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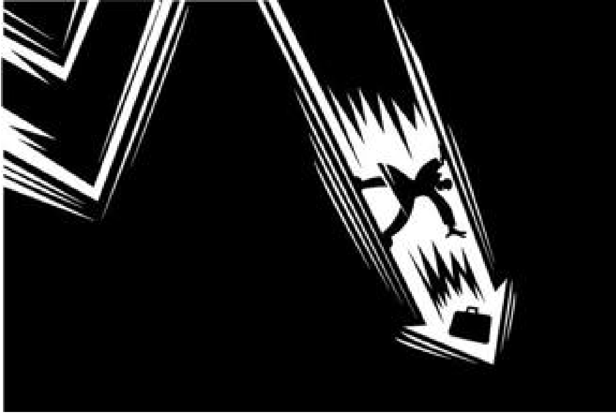

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A common advice given to every market participant is to always use stop-loss. So how good is this advice?

If you are a speculator or a trader in the market, it is probably one of the few or only good thing that you will be doing. However, if you are an investor, and an intelligent or smart one at that, then it is one of the worst pieces of advice you could take.

A smart investor works on the principle of buying below the intrinsic value of a stock. Consider that you have determined that a stock is available at a price significantly below its intrinsic value and have decided to buy it. Now, just when you have made a purchase of one tranche and are in the process of buying a second, the stock falls further. Would you be happy to see your previous tranche being sold off at the lower price because of a stop-loss order? Or would you have continued the purchase of the second tranche but at a lower price? You could now buy more shares of the company for the same investment amount as the first tranche.

For a trader the whole thing is reversed. She was buying because the stock was going up. So she would buy at a certain price, the stock would continue on its upward trend and then she would sell it at the higher price. However, now the stock has unexpectedly reversed its trend. It is moving in the other direction. The trader wants out. Her stop-loss will trigger on the way down and she will be out of her position. And yes, she has lost a part of her capital.

Most likely she is trading on a margin. Her losses, if they continued, would have been magnified to that extent. Any leveraged trader, whether using margin money or using derivative instruments like futures and options, is best advised to use stop-loss.

However, the stop-loss does exactly what it says—it stops your losses. But remember that for a trader most likely there will be a lot of losses. If you don't know what you are doing or are following a trend or using any of the trading strategies, then you should definitely limit your eventual losses using stop-loss. Otherwise, you will lose your capital in larger amounts and that too, faster.

With a stop-loss the size of each loss will be more limited and it will take you longer to lose your capital. But all traders are eventually likely to lose all their capital. What stop losses do is that they make it last longer.

On the other hand, smart investors do not need stop losses. They don't look at the market for guidance. If the market is pricing stocks lower, chances are all the smart investors are happy. In their view, more stocks will be available below their intrinsic values as prices fall. Furthermore, the discounts to intrinsic value will be larger. Hence, they will buy more, assuming they have more capital to invest with.

Any smart investor who claims to buy below the intrinsic value and also uses stop losses, either doesn't know her intrinsic values or doesn't know herself. She is, most likely, a not-so-smart trader. In this case, she should "know herself" properly first, decide on how she wants to make money from the markets, i.e. as a trader or a speculator or as a smart investor.

Even worse is the speculator who invests in some stock as it "has to go up", and that too because a half-buffettologist has written something good about it, and when it falls and she rues the fact that she did not use a stop-loss, otherwise it would have been a good speculative bet. Now, of course, the speculator has no option but to classify her bet as a value investment for the long-term. Now that is what should be called a sure-fire way to lose money. Other speculators can bet on "how fast?"

A smart investor would satisfy themselves with the fact that the company is of reasonable size, has zero or low leverage, has a stable business model which is not capital destroying and is available below its intrinsic value. If any of the conditions were not true, she would not buy. If she did buy, it would be without a stop-loss, but rather, with an order to buy more if the price falls. She would be able to live with the notional loss in the portfolio value. The smart investor would look at the fundamentals of the company to satisfy herself with the fact that everything was fine with her investment even if the market price had fallen.

During the holding period of the smart investor, the price could keep dropping and she would either buy more or hold. Of course, she could look at all the news—factual news, not rumours—and the financial statements to make sure that the fundamental business of the company

was intact. If it was facing challenges, the question to ask would be: are they temporary or permanent? If they are temporary, then one can hold. If the profits are going to turn into losses for an undefined period of time, then it is probably a good idea to sell. However, if the profits are reasonable and there is no likelihood of bankruptcy then the smart investor will hold or buy more.

It is a possibility that there is some fraud in the company or the financial statements are incorrect or others or insiders know about something that you don't and that the company is going to lose all its value. The way to counter that kind of an "information asymmetry" is to buy a diversified portfolio of a large number or stocks, say 20 or more, from different sectors or industries. That kind of a portfolio has an automatic stop-loss of 5% per stock built into it. That is the maximum allocation one would have to any stock. Now if it falls and goes to zero, one still has only a 5% loss. However, if one has followed the buying criteria of the smart investor, the only way it can go to zero is if there is an insider fraud or a very rare black swan. In both cases, the loss is again capped at 5% due to prudent allocation.

I will end with a quote from Warren Buffett's 1987 letter to the shareholders of Berkshire Hathaway Inc.:

"After buying a farm, would a rational owner next order his real estate agent to start selling off pieces of it whenever a neighboring property was sold at a lower price? Or would you sell your house to whatever bidder was available at 9:31 on some morning merely because at 9:30 a similar house sold for less than it would have brought on the previous day?"

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