EXIT STRATEGIES FOR

PART I

Joe Ross provides strategies for retaining trading profits.

CURRENCY TRADERS

Trading currencies, whether in the futures or forex markets, requires an exit strategy. (In this article 'currency' or 'currencies' refer to both currency futures and spot forex.) It is vital that you have an exit strategy for every single trade. All too often traders concentrate on entering a trade, while giving little thought to how they will exit it.

Trading goes two ways

We really need two exit strategies. We have to be able to handle both winning and losing. We not only need to know how to make profits, but we also need to know how to protect our profits, as well as how to defend ourselves. We need one profit-taking exit strategy, and one capital-protecting exit strategy.

Self-defence

How we defend ourselves is the most important aspect of trading. Since we must always assess the risk in a trade before we do anything else, part of that assessment is deciding where we will protect against a loss of our capital.

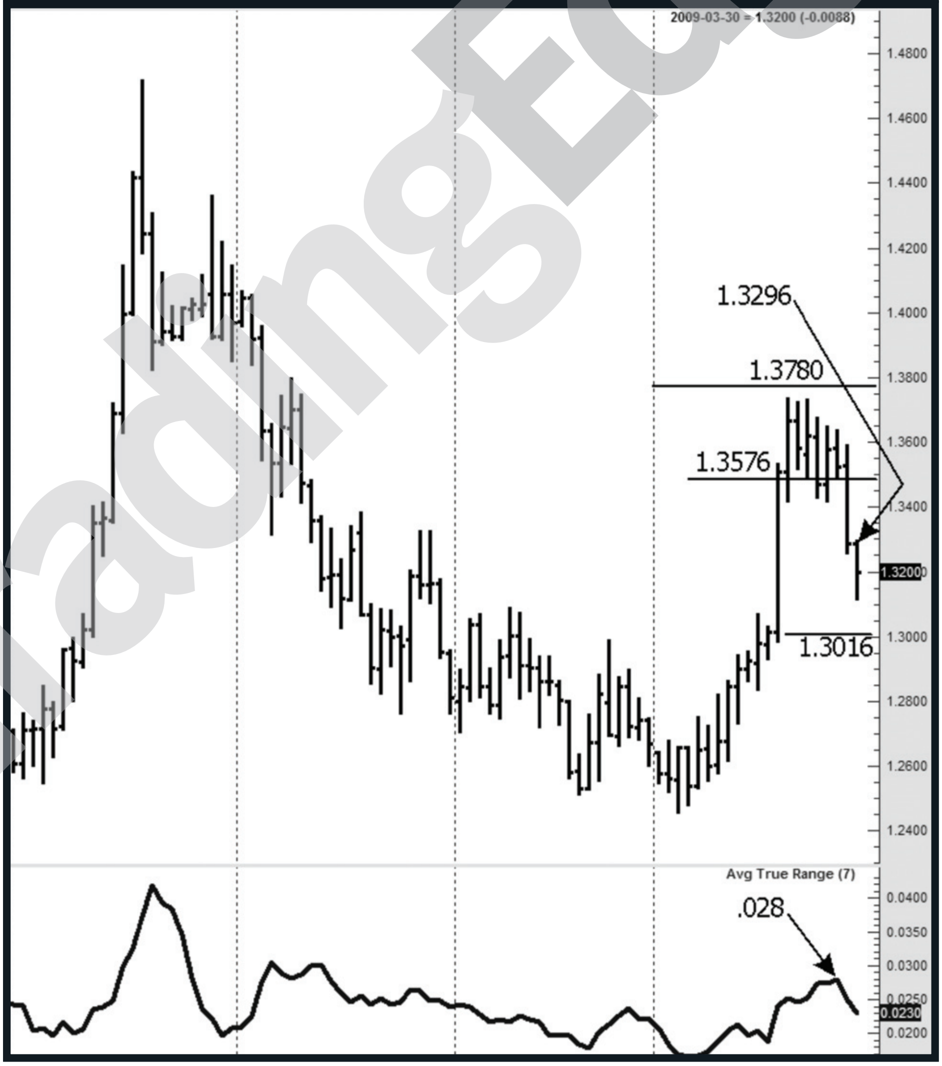
In any trade, the defensive exit strategy is our loss-protection order. We place a stop loss at the point where the market will prove us wrong in our trade.

Another way to place a stop loss is to put it where we have risked the maximum amount of our account that we're willing to lose on any particular trade.

Average true range

Both defensive objectives can be met by using a study known as the Average True Range (ATR). ATR provides a very efficient way to set stops based upon volatility. The

FIGURE 1: AVERAGE TRUE RANGE EXAMPLE



ATR is used in four ways:

- To set a stop loss
- To set an objective
- To create a trailing stop
- To assist us in position sizing (how many lots to trade)

Instead of using support or resistance, as many traders do, our stop loss is set below the number for the ATR when going long, and above the number for the ATR when going short. The same ATR number can be used for the first profit-taking objective, as well as for an ongoing trailing stop.

If the ATR number produces a stop loss of more than one per cent to five per cent of our account balance, it's better for us to trade fewer lots.

One of the nice things about ATR is that it

enables us to risk only what we can afford – a money amount with which we are comfortable. Let's look at how that works.

Let's say we are willing to risk $1000 on any one trade, and that $1500 is 1.5 per cent of our trading account.

We look at our chart (see figure 1). In this case, using a 7-bar ATR, we find the most recent high value for ATR is 0.028.

If we want to get long at 1.3296, we will place a loss-protecting order at 1.3016 (1.3296 – 0.028 = 1.3016), which amounts to $280. That means we can trade five lots and stay within our $1500 risk amount.

The next step is to figure out where to place our first objective. We add 0.028 to our proposed entry price of 1.3296, giving us a first objective of 1.3576. If prices reach 1.3576, we can take profits on all or part of our position.

Let's say we sell three of our five lots, and move our loss-protecting stop to breakeven at 1.3296. What then?

If prices continue to rise, we begin to trail our stop at 0.028 below the highest high achieved as the market moves up.

If prices reach 1.3780, our trailing profit-protecting stop will be located at 1.3500. We can continue to trail a profit-protecting stop 0.028 distant from the highest high reached by the movement of prices.

Another way we might consider managing the trade is that as soon as prices move another 0.028 above our entry at 1.3296, we sell our fourth lot. In that case, we would sell lot number four at 1.3856, and allow lot five to remain as a profit-protecting stop at 1.3576.

Thus the ATR gives us a sound basis for setting a loss-protecting stop, an initial objective, a profit-protecting stop, and it also enables us to determine exactly how many lots to trade.

But what do we do if the ATR number is too high? For example, what if the ATR was 0.0418? Assuming the same entry at 1.3296, subtracting 0.0418 would cause us to have to place our loss protection at 1.2878. Can we safely handle a $418 loss? We can if we lower our position size to three lots.

What we can learn here is that if the ATR, which is an expression of volatility, becomes too great for our risk tolerance, we can opt to pass on a trade in this market. Or we can drop down to a shorter time and trade there. A shorter time will give us a lower ATR number.

A friend found that at one point trading the euro became much too volatile for his risk tolerance. At the time he was trading from a 60-minute chart. He simply dropped down to a 5-minute chart where he felt comfortable with the ATR numbers.

Stop loss

A stop loss is a capital preservation strategy. A stop loss is really a secondary strategy for each trade – the level where we automatically exit the trade and cut our losses.

Profit-taking exits

We also need a primary strategy; a profit taking exit, because it helps us to manage our trades.

A profit-taking exit involves knowing when a trade has reached its profit potential. We then set what's called a limit order at that level, so we can take profits and reduce the risk to our account balance.

The exit strategy is very important. A currency trading strategy may be able to win on eight out of ten trades, but if it fails twice and wipes away the gains from the previous eight trades, it is not a very good strategy and will ultimately fail.

It's not just how many winners we produce or how 'perfect' our entry is. If our exit strategy isn't planned out from the beginning, we're not going to manage our trades properly. That's especially true when emotions get out of control and our account balance is gyrating up and down. The best traders know their exit before they ever enter a trade.

Part II of this article will be featured in the Sep/Oct 09 issue of YTE.

Joe Ross is a trader, author of 12 books, and trading educator. His more than 50 years in the markets include position trading of shares and futures. Joe day-trades stock indices, currencies, and forex. See www.tradingeducators.com and www.spread-trading.com