Good Bye & Good Riddance

SYNOPSIS

- The New York Stock Exchange announced this week that it will eliminate "stop orders" as of February 26, 2016.
- This announcement is music to my ears, as there are fewer ways that are more effective to lock in unnecessary losses than by using stop orders.
- Although stop losses should never be used, it is still important to know when to sell a stock.

THEY WON'T BE MISSED

The New York Stock Exchange (NYSE) announced this week that it will eliminate "stop orders" as of February 26, 2016. Talk about music to my ears. Before I explain the importance of such a move by the NYSE, let's walk through the difference between the various order types to get a better understanding of why some orders are better than others.

MARKET ORDERS

A "market order" is a type of order that an investor places to buy/sell a security immediately at the best available current price. Market orders almost always guarantee execution and low commission charges because there's not much work required for the broker, and there are no restrictions on the price or timeframe for the order.

The problem with market orders is that they risk major losses to investors during times of volatility. For example, if a stock's quoted price was $50, and an investor entered a market order during the panic with the expectation that the sale would close at $50 a share, the order could have easily executed lower than $40 because of the erratic trading. To make matters worse, the volatility could have then pushed the price back up to over $50 in a matter of seconds.

It's imperative to always remember that market orders are the default option for brokerages, and highly volatile times or less liquid stocks pose tremendous risk to those who use these orders. Hence, it's up to you to place "limit orders" instead.

LIMIT ORDERS

Limit orders allow investors to set a price and attach other conditions to the trade when needed. By setting restrictions on a trade, investors can protect themselves during times of intense volatility.

In our example above, an investor could have stated that the trade only be executed at a price of $50 or better. Doing so, would have protected the downside from the violent price swings that we experienced early last week.

Simply put, investors should not use market orders because you lose the control of how the order gets executed, and most importantly, at what price. Use limit orders to maintain control of where the trade gets executed.

STOP ORDERS

Admittedly, not all market orders are dangerous or inherently risky. Selling 100 shares of Apple on a slow day in the market won't pose much risk to an investor because it is one of the more liquid stocks in the world.

What will harm investors over the long run are "stop orders" (a.k.a. "stop loss" order), and I have preached repeatedly over the years that these orders are never to be used under any circumstances. Stop orders are designed to limit an investor's loss on a position by instructing a broker to sell a specified price. For example, if an investor bought a stock at $50 with a stop loss at $40, the stock would be sold on the next price after hitting $40.

At first, the appeal of such an order is obvious. Capping a potential loss on an investment to prevent a major drawdown in a portfolio sounds great on paper, but stop orders are to be avoided for two reasons:

1. **Execution**: Stop losses do not guarantee execution at a specified price. Once a stop order is triggered, the trade is entered as a market order, which exposes it to the issues explained above. Hence, it's the worst of both worlds during volatile times.
2. **Intent**: Short-term traders use stop orders to limit their exposure to the market, but long-term investors should never sell a stock simply because it drops below a price threshold. It's rare to buy stocks at the bottom, and trying to time bottoms never works consistently.

The volatility that rocked equity markets back on August 24th is all the evidence I need to support my claim. Stop losses acted as gasoline on a flame because panic selling triggered stop losses, which then dumped even more market orders into the system.

J.P. Morgan's stock (ticker: JPM) was down over 20% at the open on that Monday morning. Long-term investors who owned JPM, but who also used stop losses anywhere up to 20%, may have locked in a loss even though the stock recovered within seconds.

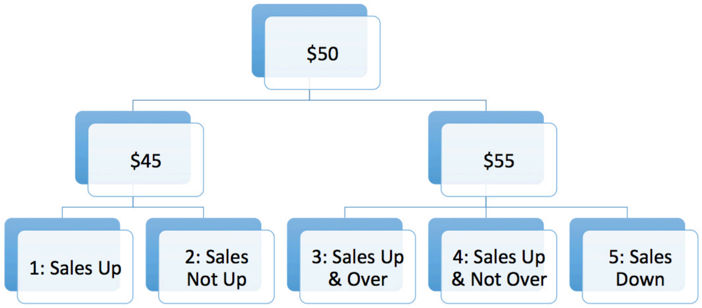
In summary, the NYSE should be applauded for their decision because stop losses offer zero upside to investors and should never be considered anyway.

WHEN SHOULD INVESTORS SELL?

Now that we have discussed how to sell a stock, the next step is to discuss when to sell. In other words, all investors need a "sell discipline."

Unfortunately, the decision when to sell a stock is not as black and white as it may appear. There are times when stocks go down but do not warrant selling, and there are times when stocks rise and should be sold immediately. Said another way, whether I am right or wrong cannot be determined by simply checking to see if the stock price has risen or fallen.

Although there are numerous potential outcomes following the purchase of a stock, the flow chart below addresses a few of the more common ones to get a sense of how a sell discipline is designed to cut losses and let winners run.



Let's assume that a company is releasing a new product, and I have determined through fundamental analysis that the company's sales and earnings should rise due to the attractiveness of this product to its target audience. I bought the stock at $50 and six months later, we review five different scenarios.

Scenario 1: I am down 10% from my purchase price of $50. However, the drop in price does not necessarily mean that I am wrong. In fact, after some analysis, I have determined that sales of the new product are not only rising but actually increasing the company's earnings as I had originally hypothesized.

Since timing entry points is impossible, buying too early is a common occurrence for a long-term investor. Selling the stock simply because I am down 10% would be a mistake because my thesis appears to be working. Hence, I would remain patient or perhaps even add to my position now that my conviction is even higher than before.

Scenario 2: I am down 10%, but company earnings are not rising because the new product is selling poorly. My thesis is probably incorrect and I should most likely sell.

Scenario 3: I am up 10% and sales are translating to earnings for the company. My thesis is working, but I also have determined that the future no longer looks as bright. For example, this new product may have attracted competition, which could impact future sales. In any event, I take profits because conviction has fallen and risk has increased.

Scenario 4: I am up 10% and sales are translating to earnings for the company. This time, I have determined that the new product is gaining phenomenal traction, and its market has the potential to expand significantly. I will not sell and most likely buy more because my conviction is now much higher than before.

Scenario 5: I am up 10% but sales on the new product are disappointing. This scenario is a tough spot because I made money so far, but I don't know why. As counterintuitive as it may sound, I immediately sell unless I can get a better sense of what is driving the stock because I clearly don't know at the moment.

IMPLICATIONS FOR INVESTORS

Notice a few consistent themes throughout the scenarios above.

1. **Know the Story**: I chose to sell the moment I realized that my thesis was either wrong or incomplete, despite whether I made or lost money. Investors should never own a stock unless they truly know the story.
2. **Conviction Matters**: When I bought at $50, I was unsure if my thesis would play out. However, in the scenarios where sales were rising over time, conviction increased because my thesis was working. Higher conviction led to buying more because the risk of being wrong fell.
3. **Fundamentals Drive Decisions**: Each decision to buy and sell the stock was predicated upon fundamentals of the company and not the direction of the stock price.

Even the most successful investors are wrong far more times than they are right. The secret to their success is in their ability to cut losses quickly and let winners run. The only way to follow such a process is to think long term and focus on the fundamentals that drive results.

This cohort would never consider the use of stop orders because such a decision is based solely on price and not on the drivers of the stock price. Instead, they remain incredibly focused by adhering to similar sell disciplines as the one outlined above, and eliminate as much emotion as possible from their investment process.

The bottom line is that the NYSE is doing everyone a favor by getting rid of a trading tool that does nothing but risk hurting investors. Good bye and good riddance!

Sincerely,

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