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To Stop or Not to Stop? A Question Every Trader Must Answer

An encore presentation originally printed in the December, 1994 CSI Technical Journal

"They did it to me again!"

I can't tell you how many times I've heard this lament from traders who were stopped out of a position just before the market resumed its previously profitable track. "They" in this case, are (of course) floor traders, who are cast as villains in a plot to stop out the little guy and take the profits for themselves. Does this really happen? Perhaps. But more often than not, the natural forces

of supply and demand or reactions to current events trigger blip-like fluctuations in the market. A more important question is, "How can one use stops wisely to protect assets, rather than pre-arrange the extent of the next loss?" A more basic question is, **"Should I use stops at all?"**

Traders, big and small, typically hate stops because of the poor market order executions that inevitably result. You can get killed when you use them and murdered when you don't. Mental stops don't help much unless you are very disciplined, watch the markets minute by minute, and are willing to take yourself out when the critical price is touched.

Any trading system could use stop-loss logic to exit a position if the market were to turn against it. Although stop-loss controls will help

some of the time, they will also force early exit from otherwise profitable positions. Before selecting a system that relies heavily on stops, please consider their pros and cons.

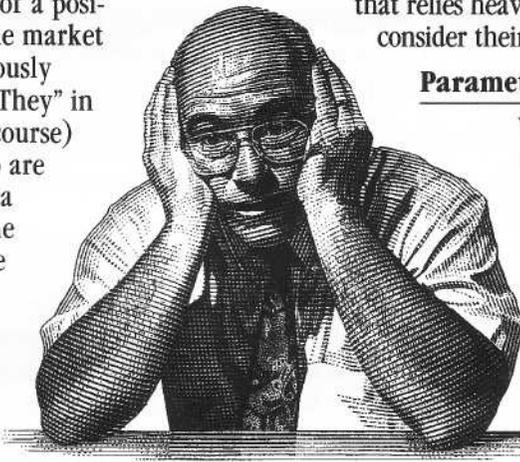
Parameter control

When stops are part of a system's design, they add parameter control, making most actual performance trials fare worse than simulated performance. Simulated results which

rely heavily on stops are highly suspect. The performance measurements must be discounted to compensate for the added parameter control that surely degrades actual performance.

It is more appropriate to add parameter control through the use of additional independent, intermarket time series support. It is not unusual in these days of abundant computer power and readily available data base scope and longevity to use many markets to help predict only one. When market direction can be forecasted more reliably, the use of stops to hold onto profits can be reduced. Intermarket analysis has always offered more abundant profits and better performance, given that proven methods have been employed.

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To Stop or Not to Stop? ...

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“Although it may be convenient to blame anonymous floor traders for your financial disasters, it is more beneficial to look to the design of your own trading system for a solution to the problem.”

The Double Whammy

Stops may have a place in your trading plan, but I believe they should be used sparingly. They are particularly insidious when used in a system which reverses direction when stops are hit. Typical of this application is the purchase or sale of double the quantity of units held when the reversal level is hit. The trader suffers an erosion of capital in his current position, then starts the opposite market position at the eroded price. When price is your only governing input, little can be done to avoid suffering the effects of double dollar erosion without adding still more parameter control and taking additional performance discounts against your real results.

The Option Alternative

Every analyst must consider whether stops are preserving capital or jeopardizing performance by increasing losses beyond what would have occurred in their absence. In general, any decision which will force extra trading is undesirable. Activating stop losses will generally increase the transaction costs of playing the game. Consider the additional two alternatives of buying an option (a put, if your sell stop is hit) or writing an option (a call, if your sell stop is hit). The advantage of the option over a stop in this case can be determined by calculating the reward-versus-risk ratio of each of the three alternatives. Admittedly, this is a tall order, but one can estimate possible returns from past data. The market volatility, option premiums and option time values can all translate into a measure of risk. It will take some effort, but one of the three proposed alternatives is better than the other two for every situation. An empirical solution exists for each problem that arises.

If you are approaching a stop loss

point, you have probably already lost substantial equity. Think of this loss as a “realized” capital erosion for your mental frame of mind. Moving to this point frees your thoughts to concentrate on the alternatives and other positions. Hope springs eternal and clears your mind to cope with adversity.

Although it may be convenient to blame anonymous floor traders for your financial disasters, it is more beneficial to look to the design of your own trading system for a solution to the problem. Using stops wisely and sparingly in conjunction with a proven trading system will almost certainly be more gratifying in the future. To stop or not to stop? That is your choice to make. Like most things in life, stops are best used in moderation. ♦

Bob Pelletier

What’s your e-address?

E-mail has become the method of choice for getting information to customers in need. If we don’t have your address, please send a brief note with your name and User ID to:

techsupport@csidata.com

Thank you! ♦

Use 561 Area Code to Call CSI

CSI’s area code is changing from 407 to 561. Although 407 should work through March ’97 some callers have been unable to reach our service staff using the 407 area code. We recommend that all callers use area code 561 for long distance data retrieval and when speaking with the CSI staff. Please note that some office telephone systems must be reprogrammed to handle area codes that lack a 1 or 0 as the middle character. ♦

Ask Customer Service

Each month in this column, the CSI Customer Service staff addresses common questions of interest to many CSI subscribers. With Unfair Advantage finally in the hands of many customers, a new batch of questions has arisen.

Q. *How do you handle suspected errors in Unfair Advantage®?*

A. As with any data supplied by CSI, errors are rare, but possible. If you suspect an error, we urge you to report it right away. Your questionable data point will first be compared with our internal data base to see if it was corrupted during or after distribution. If your data matches ours and there is reason to suspect an error, we will check with the exchange and make revisions if necessary. Please e-mail your name, User ID, the date of the suspected error, the field of the suspected error and why you think it may be wrong.

Q. *Is it possible to manually edit a data point in Unfair Advantage?*

A. Not permanently. The system creates new charts and files from source data with each use. Any change you make to a data file will be voided with your next update. The only way to change your Unfair Advantage data base is to report suspected errors to CSI, then let the software retrieve and distribute the corrections as part of the normal update procedure.

Q. *I understand CSI has made a few revisions to Unfair Advantage since I received my copy. How can I get the updated program?*

A. We maintain a special web site for our Unfair Advantage customers which offers news on the program and all software revisions. You'll find a list of revised files, along with descriptions and instructions to download. To reach the site, please visit URL address: <http://pcweb.csidata.com/ua/ua.htm>

Q. *I got an unexpected error in installing Unfair Advantage, telling me I was out of disk space. My hard drive is not large, but I know I have more than the 40MB the program requires. Please explain.*

A. Although when fully functional

the program uses just 40MB, the installation process itself requires twice that amount (80MB). The extra 40MB of disk drive space is only needed during setup and will be available for other uses once the program is installed.

Q. *What delivery month codes does UA use for ASCII and Gann files?*

A. They are the ones used by the exchanges and most quote machines:

F	=	Jan.	N	=	Jul.
G	=	Feb.	Q	=	Aug.
H	=	Mar.	U	=	Sep.
J	=	Apr.	V	=	Oct.
K	=	May	X	=	Nov.
M	=	Jun.	Z	=	Dec.

Q. *I love Unfair Advantage's charting, especially the ability to display data and pre-selected studies automatically. I only wish there were more study options. Does CSI plan to add more technical analysis?*

A. Our main purpose in offering UA is to provide managed and manageable data to investors. It includes charting and a few studies, but is not intended to compete with the many technical analysis programs on the market today. If high performance analysis is your goal, we recommend using Unfair Advantage as your source for both raw and massaged data. Then let UA create files for use with your analysis program.

Q. *I have had occasional problems connecting to the CSI data base with Unfair Advantage. Is there a particular method of access that is most reliable?*

A. Yes. The Direct Internet option seems to be the providing very stable, reliable and consistent access to the service. We recommend it over either direct dial or connecting through an Internet Browser.

It is important to remember that you should access daily updates at least once per month to avoid tempo-

rary, but correctable software limitations. You must access at least once every two months to avoid permanently disabling your copy of Unfair Advantage and its database.

Q. *Can I retrieve daily updates with UA before all the markets have closed?*

A. Yes, but your updates will be limited and there may be additional costs. Here's why: We update markets through a series of database "copies" throughout the afternoon. Any market that has been settled and whose prices have been copied to the host computer is available for updates. For example, you could retrieve prices for Corn, which closes early, before you could retrieve data for heating oil, which closes late. No intraday data is available before a market closes.

Since UA always retrieves the previous day's data along with the current day's prices, there is no chance you could be left with a partial update for a given day. See the next question for pricing information.

Q. *What is the charge for updating my database two or more times each day?*

A. Our billing procedure allows for retrieving up to 50 days of data per month. A typical update includes two days of data - the current day and a repeat of prior day. The retrieval of the redundant day is not an option - it is required to assure the integrity of your data base. A typical month has 21 trading days, so if you call once per day, this procedure leaves three-to-four extra updates for good measure.

The practice of regularly calling for the current day two or more times will increase your monthly charge. Collecting between 51 and 100 days of data in a month will result in a \$10 double-access surcharge. The next fifty will cost another \$10, and so on.

Q. *One of the reasons I subscribed to*

UA is the ability to create custom back-adjusted and Perpetual Contract® data files. The feature works well, but it takes more time than I would like. Any suggestions?

A. Aside from limiting the number and time period of computed contracts in your everyday portfolio, you might consider changing your updating habits. Using UA's Unattended Download feature to collect data an hour or so before you need it can free you from waiting while an exhaustive list of computed files is built. ♦

Market Statistics Update

DELETIONS FROM THE STOCK DATA BASE

13018	ATH	Advanced Therapeutic Systems Ltd
14370	AEAGX	Aetna Series Fund/Select Aetna Asian Growth Fund
2506	ATRE	Appletree Cos., The
3062	VHT	Banyan Hotel Investment Fund
12844	BYDS	Boyd Gaming Cp 10 3/4% SR. Sub. Notes Series B 2003
14890	CTFMX	Calvert Tax-Free Resolves/Limited-Term PTF. CL C
12359	CINDE	China Industrial Group Inc
2408	COEV	Comprehensive Environmental Systems Inc
15954	CYCN	Cycle-Sat Inc
12397	DPCAQ	DEP Cp CL A
4115	DOUG	Douglas & Lomason Co
2020	NCON	Encon Systems Inc
1961	FSHWX	Fidelity Short-Term World Bond Fund
7878	FTC	Fruehauf Trailer Cp
4135	GAMEC	Gametek Inc
8797	GEMC	Geriatric & Medical Cos
3284	HOLA	Holco Mortgage Acceptance Cp I
2116	ICIS	ICIS Management Group Inc
8996	INTP	Interpoint Cp
15076	KNET	Kinetiks.com Inc
12994	MESW	Meta-Software Inc
11372	MHX	Morgan Hydrocarbons Inc
11129	MVY	Munivest New York Insured Fund Inc
11131	MYY	Muniyield New York Insured Fund III Inc
4162	MFSB	Mutual Banccompany
12575	NCMC	National Capital Management Cp
2906	RDMN	Redman Industries Inc
13060	MEK	Salomon Inc 5.00% MSFT Common Equity-Linked Securities
13076	OLK	Salomon Inc 7 1/4% Oracle (Elks)
4682	SBRD	Seaboard Oil Co
13109	SVN	Spectravision Inc CL B
23168	SRLIX	Stein Roe Limited-Maturity Income Fund
3732	STER	Sterling Healthcare Group Inc
6820	CUTS	Supercuts Inc
1956	RPSGX	T. Rowe Price Short-Term Global Income Fund
12739	TELOZ	TEL Offshore Trust UBI
4326	TBIT	Telebit Cp
2485	THIR	Third Financial Cp
11265	TZC	Trizec Cp
12785	VCAR	Vector Aeromotive Cp 1
2265	VMAX	Victormaxx Technologies Inc
3594	WHO	Waterhouse Investor Services Inc

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Holiday Schedule

CSI will be closed for voice communication from 7 p.m. Tuesday, December 24th through 8:30 a.m. Thursday, December 26th and from 7 p.m. Tuesday, December 31st through 8:30 a.m. Thursday, January 2nd for the Christmas and New Years holidays, respectively. The CSI host computer will remain accessible, but the posting of data from December 25th may be delayed until the morning of the 26th. The entire staff wishes you all a joyous holiday season! ♦