

<http://www.myforexdot.org.uk/stop-losses.html>

## *Setting Stop-Losses*

If you read many of the articles on the Internet about setting appropriate stop-losses, no doubt you will have come across advice like the following –

- Calculate your stop-losses so that you never risk more than 2% to 5% of your account.
- Always set your stops just below the support when you're long and just above the resistance when you're short.
- Set your stops outside the market's 'range' etc, etc...

These bits of advice might be very useful, but there is one key piece of information that usually seems to be missing, particularly when it comes to mechanical trading systems. That information is that **using a stop-loss of any size (other than a very, very large one) almost always degrades the performance of any mechanical trading system.** It's true that a good trade rarely moves to far against you, but I find that almost all the advice I read severely underestimates just how 'far against you' the price can go before it should be considered 'to far'.

No doubt most of the writers that advise using stops of 30-50 pips or whatever believe their advice is good advice and offer it in good faith. However, a lot of this advice seems to come from seminars offered by various bucket shop brokers and some unscrupulous spread betting companies who take the other side of their client's trades. It's in these company's interests for their clients to be over leveraged and lose. It is almost impossible to pick a market's exact top or bottom; this means that after you enter a trade if the price goes 50 or 100 pips against you it doesn't necessarily mean that you were wrong, and in fact is perfectly normal and is to be expected. Using to tight a stop-loss therefore usually means that when you're right you're wrong as you get stopped out before the trend moves the market in your trade's favour. With to tight a stop-loss you're wrong when you're wrong and wrong when you're right! If a large stop-loss means you're risking more than x% of your account on single trade then you need to use less leverage, not tighten the stop.

To illustrate the effect of tight stop-losses on a mechanical trading system I am going to use stop-losses of various sizes on an 80 breakout system with a 20 day time-based exit. Whenever the EUR/USD closes higher than it has ever closed in the previous 80 days we enter a long position, which will be automatically exited after 20 days or when the stop-loss is hit, which ever happens first. And whenever the EUR/USD closes lower than it has ever closed in the previous 80 days we enter a short position, which again will be automatically exited after 20 days or when the stop-loss is hit. The stop-losses will not 'trail' and will stay fixed at x number of points above or below the market when the trade was first entered. I will test this system with stops of 200, 400, 600, 800, 1000, 1200, 1400 and 1600 pips.

The results of this experiment are as follows –

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|---|---|---|---|
| <p><u>With a 200 pip stop-loss</u><br/>           Number of wins: 177<br/>           Number of losses: 173<br/>           Percentage of winning trades: 50.6%<br/>           Number of pips won: 55,614.1<br/>           Number of pips lost: 30,379.9<br/>           Win to loss ratio: 1.83 to 1</p>  | <p><u>With a 400 pip stop-loss</u><br/>           Number of wins: 212<br/>           Number of losses: 138<br/>           Percentage of winning trades: 60.6%<br/>           Number of pips won: 62,480.3<br/>           Number of pips lost: 34,174.2<br/>           Win to loss ratio: 1.83 to 1</p>  | <p><u>With a 600 pip stop-loss</u><br/>           Number of wins: 214<br/>           Number of losses: 136<br/>           Percentage of winning trades: 61.1%<br/>           Number of pips won: 62,911.3<br/>           Number of pips lost: 32,347.9<br/>           Win to loss ratio: 1.94 to 1</p>  | <p><u>With a 800 pip stop-loss</u><br/>           Number of wins: 218<br/>           Number of losses: 132<br/>           Percentage of winning trades: 62.3%<br/>           Number of pips won: 64,504.3<br/>           Number of pips lost: 29,576.2<br/>           Win to loss ratio: 2.18 to 1</p>  |
| <p><u>With a 1000 pip stop-loss</u><br/>           Number of wins: 219<br/>           Number of losses: 131<br/>           Percentage of winning trades: 62.6%<br/>           Number of pips won: 64,836.3<br/>           Number of pips lost: 28,718.7<br/>           Win to loss ratio: 2.26 to 1</p> | <p><u>With a 1200 pip stop-loss</u><br/>           Number of wins: 219<br/>           Number of losses: 131<br/>           Percentage of winning trades: 62.6%<br/>           Number of pips won: 64,836.3<br/>           Number of pips lost: 28,918.7<br/>           Win to loss ratio: 2.24 to 1</p> | <p><u>With a 1400 pip stop-loss</u><br/>           Number of wins: 219<br/>           Number of losses: 131<br/>           Percentage of winning trades: 62.6%<br/>           Number of pips won: 64,836.3<br/>           Number of pips lost: 29,118.7<br/>           Win to loss ratio: 2.23 to 1</p> | <p><u>With a 1600 pip stop-loss</u><br/>           Number of wins: 219<br/>           Number of losses: 131<br/>           Percentage of winning trades: 62.6%<br/>           Number of pips won: 64,836.3<br/>           Number of pips lost: 29,318.7<br/>           Win to loss ratio: 2.21 to 1</p> |

### Setting Stop-Losses - My Conclusion,

The return of trading this system with no stop-loss before the costs of trading is 2.20 to 1. With a stop loss of 600 pips or less this system's returns were seriously degraded, whilst the best performing large stop-loss of 1,000 pips performed only slightly better than 2.20 to 1. **My conclusion is therefore that any stop-loss, other than a very, very large one, almost always degrades the performance of any mechanical trading system.**

**Note: Chief SectorSurfer concurs with this result based on his personal experience.**