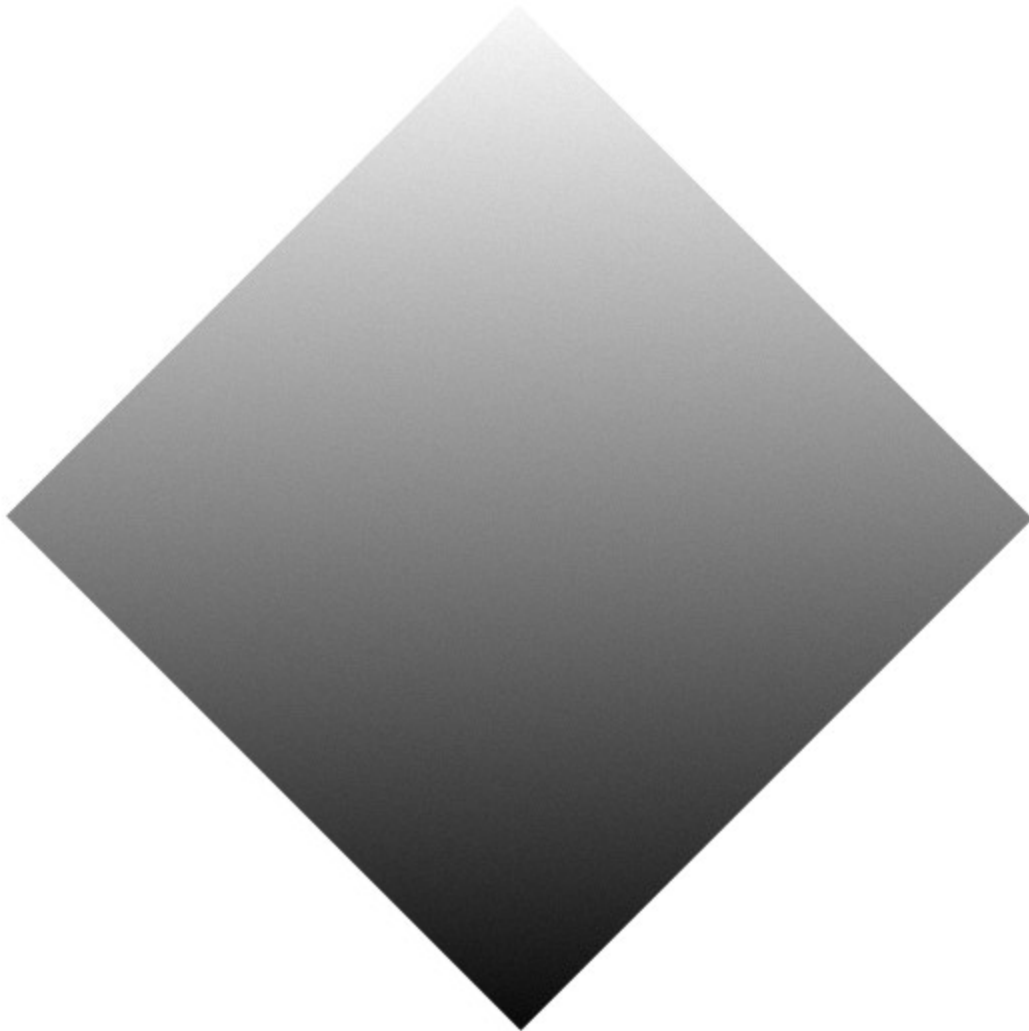


⇒ *THE ART OF EFFECTIVE*
⇒ *STOP ORDER PLACEMENT IN*
⇒ *TRADING MARKETS*



Jim Wyckoff is the editor of the "Jim Wyckoff on the Markets" analytical, educational and trading advisory service. He is also a technical analyst for Dow Jones Newswires and the senior market analyst with TradingEducation.com. Jim was also the head equities analyst at CapitalistEdge.com. He received his degree from Iowa State University in Ames, Iowa, where he studied journalism and economics.

Jim has spent over 20 years involved with the stock, financial and commodity futures markets. He was a financial journalist with the FWN newswire service for many years, including stints as a reporter on the rough-and-tumble commodity futures trading floors in Chicago and New York. As a journalist, he covered every futures market traded in the U.S., at one time or another.

It didn't take Jim long to realize the successful traders in every market—be it pork bellies, Treasury bonds or stock index futures—had a common thread among them: nearly all relied on technical analysis to give them a trading edge.

Not long after he began his career in financial journalism, Jim began studying technical analysis. He found it fascinating. By studying chart patterns and other technical indicators, Jim realized the playing field could be leveled between the “professional insiders” in the markets, and traders like himself. How can this be? This is how: Market (or stock) price activity and price history, including volume, is a composite reflection of every news event and-or other fundamental factor known to all traders. Price activity also factors in ideas and speculation about the future prospects, and future news, for the market (or stock).

If an individual trader tried to study and learn all there is to learn about a stock or a futures market, including knowing all the fundamentals that impact, or could impact the stock or commodity, it would be nearly a full-time job. And even if a trader did spend all his time studying a market or stock, he still would not know as much, as soon, as the professional insiders. This is why successful traders employ technical analysis. Importantly, Jim also spends time studying the fundamentals in markets.

Jim believes traders who have been involved with commodity, financial and stock index futures markets have a trading advantage in today's stock market environment. This is because the more volatile stock market environment of today is just like the volatile commodity and financial futures markets that have been around for many years. Being a successful trader in volatile markets requires specialized entry and exit strategies, in order to maximize profits. Successful futures traders have been forced to deal with volatility on a routine basis.

Following are just a few of Jim's most important trading tenets:

- ⇒ Like success at any other job, successful trading requires hard work. There are no short-cuts. Do your homework before initiating any trade.
- ⇒ Simple trading strategies work the best. Jim has read the classic technical analysis books and talked face to face with the best trading professionals in the world. Most agree that, as Jim's friend Stewart Taylor says, “Simple is Simply Better” when it comes to employing successful trading strategies. All the neural networks and powerful computers in the world won’t compare to a good, basic and well-researched trading plan. Don’t confuse simple strategies with easy trading. Simple trading methodologies still require a lot of preparation and work.

In an active stock, FOREX or commodity futures market, it’s critical to let trading profits run, and cut losses short. If Jim's technical signals are on the mark, he will let the market work in his favor and profits will accrue. If the market turns against him, Jim will have had tight protective stops in place to get him out of the trade before any serious damage is inflicted.

Jim's mission is not just to generate profits for you, but to also provide educational and insightful information to you. In this fascinating business, one never stops learning.

On the personal front, Jim was born and raised in Iowa, where he now resides. He has a wonderful wife and two great children. Jim works very hard on the job, but he also plays hard after work, as he loves adventures. From driving a Jeep across the highest mountain pass in the continental U.S., to summertime speed-boating, to extreme winter camping in the Boundary Waters, to hiking in the jungles of South America, Jim is always up for a new challenge.

Drop Jim an email to say hi. He enjoys hearing from his readers all over the world.

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THE ART OF EFFECTIVE STOP ORDER PLACEMENT IN TRADING MARKETS

BY JIM WYCKOFF

In my 20-plus years of involvement in markets and trading, the most popular and perplexing questions I receive from traders are those concerning placement of stop orders--both for market entry and exit--but mostly for the placement of protective buy and sell stops after initial entry into a trading position.

Here are three representative email messages from traders asking about how to best determine exit strategies when trading markets.

- ⇒ "Though my success rate has been high, I am only breaking even financially, due to getting out too early in profit and letting my losses run too far."
- ⇒ "Many articles are written showing when and where to enter trades--but how many articles are written about 'running' positions? Where to exit surely has to be the biggest key to trading success!"
- ⇒ "I would appreciate some advice or tips on how to and when to enter a market and when to exit."

Of course, if a trader knew exactly when to get into a market and exactly when to get out, wouldn't trading be easy! But even the most successful traders in the world can't do that. The best they can strive for is to catch a bigger part of any move (price trend) in the market, and then get out with a decent profit before the market turns against them.

In this e-book I will show you how and where to place buy and sell stops for market entry and for market exit, with the majority of focus on market exit. While most traders use the "market order" as their most popular method to enter a trading position, many traders do use stop orders for their market entry.

My good friend and mentor Glen Ring said this to me several years ago: "Any fool can get into a market, but it's the real pros who know how and when to get out."

Keep in mind there is no absolutely perfect money-management tool in futures trading, although purchasing options on futures does limit your risk of loss to the amount paid for the option. What I will focus mainly upon in this e-book is the placement of protective

stops (a sell stop if you are going long and a buy stop if you are going short) in futures, stock and FOREX trading.

While protective stops are not a perfect money-management tool, they are very effective in helping a trader solve one of the most important elements of futures trading: When to exit a position.

TYPES OF MARKET ORDERS

Before a full discussion on effective stop order placement begins, it's prudent for the trader to know the different types of orders for market entry and exit that are at his or her disposal. Below is a description of most of the types of orders used by futures, stock and FOREX traders.

MARKET ORDERS

The "market order," also termed buying or selling "at the market," is the most frequently used futures trading order. It usually assures the trader of getting a position (a fill). The market order is executed at the best possible price obtainable at the time the order reaches the futures trading pit.

LIMIT ORDERS

The limit order is an order to buy or sell at a designated price. Limit orders to buy are placed below the market; limit orders to sell are placed above the market. Since the market may never get high enough or low enough to trigger a limit order, a trader may miss getting filled if he or she uses a limit order. Even though the trader may see the market touch the limit price several times, this does not guarantee a fill at that price.

"OR BETTER" ORDERS

"Or better" is a commonly misunderstood order type. You should only use "or better" if the market is "or better" at the time of entry to distinguish the order from a stop. "Or better" on an order does not make the pit broker work harder to get a better fill. It is always the broker's job to provide the trader with the best possible fill. If an order is truly "or better," then this designation assures the broker that you have not left "stop" off the order.

In many instances, unmarked "or better" orders are returned for clarification, potentially costing the trader valuable time and possibly a fill. Orders that are not "or better" when entered only serve to better use the pit broker's time upon receipt as he checks to see whether or not the order deserves a fill. Sometimes, using the "or better" designation before the opening is helpful in assuring the broker that your order is meant to be filled.

MARKET IF TOUCHED (MIT) ORDERS

MIT's are the opposite of stop orders. Buy MIT's are placed below the market and Sell MITs are placed above the market. An MIT order is usually used to enter the market or initiate a trade. An MIT order is similar to a limit order in that a specific price is placed on the order. However, an MIT order becomes a market order once the limit price is touched. A fill may be at, above, or below the originally specified MIT price. An MIT order will not be executed if the market fails to touch the MIT specified price.

STOP ORDERS

Stop orders can be used for three purposes: One, to minimize a loss on a long or short position. Two, to protect a profit on an existing long or short position. Three, to initiate a new long or short position.

A buy stop order is placed above the market and a sell stop order is placed below the market. Once the stop price is touched, the order is treated like a market order and will be filled at the best possible price.

Importantly, while stops and MIT's are usually elected only when the specific price is touched, they can be elected when the opening of a market is such that the price is through the stop or MIT limit. In this case, a trader can routinely expect the fill to be much worse than the original stop or better on the MIT. This applies to stop orders and MIT orders placed before the opening of pit trading.

STOP-LIMIT ORDERS

A stop-limit order lists two prices and is an attempt to gain more control over the price at which your stop is filled. The first part of the order is written like the stop order. The second part of the order specifies a limit price. This indicates that once your stop is triggered, you do not wish to be filled beyond the limit price. Care should be taken when considering stop-limit orders--especially when trying to exit a position, because of the possibility of not being filled even though the stop portion of the order is elected. There is no stop-limit order without a second price. If your order cannot be filled by the floor broker immediately at the stop price, it becomes a straight limit order at the stop price.

STOP-CLOSE ONLY ORDERS

The stop price on a stop-close only will only be triggered if the market touches or exceeds the stop during the period of time the exchange has designated as the close of trading (usually the last few seconds or minutes).

MARKET ON OPENING ORDERS

This is an order that you wish to be executed during the opening range of trading at the best possible price obtainable within the opening range. Not all exchanges recognize this type of order. One exchange that does is the Chicago Board of Trade.

MARKET ON CLOSE ORDERS

This is an order that will be filled during the period designated by the exchange as the close at whatever price is available. A floor broker may reserve the right to refuse an MOC order up to 15 minutes before the close, depending upon market conditions.

FILL OR KILL ORDERS

The fill or kill order is used by customers wishing an immediate fill, but at a specified price. The floor broker will bid or offer the order three times and return to you with either a fill or an unable, but it will not continue to work throughout the trading session.

ONE CANCELS THE OTHER (OCO) ORDERS

This is a combination of two orders written on one order ticket. This instructs the floor brokers that once one side of the order is filled, the remaining side of the order should be cancelled. By placing both instructions on one order, rather than two separate tickets, you eliminate the possibility of a double fill. This order is not acceptable on all exchanges.

SPREAD ORDERS

The customer wishes to take a simultaneous long and short position in an attempt to profit via the price differential or "spread" between two prices. A spread can be established between different months of the same commodity, between related commodities, or between the same or related commodities traded on two different exchanges. A spread order can be entered at the market or you can designate that you wish to be filled when the price difference between the commodities reaches a certain point (or premium).

GOOD TILL CANCELLED ORDERS

These orders are also known as open orders and will remain valid until cancelled.

EMPLOYING PROTECTIVE BUY AND SELL STOPS

Okay, on to the advantages of traders employing protective buy and sell stop orders. As I said earlier, the major advantage of using protective buy and sell stops is that when you initiate the trade you have a pretty good idea of where you will be getting out of the trade (and how much money you will lose) if it's not a winning trade.

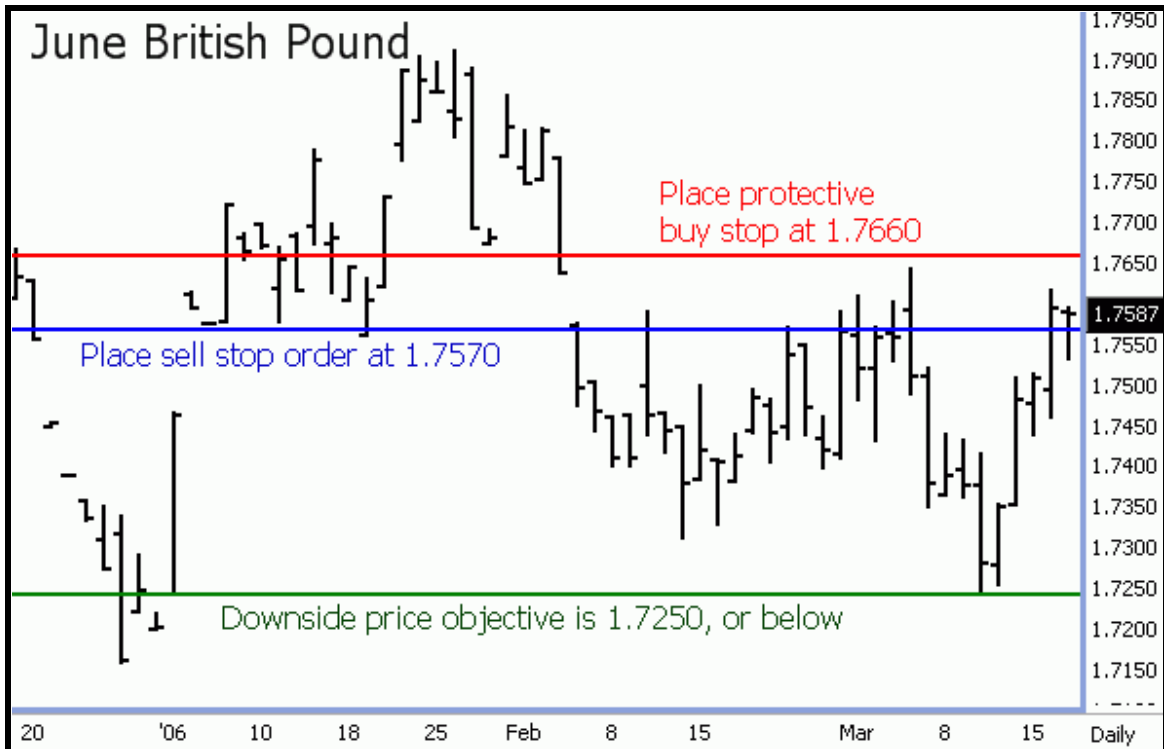
On specifically where to place your protective buy or sell stop upon entering a trading position, one of the most popular and effective methods is to find a technical support or resistance level that is within your financial loss parameter for that particular trade.

See in **Example 1** that a trader decides to go long gold futures and he does not want to lose more than around \$800 per contract if the trade turns out to be a loser. He should try to find a technical support level that's around \$8.00 an ounce (\$800) below the expected market entry level. In this example, market entry is expected to be around \$571.00 an ounce. Upon getting a price fill (market entry), the trader would then place the protective sell stop order at \$563.00, which is just below technical support located at the \$565.00 to \$564.00 level.



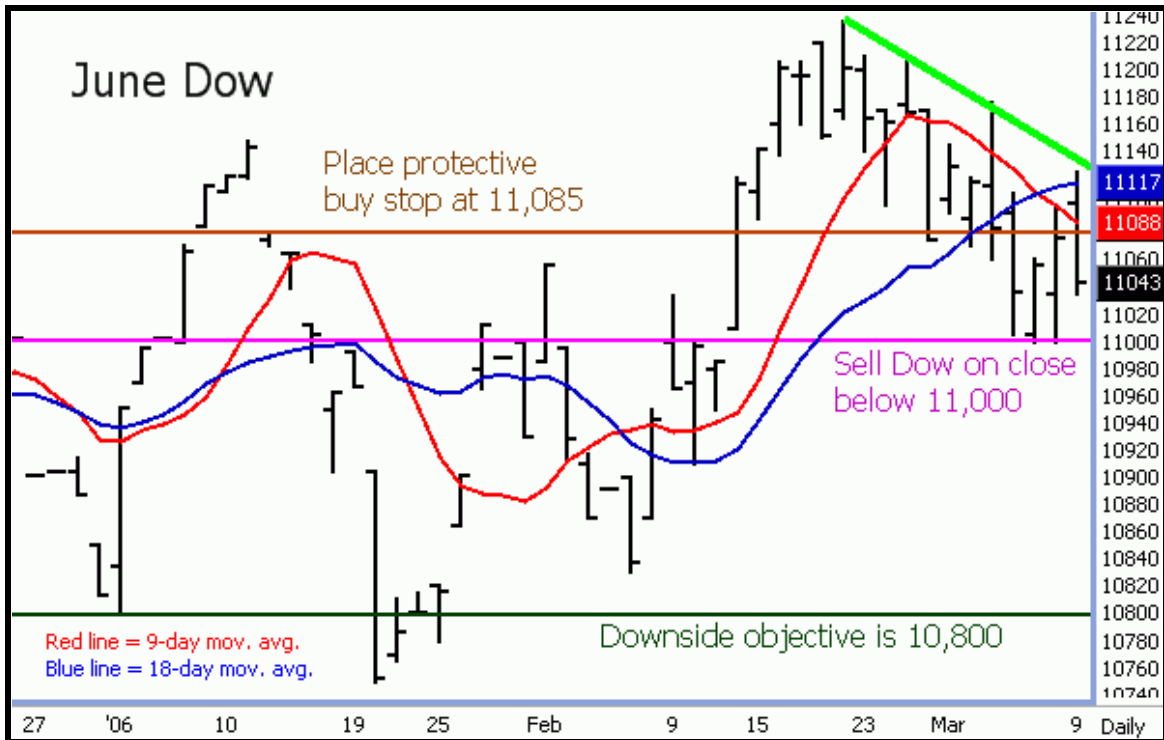
Example 1

In **Example 2**, see that the trader wants to establish a short position in the June British Pound futures. The market has been in a downtrend recently and has just seen a "corrective bounce" that the trader believes is about to end, with the downtrend expected to resume. The trader places a sell stop order at 1.7570 for market entry, and when filled, he will place his protective buy stop at 1.7660. See how the protective buy stop is placed just above solid technical resistance at the March high, and above a downside gap area, which is also a technical resistance area.



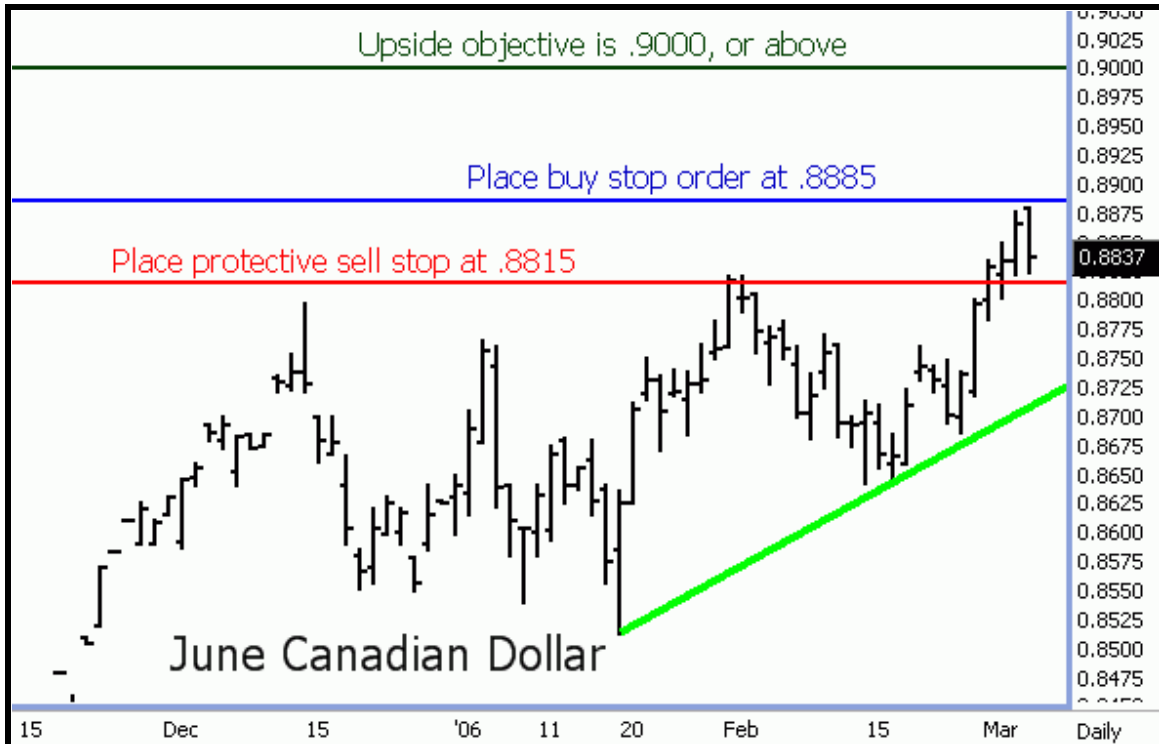
Example 2

See in **Example 3** that the trader wants to sell (go short) Dow futures, as prices are in a fledgling downtrend and the two moving averages just produced a bearish crossover sell signal. The trader will sell the Dow (on a market order the following trading session) after a close below solid technical support at 11,000. When filled, the trader will place a protective buy stop at 11,085, which is just above technical resistance around the 11,050 area.



Example 3

In **Example 4**, the trader wants to buy (go long) the Canadian dollar futures. He places a buy stop order just above technical resistance at the fresh for-the-move high that was just scored. If he is filled, he'll then place his protective sell stop just under some strong technical support at the February high, as seen on the chart.



I generally use support and resistance levels when I place my protective buy or sell stops. However, I also know that the floor traders, also called "locals" also know where it would be most logical for most traders to place their protective stops. So, I will sometimes "tweak" my stop placement a bit to reflect this. (More on the locals "gunning for stops" at the end of this e-book.)

For example, if I decide to go long corn and there is a solid support level that is within my loss-tolerance parameter, I will set my protective sell stop maybe a couple cents below that support level. My thinking would be that most other traders would set their protective stops about a penny below that solid support, and if floor traders were going to gun for stops, then they may not be able to hit mine if it's a couple cents below the solid support level.

The disadvantage to this theory is that your stop may be hit anyway, if there were a bunch of stop triggered above my own stop and pushed prices lower. Also, my losing trade would be about \$100 or \$150 steeper per contract than if I had not tweaked my stop.

USING TRAILING PROTECTIVE STOPS

If your trade becomes a winner and profits begin to accrue, you may want to employ protective "trailing stops," whereby you adjust your protective stop order to help you lock in a profit should the market turn against your position.

See in **Example 5** how the trader has a winning trade in lean hog futures going and has adjusted his trailing protective buy stop several times (red lines) to help ensure he can get the maximum profit possible if the market turns significantly higher. Note how the trailing stop orders are placed just above some technical resistance levels.



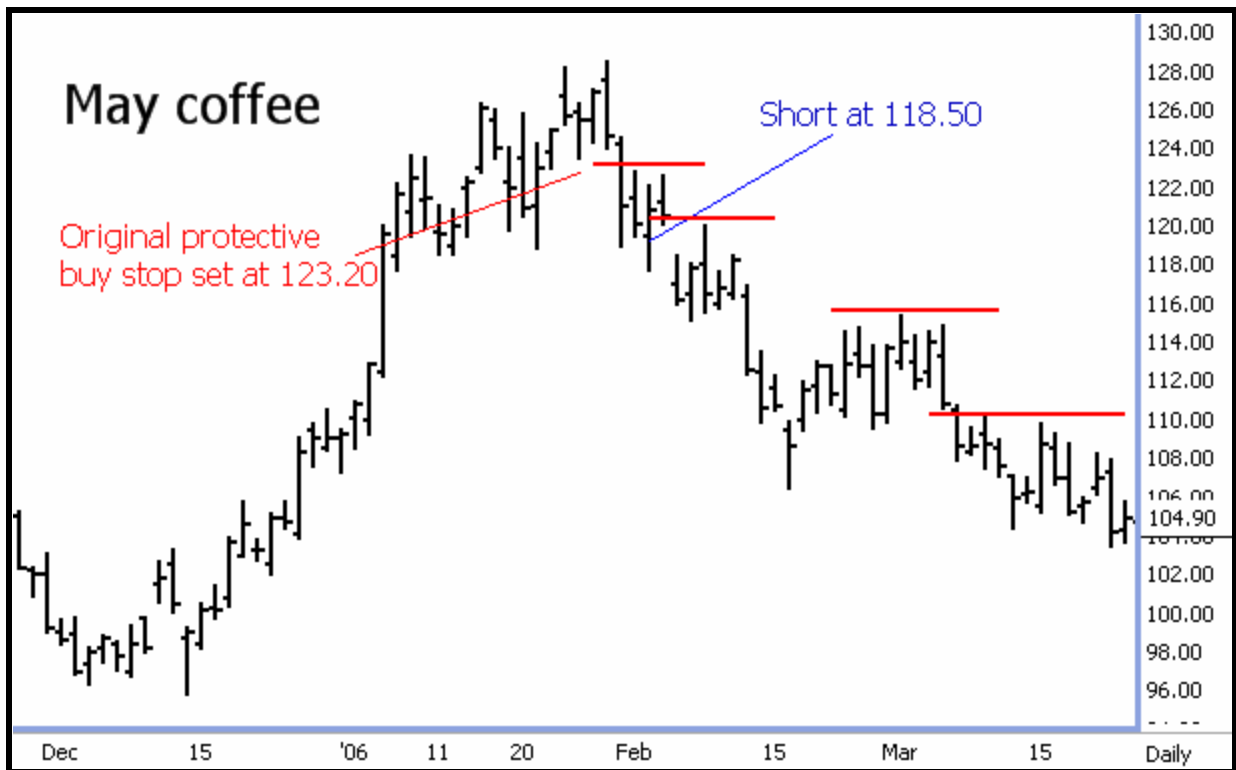
Example 5

In **Example 6**, see how the trader, who is long silver futures, has adjusted up his protective sell stop as the market continues to rise. He places the trailing protective buy stop order just below the last "reaction low" in the uptrending market. A reaction low is made when a market in an uptrend sees a downside correction and then resumes its uptrend. Then the daily low during that downside correction becomes the reaction low. Many successful traders to place their protective sell stops just below reaction lows and place their protective buy stops just above reaction highs.



Example 6

See in **Example 7** that the trader went short coffee after prices dropped below the last "reaction low." He then placed his protective buy stop just above technical resistance at the last "reaction high." He then adjusted his trailing protective buy stop downward, placing it just above the last "reaction high" of the market."



Example 7

Only rarely will I call my broker and change the position of a protective stop in a trade in which I'm "under water"--meaning it's a losing trade at the time. That would defeat the purpose of making your decision on how much of a loss you'll absorb BEFORE you make the trade and are in the heat of battle during a trade. Conversely, on winning trades that I have going, I may call my broker every day and tighten a protective stop, if the market is moving rapidly.

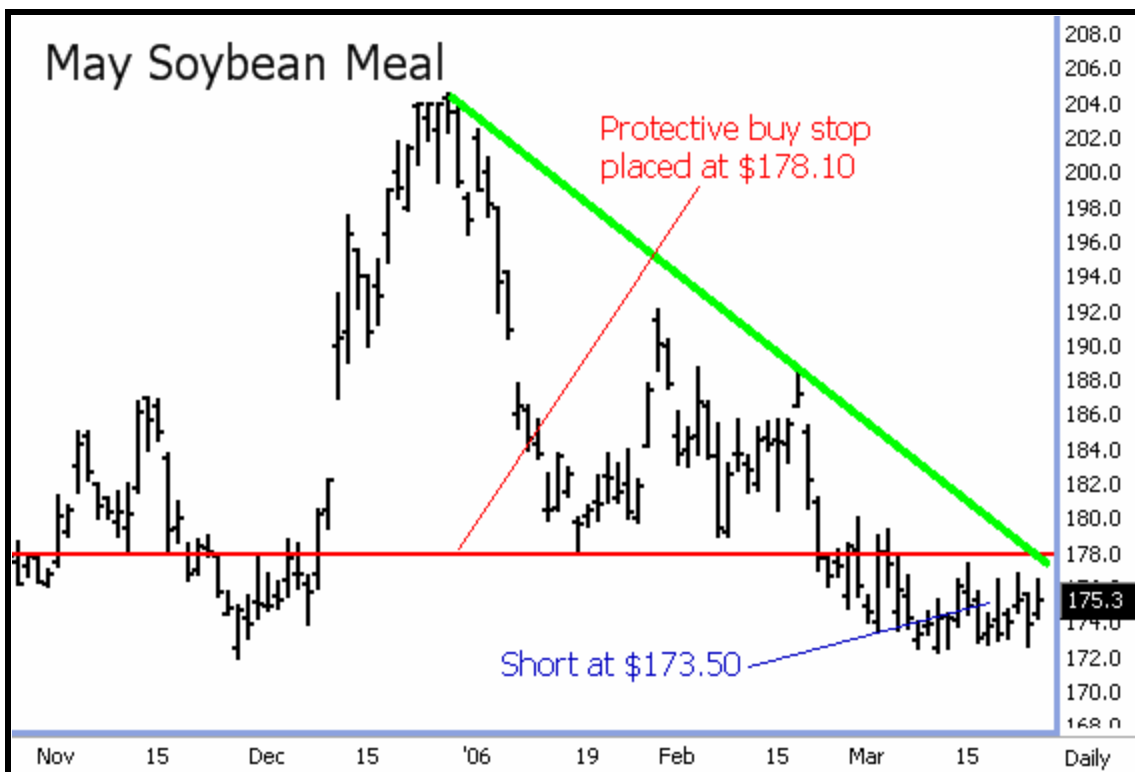
USING PROTECTIVE "TIME" STOPS

Another method of using protective stops employing "time" stops. This means giving a market a pre-determined amount of time to move in your favor--or you just exit the trading position if it does not. For example, if you are a position trader and decide to go long a market, you can give that market, say, four trading sessions to move in your favor. If, after four trading sessions, the market has not moved in your favor, you call your broker and exit the position the following trading session.

There are many veteran traders and educators who believe that if a market has not moved in a position trader's favor after three or four trading sessions, then odds decrease that the market will move in the trader's favor in the near term. I do agree with this trading tenet, and have effectively used "time stops" in the past.

Importantly, traders can also employ time stops along with the protective buy or sell stops they have also implemented.

See in **Example 8** that the trader will exit his short soybean meal position on a "time stop," after four trading sessions, as the market has basically traded sideways after he had gone short. The trader is now worried that prices may be "basing" at lower levels and be ready for a fresh uptrend.



Example 8

Shorter-term day traders can also employ "time" stops. Instead of determining the number of daily trading sessions for the "time" stop, the day trader can determine the number of price bars on an intra-day chart. For example, if the day trader has not seen a profit accrue on his trade after 12 bars on the five-minute bar chart, he may decide to exit the trade.

It's reassuring to a trader to see a market move in his favor soon after the trade is initiated. And if the market does not, or just "treads water" in a sideways pattern, the trader can exit the position at around break-even, or a small loss, and then move on to looking for other trading opportunities.

PLACING STOPS NEAR "PIVOT POINTS"

Many years ago, when I was a market reporter for Futures World News (now called Dow Jones Newswires) I had the job of figuring "Pivot Points" for many of the markets on which I would report. I remember it being a tedious job in my early years as a reporter--before there were computer spreadsheet programs to do the math on figuring the Pivot Points.

I also remember bumping up against deadlines, hurriedly punching numbers into my small calculator, on which my big fingers many times missed their mark!

Despite my early dislike for calculating Pivot Points, those figures are a useful method for figuring near-term support and resistance levels. Indeed, some traders use Pivot-Point analysis for entry and exit signals on shorter-term trades.

Floor traders, especially, like to use Pivot Points in their trading methodologies. They use the previous trading session's price data to help determine support and resistance levels, including potential entry and exit points on shorter-term trades (day trades).

Here's how you calculate Pivot Points on any market. It's relatively simple.

Using previous trading session's price data:

Pivot point = High + Low + Close divided by 3.

1st support = Pivot Point x 2, minus the High

2nd support = Trading Range (High minus Low) minus Pivot Point

1st resistance = Pivot Point x 2, minus the Low

2nd resistance = Trading Range (High minus Low) + Pivot Point

There are a few slight variances to the above formula, but the above formula is "the standard" and it is the most popular method of calculating Pivot Points.

For U.S. Treasury Bond and U.S. Treasury Note futures traders, you will have to take an additional step to break down the prices all the way into 32nds only, which is extra time-consuming--unless you have that extra math programmed into a spreadsheet, such as EXCEL. For example, if the "handle" on T-Bonds is 111, then you have to take 111 x 32. Generally, if prices are trading above the Pivot Point, it's a near-term bullish clue. Price trading below the Pivot Point means the market is in a short-term bearish posture.

FIBONACCI NUMBERS AND STOP ORDER PLACEMENT

When determining support and resistance levels on charts, and potential stop placement levels, one should not overlook the key Fibonacci percentage "retracement" levels.

I will detail specific Fibonacci percentages, but first I think it's important to examine how those numbers were derived, and by whom.

Leonardo Fibonacci da Pisa was a famous 13th century mathematician. He helped introduce European countries to the decimal system, including the positioning of zero as the first digit in the number scale. Fibonacci also discovered a number sequence called "the Fibonacci sequence." That sequence is as follows: 1,1,2,3,5,8,13,21,34 and so on to infinity. Adding the two previous numbers in the sequence comes up with the next number.

Importantly, after the first several numbers in the Fibonacci sequence, the ratio of any number to the next higher number is approximately .618, and the next lower number is 1.618. These two figures (.618 and 1.618) are known as the Golden Ratio or Golden Mean. Its proportions are pleasing to the human eyes and ears. It appears throughout biology, art, music and architecture. Here are just a few examples of shapes that are based on the Golden Ratio: playing cards, sunflowers, snail shells, the galaxies of outer space, hurricanes and even DNA molecules.

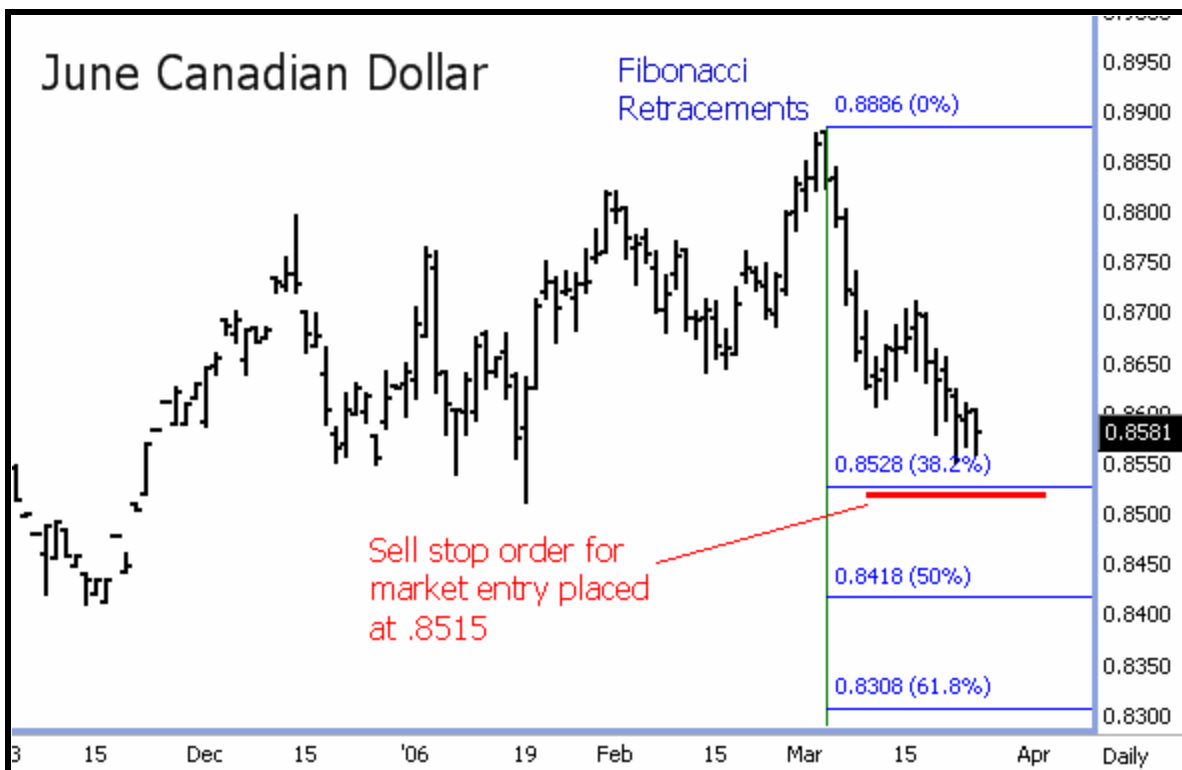
William Hoffer, in the Smithsonian Magazine, wrote in 1975: "The continual occurrence of Fibonacci numbers and the Golden Spiral in nature explain precisely why the proportion of .618034 to 1 is so pleasing in art. Man can see the image of life in art that is based on the Golden Mean."

I could provide more details about the Fibonacci sequence and the Golden Ratio and Golden Spiral, but space and time here will not permit. However, I do suggest you read the book "Elliott Wave Principle" by Frost and Prechter, published by John Wiley & Sons. Indeed, much of the basis of the Elliott Wave Principle is based upon Fibonacci numbers and the Golden Ratio.

Three Fibonacci technical percentage retracement levels that are important in market analysis are 38.2%, 50% and 61.8%. Most market technicians will track a "retracement" of a price uptrend from its beginning to its most recent peak. Other important retracement percentages include 75% and 66%.

For example, if a price trend starts at zero, peaks at 100, and then declines to 50, it would be a 50% retracement. The same levels can be applied to a market that is in a downtrend and then experiences an upside "correction."

See in **Example 9** how a sell stop order for market entry is placed just below the key 38.2% Fibonacci retracement from the move from the contract low to the recent contract high. The Canadian dollar has started to trend down from the recent contract high, and if prices drop below strong technical support at the aforementioned Fibonacci retracement level, then technical odds would favor still more downside price potential in the near term.



Example 9

MARKET ENTRY USING STOPS

As mentioned earlier, the most popular method of market entry for traders is the "market order" or buying "at the market." However, stop orders can be effectively used for market entry for several reasons.

For instance, a trader may locate a key technical support or resistance level on the chart, and then determine that if the market rises above technical resistance or falls below technical support, then market entry at that time would be warranted. The trader would then place a buy stop order above the technical resistance level he has located on the chart, or place a sell stop order below the technical support level he has located on the chart.

Also in the above scenario, the trader using a stop for market entry would not have to continuously monitor his price screen to see if and when the has market moved to his price objective for entry into the trade.

See in **Example 10** how the trader who wants to go short cocoa set his sell stop for entry just below technical support at the recent low.



Example 10

See in **Example 11** how the trader set his buy stop for entry to go long April gold on some price strength. After he's filled on the buy stop order, he would then place his protective sell stop at the level seen on the chart.



Example 11

FLOOR TRADERS "GUNNING" FOR STOPS

For decades the individual small trader has heard unsettling stories that the floor, or pit, traders know exactly where the stop orders are placed in a market, and will "gun" for those stops just to eject the individual trader from the market--only to see prices then reverse course after the stops were triggered.

Floor traders seeking out the individual traders' protective buy and sell stops is more an art than science, as market conditions have to be just right for their efforts to pay off.

For "local" floor traders to push a market in their desired direction, outside fundamental factors need to be about in equilibrium and not having an influence on market prices. For example, any floor traders gunning for sell stops just under the current market price won't get the job done if there were a bullish fundamental development that would push prices higher. Remember, no one group of traders--not even floor traders--can influence market prices very much or for very long.

Also, sometimes floor traders think they know where stops are located, and when they push a market and try to force a bigger price move, they do not find the stops and then they are forced to cover their trades at a loss.

A longtime acquaintance of mine and former Chicago Board of Trade grain floor trader, John Kleist--now a respected grain and livestock market analyst--told me the following about locals gunning for stops:

"Back in the 1970s and most of the 1980s were really the 'last hurrah' for locals wanting to gun stops. And it basically was in the 1990s when better (and more transparent) communication allowed important news to filter 'down' to the pits, rather than 'up' from the trading floor. Locals gunning for stops now is usually more effective in illiquid trading pits, such as the hogs or bellies--and less effective in soybeans and wheat, and very difficult in the corn pit.

"Gunning for stops has been replaced by locals coat-tailing the commodity funds and exaggerating price moves. Maybe that's the same effect but done a different way. Stops have to be relatively nearby current prices--i.e. support/resistance areas commonly used as 'public' stop areas, if the locals are to be effective. And, of course, if near major moving averages in the case of the funds."