Exit Strategies for Stocks and Futures

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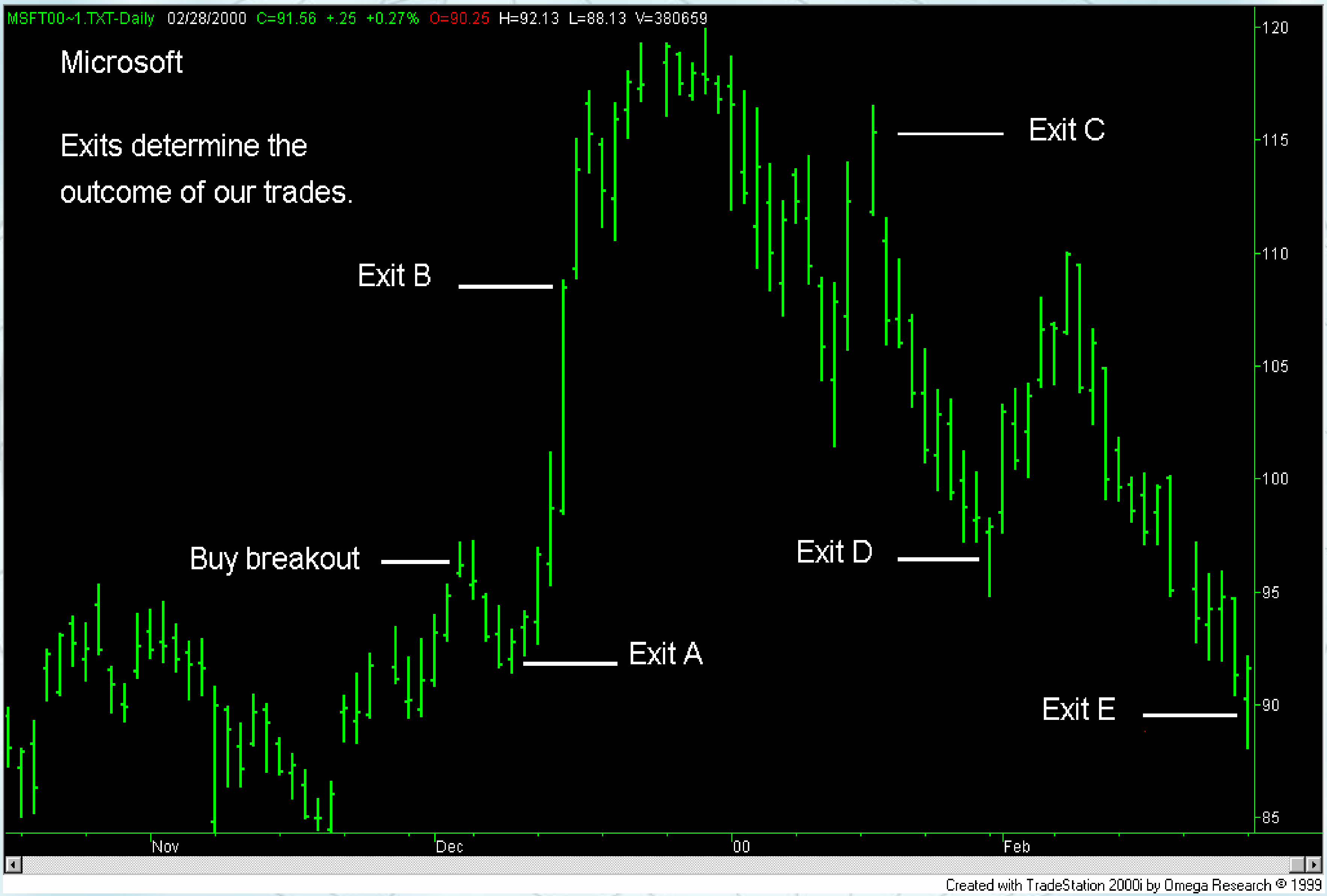
Exits are important because your exit strategy will determine:

- 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.
Exit B
Exit C
Buy breakout
Exit A
Exit D
Exit E
120
115
110
105
100
95
90
85
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Dec
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Feb
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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 you 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:

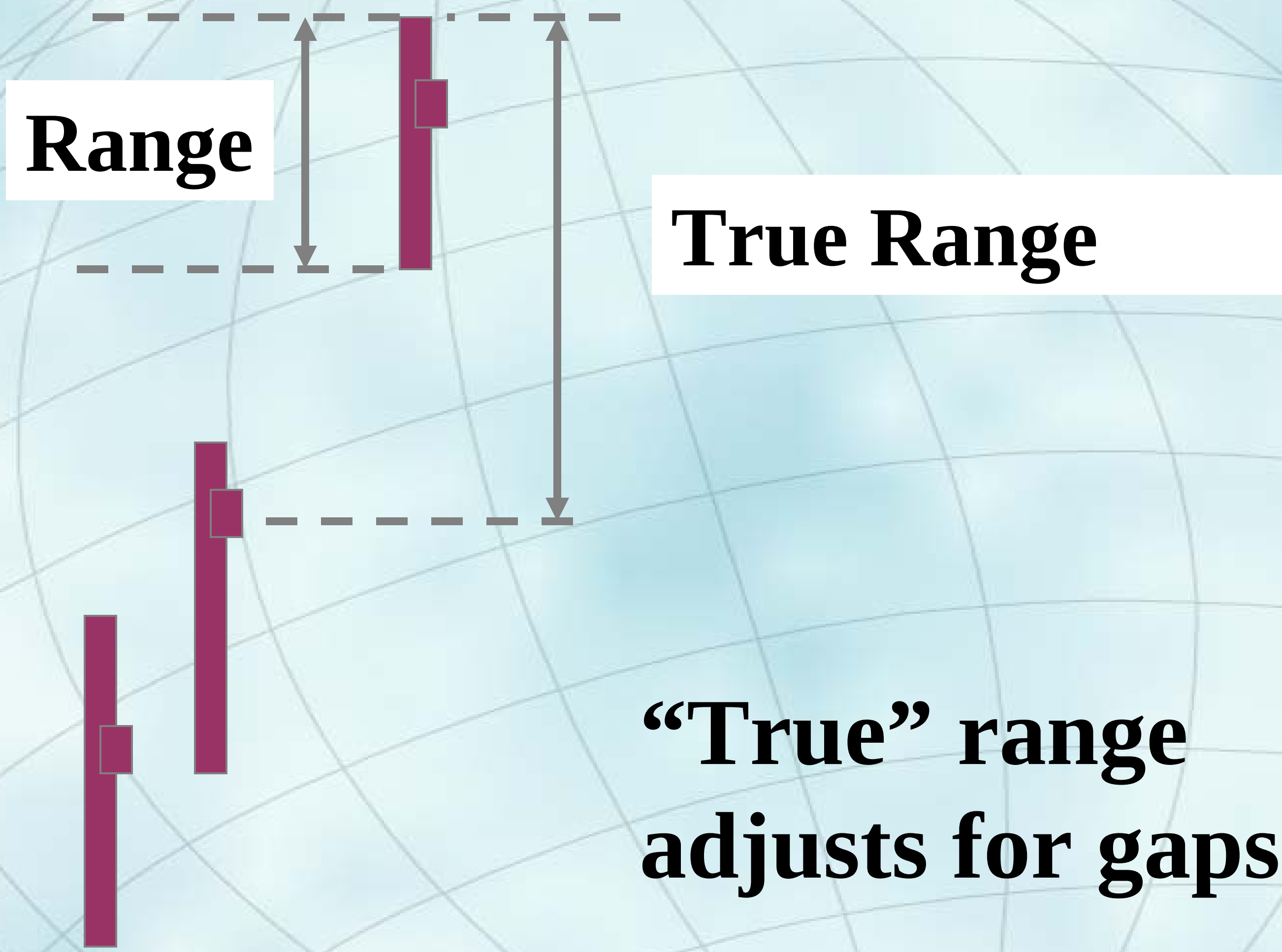
The “Chandelier” exit

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



“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.
169
132
102
80
62
48
Average True Range(20,20) 8.14
16.00
12.00
8.00
4.00
S O N D 00 F M A M J J A S O N D 01
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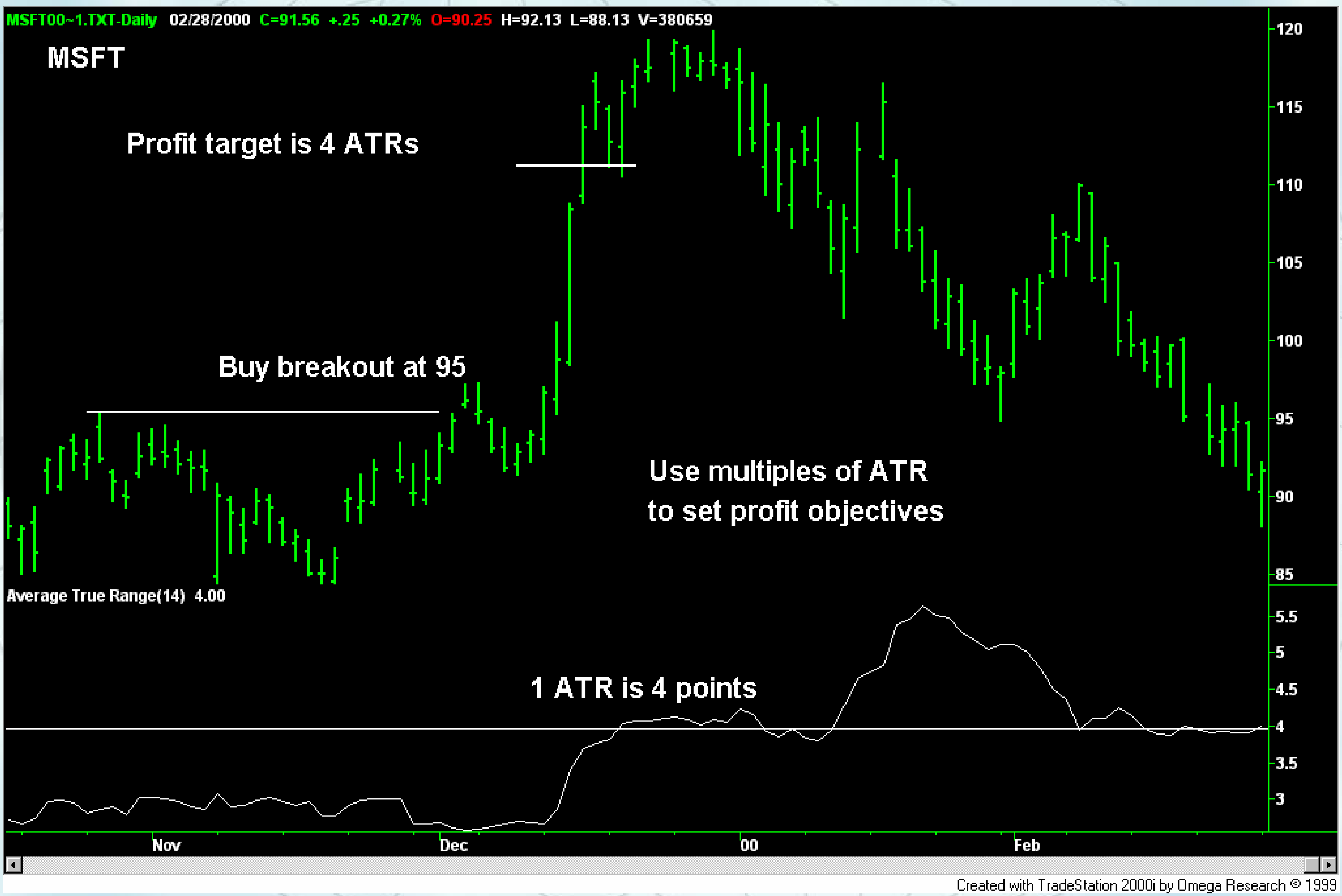
Benefits of Average True Range

- 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


MSFT00~1.TXT-Daily 02/28/2000 C=91.56 +.25 +0.27% O=90.25 H=92.13 L=88.13 V=380659
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
120
115
110
105
100
95
90
85
5.5
5
4.5
4
3.5
3
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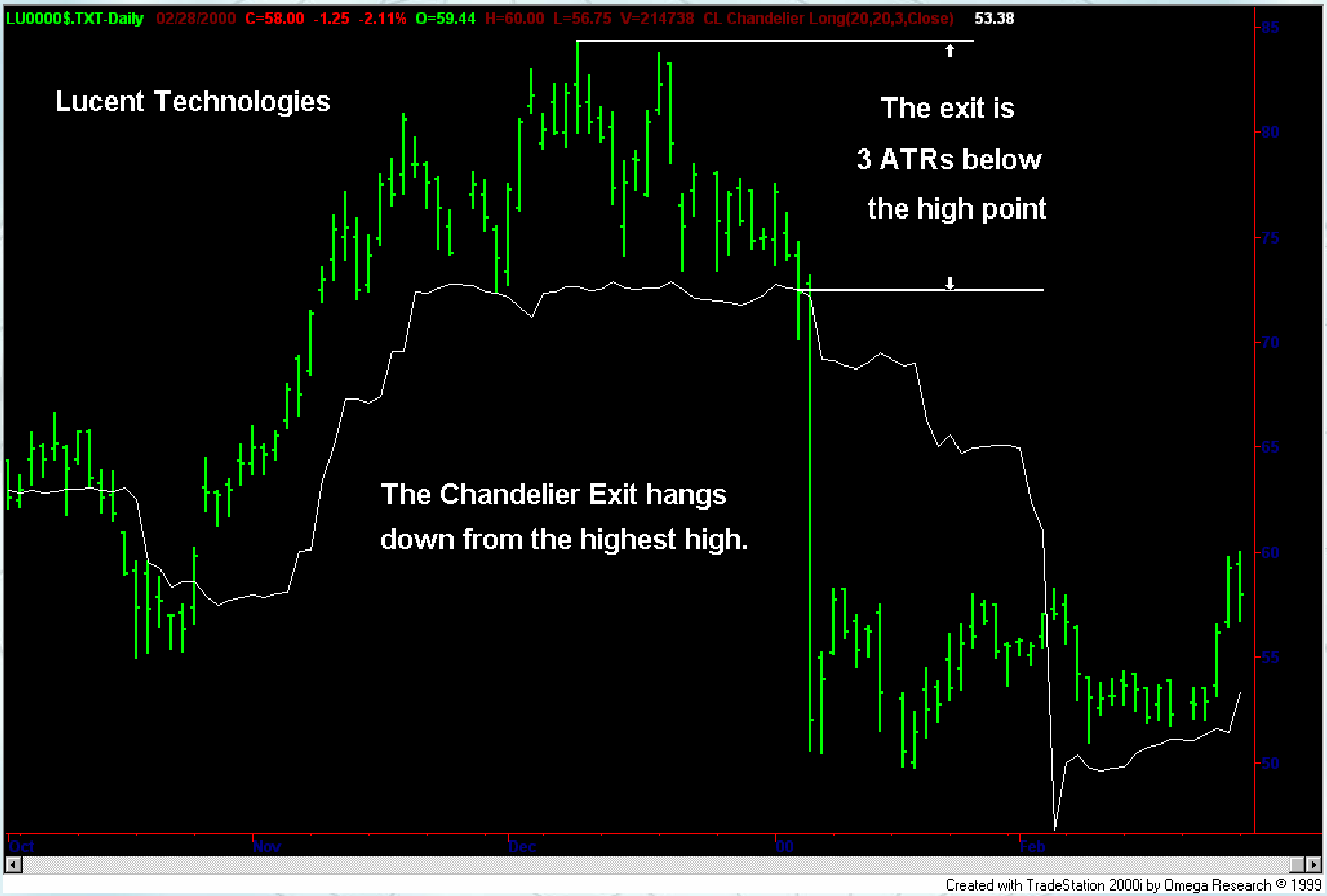
The “Chandelier” exit

- 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


LU0000$.TXT-Daily 02/28/2000 C=58.00 -1.25 -2.11% O=59.44 H=60.00 L=56.75 V=214738 CL Chandelier Long(20,20,3,Close) 53.38
Lucent Technologies
The exit is
3 ATRs below
the high point
The Chandelier Exit hangs
down from the highest high.
85
80
75
70
65
60
55
50
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Feb
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BRCM - Daily NASDAQ C=109 15/16 0 +0.00% O=107 13/16 H=119 7/8 L=104 1/4 V=16279000 Mov Avg 1 Line(Close,30,0) 104.119 ...
Chandelier exit produces fewer "whipsaws" than Mov Avg exits
ADX Buy
Chandelier Exit
DMI(14,25) 23.71 25.28 25.77
256
240
224
208
192
176
160
144
128
112
96
80
64
45.00
35.00
25.00
15.00
Nov
Dec
00
Feb
Mar
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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.

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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
Parabolic Sell
ADX Buy
DMI(14,25) 25.97 22.96 25.14
124
120
116
112
108
104
100
96
92
88
84
45.00
35.00
25.00
15.00
Nov
Dec
00
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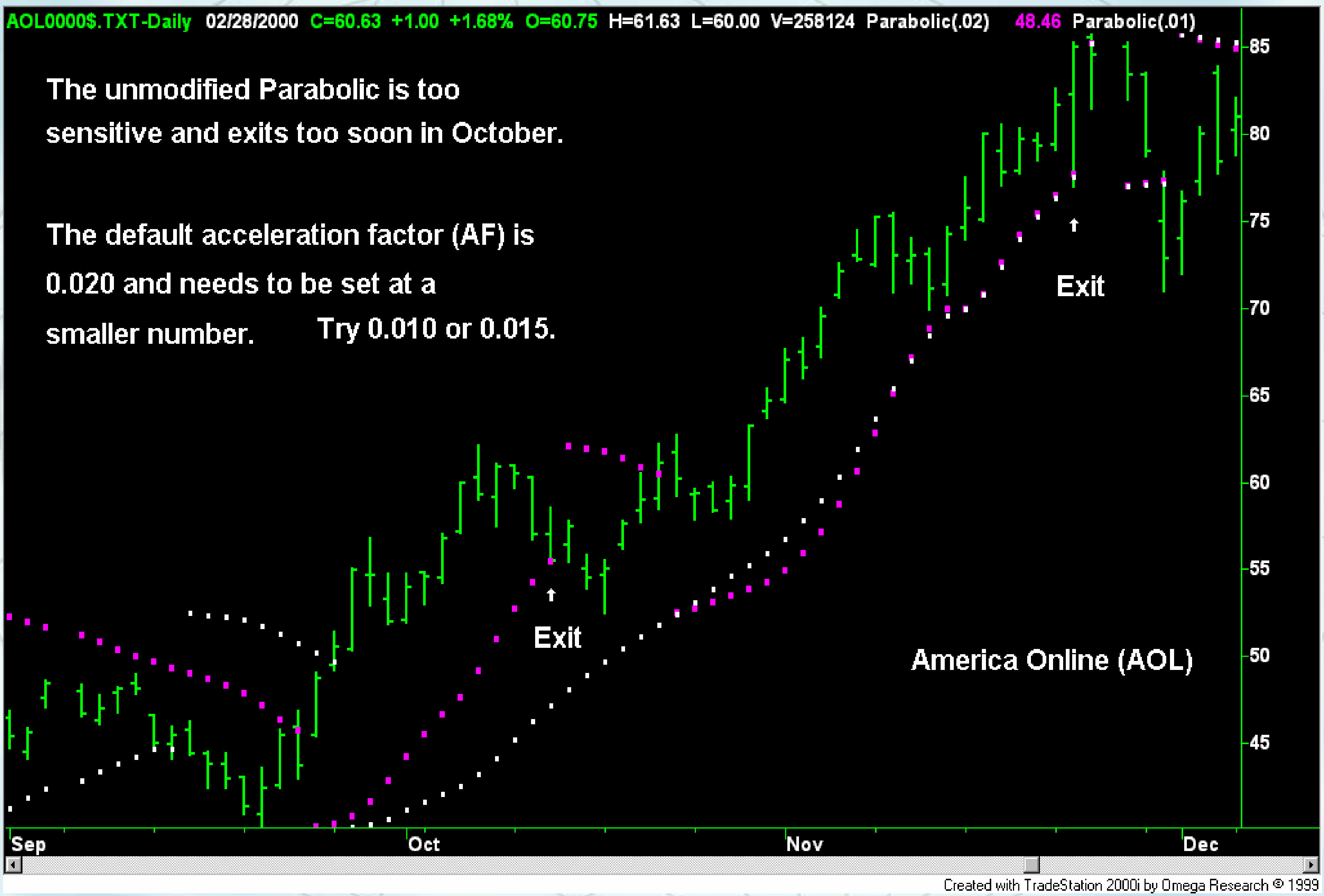
AOL0000$.TXT-Daily 02/28/2000 C=60.63 +1.00 +1.68% O=60.75 H=61.63 L=60.00 V=258124 Parabolic(.02) 48.46 Parabolic(.01)
The unmodified Parabolic is too sensitive and exits too soon in October.
The default acceleration factor (AF) is 0.020 and needs to be set at a smaller number. Try 0.010 or 0.015.
Exit
Exit
America Online (AOL)
85
80
75
70
65
60
55
50
45
Sep
Oct
Nov
Dec
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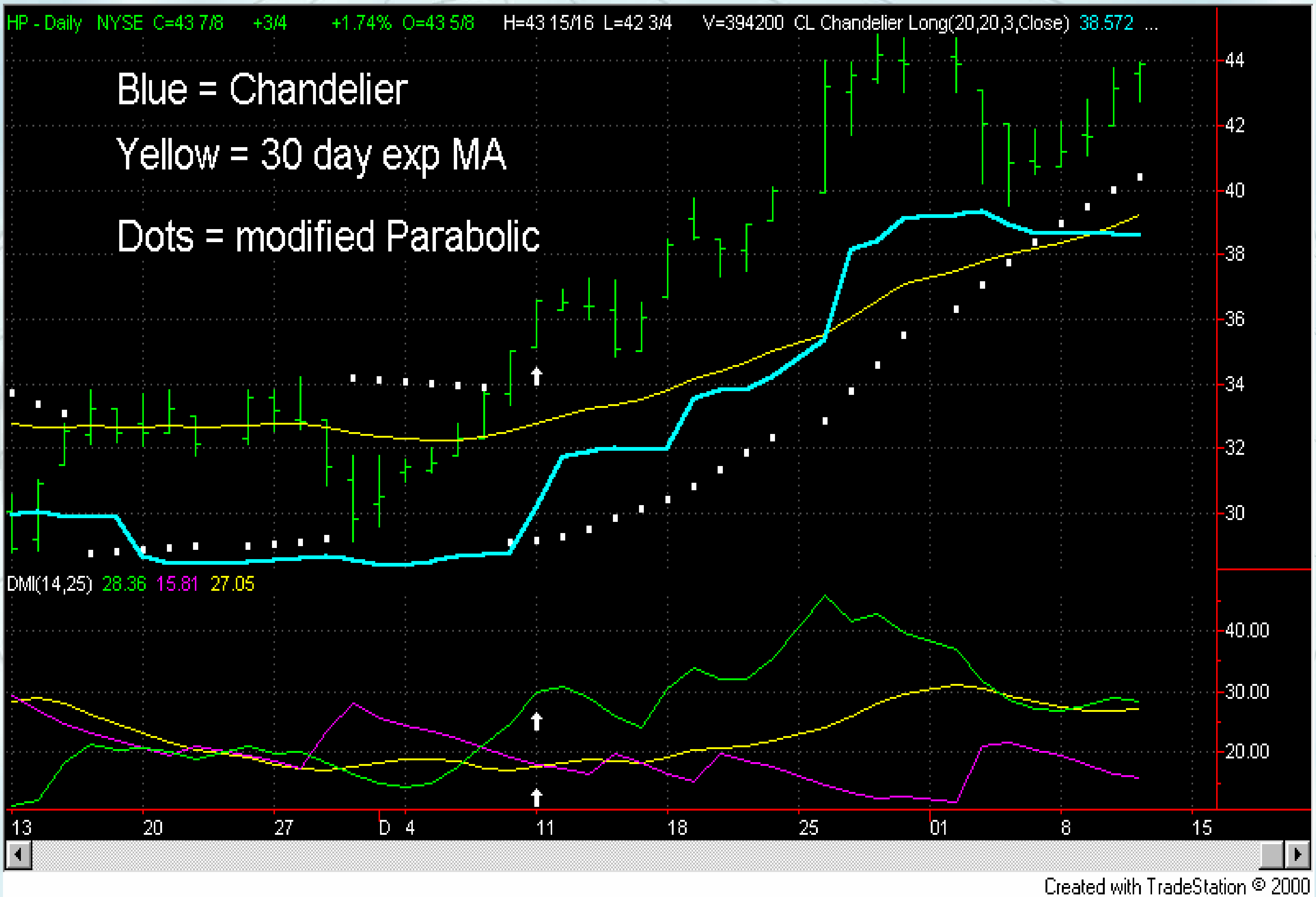
HP - Daily NYSE C=43 7/8 +3/4 +1.74% O=43 5/8 H=43 15/16 L=42 3/4 V=394200 CL Chandelier Long(20,20,3,Close) 38.572 ...
Blue = Chandelier
Yellow = 30 day exp MA
Dots = modified Parabolic
DMI(14,25) 28.36 15.81 27.05
44
42
40
38
36
34
32
30
40.00
30.00
20.00
13
20
27
D 4
11
18
25
01
8
15
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Combine 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

QQQ - Daily AMEX C=39.37 -0.11 -0.28% O=39.48 H=39.98 L=38.92 V=64035500 Parabolic SAR(0.02,0.2) 36.38
ADX
Short
"V" Bottom in the QQQ
ADX "V" Buy
DMI(14,25) 27.75 13.29 25.16
44.00
42.00
40.00
39.37
38.00
36.38
34.00
32.00
30.00
28.00
45.00
35.00
27.75
25.16
15.00
13.29
Aug
Sep
Oct
Nov
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QQQ - Daily AMEX L=34.81 -0.20 -0.57% B=34.82 A=34.84 O=35.20 Hi=35.31 Lo=34.64 C=34.75 V=133762900 Parabolic SAR ...
"V" top in QQQ
DMI (14,25) 16.68 29.95 21.53
Nov2003
Dec2003
04
Feb2004
Mar2004
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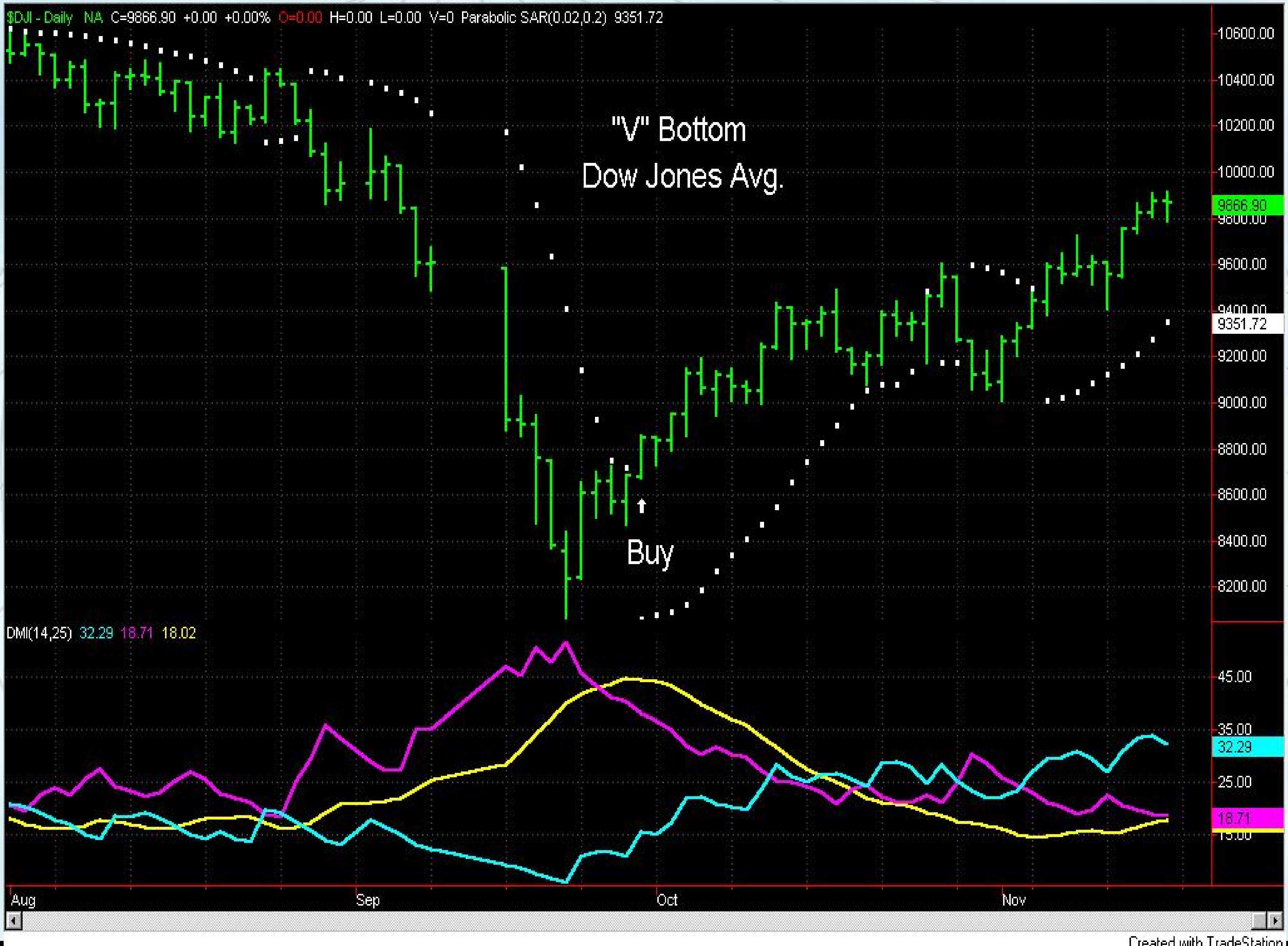
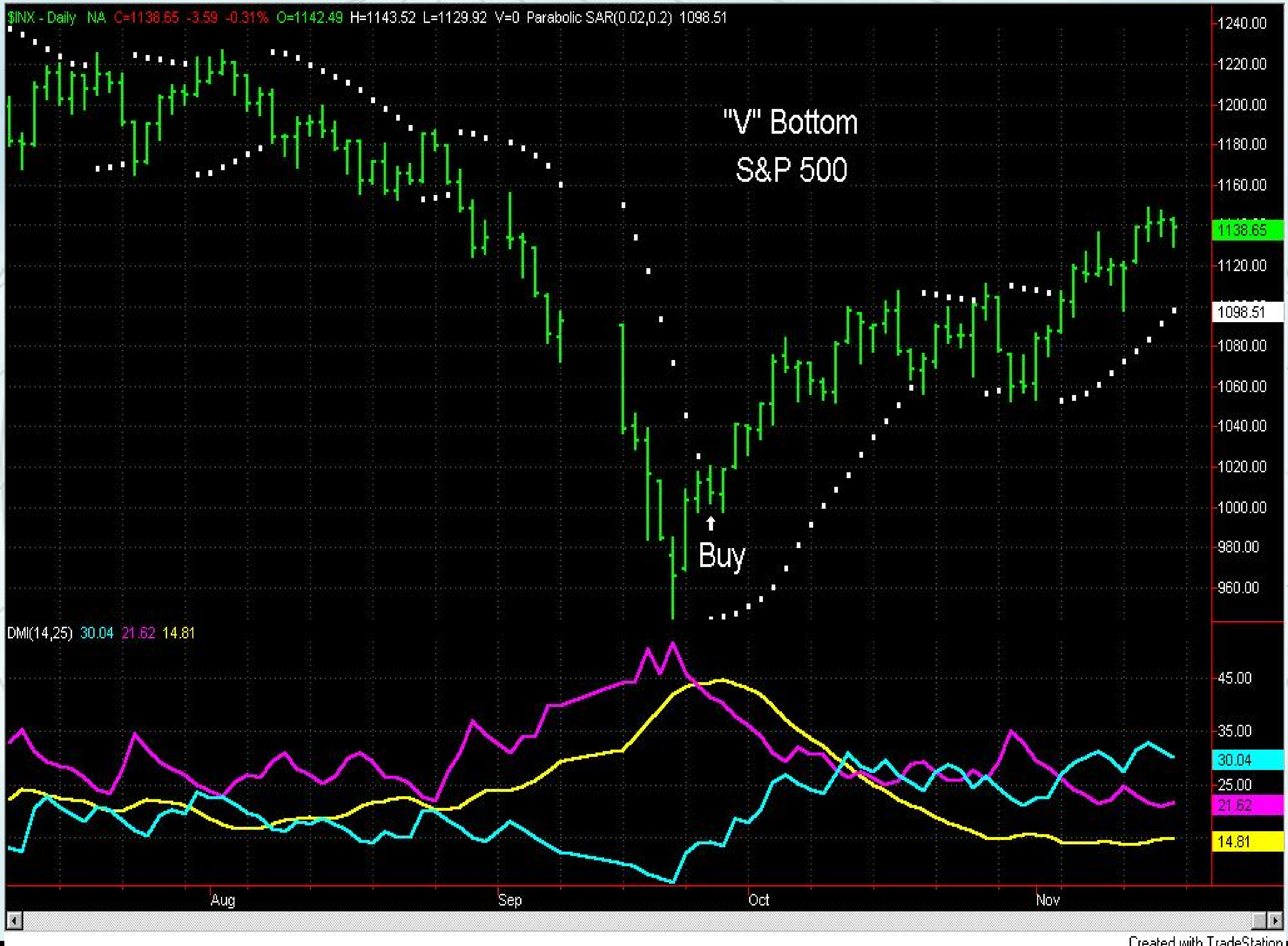

$DJI - Daily NA C=9866.90 +0.00 +0.00% O=0.00 H=0.00 L=0.00 V=0 Parabolic SAR(0.02,0.2) 9351.72
"V" Bottom
Dow Jones Avg.
Buy
DMI(14,25) 32.29 18.71 18.02
Aug
Sep
Oct
Nov
Created with TradeStation


$INX - Daily NA C=1138.65 -3.59 -0.31% O=1142.49 H=1143.52 L=1129.92 V=0 Parabolic SAR(0.02,0.2) 1098.51
"V" Bottom
S&P 500
Buy
DMI(14,25) 30.04 21.62 14.81
1240.00
1220.00
1200.00
1180.00
1160.00
1138.65
1120.00
1098.51
1080.00
1060.00
1040.00
1020.00
1000.00
980.00
960.00
45.00
35.00
30.04
25.00
21.62
14.81
Aug
Sep
Oct
Nov
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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
99
Feb
Mar
Apr
May
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Use ADX to determine appropriate strategies

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