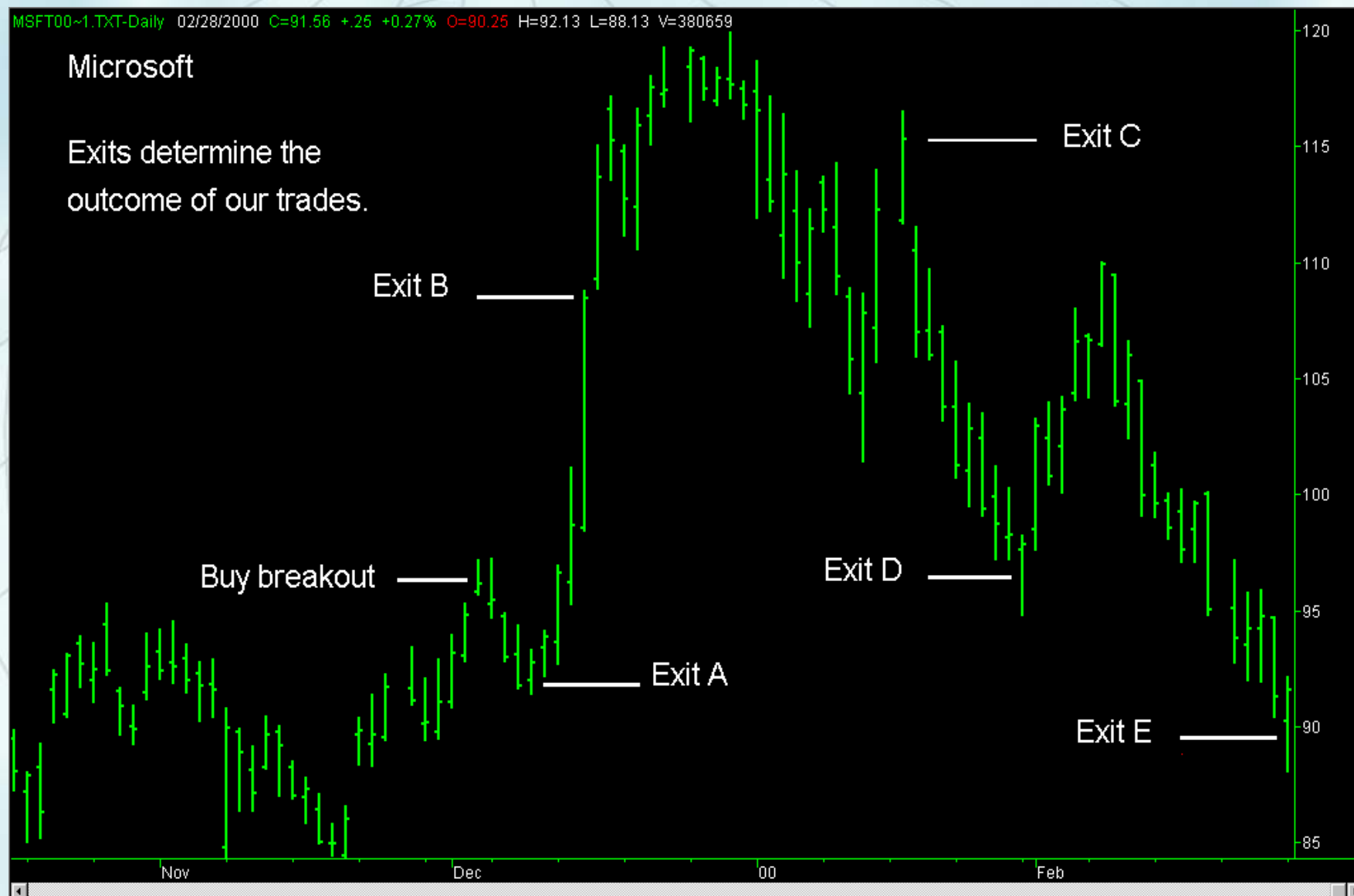
Your percentage of winners

Your total return

MSFT00~1.TXT-Daily 02/28/2000 C=91.56 +.25 +0.27% O=90.25 H=92.13 L=88.13 V=380659

Microsoft

Exits determine the outcome of our trades.



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For most traders exits are more difficult than entries. Why are exits difficult?

We have unrealistic expectations

We expect to sell at tops

We tend to apply too much hindsight

We sense lack of control

We can enter trades on our own terms

We must exit trades on terms set by the market

Solution: We need to have realistic expectations and take control of our exits.

Exit priorities:

Initial stop loss

Trailing stop loss

Moves up from initial stop to reduce risk

Protects us at break-even point

Profit protection stop

Keeps winning trades from becoming losses

Locks in a portion of the open profit

Profit maximizing exit

Attempts to exit without giving back profits

Exit priorities: (Number one)

Initial stop loss

Determines your risk and allows you to correctly determine the size of your position

Protects your capital and provides peace of mind

Keeps you from “falling asleep”

Determines winning percentage

Wide stops are usually best because they will tend to provide a higher percentage of winning trades

Tight stops can be bad because they often cause us to exit trades that would eventually be profitable

Initial stop advice: Plan to start with wide stops and then move stops higher.

Examples of initial stop strategies:

Set initial stop at some multiple of Average True Range (ATR)

Set initial stop at some pivot point low

Set initial stop below an obvious support level

Set initial stop near lowest low of last “n” days

Set stop below some moving average (try 20 or 30 bars MA for stocks –shorter length for futures)

Set stop below an important trend line

Note: My favorite initial stop is placed 2 or 3 ATRs below my entry point.

Exit priorities (Number two)

Trailing stop loss (May be same as initial stop if initial stop moves upward over time.)

As your trade becomes profitable the trailing stop moves up to gradually reduce your risk.

The trailing stop will allow you to lock in a break-even point.

The trailing stop will gradually start locking in a small profit.

Trailing stop advice:

Be patient at the beginning of the trade and don't try to raise the stop too fast.

Exit priorities (Number three)

Protect your open profits

Decide a specific level at which point you will begin to protect some portion of your open profits with a stop that is tighter than your previous trailing stop. Here are some ideas on when to start using tighter stops:

When open profits reach twice your initial risk.

When open profits reach four or more ATRs.

When open profits reach 25% of the capital invested (or pick any percentage that makes you feel the trade is worthwhile).

Advice:

Try to give the trade a reasonable amount of room so that the profit still has a chance to grow. What is a “reasonable amount”? For example – you might want to risk up to 25% of your open profit in hopes that your open profit may double. Another definition of “reasonable amount” would be to risk one ATR.

Exit priorities (Number four)

Take large profits efficiently

Never let a large profit turn into a small profit.

The bigger the profit the tighter the exit.

You need to have some practical definition of “large profit” so you will know when to start guarding it very closely or even exiting on strength.

The definition of “large profit” is a very personal definition and will vary according to your personal trading objectives and your preferred time frame for trading.

Advice: If you want to exit a highly profitable trade on strength, exit when the RSI oscillator reaches a high level. (Maybe above 70 or 80). Don't wait to get stopped out on weakness.

Most common exit mistakes:

Initial stop is set too close

The initial stop should allow plenty of room and give the trade a chance to become profitable.

Wide stops at the beginning of the trade will lead to a high percentage of winners and more total profit in the long run. As nice as it sounds to have very small losses, that strategy doesn't work for most traders. Those small losses tend to add up fast.

Profit taking exit is set too far away

Once a trade has become highly profitable the majority of the profit needs to be protected.

Remember - the tight stop is used at the end of the trade and not at the beginning. Unfortunately most traders get this backwards. They risk too little at the beginning and give back too much at the end. This leads to a pattern of many small losses and an occasional small winner. That is not a pattern for a successful trader.

Three of my favorite exits:

The “Chandelier” exit

The “Yo Yo” exit

The “Modified Parabolic” exit

Note: To understand and use the logic of the “Chandelier” and the “Yo Yo” exits it is first necessary to have a good understanding of Average True Range (ATR).

Sketch - True range bars

Range

True Range

**“True” range
adjusts for gaps**

Average True Range (ATR)

Definition of ATR – Average True Range is the largest of the following:

The difference between today's high and today's low.

The difference between today's high and yesterday's close.

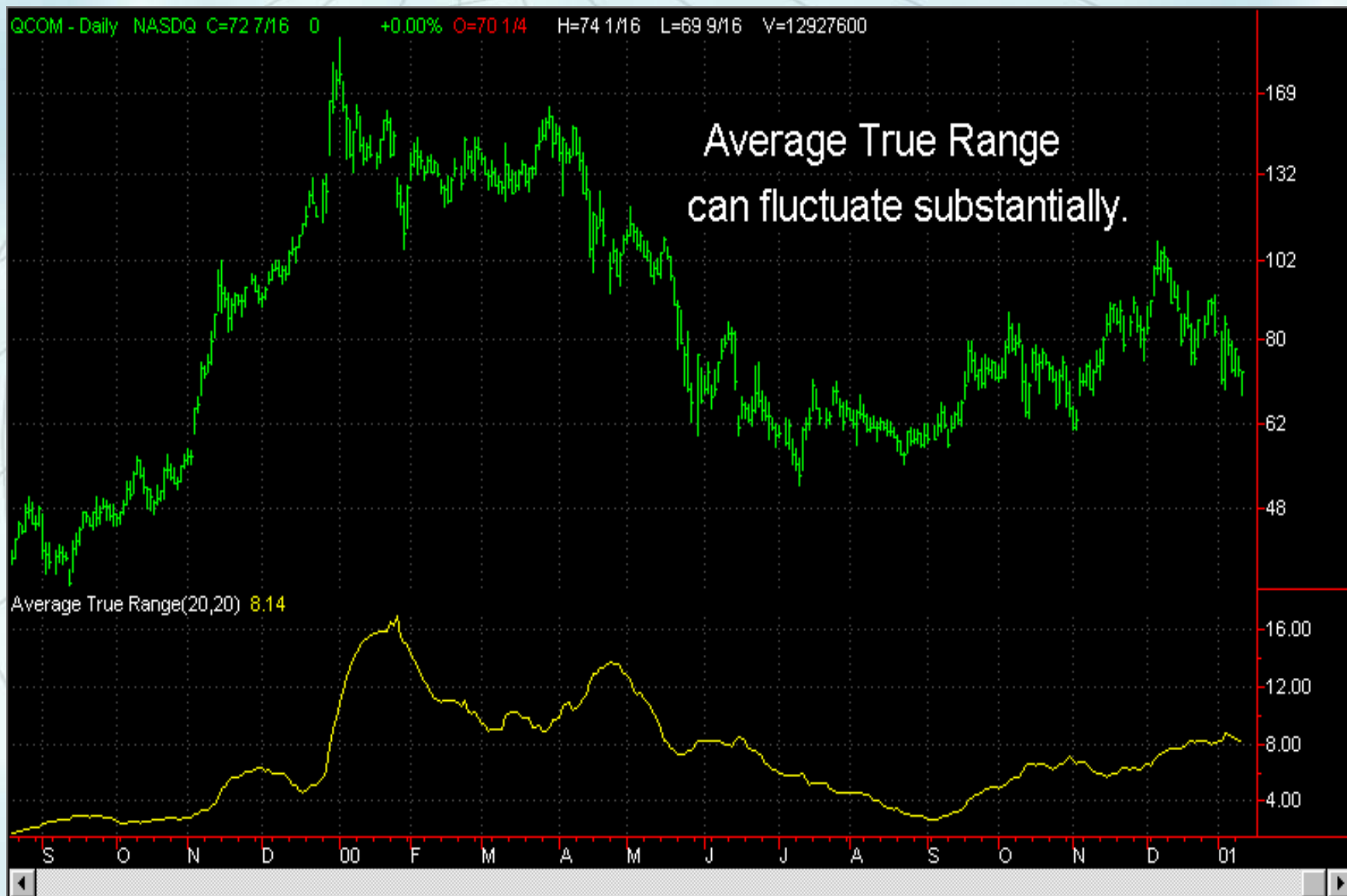
The difference between today's low and yesterday's close.

True range is always considered to be a positive number.

QCOM - Daily NASDAQ C=72 7/16 0 +0.00% O=70 1/4 H=74 1/16 L=69 9/16 V=12927600

Average True Range
can fluctuate substantially.

Average True Range(20,20) 8.14



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Benefits of Average True Range

ATR adapts to changes in volatility

ATR works same on a \$2 stock or a \$200 stock

ATR works same across markets - yen, soybeans, gold, stocks, bonds, etc.

Use ATR whenever possible to make systems adaptive and robust

ATR works particularly well for setting stops and deciding profit objectives

ATR has many other uses – it can even be used to identify trends

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MSFT

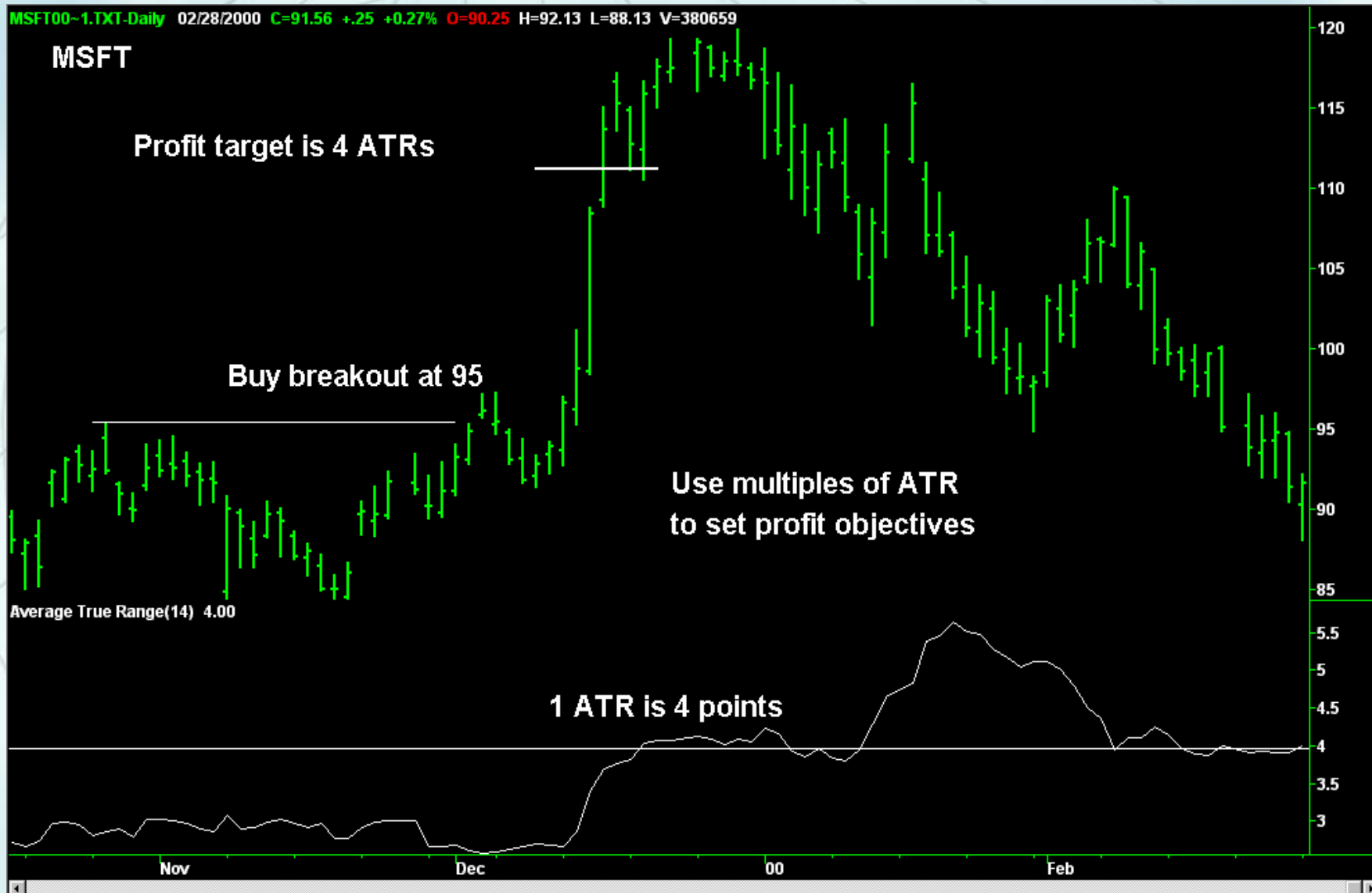
Profit target is 4 ATRs

Buy breakout at 95

Use multiples of ATR
to set profit objectives

Average True Range(14) 4.00

1 ATR is 4 points



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The “Chandelier” exit

Most trailing exits come up from underneath prices and are based on previous low points

The focus on low points causes these exits to lag badly when prices are rising strongly

The Chandelier exit is effective because it hangs down from the high point of the trade

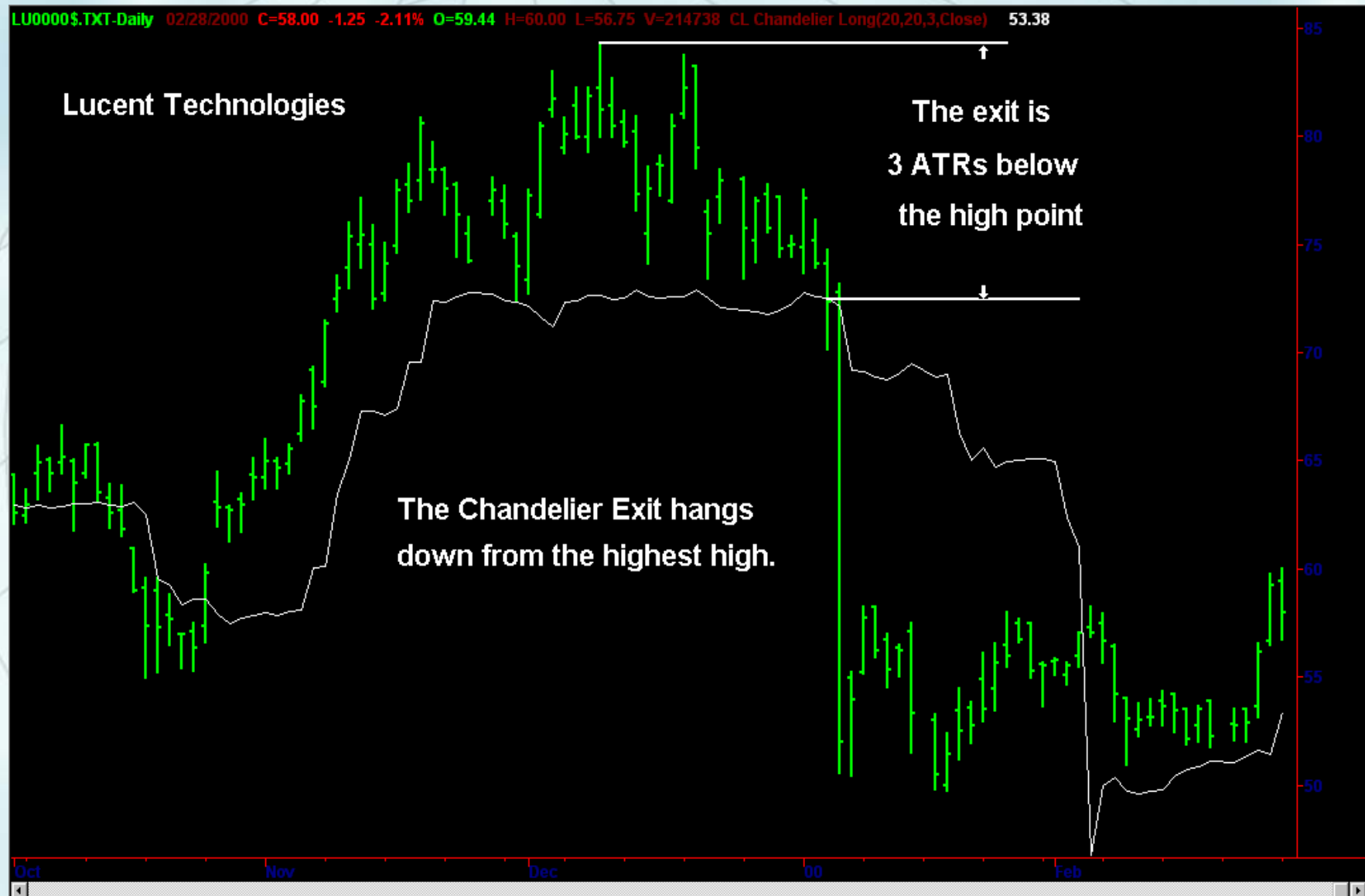
The Chandelier exit moves up proportionally whenever a new high is made

Setting up the Chandelier Exit

The stop is set 3 (?) ATRs below the highest high (or highest close) since the trade was entered

The stop moves upward whenever a new high is made

The “chain” on the “Chandelier” will contract and expand slightly as the ATR adjusts to changes in volatility



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Adjusting the “Chandelier” Exit

We usually start new trades with the default ATR of 3. (High minus 3 ATRs)

As the trade moves in our favor and becomes profitable the exit moves up

At some point of profitability we will no longer want to risk 3 ATRs so we will shorten the “chain” on the Chandelier by reducing the number of ATRs

Example: After we have reached 4 ATRs of profit we will reduce the “chain” to only 2 ATRs

The “Yo Yo” Exit

The “Yo Yo” Exit is usually set at about 2 ATRs below the most recent close

As the close moves higher and lower the stop moves up and down – hence the name.

Logic: The “Yo Yo” exit identifies abnormal volatility in the wrong direction

The “Yo Yo” exit is a supplemental exit. It can not be your primary exit. It does not protect capital – it tells you when you are on wrong side of the market.

MOT - Daily NYSE C=21 3/16 0 +0.00% O=21 H=22 5/8 L=20 5/16 V=26664100 CL Yo Yo Long(20,1.75) 17.980

Don't ignore Yo Yo signals

Something is wrong!!



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The “Modified Parabolic” Exit

This trailing stop moves closer and closer to recent price as new highs are made.



MSFT - Daily NASDAQ C=54 17/32 +1 21/32 +3.13% O=53

H=54 13/16 L=52 5/16 V=28643900 Parabolic SAR(0.02,0.2) 44.700



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AOL0000\$.TXT-Daily 02/28/2000 C=60.63 +1.00 +1.68% O=60.75 H=61.63 L=60.00 V=258124 Parabolic(.02) 48.46 Parabolic(.01)

The unmodified Parabolic is too sensitive and exits too soon in October.

The default acceleration factor (AF) is 0.020 and needs to be set at a smaller number. Try 0.010 or 0.015.



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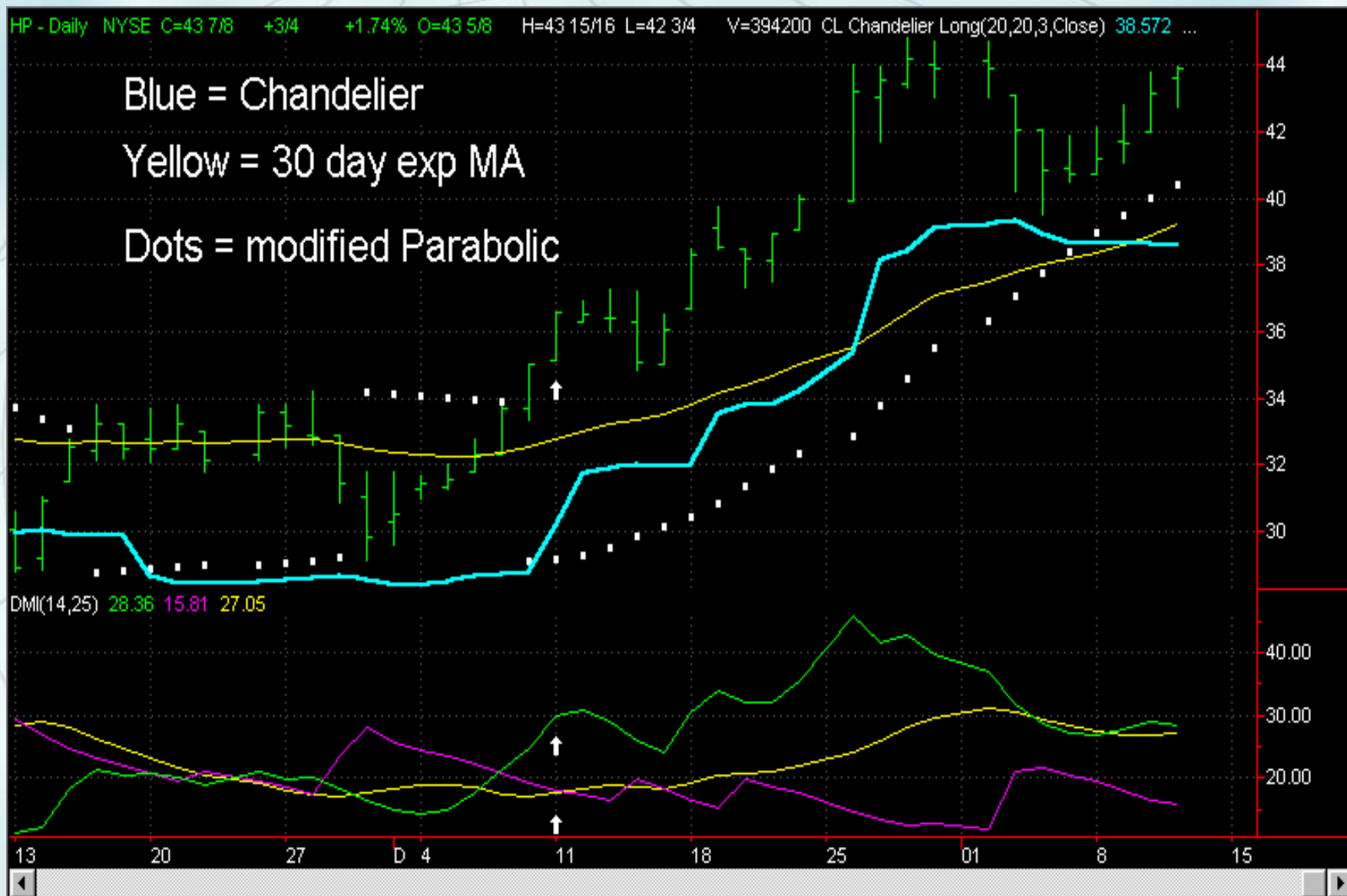
HP - Daily NYSE C=43 7/8 +3/4 +1.74% O=43 5/8 H=43 15/16 L=42 3/4 V=394200 CL Chandelier Long(20,20,3,Close) 38.572 ...

Blue = Chandelier

Yellow = 30 day exp MA

Dots = modified Parabolic

DMI(14,25) 28.36 15.81 27.05



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Combine the Parabolic with ADX

The Parabolic and ADX combination can identify “V” shaped tops and bottoms

When the ADX rises above both the Plus DI and the Minus DI – be alert for a major change in direction

Crossing the Parabolic signals that the direction has reversed

When this signal occurs a powerful move in the new direction can be expected

This Parabolic/ADX signal works particularly well on stock indexes



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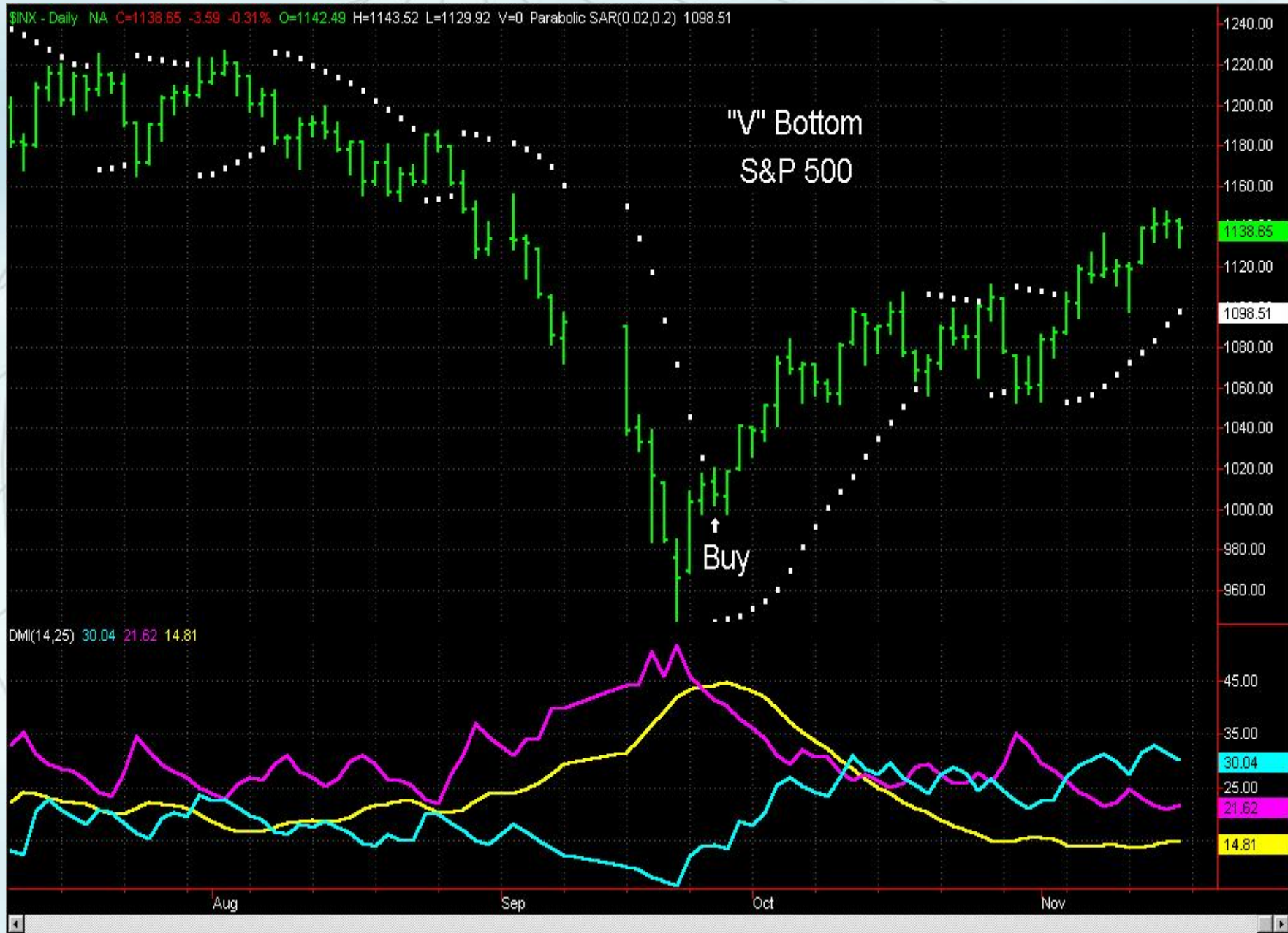
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How to set accurate profit targets

Use the direction of the Average Directional Index (ADX) to set profit targets

When the ADX is rising you should be patient and expect large profits

When the ADX is declining you should take small profits quickly before they get away

**Note: “Large” means 4 ATRs or more –
“Small” means 1 or 2 ATRs**

AOL0000\$.TXT-Daily 02/28/2000 C=60.63 +1.00 +1.68% O=60.75 H=61.63 L=60.00 V=258124

America Online

When ADX is declining
trade for small profits

When ADX is rising
look for big profits

DMI(14) 26.29 22.66 20.91

14 day ADX



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AMAT - Daily NASDAQ C=44.750 +0.000 +0.00% O=44.313 H=47.000 L=43.125 V=37796500

Use ADX to determine
appropriate strategies



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Other exit strategies to consider

Exit at the lowest low of “x” days. This is called a “channel exit” made popular by the “turtles”

Exit using moving averages. 10 or 20 days works in futures while 30 to 50 days works well for stocks

Exit if you see an entry signal in the opposite direction

Time exit – exit after “x” bars (Good for testing entries)

More exit strategies to consider:

Exit at pre-determined profit objective – works best for short-term trades. Use ADX to help

After good profit run – look to exit on strength rather than waiting for weakness

Example: after six ATRs of profit, exit when RSI rises above 75

Exit at chart support or resistance

Summary:

Exits determine the outcome of our trades

You will probably need multiple exit strategies to do the job properly

You need an initial exit to protect capital and determine position sizes for your trades

You need a trailing exit to reduce risk as market moves in your favor

You need an exit that attempts to protect and to maximize the profits

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**Thank you for attending. I hope you enjoyed my presentation.
Good luck and good trading. Chuck LeBeau**