

The life of a trade

Investing is not just about buying and selling – you need to make sure that you look after your investment while you hold it. John Cotter explains how to maintain your trades



Every trader and investor thinks about trade entry – what to buy, and when to buy it. Many also understand the importance of having an exit strategy – when to get out. How many investors, though, understand how to manage a trade throughout its life from entry to exit?

Different people have different trading strategies and the life of a trade will be from as little as a few minutes, up to a number of years, depending on the trading strategy being followed. A ‘day trader’ enters and exits trades very quickly, with a trade being ‘live’ (in the maintenance phase) for a very short period – less than one day. A ‘swing trader’ also enters and exits quickly, but each trade is typically maintained for a number of days.

A ‘position trader’ may spend more time planning and waiting for the right time to enter or exit a trade, and will usually hold a position for a number of weeks or months. Whereas an ‘investor’ will carefully evaluate a range of factors (often both technical and fundamental) before entering or exiting a trade, and will maintain an open position for a number of months or even years.

The maintenance phase is especially important for position trades and investments, and these trading styles are the main focus of this article. However, before we move on, I should say a few words about entry and exit.

TRADE ENTRY AND EXIT

There are several strategies for trade entry, including:

- Technical analysis, where a trader uses a particular chart pattern – such as a ‘double bottom’ or ‘breakout’ – as their cue to enter a trade
- Fundamental analysis, where you decide to buy when one or more fundamental ratios – such as dividend yield or price/earnings – are favourable
- Speculation – hot tips, hunches, astrology, and other dubious but far-too-widely-practised strategies!

Traders may use order types to effect their entries. For example, a swing trader might use a limit order to buy when the price of a stock or other security falls to the bottom of its trading range; a position trader might use a

stop order to buy when the price of a security breaks upwards out of a trading range.

As with trade entry, an open trade may be exited as a result of adverse price action identified by technical analysis or as a result of changing fundamentals – when a holding has realised its true value or when a better opportunity presents itself. Again, traders may use automated orders to effect their exits.

We ran a feature on exit strategies in the Spring 2009 edition of *Smart Investor*, which you can find in the Market News & Data section of the Barclays Stockbrokers website.

TRADE MAINTENANCE

This is where it gets really interesting, because traditionally very little attention has been given to the subject of maintaining a trade during its life from entry to exit. Maintaining a trade means keeping it open long enough to realise the full profit potential, but not so long that any accrued profits evaporate before they can be crystallised.

Effective trade maintenance allows you to let your profits run. It may also be possible to amplify those profits while at the same time

keeping your risk to a manageable level, by building your position over time. In terms of trade maintenance, the two themes I would like to explore are stop orders and position building.

STOP ORDERS

A stop order can be used not only to stop out a position at a loss, but also to lock in some secured profit without having to sell your holding prematurely. The chart for Enterprise Inns (below) between March and May 2009, shows how a stop order can be trailed – manually, or using an automated trailing stop order – in order to secure an increasing amount of profit at each stage.

The trick here is to trail the stop order at a distance that is sufficiently below the rising price so as to not get stopped out on a random fluctuation or price spike, but close enough to secure a good profit when eventually the tide turns.

In this example, the tide does turn in May so that the stop order triggers at a price of 150p for a profit of 80p per share. While this 100%+ return in only two months is gratifying in itself, the main point is that from 6 April onwards this trader (assuming efficient stop order execution) was assured some profit and no loss.

Although this example assumes the use of an automated trailing stop order, you might consider employing a non-trailing stop order and adjusting it yourself – always upwards,

You should aim to keep a trade open long enough to realise the full profit potential, but not so long that the profits evaporate

never down. This will allow you to raise the stop level in line with observed price support levels, and will give you ‘something to do’ in the market when you feel the urge to buy or sell something unnecessarily.

Taking this example a stage further, imagine if you maintained your position not only by trailing the stop order but also by adding to the position.

In this example, even an unlucky trader who made additional £1,000 investments at the worst possible times, on the intermediate price peaks indicated by the arrows, would still have secured slightly more profit overall (thanks to the trailing stop order) when his combined trades exited, despite the last two contributions being stopped out at a loss.

NOT JUST FOR TECHNICIANS

Although this example demonstrates a technical approach to trade maintenance, you should not lose sight of the fundamentals. Just because the trailing stop order will get you out

automatically for an assured profit, it doesn’t mean that you can’t exit instead when you consider your holding to be ‘fairly valued’.

When it comes to building your position, you might build it more quickly (make bigger investments) while you consider the stock to be undervalued and then scale back your additional investments when the value case is less clear.

If you are a short-term day trader or swing trader, your trades will have a short lifecycle in which the entries and exits are most important. Your aim will be to make a large number of small profits.

If, on the other hand, you are a longer-term position trader or investor, you will know that your trading strategy is working when you find that you are spending more time maintaining existing positions than you spend establishing new ones. Your aim will be to make a smaller number of big profits by riding the long-term trends. ☘

John Cotter, Vice President, Barclays Stockbrokers.

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Learn about stops
 You can find out more about how to place advanced stop orders in ‘Order types made clear’ section. Simply run the demo, which you will find in the Demos section under the Education tab on the Barclays Stockbrokers website.

ENTERPRISE INNS

