

Candlestick Trading Forum Stop Loss Strategies

Simple, Common Sense Techniques To Protect Your Assets

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Candlestick Analysis made available in concise formats.

Information that when learned and understood will
revolutionize and discipline your investment thinking.

Candlestick Stop Loss Strategies

**Progress always involves risk. You cannot steal second base and keep your foot on first.
Frederick B. Wilcox**

Protecting your assets, that is the main function of putting on stop losses. It is to provide a point where the reason for buying becomes null and void. Many trading strategies incorporate them into their trading formulas for closing a trade that has gone sour. Usually this is done by establishing a percentage loss as the parameter. The candlestick method completely disregards a preset formula for stopping out.

There is a major flaw in using a prescribed percentage loss as the stop loss. Your purchase price becomes an important function of where you are to stop out. Some investment advisors recommend three percent as the stop out level. Others suggest eight percent. But where you buy a trade position now becomes the quantitative element of where you should place your stop. A couple of extreme disadvantages become apparent.

A buy recommendation is placed on a stock. You are advised to place a stop at a preset number, for example, three percent below your entry price. The buy is placed on a stock at \$50.00. However,

by the time you get executed, you have paid \$50.80. Buying the stock at \$50.00 would have meant your stop out level was \$48.50. Your entry at \$50.80 now means that the stop loss is to be placed at \$49.27. As often mentioned in candlestick analysis, where you bought a stock or sell a stock does not mean a hill of beans to the market. Your arbitrary level of where to come out of a trade has absolutely nothing to do with what the price trend should be doing. What if \$48.50 is a level that negates the uptrend move, but \$49.27 does not change the trend direction.

Your entry level, although may not have been the ultimate point to get in, \$49.27 may not have been a level that affected the uptrend. You could get stopped out while the trend direction was still valid.

Additionally, the volatility of a particular stock has a great bearing on whether a trend has been affected. A three percent pullback on some stocks might be more than big enough to reverse a trend, while a ten percent move in other stocks are common and is not a factor on the trend direction.

The most important factor for establishing a stop loss is very basic. What price point would indicate that the established trend has been negated? This now becomes a stop loss level established based upon the trend being stalled and/or negated. As with all of candlestick analysis, this becomes a "common sense" evaluation. If you have put on a long position, based upon a bullish buy signal, where would the price have to back off to confirm that the sellers were still in control?

The person who knows how will always have a job. But the person that knows why will be the boss. Carl C. Wood

Another important factor is having an idea of which direction the markets are moving in general. Logic suggests that if the markets are in a downtrend and a buy signal is witnessed in a specific stock, then the uptrend needs to be diligently followed versus a buy signal appearing when the markets are in an uptrend.

The simple visual evaluation establishes the proper stop loss point as it pertains to that specific stock position, taking into consideration the volatility of the stock and the signal that created the buy signal. A stop loss on one stock may be relevant at a close level whereas the next stock position requires greater latitude. Candlestick analysis allows the investor to establish a stop loss that would logically indicate the sellers were still in control, and the buyers have been overcome.

What Does the Signal Tell You?

Keep in mind, not all trades work. “Probabilities” of a successful trade, after witnessing all the parameters that make for a successful trade, is the key word. Although the probabilities are greatly in your favor, there is also the small probability that a trade will not work.

The signal itself is still the result of centuries of observations: Observations that were reinforced by profitable trades. The signals have meaning. They represent the change in sentiment of the buyers and sellers. The signal comprises that new change. The candle formation is the basic element of the reversal signal. However, when that reversal signal illustrates that a new force has entered the market, but is immediately negated by the original trend force, it is clear that the new trend is now nullified. Get out of the trade immediately.

Does that mean the analysis was not correct on identifying the signal? No. If a buy signal was formed in an oversold condition, candlestick analysis establishes that there is a high “probability” for that trade to make money. Again the word “probability” is what needs to be addressed. The trade should make money. However, if the trend does not establish itself, it becomes obvious if you know the candlestick signals. Your stop loss strategy now becomes customized to that trade set-up. This is an easy visual process. Take each signal set-up, knowing what makes it work, and set your stop loss price based upon where that signal would be negated.

Negating the signal

What created the signal? The Bullish Engulfing pattern, the Doji followed by a bullish confirmation day, a Hammer signal confirmed, a Kicker signal? When a signal is created, we will see the candle formations that established the new trend. That becomes the stop loss criteria. The same rules for what makes a successful signal can be used for showing what makes the signal unsuccessful.

Everything comes to he who hustles while he waits.
Thomas A. Edison

Establishing the level showing the trade is not working builds much more control in the investors' psyche. They establish where they get in and out of the trade instead of arbitrarily setting stops that have nothing to do with how a trend should be working. That control can be directed to making proactive decisions versus passive reactive watching. It allows the candlestick investor to prepare for strategies to re-establish a trade in the same position, based upon selling when the trade was not working and getting back in when the trade is working again.

Initiating a Trade

A signal has significant meaning. Knowing that, the thought process for when to stop out of a trade becomes easy. A buy signal indicates a new trend. What would counter that "indication"? Probabilities mean being in that trade has favorable odds for profitability, but not any guarantees. Even though a majority of the trades will work using the signals, this also means some trades won't work. Keeping that mindset in focus, stop loss analysis creates a format for identifying when a trade is not working and getting out of the trade as soon as possible.

Establishing the stop loss point is using the same common sense approach that is incorporated throughout the candlestick method. Examine the chart of Wynn Resorts Ltd. Note the three Spinning Tops on July 23, 24, and 25.

Wynn Resorts Ltd.



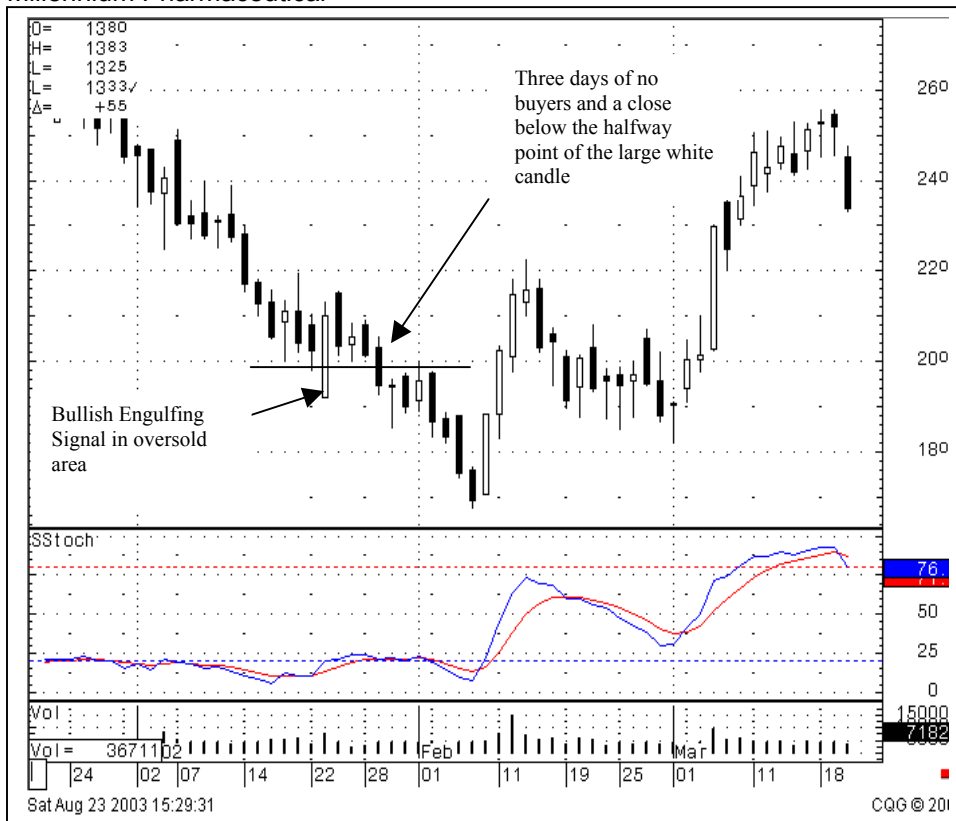
The gap up on July 28 should have been the buy signal, the entry being at \$16.50. A big bullish candle the next day followed by a couple of Dojis. The Bearish Engulfing signal the following day, with stochastics still heading up, may not have convinced anybody that this uptrend is over. What becomes an obvious level that would indicate they were not taking the trend up any more? The bottom of the large white body on the 29th becomes a logical level. If the sellers take it back down through that level, the trend is obviously not up anymore.

What does that do for profits? Break-even. But if you can break even on the bad trades, that is not bad at all. Built into the candlestick trading concept is a factor not evident in most other trading systems. The signals provide that extra day or so of getting in earlier than the other technical methods, which need more confirmation than what the candlestick signals provide. Getting in that much lower makes the sell stop levels more effective. The negation of a buy signal is very close. For example, getting into a position at \$10.00, when the \$9.50 level indicates a failure of that trade, is much better than getting in the trade, using other techniques than candlesticks, at \$10.70. The failure level, after

entering the trade using a candlestick signal, makes the loss much smaller and less time consuming.

What are you expecting to witness after a buy signal? More buying, of course. That sounds trite, but that is exactly what the buy signals should reveal. Note in the Millennium Pharmaceutical chart, the Bullish Engulfing pattern on January 23, 2002.

Millennium Pharmaceutical



Stochastics oversold and turning up, the Bullish Engulfing signal followed by a gap up open the next day. This is the perfect buy scenario. However, as we see, it closes lower that day. Not disconcerting, it is not unusual to see residue selling from the previous trend still around. The important point is that a Bullish Engulfing signal, in an oversold area, has appeared. The following day a Spinning Top signal, a good sign, the selling of the previous day may have stopped. The following day, a higher open, but then a lower close. What should now be gleaned from the chart? The obvious, there is no extensive buying now for three days after the buy signal. Basic analysis tells us that if a buy signal occurs, then we should see the buyers continuing the trend.

The fourth day after the Bullish Engulfing signal results in a close more than halfway down the Bullish Engulfing candle body. The halfway point of that body represents an important factor. The sellers are now more evident than the buyers that formed the white Bullish Engulfing signal. The sellers are stronger, get out of the trade. Plus it is now four days after the buy signal and no buyers have made their presence. The trend is not up. Move to a better trade.

Learning is not child's play; we cannot learn without pain. Aristotle

The halfway point of a body that creates a signal is the pivotal point. At that level, the existing trend has negated the new trend indicator. This works for both directions, bullish and bearish trend reversals. Does that mean the trade should be ignored? Definitely not! The reason for buying in the first place was due to a buy signal appearing in oversold conditions. The conditions have not changed. It is still oversold. And there were buyers that stepped in once at these levels. If the first entry does not work, keep an eye open for the next buy signal. That will be stronger because the sellers will see that even though they overcame the first buying signal, that another buy signal illustrates new buying is starting again. The sellers now may just get out of the way.

The halfway point is crucial. As seen in the Kana Software chart, the bullish breakout signal indicated new investor sentiment. Trading at the \$3.00 range for a month and a half suddenly has a new dynamic come into the price of the stock. This is a good time to buy. But the next day it backs off. Should that be a worry? Not really. It is not unusual to see some residue selling after a big percentage move. A Harami is formed. At this point in the new trend, the Harami indicates a day or two of consolidation before the next leg up.

The next day, it continues to back off. However, note the candle formation, a Hammer. That alone reveals that the buying has started back in. Secondly, notice where it closes, above the halfway point of the body of the white candle that initially indicated the new sentiment in the stock. Importantly, that day revealed the buying has presented itself again and illustrated the buyers were still slightly in control.

Kana Software Inc.

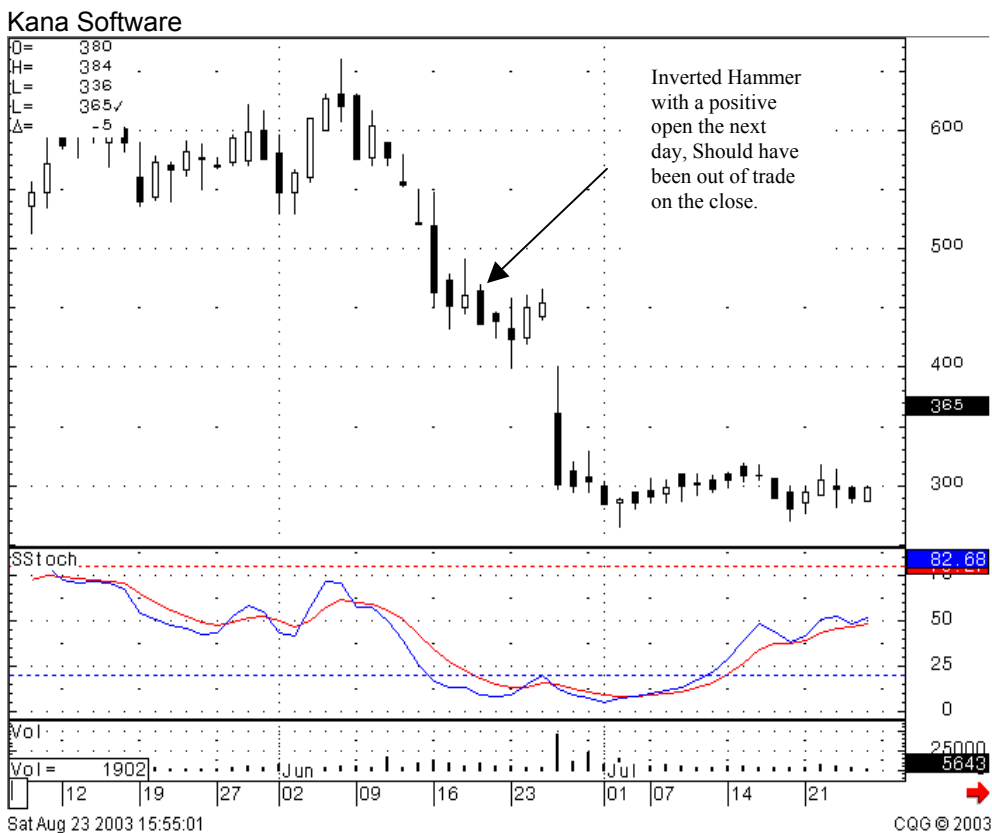


Now the stop loss decision-making process becomes simplified. If the price closes below the halfway point of the large white candle on the third day after the bullish candle, it becomes obvious that the buyers are not around anymore and that the sellers are a stronger force. Close the trade. On the other hand, the overriding facet to this trade was that strong bullish candle day, which should have been evidence a new attitude was being applied to this stock price. That direction will persist until there are signals indicating the direction has been negated. Expect the probabilities to continue the uptrend. As seen in the chart, the third day showed the buyers continuing what the first big bullish candle indicated.

To summarize, use the halfway point of the bullish candle as the level that would demonstrate the buyers were not in control any more. Also, a buy signal should represent the buyers are taking control. After the third day, if no new buying becomes apparent, that should imply that the buyers are not around. Take those funds and move to a higher "probability" trade.

The Inverted Hammer is an excellent buy signal. Remember, the basic rule is if witnessing an Inverted Hammer signal and seeing the price open positive the following day, with stochastics in the oversold area, the probabilities are extremely high this will be a profitable trade. As expected, the trend should continue upwards. With that knowledge, placing a stop becomes very logical. If a positive open indicates the trend should be up and usually immediately, then a close below the open of the previous day, the bottom of the Inverted Hammer's small body, would signify immediately that the signal did not work. Close out immediately or put your sell stop at the previous day's open price.

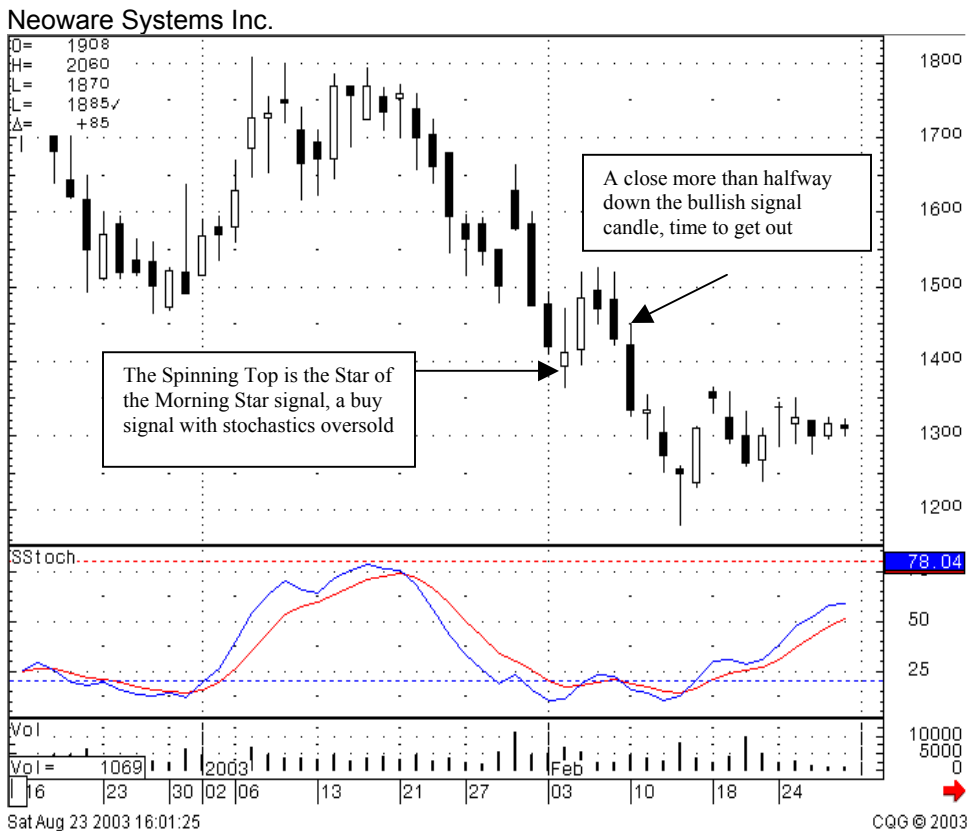
Review the Kana chart again. June 16, 2003 created the perfect set-up for an Inverted Hammer trade. It opened higher that day. This is the exact proper set-up for starting an up-move from the Inverted Hammer signal. But there was no follow-through in the buying.



The price moving back down through the previous day's open, the bottom of the white body of the Inverted Hammer, would be the telling story. The buyers are not present, as hundreds of years of

candlestick charting analysis revealed that they should be. Breaching that point should be the stop loss level.

The same analysis can be seen in the Neoware Systems Inc. chart. The Spinning Top signal, followed by the bullish candle, creates a perfect Morning Star signal at the oversold stochastics area. Two days after the Morning Star signal, a black candle closes more than halfway down the white body of the Morning Star “buy” formation. The sellers are still dominant. Take those funds and move to a higher probability trade.

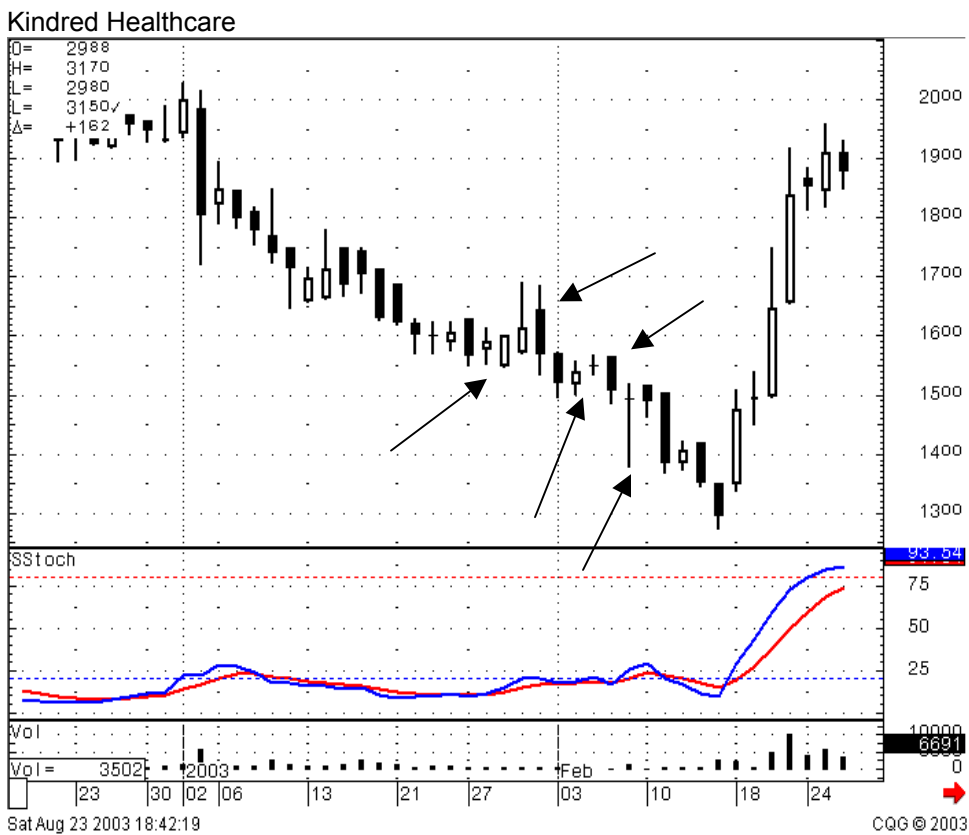


The same rationale can be applied to the Hammer buy signal. To review, seeing a Hammer signal in the oversold stochastics area, with a positive open the next day, indicates the buyers are back in the trading. There is a high probability that the trend has reversed. That given, the trend should be moving up from that point. Rarely will you see a Hammer in the oversold area, with a positive open the next day, fizzle and move back down. That is the reason we still utilize the signal after hundreds of years. The signal discloses a

new investment sentiment has entered the stock price. However, the operative word is “rarely”.

This same scenario should not see a positive open and a close below the body of the Hammer signal. A close below the body, whether a white or black body, negates the concept of the bullish implications of the signal. Close the position.

As seen in the Kindred Healthcare stock price, the buy signals are followed by sell signals. Even what should be considered a strong Doji/Hammer signal, confirmed the next day with a positive open, immediately shows weakness. This now becomes a trade that has no follow-through buying, not a trade you want to be in.

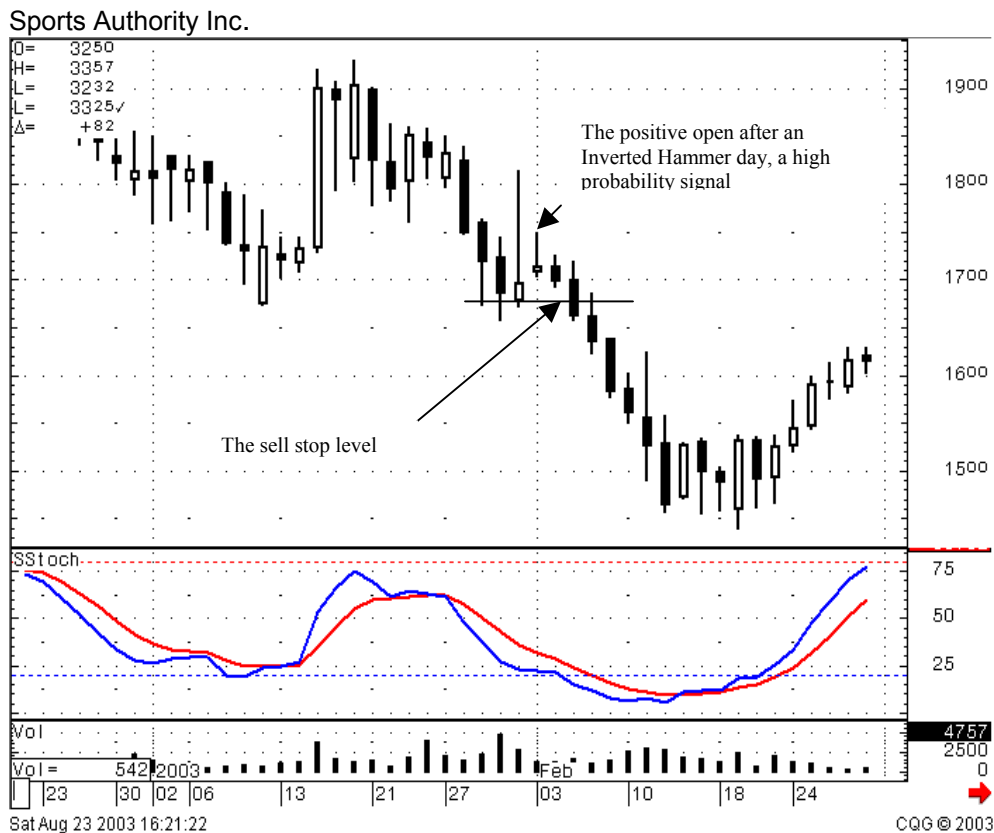


Advanced Micro Devices illustrates a chart pattern that set up with a Doji at the bottom, followed the next day with a positive open, a strong buy indicator. Even the next day after that gapped open to the upside. But it traded lower from that point, creating a black candle. The lower open after that was expected, anticipating that a Doji or Hammer forming that day would stop the selling and continue the uptrend. The close, being lower than the Doji that first indicated the reversal to the upside, now reveals the sellers have overpowered the buyers. Not a position representing buying any more. A bad trade. Close it and move those funds to a strong chart.

Advanced Micro Devices



Illustrated in the Sports Authority Inc. chart is another Inverted Hammer that set up exactly as it should for producing a profitable trade. The stochastics nearing the oversold area and a strong Inverted Hammer should have prepared the candlestick investor for an opportunity the next day. The opportunity would have presented itself by a positive open after the Inverted Hammer signal. Buying on the open the next day was the right execution. The little selling day after that did not change the direction of the trend. However, the fact the sellers could push the price back down through the body of the Inverted Hammer which initiated the buy gave a clear indication the sellers had overpowered the buyers.



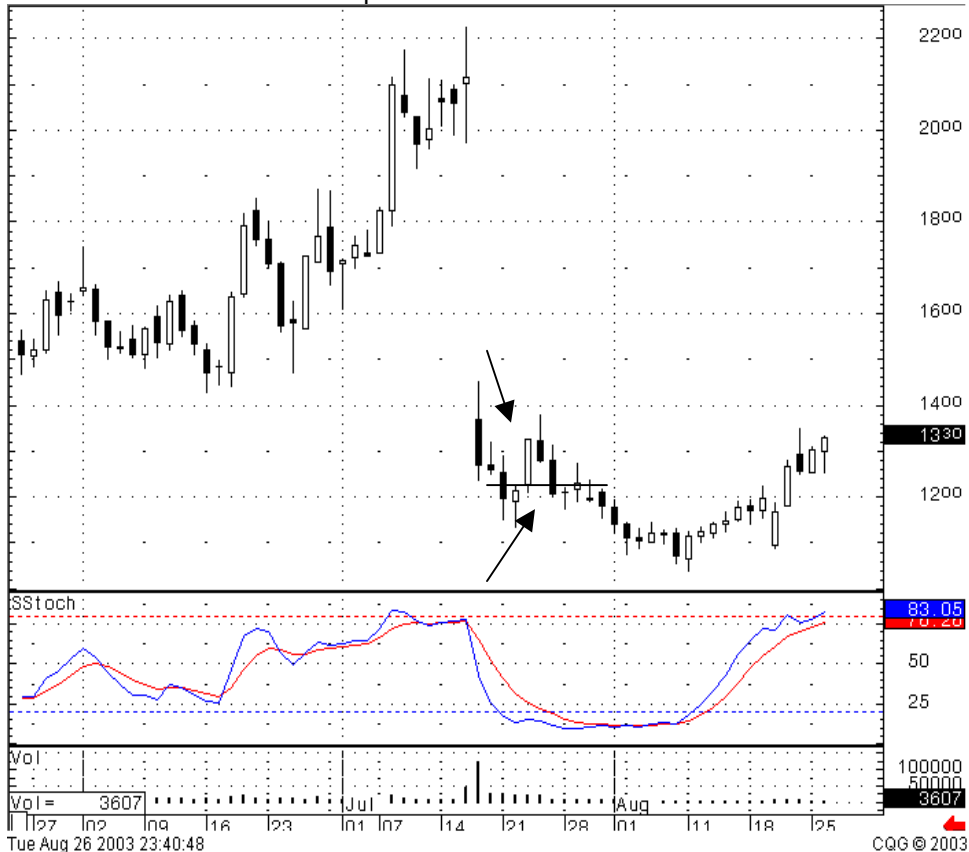
As illustrated in the chart examples, the basis for proper stop loss levels using candlestick analysis, boils down to one simple observation. What level demonstrates more sellers than buyers? That revelation can occur the next day or after three days or so. If no new buying comes into the stock, this does not reinforce the buy signal. Take the funds and move to a chart that shows buyers.

Does that mean the trade is dead? No. Watch it. It has already been evaluated as being oversold. The buyers may still be ready to buy in that price level. The next buy signal will reveal the buyers are back again. This same message will be noticed by the sellers. They

may start backing away from their selling or start covering their shorts.

Examine the chart of Boston Communications Group in mid-July, 2003. After the big drop, an excellent candlestick buy signal, a Hammer with a bullish confirmation candle, presented itself. Stochastics are at the bottom, trying to turn up.

Boston Communications Group



As the price came back down through the halfway point of the large bullish candle, that should have been the alert the buyers were not around any more. However, the close is the important factor. It could have done a Hammer formation the second day after the large white candle, closing above the halfway point. Upon seeing that it was closing near the bottom of the white candle would have been the clue that this trade did not have the buyers' support any more.

The strategy for setting stops when utilizing the signals becomes a function of how the buy signal was formed. Note in the TOO Inc. chart of July 29, 2003 how the Doji Hammers would have been the signal to get in on a positive open the following day. The gap up

that day should have been producing buy orders on the open. As seen, it finished up nicely that day. A low risk stop loss point becomes the bottom of that bullish candle. That is where the buyers first indicate they are taking control.

Placing a sell stop at one tick below the open of that candle now protects the majority of your trade funds. The thinking being that after the price closed up on the bullish candle confirmation day, any price move back down below the open of the bullish candle would be evidence that the sellers were still in control. In this case, that occurred four days later. The result of this trade would be a breakeven and the tie up of funds for five days.

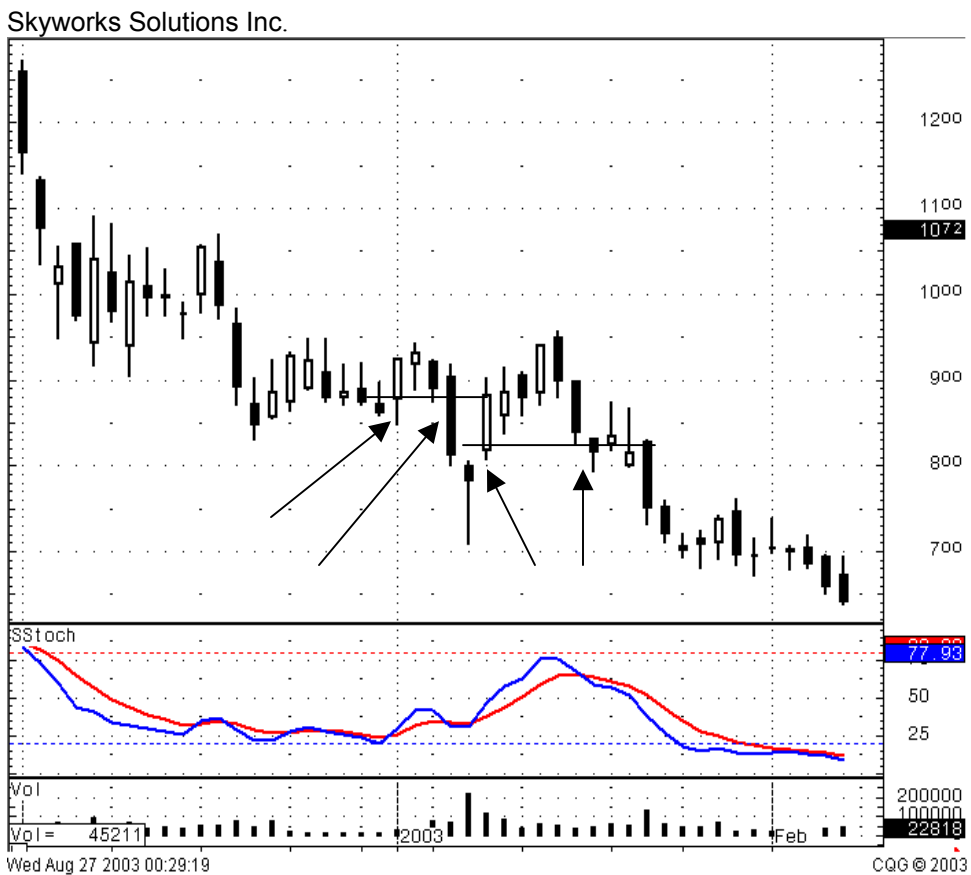
Keep in mind, not all the trades are going to work as expected. If the bad trades can be limited to break even, while the good trades produce nice profits, that is much better than offsetting gains with losses.



Look at TOO Inc during the December, 2002 decline. A couple of times, placing a stop loss at the bottom of the confirming candle would have stopped the trade out. As you will see mentioned elsewhere in candlestick analysis, the longer a trend persists, the

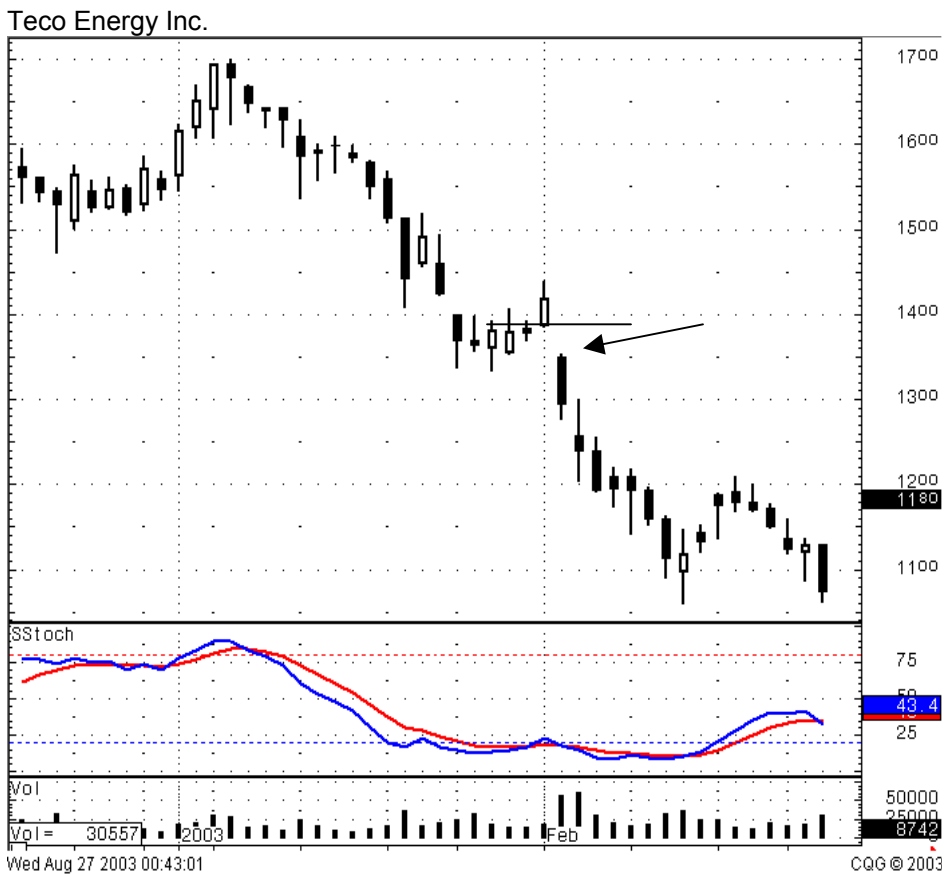
more convincing the reversal signal needs to be. In this situation, it becomes evident that the trend is solidly downward. Wait for a signal that has severe strength, a candlestick signal followed by a gap up for example, or a Kicker signal, to demonstrate the buyers have reversed the trend. Take the funds elsewhere, a sector that may be showing more strength.

In December 2002 and January 2003, Skyworks Solutions Inc. shows a downtrend . It presents a few good candlestick buy signals. However, each case becomes clear the buyers are not strong.



Placing the stops at the open of the confirming candles acts as the logical point illustrating the sellers are still in control.

Having the knowledge of how signals are formed creates an immense advantage for the candlestick investor. Teco Energy Inc., on February 2, 2003 opens in the opposite direction of what is expected. The moment it opened below the open of the confirming bullish candle would have been the signal to get out of the trade. Upon seeing that after it opened, there was no immediate buying, the start of a white candle, the trade should have been closed.



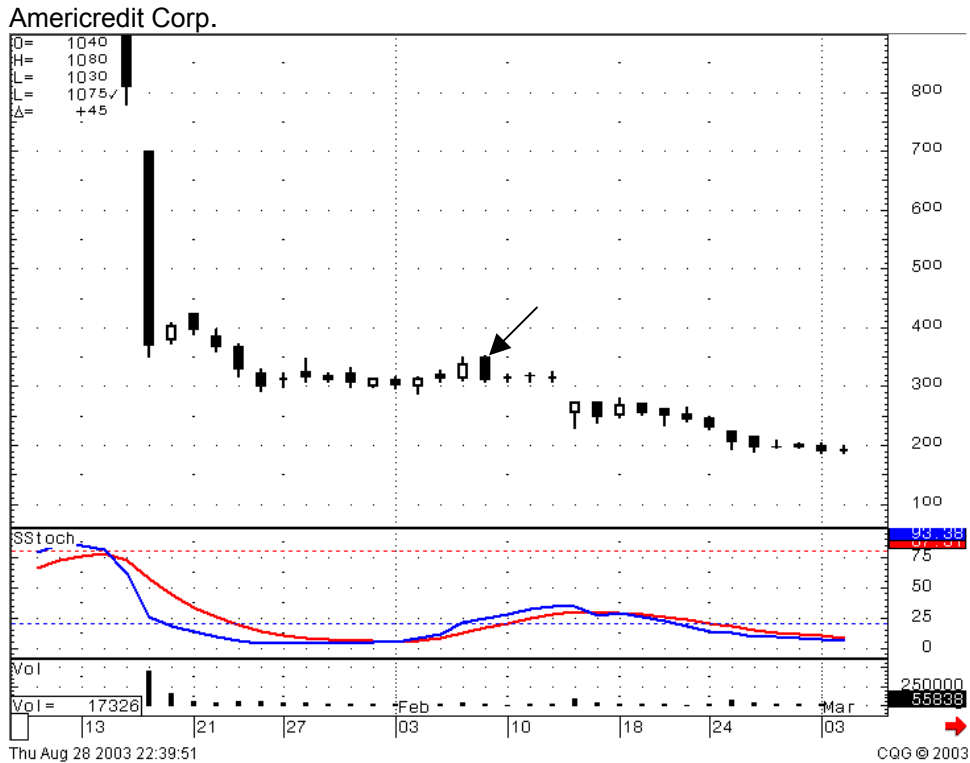
An open to the downside, well below the open of the buy confirmation candle, has the characteristics of a Kicker signal well before the end of the day plays out. It is not doing what the buy signal indicated. Get out and find a better chart signal.

Nanometrics Inc. is another illustration of the signals being negated. The strong Morning Star signal, with the Doji/Hammer being the indecision day, reverses the trend. But two days later, it is apparent that the sellers are dominant. A few days later, another Doji followed by a bullish confirmation day. This is another excellent buy set up, only to see no follow-through from the buyers. Unfortunately, it took another five trading days to confirm the buyers were absent, and the selling gained control. It was not until the gap up that this trade got steam behind it.



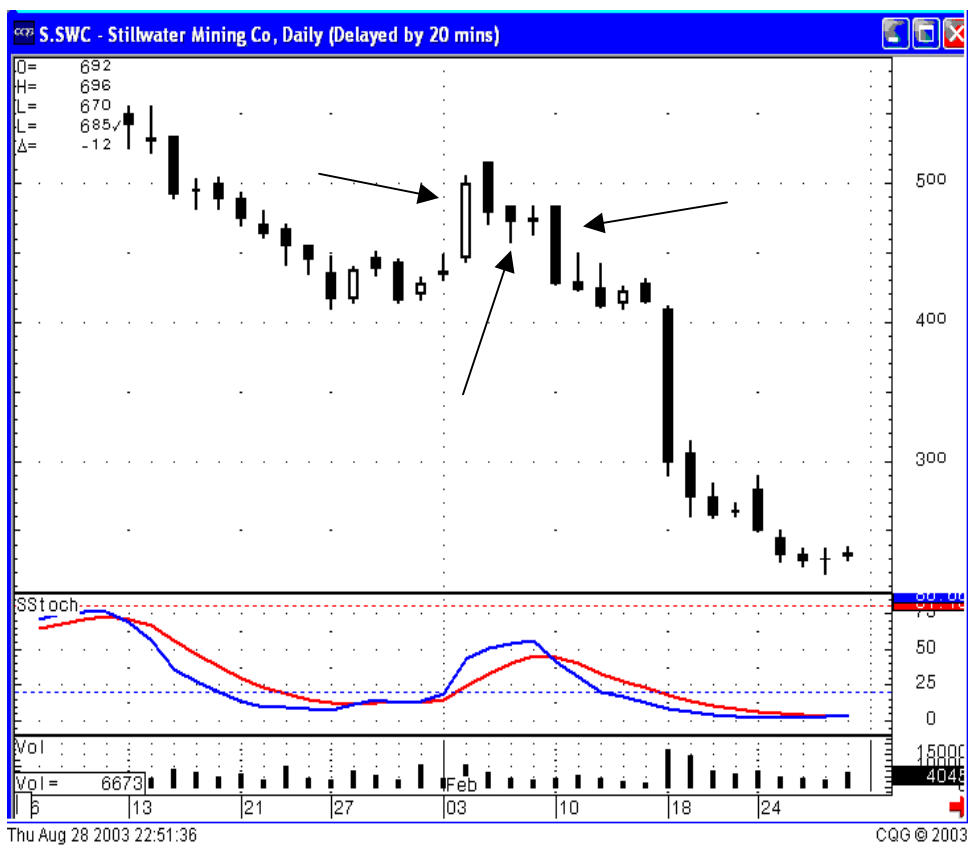
Aggravating as it was, sell stops at the logical spots did not create any major losses other than the time spent. But that is part of the probabilities.

As seen in the AmeriCredit Corp. chart, the trend was just getting established, a Hammer signal, a Doji, and then bullish confirmation. The positive open the next day with a close at or below the open of the previous day's candle indicates that the sellers were still present. Get out. Why take the risk? The worse case will be that the next day shows another buy signal; you can get back in. There is nothing wrong with closing a position when it looks bad, buying it back when the signals look good.



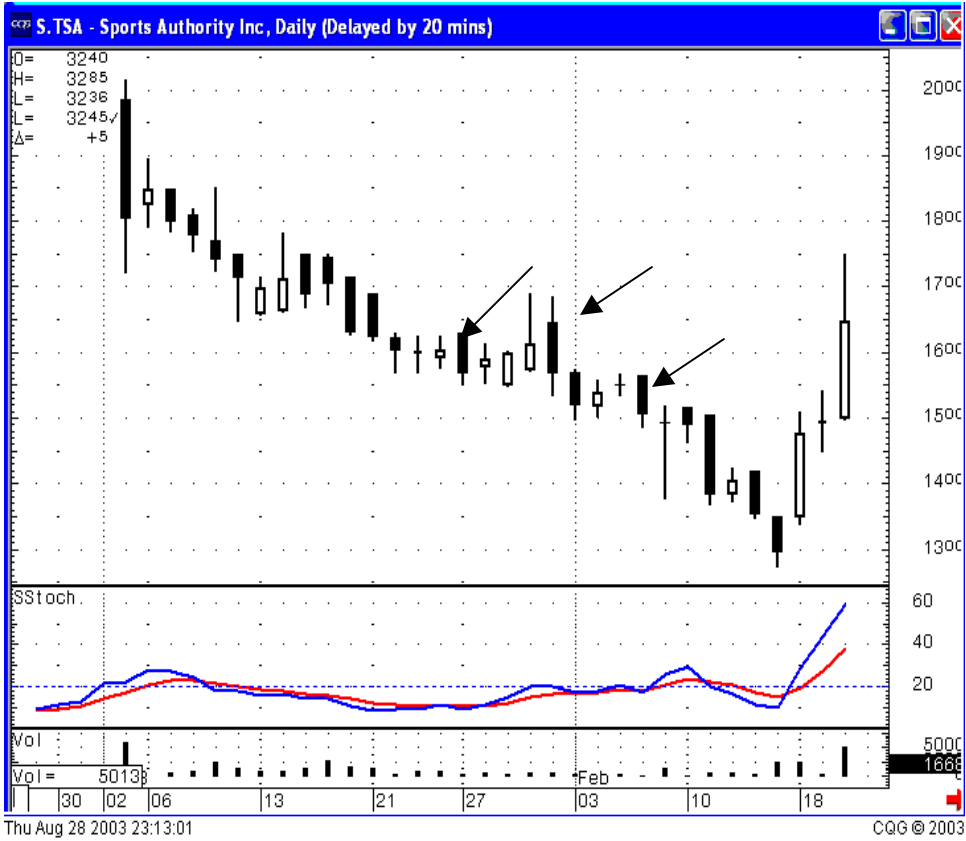
The Stillwater Mining Co. chart in February 2003, reveals a trend starting to the upside. The small double bottom started the uptrend with a Harami, then a Doji, followed by the bullish large candle. However, as can be seen, the Dark Cloud type pattern showed the sellers back in the game. This is not unusual after an extensive downtrend. But what is needed is evidence of the buyers counteracting the selling the next day.

The chart illustrates a Hammer type formation the day after the Dark Cloud. Still not a reason to think the reversal signal is not going to work. The next day a Doji. By this time however, buying should be around. It would be prudent to put a sell stop at one cent below the low of the Doji day. The reasoning being that the buying should be present by the third and fourth day after the buy signal. If the sellers were able to push prices below the low of the Doji day, this would make clear that buying was not showing up.

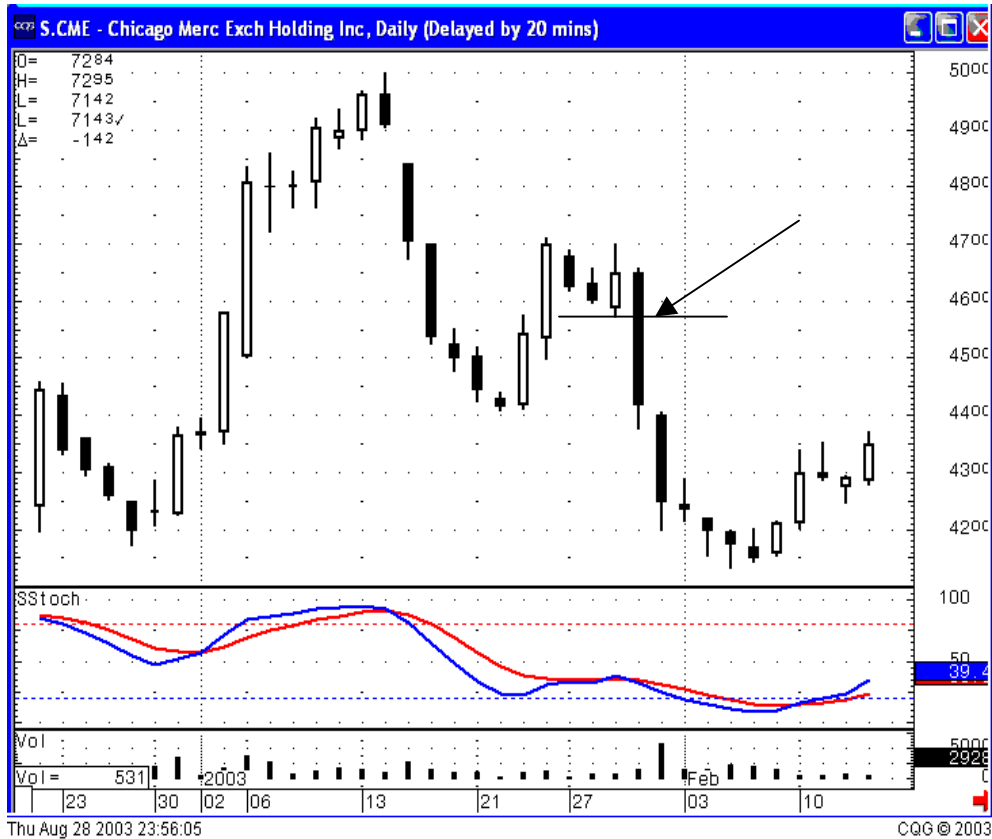


Stop losses placed at the bottom of the trading range in the Sports Authority Inc. chart would have stopped out numerous false starts. After two or three of these stop-outs, it would be prudent to move

money to another position until a very strong signal reveals a much stronger reversal situation.

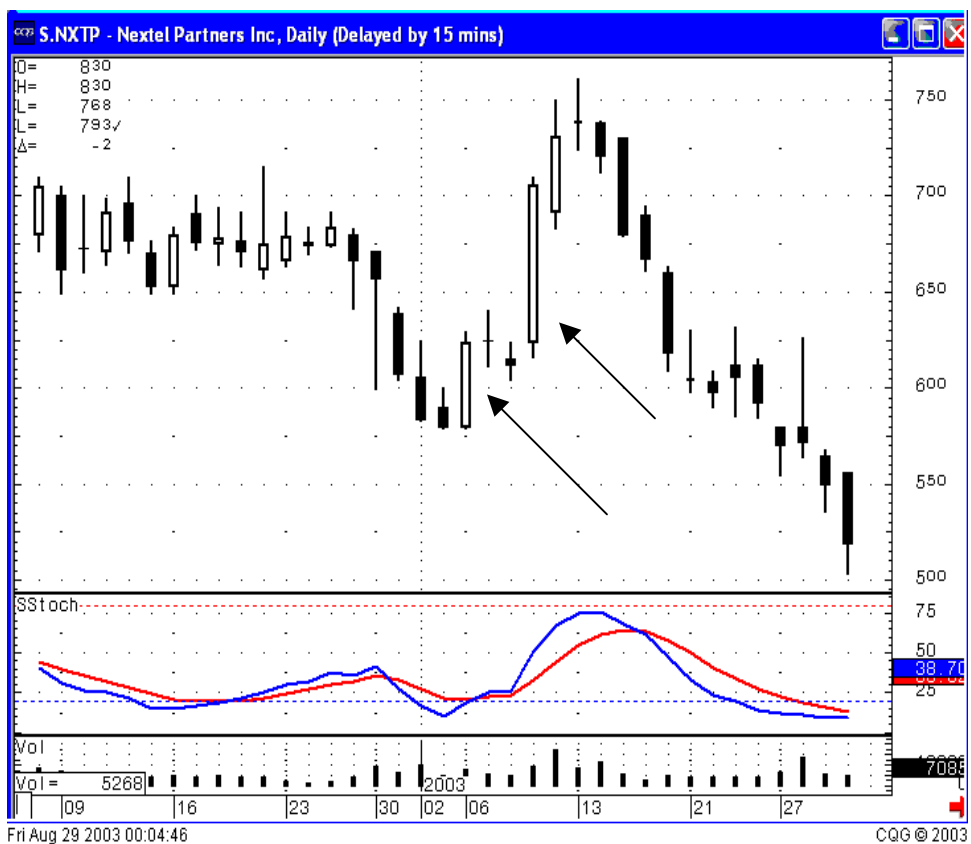


The Chicago Mercantile Exchange Holding Inc. chart is an example of using the halfway point of the last large bullish candle as a stop point. Especially after the signal has not confirmed buying by the third day, any new selling now has to be a sign that the buyers are not stepping in.

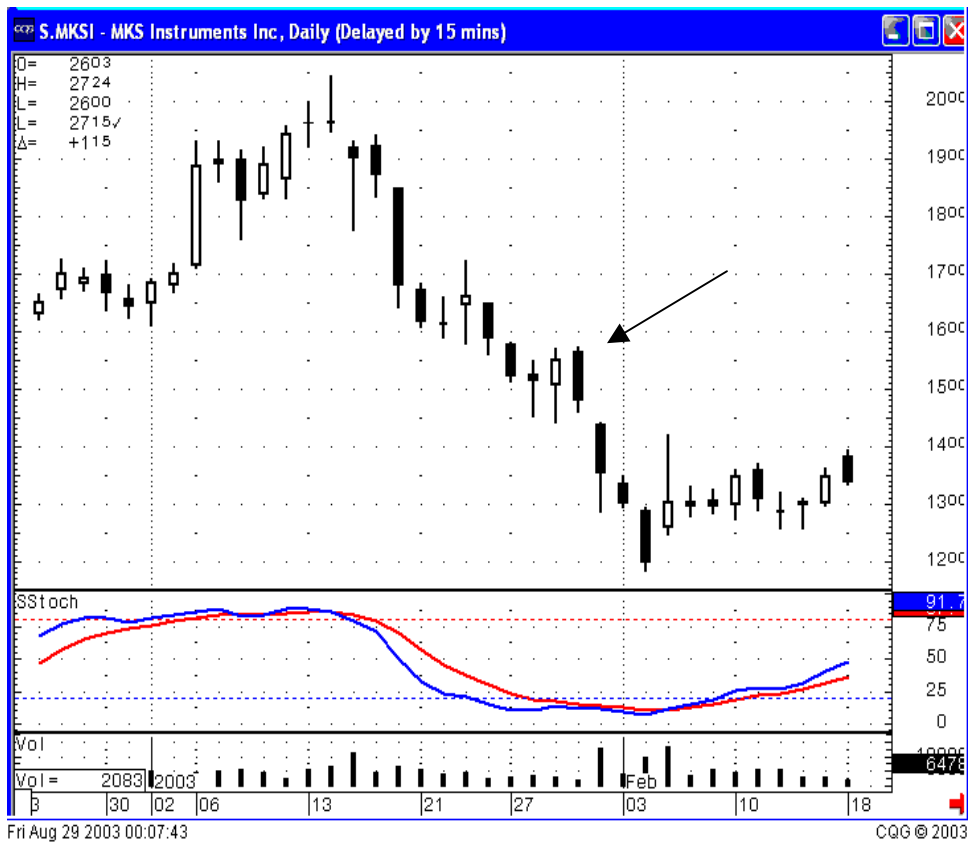


What is expected after a strong buy signal is a day or two of the residue selling from the previous downtrend, where prices consolidate. After that, the sellers should start to recognize the buyers are staying in and not allowing prices to continue the downtrend. Then the sellers start stepping out of the way.

As seen in the Nextel Partners Group chart, the Bullish Engulfing pattern started the reversal. Two indecision days followed - the bulls and the bears butting heads. On the third day, the buyers showed strength. The sellers realized the downtrend is over and stand aside.

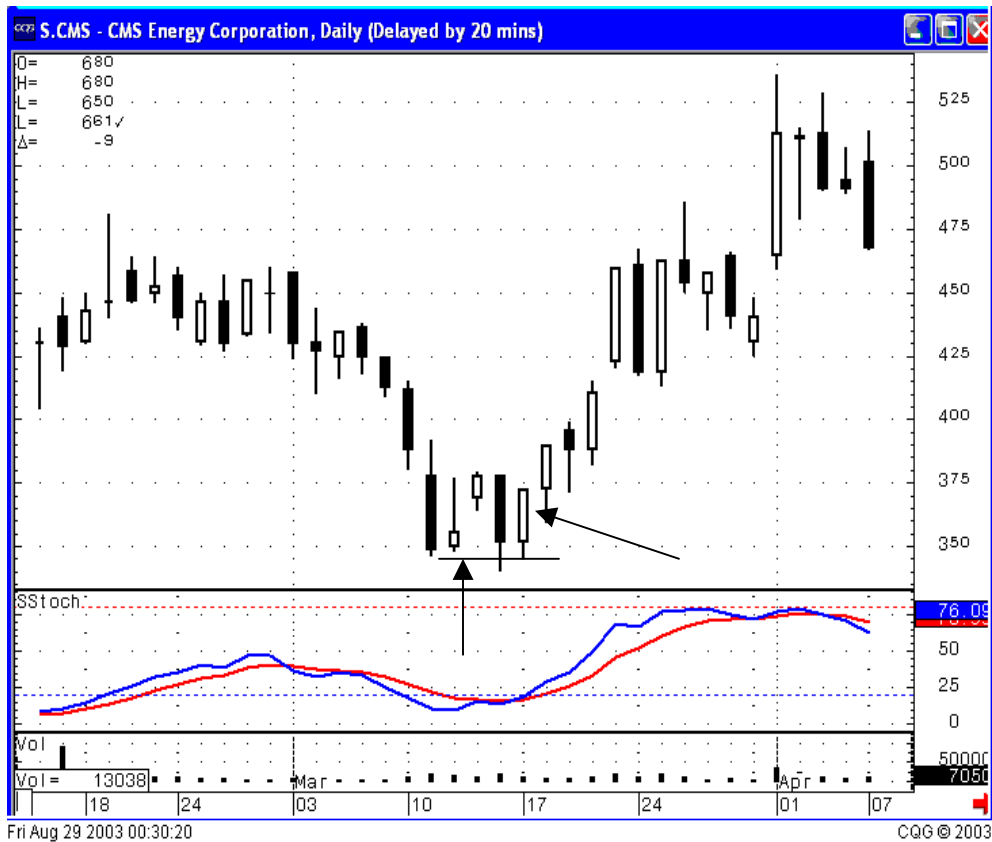


The MKS Instruments Inc. chart illustrates a very simple stop loss strategy. The stochastics are oversold. A Doji, followed by a Hammer type formation, then a positive open the next day. This has the makings of a good solid trade. But on the close, seeing that the sellers have pushed the price back down through the open of the previous day would have been an indication that the buying is not the dominant force anymore. Get out. Could it turn around and rally the next day? Sure, but there is nothing that says that buying it on another buy signal is wrong. Sell when it looks like it is time to sell, buy when it is time to buy.

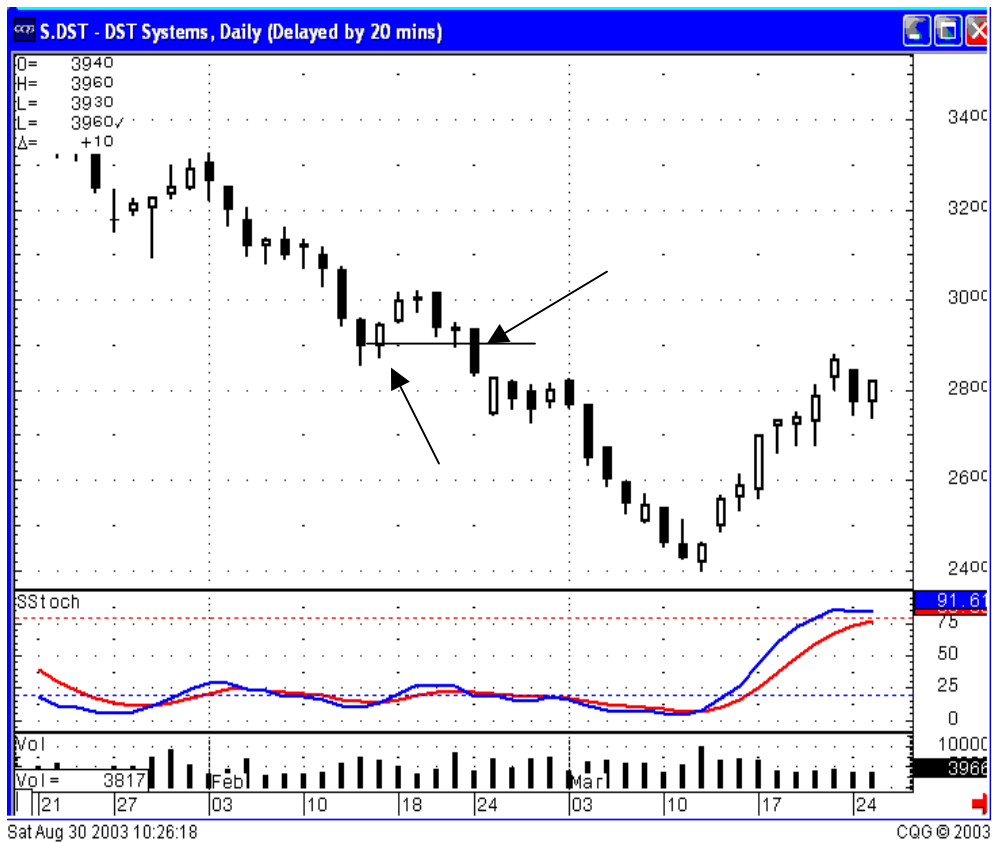


As a case in point, CMS Energy Corporation, in March of 2003, had an Inverted Hammer signal. The gap up open the next day would have been an immediate buy. However, the price moving all the way back down through the open price of the Inverted Hammer signal would have been a clear indication that the sellers were still around in force. Yet the following day revealed a Bullish Harami signal. Keep in mind, the reason for buying the first time was due to being in the oversold area, stochastics, and witnessing a candlestick buy signal. The conditions are still the same, be ready to buy again on a confirmed Harami signal.

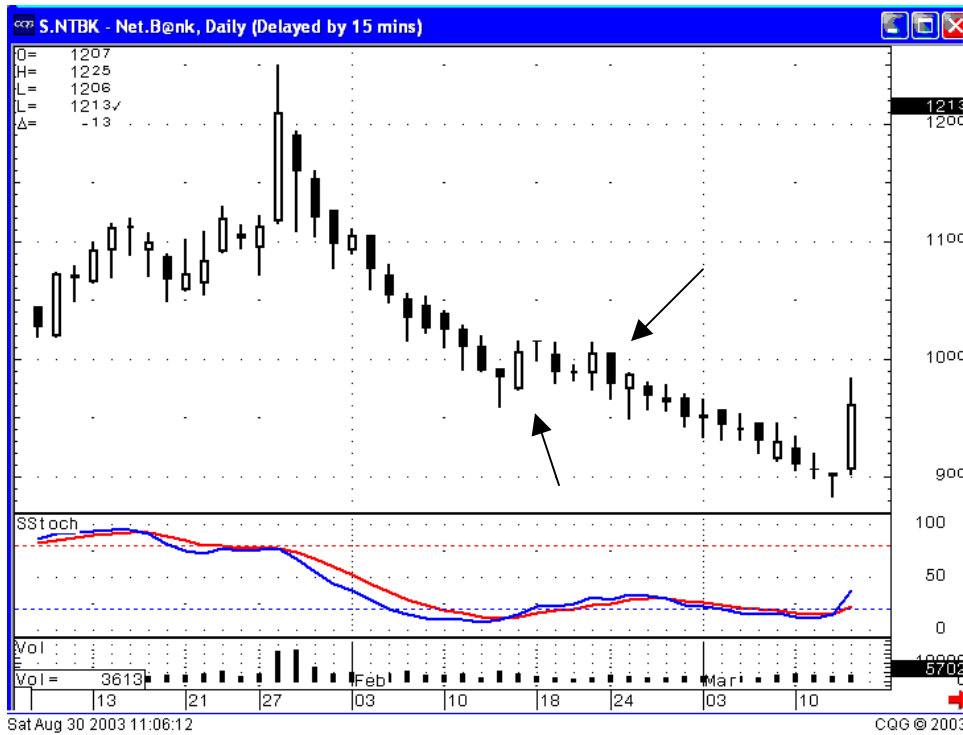
Getting out on a stop at the opening price of the Inverted Hammer, the initial signal showing that the buyers might be coming into the stock, is the correct thing to do. Even though the stochastics are in the oversold area, the stochastics could stay in the oversold area for the next two months if the downtrend persists. Why risk it? There is no way of telling if this stock was going to continue down after negating the buy signal.



In mid-February 2003, DST Systems demonstrated another opportunity to buy at the bottom, only to see prices breach the buying signal. The Bullish Harami was confirmed with follow-through buying the next day. The higher open the following day would have been positive, but that day sold off, forming an Evening Star type formation. If that didn't alert to watch for an exit, then prices falling through the open of the Harami day would have been a clear sign that the bears were still in control.

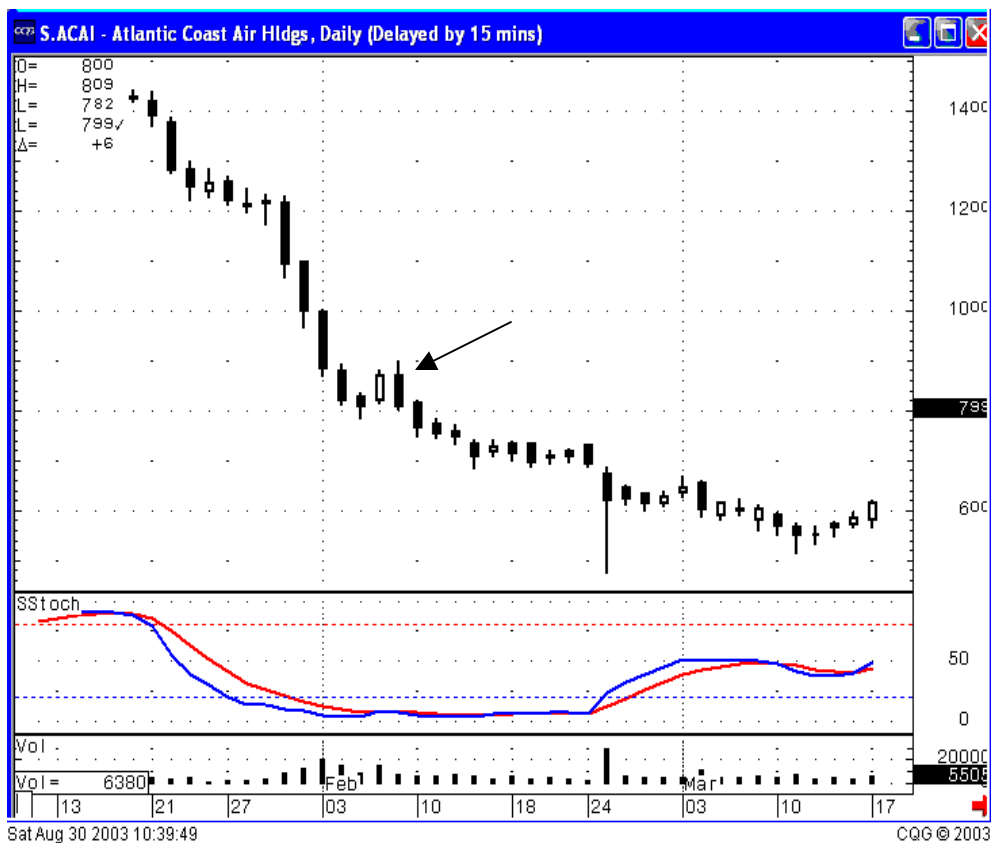


The very same illustration can be found in the NetBank, Inc. in February 2003. Note the buy signal, a Bullish Engulfing pattern followed by more buying. Then the next four trading days showed the buyers were not around any more. Observe the obvious. Get out and find the market sectors that are showing buying signals.

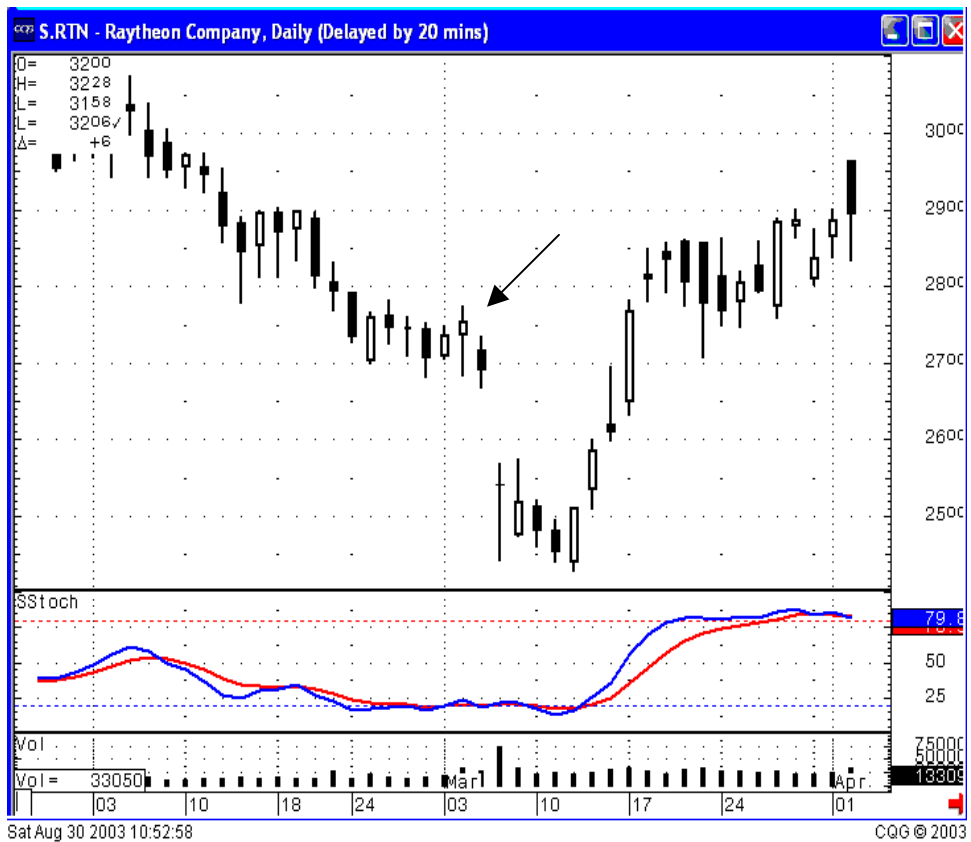


What should a perfect buy signal illustrate? That the buyers have decided to step in. Simply stated, there should be signs of continued buying after the buy signal appears.

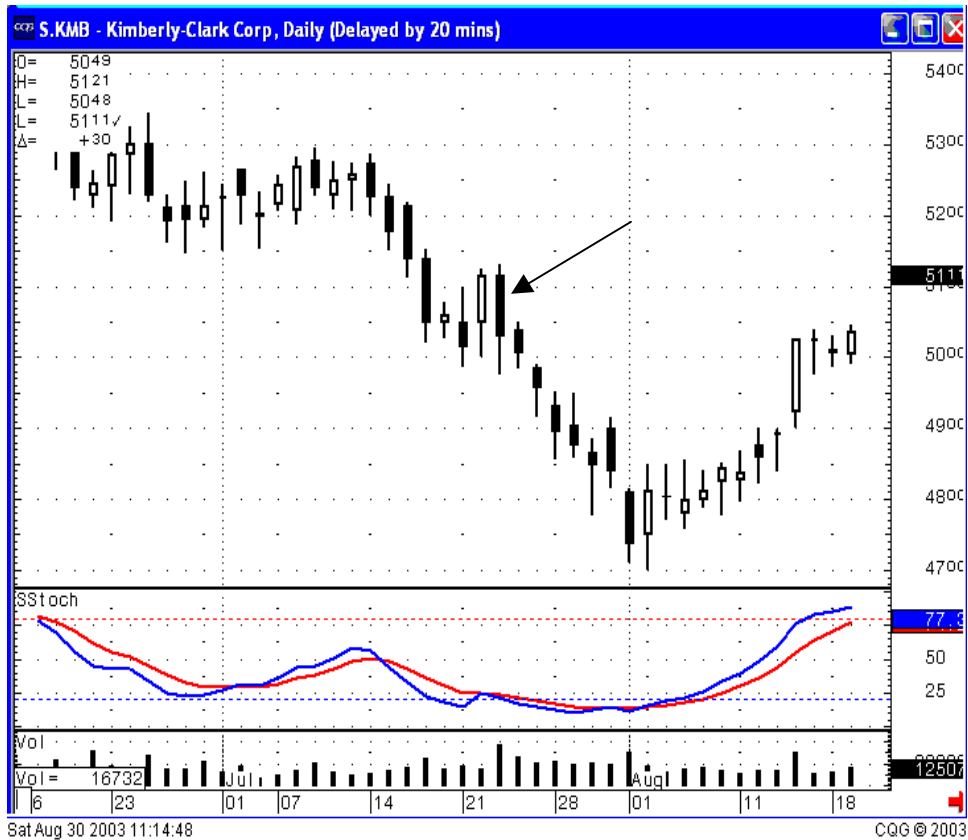
Note the Atlantic Coast Air Holdings stock price during the market decline in February of 2003. A perfect Morning Star signal formed. However the next day, after opening higher, it eventually closed below the open of the confirmation candle of the Morning Star signal. This was an obvious sign the buyers were not still in the game. Take the small quick loss and find a better place for your funds.



The Raytheon chart of March 2003 also reveals the lack of buyers. The Harami of March 1st was confirmed with buying the next day. However, the following day was a Kicker type day to the downside, closing below the bottom of the Harami signal. Visually, this immediately tells you that the buyers disappeared. Get out, there are better places to put your money. This chart now negated the high probability aspects that the buy signals should be portraying.



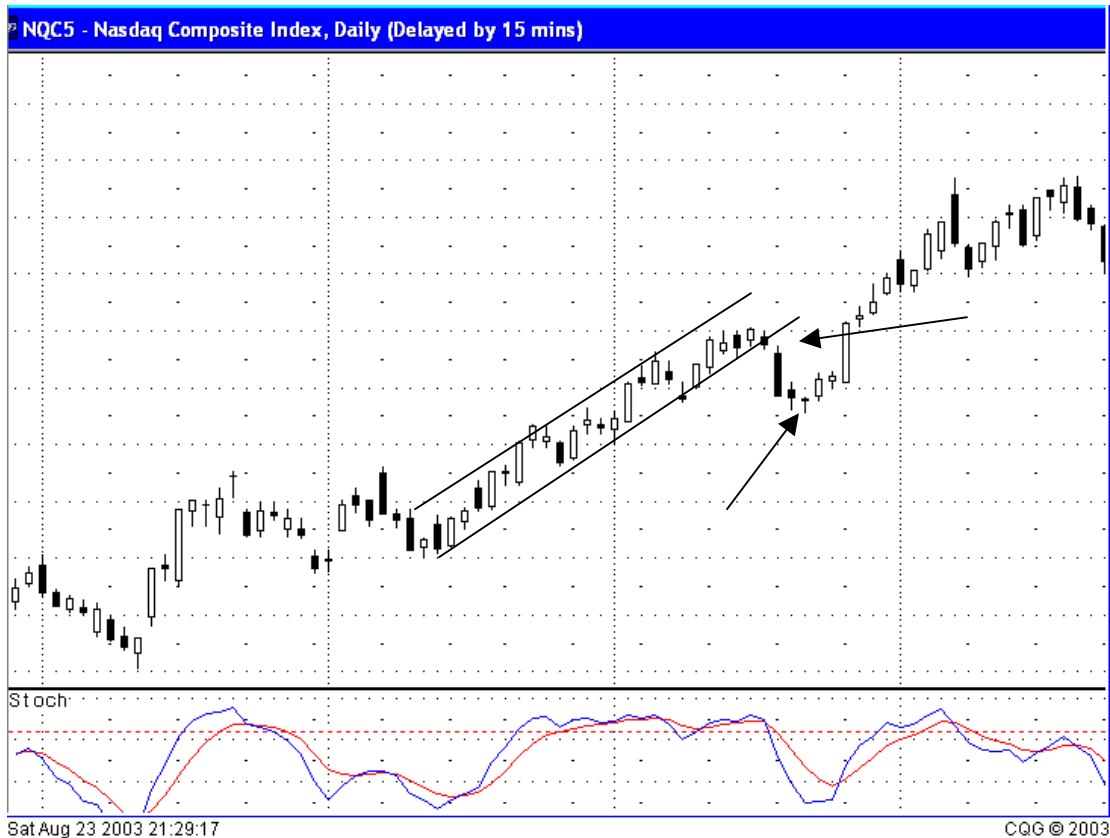
Kimberly Clark Corp. in July of 2003 started a strong bullish up signal, but revealed that the sellers were still in control.



Stop Losses During the Uptrend

The previous examples were illustrating stop loss reasoning in the establishment of a trade. The next strategy to consider is what should be done when the uptrend has started. This again incorporates common sense planning. Back to the basics, what does the candlestick buy signal represent? It is the change of investor sentiment, the "trend" should be upwards. Does a trend go straight up? As much as we would like it to, there will be zigs and zags as the price moves up. The only reason for putting a stop loss in during a good trending situation is to protect from that rare catastrophic announcement. Otherwise a stop loss too close to the price oscillations could stop you out at a low point of an uptrending trade.

Once the trend starts, candlestick analysis can be applied. Not solely a stop loss scenario. Again, using the same thinking process for evaluating whether a trade is still working or not, a price level can be predetermined as to what would indicate that the sellers have taken control. During an uptrend, more latitude can be given. Further, the longer the uptrend continues, the more definite a sell signal needs to be to reveal the trend is terminated. Note in the Nasdaq chart below:

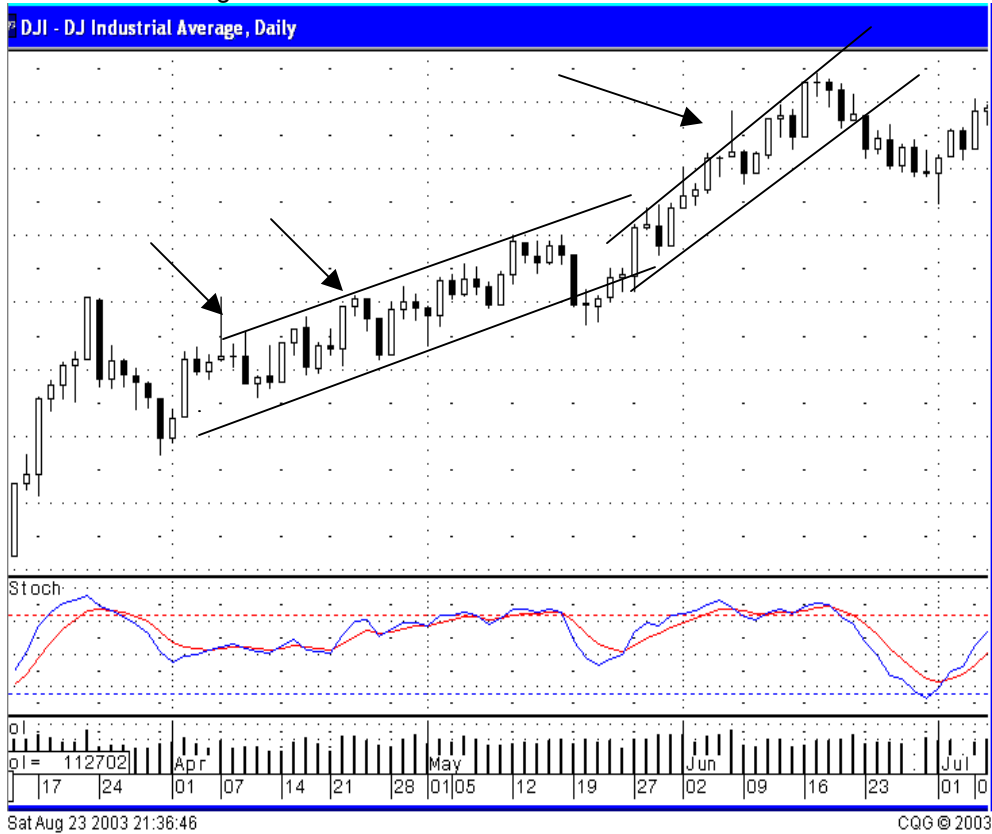


Since March 10, 2003, the Nasdaq chart has shown some steady uptrends. These trends would continue for a month and a half at a time. Upon closer observation, it will be seen that there were definite sell signals in those periods. Does that diminish the validity of the signals? No, the signals need to be heeded. However, they need to be evaluated based upon the environment in which they are being viewed.

As seen in the DOW chart, the signals divulge selling at the top of the trend channel. That provides valuable information. For the short-term trader, it makes evident that the upside channel is not going to be broken out of. Individual stock charts that may have already produced a strong run up, now showing topy signals, can

be liquidated. Why own a stock that appears to have great probabilities of going back down?

Dow Jones Averages



Will the stocks with toppy chart patterns be finished as far as further upside? That can also be determined by the benefit of seeing what the next down move will do. Experience reveals that for the past few weeks, the down moves have been supported by the bottom channel trendline.

If not as aggressive a trader, the longer-term position holder can sit through a pullback, using the bottom of the trend channel as a guide. Thus alleviating the need for bopping in and out of a trade.

Note the third week in May, the bottom of the trend channel is breached, this occurring about three months after the start of the uptrend. Not a bullish sign. Take some profits. But keep in the back of your mind that a strong reversal signal is required to change the trend. The longer the trend, the more powerful the reversal has to be demonstrated. That is a function of the investment psychology in the markets. The longer a trend occurs, the more convincing it takes to show investors it is over. The optimistic (or pessimistic)

attitudes that are being ingrained during the trend are hard to dispel when the direction of the trend changes.

Further analysis of the Nasdaq chart shows the selling that broke through the bottom of the trend immediately stopped with the appearance of a couple of small Hammers, followed by continued buying. Other technical analysts would have evaluated this as consolidation in the beginning of a downtrend. The candlestick analyst has the benefit of visual signals that buying is occurring, stochastics at the bottom, curling up. Instead of a full-fledged selling program, the candlestick investor would be watching to see if continued strength was coming back into the market.

Would a sell stop have been prudent when the trading breached the lower trend channel? The “probabilities” indicated the sellers were taking control. However, the individual stock positions should have been evaluated as to what their chart signals indicated. This would have eliminated a mass selling spree.

Seeing the Hammers after the bottom of the trend channel was breached, gave a foretelling of the downtrend not being a powerful move. If stopped out, it was probably done in positions with good profits from the preceding uptrend. That does not preclude an investor to get right back into the same positions after they have consolidated and started moving back up. Better yet, those funds could be moved to new sectors/positions that were coming out of oversold conditions, with much greater upside potential and lower downside risk.

Stop Losses/ Exit Strategies at the Top

The other major concern for most investors is where does one start trying to protect profits. The easy answer is when you start witnessing sell signals. That should be the ultimate method. But that does not work for all investors. If the trades can not be watched at the beginning or the end of each day, a problem that most working investors face, then a stop loss strategy can be implemented that protects most of the profits. The phrase “most of the profits” has a significance.

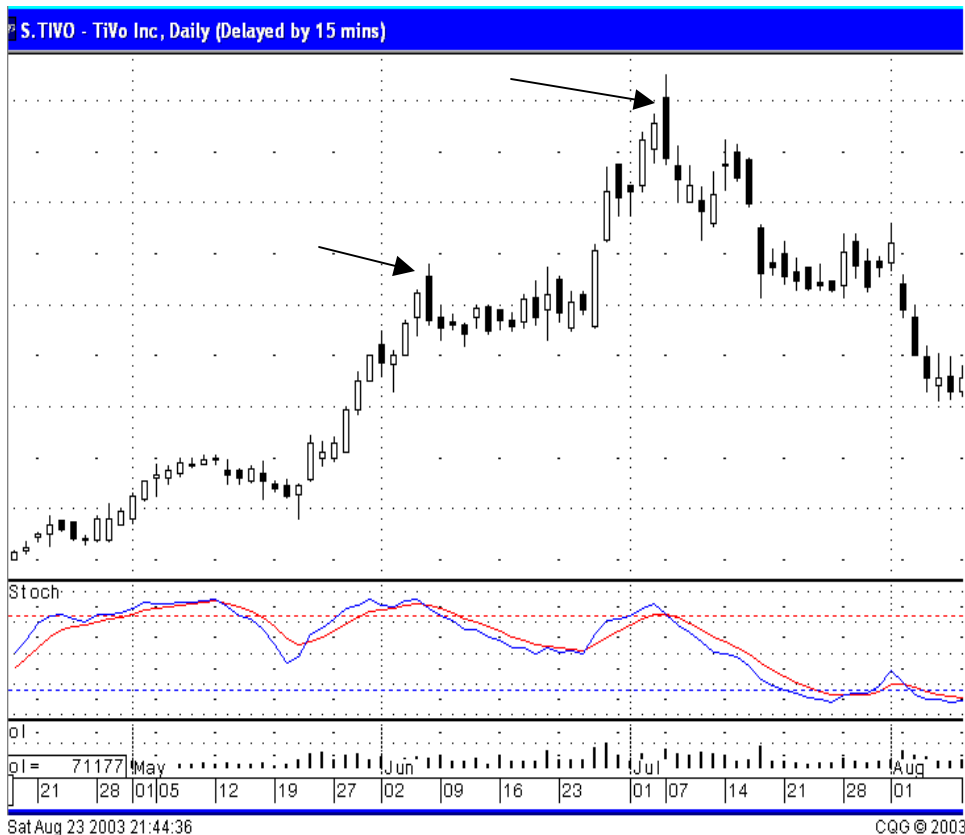
Our egos have a severe deterrence for allowing us to make money. The majority of investors feel a trend needs to be bought at the very bottom and sold at the very top. To take profits before a trend peaks out or after the high has been seen is a blow to the ego.

“Why didn’t I get out when it was a point and a half higher?” The question always asked with a tinge of anguish in the voice. A defeat to the ego if that trade was not maximized to the hilt. The point to maximizing profits is not to maximize the profits from a trade, it is to maximize the profits in the account. Two completely different objectives.

The depiction of human emotions is portrayed in the price action of the trend. To reiterate, the average investor panic sells at the bottom and is an exuberant buyer at the top. Knowing this (and probably having experience with those flaws in our own previous investing habits) the candlestick investor can be prepped for when a sell signal should be occurring.

What do we see at the top of the trend? Exuberant buying, buying that is usually shown as a larger white-bodied candle after an extensive uptrend. Or a gap up at the top. Being armed with that knowledge permits the candlestick investor to extract a high amount of profit from a trade that is about to terminate.

As seen in the Tivo chart, the gap up when the stochastics were peaking out indicated the exuberance had culminated. The gap up was the signal. What is the best way to exit from this trade? First, the gap at the top is the sign to be ready to sell. A couple of simple applications made getting out an easy mechanical procedure. When the price gaps open at the overbought level, only a few things can occur. The price can go up from that point, it can stay the same, or it can go down. Undoubtedly these are not earth moving revelations. But fortunately dissecting what each will do, as far as a candlestick signal, produces an easy to execute exit strategy. This is where placing stops becomes an excellent mechanical process.



If the price gaps up, the first action should be to place a sell stop at the previous day's close. If the price gaps up and immediately shows strength, moves higher, place a sell stop at the opening price. What is the rationale behind these moves?

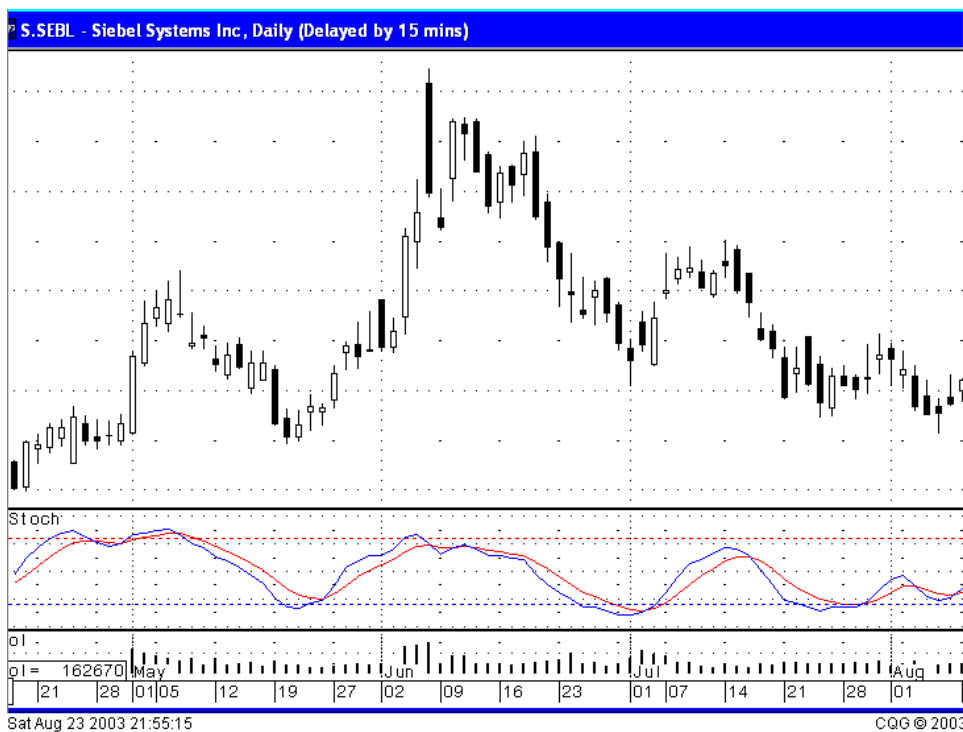
Consider what signals will be created after a gap up move. If the price gaps up and continues to move higher, placing a stop at the previous day's close, and then to that day's open hasn't hurt you at all. No stop out, continue to make profits.

If the price opens higher and continues to move higher, knowing that a gap up in the overbought area is a sign that the top is here, then placing a stop at the open is very advantageous. If the price moves up, then back down through the open price, what does that do for forming a candlestick signal?

Closing at or below the open now produces a Shooting Star signal or a Doji/Shooting Star, both sell signals. Even a close slightly above that day's open will produce a Shooting Star. A close back at the previous day's close will produce a Meeting Line signal. A close halfway down the previous white body produces a Dark Cloud signal. A close below the previous day's open produces a Bearish Engulfing pattern. All sell signals.

The only bullish scenario that can occur after the price was up and came back down through the open would be to turn around and have the price move back up substantially. Substantially, being far enough up to not create a Hanging Man signal. A gap up at the top, whether it opens and continues higher or it opens and immediately retraces, has many more sell signal opportunities versus the continuation of the uptrend. Back to a basic premise, maximize profits for the account. A gap up at the top is now a low probability long situation. Be ready to move the funds elsewhere.

Siebel Software is another example of the gap up at the top. A sell stop at the open would have provided a very profitable execution. Not all trades will give you time to place the order at the open price if upon opening, it immediately moves up and quickly falls back. The next safe stop is at the last white candle close, which in this case did not get executed until the following day.



Cree Inc's chart illustrates another example of how the open or the previous closing price becomes the best strategy point for placing a sell stop. This chart reveals the warning signal four days earlier, a Shooting Star. Again, it would have taken a huge up move after pulling back through those levels to eliminate the possibilities of a sell signal forming. The stochastics in the overbought range and a

gap up at the top of the trend; get out. Why try to buck the odds. Take the profits and go to a low risk, high probability trade.



Candlestick Stop Loss Reasoning

Limiting your losses using the candlestick method has immense advantages. Understanding the signals, knowing why it is time to enter a trade makes it easy to understand when to be out of a trade. The use of arbitrary percent movements do not pertain to what the price movement is expected to do.

The basic premise being that the majority of trades will be profitable utilizing candlestick analysis. That still means some trades are not going to work. Having the prepared mind-set for addressing the losing trades keeps funds moving to the best probabilities. Most investment programs teach very little about getting out of losing trades. Cut the losses short, that is sage advice. Yet very little is taught on how to recognize the losing trade. Furthermore, even less is taught in how to effectively close out the losing trades.

Learning when a trade is not working has two benefits. Limiting the loss is the obvious benefit. But additionally, getting those funds out of a nonproductive trade and placing them immediately back into a positive potential trade greatly enhances the ability for those funds to create gains for the portfolio.

How often do we hear investors say, when their stock position is going down, "That's alright, I'm in this position for the long term, it will come back." Poppycock!!! That is the answer of somebody that does not have a strategy for coming out of a position.

Know why you are going into a position. Know why you want to be back out. That gives you control of your portfolio management. The whims of the markets or price moves are not throwing you around. The constant cultivation of placing investment funds where they should be, or closing positions that are not doing what the signals indicated, will greatly enhance the profit potential of a portfolio. Remember, this is not rocket science, this is simple common sense evaluation of what the buyers and sellers are doing.

Keep the stop loss process simple. Where does it appear that the buying is not present any more? That can be two percent lower. That can be ten percent lower. Each trade will have a different scenario.

The usual points of exit, at newly established trades and prices that have moved to the overbought area, are at the bottom of the previous white body. This immediately indicates that the selling sentiment has taken over with force.

Another rule of thumb, as illustrated in the above examples, is expecting to see buying within the next two or three days after the buy signal. If there does not appear to be any buying interest after the third day, close the position and move on. By that time, the next buy signal will be more relevant.

Studying charts will vastly improve your ability to recognize where and when a stop loss should be placed on a trade. Study charts with extensive downtrends. Often a fizzled buy signal can be found. Recognize what the trading candles did after the buy signal and what selling candles negated the buy signal. Keep in mind that all trades do not work. Learn to move out of those trades and move to other trades immediately.

Good Investing!