Investment in Equity (Part 12)

In the preceding chapter, I had promised to deal with daytrading, speculation, trading from home, etc. Before I go into those topics, let me say something more about stoploss orders.

Let me compare stoploss orders with normal orders.

Before we do so, let us be clear about our concepts. In one of the previous chapters it had been mentioned that when a scrip is shooting up, people will rush in to buy it. When a scrip is crashing, those who are still holding it, will frantically try to sell their holdings away. When a scrip keeps climbing, it brings about some kind of a snowball effect, and more people hurry to buy it. A similar snowballing effect, but in the reverse direction, occurs when a scrip is crashing. So, the tendency of the majority of those present in the trading hall is to buy a scrip when it is steadily rising, and to sell a scrip away when it is steadily falling. These general sentiments are the bases of my own theory which asks us to buy when the price starts rising and to sell when the price starts falling. For making it clearer, let me list out the two basic principles which a majority of the investors or traders follow:

- (1) Buy when price is rising.
- (2) Sell when price is falling.

We can derive another pair of principles from the above listed two principles; they are:

- (1) Do not sell when price is rising.
- (2) Do not buy when price is falling.

We shall now get on with the task of comparing normal orders with stoploss orders. Let us imagine that a scrip is now priced at Rs. 100. Investor A thinks that the present price is too high, and that the scrip would be worth buying if it falls to Rs. 95. So he enters a normal buy order for Rs. 95. If the scrip falls to Rs. 95, his buy order will get executed. Suppose the price falls to Rs. 95 and the buy order gets executed. Let us now view this purchase against the background of the above given four principles. One of the principles had asked us to buy when the price was rising, while another principle (a converse of the former) had asked us not to buy when the price was falling. Here, in the case on hand, the investor A bought the scrip for Rs. 95 when the scrip was falling. Buying a falling scrip is against the above quoted principles. A normal buy order of the above kind goes against the above listed principles.

Let us consider stoploss orders now. Let us take the same instance, but a different investor, investor B. The scrip is priced at Rs. 100. Investor B is not sure where the scrip is headed, whether it is rising or it is falling. He thinks that if the price climbs to Rs. 105, it will further climb to far higher heights, and decides that he will buy it only if the scrip climbs to Rs.105. Since the current ruling price is Rs. 100, and he wants to buy the scrip only after it climbs to Rs. 105, the only order Investor B can now enter is a stoploss buy order. The trigger price of the stoploss buy order should be Rs. 105 and the limit price can be anything higher than the trigger price, say, Rs. 106. Let us imagine that the price rises to Rs. 105 and the stoploss buy order gets executed. Here, the purchase was made when the price was rising. Such purchases, through stoploss buy orders, adhere to the above listed principles which ask us to buy when price is rising.

We shall now consider sale through normal sell order as well as through stoploss sell order.

Let us imagine that a scrip is currently priced at Rs. 100. Investor A, who holds some shares of the scrip, thinks that if the scrip rises to Rs. 105, he will sell the scrip away as he would, at that rate,

get a reasonable profit. He might also be thinking that once the scrip hits Rs. 105, the scrip is unlikely to climb any further, and that it would only fall thereafter. So, he enters a normal sell order for Rs. 105. Let us imagine that the price rises to Rs. 105 and his normal sell order gets executed. Here, the sale took place when the scrip rose from Rs. 100 to Rs. 105. The sale took place when the price was rising. Our principles tell us to sell when price starts falling. The same principles further tell us not to sell when price is rising. The sale in the instant case violated both our principles (sell when price starts falling, and do not sell when price is rising). Investor A sold the scrip away while the scrip was rising.

Besides, more important, by selling at Rs. 105, the investor A denied himself further profit which he would have got if the price had kept rising further above Rs. 105. The scrip could have risen to Rs. 120 or Rs. 130 in course of time, who knows? Nobody knows for sure how far a scrip will climb. So, once invested, it will be better to wait until the scrip, steadily climbing, exhausts itself and starts falling. When the investor waits until the scrip stops climbing and starts falling, the profit he will gain is market-wide. In other words, he takes all the profit which the market provides. If an investors decides that it will be enough if he gets 10% profit, such a policy can have two serious deficiencies: (1) it will deny him a part (it could be a substantial part) of the market-wide profit. (2) In other cases, he may be incurring loss. Thus on the one hand he denies himself a part of the eligible profit, and on the other, he incurs loss which he can't avoid. Such a policy will often end up in net loss over a period of time. The policy must always be (this is important) to take market-wide profit, and, at the same time, limit the losses. This is the winning combination.

There are two never-dos in stock market: (1) never let yourself suffer market-wide losses and (2) never fail to take market-wide profits. The first one ('never let yourself suffer market-wide losses') requires you to sell your holdings away when the scrip falls 5% (or whatever is chosen as the trigger) from the last formed high. The second one requires you to buy the scrip as soon as it rises 5% (or whatever is chosen as the trigger) from the last formed bottom, and to sell it away when, only when, it falls 5% (or whatever is chosen as the trigger) from the last formed high. In this way, you can ensure that you take all the profit that one can take, and, at the same time, limit your loss in any given deal to 5%. The net result of this policy over the long term will be that your loss in every deal will be limited to 5% while your profit in every deal will be market-wide. In the long run, the market-wide profits (which can range as high as 40%, 50%, and so on) are bound to far exceed the losses which are limited to 5% per deal. The figures of Reliance Capital (please see the chapter 5) had shown an unbelievably high net growth of 179503.36% in 8 and a half years! Of course, such huge profits are can't be common, but, I will stick to my humble prediction: '*In the long run, the market-wide profits are bound to far exceed the losses which are limited to 5% per deal*'.

Why do we limit our profit? Why do we not take market-wide profit?

We are afraid of crashes, that's why. Agreed. It is natural. Stock markets have witnessed too many crashes to forget. But, then, it is to insure us against such crashes that my theory asks us to protect our scrips by entering stoploss sell orders 5% below the last formed high. Whenever we are holding a scrip, the necessary stoploss sell order must be in place. There should not be any time when your holdings are not thus protected with the necessary stoploss sell orders. By 'any time', I mean any time during the trading hours. Stoploss orders cannot continue to be in existence overnight. When the trading hours are over, all the pending stoploss orders will get automatically cancelled. The next trading day, as soon as trading commences, you will have to enter stoploss buy orders), as soon as trading commences every day, is something you should do rather religiously. Needless to add, every stoploss order should be modified whenever the related top rises or the related bottom falls. This has already been dealt with in one of the previous chapters. Stoploss sell orders protect your holdings, but stoploss buy orders are also equally important because, unless you buy the scrip on time, you cannot hope to earn market-wide profit. Any delay in the purchase will reduce your profits and might even force the deal to end in loss. So, both the

stoploss buy order and the stoploss sell order should be entered at the appropriate time itself, i.e., without any delay at all.

At the end of the figures given in chapter 5, the quantity of Reliance Capital had grown as high as 5238 shares. When the quantity in every deal becomes so high as this, a problem can creep in. Now-a-days, a few million shares of Reliance Capital get traded daily. Suppose you enter a stoploss buy order for 10 shares, and with Rs. 325 as the trigger price and Rs. 330 as the limit price. The quantity is very small, and, hence, the stoploss buy order has good chance of getting executed at the trigger price of Rs. 325 itself if price rises to that level. We need to remember here that, execution of this stoploss buy order at the limit price of Rs. 330 is also possible. If the execution takes place at Rs. 330, our cost will increase to that extent. We always want to reduce our costs as much as possible. If the quantity is 5000, and not just 10, there is every chance that some part of this quantity gets bought at rates closer to the limit price of Rs. 330. The average price at which the buying takes place (when the stoploss buy order gets executed) may be nearer to Rs. 330 than to the trigger price. When the average buying price is moves away from the trigger price and moves nearer to the limit price, our cost increases. When our cost increases, our ultimate profit will decrease.

The problem, in a nutshell, is that when the quantity is huge, the average buying price rises, increasing our cost. Likewise, when the quantity is huge, the average selling price (in a stoploss sell order) falls, reducing our profit in the deal. However, this is nothing to be afraid of. Ideally, the average buying price or the average selling price (as the case may be) should be either the trigger price itself, or, it should, at least, be closer to the trigger price, rather than nearer to the limit price. When the average price of execution tends to move closer to the limit price, it will be the signal for us not to increase the quantity of that scrip any further. If the daily traded quantity of the scrip in the whole market increases, it could be one of the solutions, but this solution is not within our hands. The only solution open to us is not to increase the quantity of the scrip in our future stoploss buy orders any further. You can continue to deal in the scrip, but all the future profits you gain and the losses you suffer in future deals of the scrip, should be shifted to another scrip the quantity of which hasn't reached such high levels.

The idea in a nutshell is, when the quantity has grown to levels as high as 5000, it will be better not to increase the quantity any further.

(To continue)