Stock Markets Guides

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Stop Loss and Take Profit Strategies

Risk management is defined as forecasting and evaluating financial risks and identifying procedures to avoid or minimize their impact.

The most widely successful traders will master the art of managing their risk while trading in the markets.

Anyone can make significant gains on a lucky trade. Recent times have presented us with many examples of this, from Glauber Contessoto (the Dogecoin Millionaire) to the infamous Keith Gill (u/deepfuckingvalue) of the GameStop saga. Which one of these two is still a multimillionaire? The one who was trained in managing risk and taking profits.

Keith Gill was a Chartered Financial Analyst and licensed securities broker. Trained in finance, Keith Gill knew to slowly take profits and manage his portfolio’s risk as the GameStop saga developed. He ended up walking away from his investment with a comfortable 8 figure profit.

On the other hand, Glauber Contessoto has now lost his millionaire status as his portfolio crashed with the rest of the cryptocurrency markets in late April. He failed to set safeguards in place to protect his profits and neglected to take profits throughout Dogecoin’s incredible run.

This post will dive into the basics of stop-loss and take-profit orders and the tools you can use to operate these trading mechanisms to your advantage properly.

These two trading orders are fundamental for you to be able to manage your risk successfully.

We will refer to examples of these tools being used in the stock market. However, they can also be used with any asset class and in any market, including forex, cryptocurrencies, and commodities.

What is a Stop Loss?

A stop-loss order is a trading mechanism designed to limit your losses if the price of a security begins to move in an unfortunate direction. It is always more helpful to explain these concepts using examples, so let's look at a possible scenario for when a stop-loss order might be used.

Imagine that you have $1000. You wish to purchase shares of Etsy as after reading their latest earnings report, you believe that they are a fantastic company with massive upside potential in the short term.

However, you are unwilling to lose more than $100 of your initial investment on the trade as you need that money for other expenses. Etsy is currently trading at $100 per share. You decide to use your $1000 to purchase 10 shares of Etsy. Since you are not willing to lose more than $100 of your initial investment, you would set a stop-loss at $90 per share.

Setting a stop-loss at $90 per share would mean that if the share price of Etsy fell from $100 to $90, your position would automatically close, leaving you with $900 in your brokerage account.

The stop-loss has prevented you from suffering losses that you were unwilling to sustain and removes the need for you to constantly check the security price to make sure it has not dipped below acceptable levels.

It would be best if you were very cautious about where you set your stop-loss order. The financial markets frequently experience extreme volatility in short spaces of time.

It is entirely possible, and all too common, for a flash crash to trigger your stop-loss, only for the security to recover and move higher later in the trading day.

What is a Take Profit?

Take-profit orders operate similarly to stop-losses. In a sense, they are the opposite of a stop-loss order.

Take-profit orders are triggered when a certain amount of profit has been secured in a position. Once it is triggered, it automatically closes the position on behalf of the trader.

Regarding the example above, imagine that the trader in the Etsy position wished to close his position once he reached $100 in profit. He would enter a take-profit order at $110 per share.

Once Etsy's share price reached $110, the position would automatically close.

Take-profit orders are typically used in conjunction with stop-losses.

The benefit of using these two tools is that you do not have to enter the trades manually. Prices in the markets fluctuate rapidly; by entering these orders, you know exactly how much of a loss you will sustain or a profit you will make.

These orders also remove the need to monitor your portfolio whenever the markets are open constantly.

Short-term traders usually use stop-loss and take-profit orders to make a quick profit from a trade. If you use a take-profit order, you should be aware that your position will close at that level irrespective of price action.

This means that if the security enjoys a breakout in its price because of some external event that you did not foresee, you will be cut out of the trade at the level that you set your take-profit order and miss out on any further profits.

What is a Trailing Stop Loss?

A trailing stop-loss is an altered version of the typical stop-loss order we discussed above.

These orders are set at either a defined percentage or dollar amount. In a long position, you would set a trailing stop-loss below the security's current market price. In a short position, you would set a trailing stop-loss above the security's current market price.

Let’s look at this in the context of the example above.

Assume the same trader bought his shares of Etsy at $100 per share. He has done fantastically well, and Etsy’s share price is now at $240 per share. He wishes to keep the trade open to continue to profit from this momentum.

Rather than set a specific stop-loss order at a certain price, this trader can set a trailing stop-loss at $10. This means that the trailing stop-loss order will be triggered if Etsy’s share price ever falls $10 from its most recent peak.

Let’s assume the trade remains open and Etsy’s share price continues to move higher before the momentum dies down and Etsy’s share price begins to fall.

The trailing stop-loss order would be triggered once Etsy’s share price losses $10 in value. In this example, it would be triggered at $230 per share.

These orders are specifically designed to protect the investor's profits by allowing the trade to remain open only as long as the price is moving in the investor's favor. The order is only triggered if the price changes direction by a specified dollar or percentage amount.

Trailing stop-loss orders are more flexible than traditional stop-loss orders. They do not manually have to be reset and can fluctuate automatically depending on the security's price movement.

The challenge in using these orders effectively is determining whether to use a dollar amount or a percentage amount and ensuring that you set the order at a level that is neither too tight nor too wide.

How to Calculate Stop Loss and Take Profit

Stop-losses and take-profit orders are relatively simple trading concepts to understand.

The key to using these tools effectively is in knowing at what level to set them. Identifying the correct levels to place these orders can be difficult, especially for newer investors.

Determining where to set your orders will depend largely on the asset class that you are trading.

However, the basis of where to set a stop-loss order should always be how much you are comfortable losing on a trade. If you are not willing to lose more than 10% of your capital, then that should be where you set your stop-loss order.

There are technical indicators that can help you to determine where you should place a stop-loss and take-profit order if you do not have a specific amount in mind.

Support and resistance levels are excellent technical indicators for placing stop-loss or take-profit orders.

There are various indicators available online for traders to determine where support and resistance lines are.

Once you have identified your support and resistance lines, a simple strategy would be to set your stop-loss order below a support line and your take-profit order below a resistance line.

Alternatively, you could use other stop-loss setting techniques with indicators such as moving averages or the Relative Strength Index (RSI). These are slightly more advanced stop-loss setting techniques and might not be suitable for investors with less experience. We will detail two indicators that you can use to set your orders below.

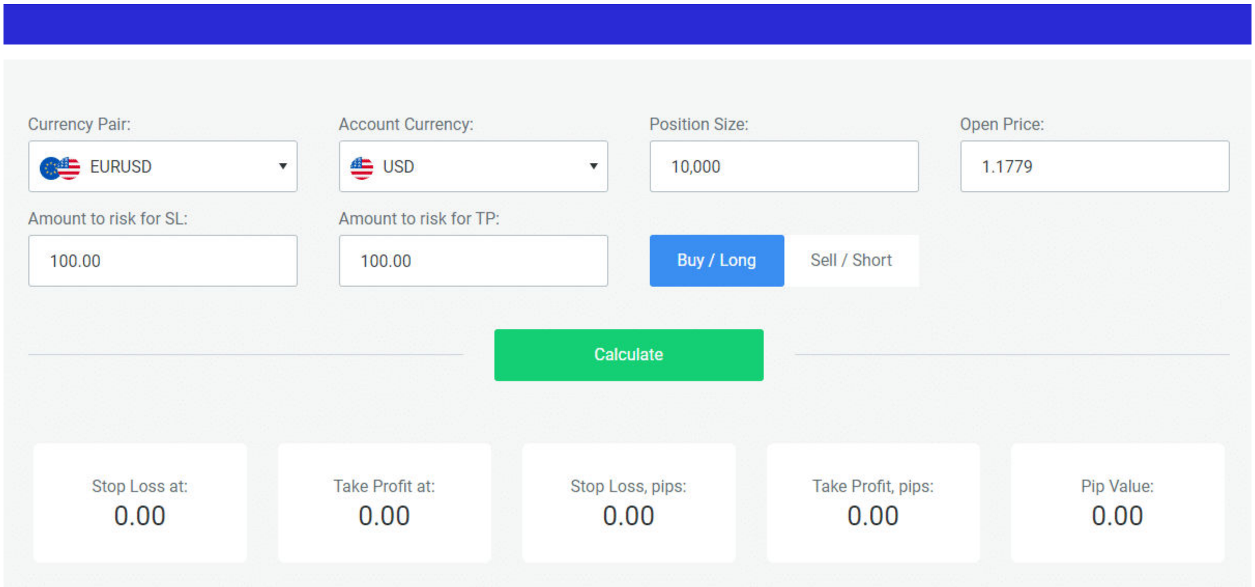
Stop Loss and Take Profit Calculator

Some useful calculators online can help forex traders calculate where to set their stop-loss or take-profit orders. To use them, input the necessary data into the relevant sections, and it should automatically calculate your stop-loss and take-order levels.

You can find the links for two forex stop-loss/take-profit calculators below.

FXPro Take Profit and Stop Loss Calculator

Trading.com Take Profit and Stop Loss Calculator



Stop Loss and Take Profit Indicator

There are specialized indicators available on platforms such a TradingView that can assist traders in determining where to set their stop-loss or take-profit orders.

For example, Trading View’s “Yesillim” indicator is a trend follower and useful trailing stop-loss indicator that reacts quickly. Its goal is to assist you in entering early during an uptrend and exiting early during a downtrend.

Another fantastic indicator used in setting both stop-loss and take-profit orders is the Average True Range (ATR) indicator. This indicator is also available for you to use on TradingView. When using it to set your stop-loss the general rule is to set the stop-loss order at a level twice the ATR below the entry price.

If you are shorting a stock, then the opposite is true, and you would set the stop-loss order at a level twice the ATR above the entry price.

Lastly

Regardless of whether you trade in forex, stocks, or cryptocurrencies, you should regularly evaluate your own risk tolerance in determining where to place your stop-loss orders.

You must understand the specific market and security that you are trading and know whether or not retracements are common.

Securities that regularly retrace after price increases generally require more active stop-loss placement and a more sophisticated re-entry strategy.

Ultimately, stop-loss and take-profit orders are fantastic tools for profit capturing and risk management, but they do not guarantee that you will be profitable over time.

What they will guarantee is a significantly reduced risk of you sustaining catastrophic losses in your portfolio. As we mentioned at the start of this post, the most successful traders will be the ones who master the art of risk management and can use their stop-loss and take-profit orders intelligently.

Both Keith Gill and Glauber Contessoto made significant gains in the stock and cryptocurrency markets. Still, only Keith has secured his profits by employing a sensible take-profit strategy throughout his trading.

At the time of writing, Glauber Contessoto has lost most of the profits he made and still stands to lose more as Dogecoin continues to fall along with the rest of the cryptocurrency market.

These two individuals perfectly demonstrate the importance of managing your risk and implementing sensible tools like stop-loss and take-profit orders into your trading strategy.

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