VOLATILITY BASED STOPS AND TRADE SIZE part 2
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Every good system should have several exit techniques to allow for ever-changing characteristics of the market. By saying this, I don't mean we change our pre-determined stop loss points mid way through the trade. What I mean is we should have our stop loss point firmly in place, then we should have a few trailing stop techniques in our tool box to make sure we keep as much of the profit on the table as possible whilst still giving the market room to trend.

Trailing stops differ from stoploss points by the way they are used; trailing stops are used to lock in profit where as stoploss points are used to protect capital.

Last week, we looked at a method that would calculate a stoploss point, based on the stock/commodities past volatility. This was calculated using Standard deviation and the distribution of the continuously compounded percentage price change.

It was to give us a stop loss point that would give us a 99% confidence level of not being hit over the coming week, if the distribution used in the calculation remained the same.

It usually works out to be pretty close in slow moving markets where the day's range is shrinking and further away in volatile markets to give us as much room as possible to allow the stock to breathe.

What we are trying to do is limit our losses when proven wrong and ride the big trending moves when proven correct without getting spooked midway.

We can be wrong 80% of the time and still make money as long as we can get a couple of big moves in-between the tiny losses.

Every system should have at least 3 exit methods
- ➢ A capital protection stop
- ➢ A trailing profit protection stop
- ➢ And a psychological stop

Last week we covered the capital protection stop, the psychological stop is a stop used when something outside of the market comes up i.e. a death in the family, Holidays, Interstate work commitments etc.

We should have a method practiced in case of such emergencies.

What would you do if you had 2 or 3 big trades going and your Father, Mother, Son etc died?

Would you have a plan in place to protect your capital, or would you worry about it after the funeral, when you realised that you have just lost your Families life savings or a good chunk thereof.

Some would be saying that they would not care about money after such a tragedy, but for those that have been through it know that life goes on, and you need money to live, especially if you are a full-time trader.
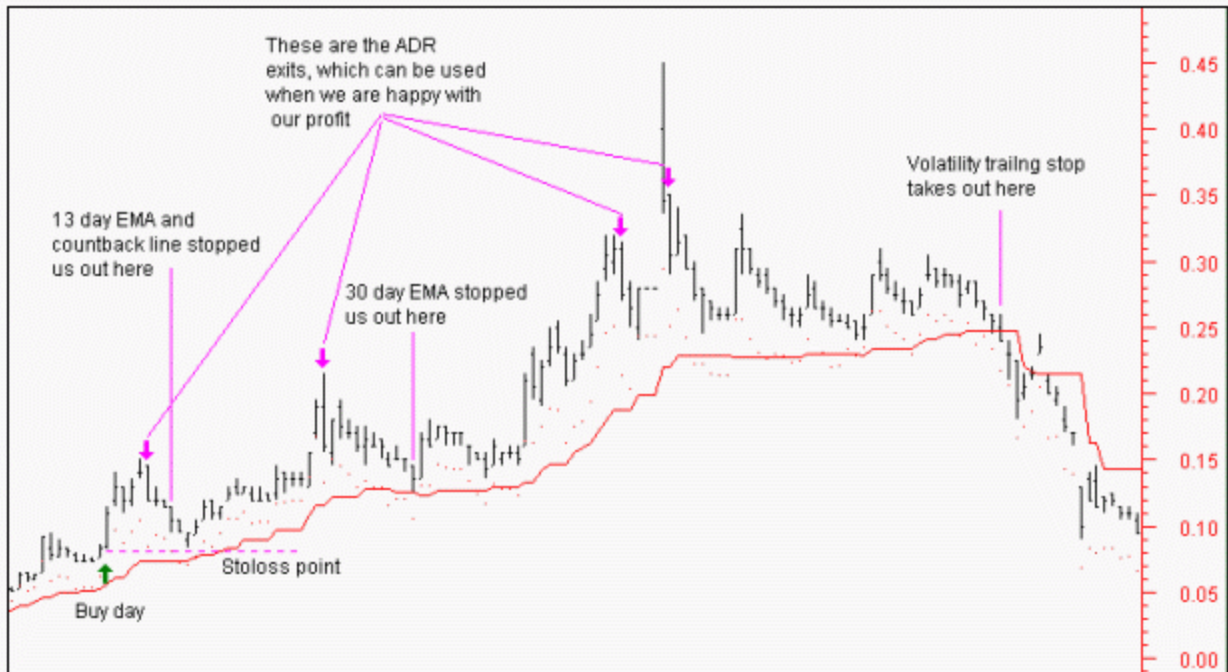
Set aside a time and visualise such a tragedy, and practice a method of closing down your trades, maybe by passing the information onto a friend or broker, so they can handle the exits as painlessly as possible, at least you will be comforted by the thought that you have no trades spiralling downwards out of control, this is essential for futures and option traders, where losses can accumulate very rapidly.

Last we need a trailing stop method [preferably 2] in place to ride the winners all the way to the top.

In addition to the trailing stop I'm about to show you, you could use a close below the previous days daily range, i.e.ADR= [C < Ref(CLOSE - ATR(10),-1)] as a stop to keep profits intact if you have substantial profits already in place.

The trailing stop we will look at is basically a smoothing of the stop loss calculation from last week.

It is still using the past volatility of the stock, but we are smoothing it so it will move up and down with the stock without being too erratic.

Below is the same chart from last week using the Volatility stop with the ADR stop thrown in for good measure, you might want to use this when profits are above 70%.

You can see by the chart the significant gains we kept using this method, remembering that it is easy to pick a chart that shows a perfect example, so after reading and understanding this, please play with this technique on your own charts.

I have written a Metastock code for this below. Paste this in the indicator list.

Name: VMOVSTOP:
Formulae: Periods:= Input("periods",5,30,15);
M:= Mov(((C/Ref(C,-1))-1),14,E);
SD:= Stdev(((C/Ref(C,-1))-1),14);
R:= M-(2.364)*(SD);

{R at 2.364 will give a 99% confidence rating}
Stop:=Mov((C*Exp(R)*1),periods,E);
If(C>Ref(C,-1),Stop,PREVIOUS)

The ADR Fml above can be pasted directly into the Expert advisor.
Name: ADR stop
Condition: C < Ref(CLOSE - ATR(10),-1)