Bulkowski’s Trading Quiz

One trader had a question about stop placement, so I thought a review would be a good idea. Since this took too long to put together, there’s no quiz today.

Consider this chart.

You might want to print it out or just view it split screen. At the top of the right vertical scrollbar in Word, you’ll see a small rectangle just above the up arrow button. Pulling the small rectangle down allows you to split the screen so you can view a portion of the chart and review theses notes at the same time.

Imagine that you bought the stock at the breakout from the pennant in July. Where would you place a stop? Since the pennant and most chart patterns offer support or resistance, placing a stop below the pennant at point 1 would work. Point 2 would be a choice for more volatile stocks but it’s farther away so you would incur a larger loss. The point is just below the horizontal price trend (shown by the horizontal line). Ignore the price scales for the moment (meaning that both stops are relatively far away on a percentage basis).
Point 3 is a throwback. I always assume a throwback will happen. That’s when price returns to or nears the breakout price within 30 days and shows white space in the process. The white space rule is used to prevent a throwback label from being applied when price slides along the breakout price instead of moving up then curling back down.

As price rises, raise the stop, but to where? When price at point 5 rises above the prior peak at 4, then raise the stop to 6, the prior valley low. This method doesn’t always work. Consider points 7, 8, and 9. Price at 8 (a new high) rises above point 7 (the prior high), so this would call for a stop at 9 (the prior low). The low at point 9 is at 9.88, and price closed at 15.03 at point 8. The stop would be 52% below the close. That’s huge. Try to keep your stops less than 15% away at the start of a trade and below 10% away as the trade progresses. Point 10 is a closer minor low, another choice for a stop. Point 10 bottoms at 12.16, but that’s still 24% away. Still too far below the current price.

Another method is to use a Fibonacci retrace. That’s when price drops back between 38% and 62% of the prior rise. Look at points 3, 11, and 12 in the lower left of the price trend. Point 3 bottoms at 5.16, point 11 peaks at 7.19 and the retrace bottoms at point 12, at 6.03. The move from 3 to 11 is 2.03 points. The decline from peak 11 to bottom 12 measures 1.16. Thus, the retrace of 1.16 out of 2.03 points, or 57%. A stop placed at the 62% retrace of the move from 3 to 11 would have worked (I prefer a 62% retrace value as price most often reverses before reaching it). Point 3 is the swing low, point 11 is the swing high, and point 12 is the swing low. With my computer program, I just click on the swing low and high and it draws 3 parallel lines at the 38%, 50% and 62% retrace values. That way, I can place the stop as needed. Your program may have a similar feature.

One last method is to use a volatility stop. Dump the daily price data into a spreadsheet and then calculate the difference between the intraday high and low – think of it as the daily price range. Place the result in a separate column then average the last month’s worth of data, about 21 values, to get the average daily price volatility. From there, multiply by 1.5 or 2 (testing shows that 2 results in better performance) to get a volatility reading.

Let’s say the average price range is $1. Multiply it by 1.5 to get $1.50. I use the current day’s low and subtract $1.50 from it. A stop should not be any closer than $1.50 below the current low. If the stock has a low of 40, I would not put a stop closer than 38.50. A volatility stop would work well for Abgenix as price has zoomed upward. Also note that the scale is logarithmic not arithmetic. I prefer the log scales as it shows more detail when price makes a large move and trendline piercings will occur sooner, too.

Finally, some brokerages have automated trailing stops. You set the dollar amount or percentage below the price and the stop is raised automatically as price moves intraday.

The end.