Brainy's Articles on

Technical Analysis

Exit strategies — Introduction

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Introduction

In this day and age it can be seen that the old traditional buy-and-hold investment method is no longer a reliable wealth-builder. A good investing/trading strategy will have a clear method for managing both the entry into a position, and the exit from the position when required. And it might be useful to have multiple exit strategies to cater for different situations. However, many traders and investors in the equities market don't give much serious thought to how to exit investment positions.

Table of Contents

Introduction....................................1
Why do we buy shares?...............1
Why exit a position?....................1
The price charts can help?...........1
This eBook Article........................1
Overview..1
The ideal strategy........................1
Several reasons to exit.................2
Price weakness............................2
Avoid haphazard exits..................3
Taking early profits?.....................3
Take profit....................................3
Exit strategy options.........................4
Summary..4

Why do we buy shares?

Sometimes investors forget why we buy shares in the first place. Many investors lend their hard-earned money to companies (by buying the company's shares) so that they can increase their own net worth. That is, they want to make a profit over a reasonable time period, and possibly earn an income from dividends along the way.

Why exit a position?

Why would we ever exit a share market position? Why not hold for the long term? Well, over many years, the so-called sage advice was that we should hold our positions for the long term, because it will eventually deliver returns. However, since the GFC (2007-2008), this is no longer a certainty. For many investors it is now much more important to protect our investment capital from the possible downside risks, and it can be prudent to lock in profits by taking some money off the table when the time is right. But when is it the right time? That's what this discussion on *exit strategies* is all about.

The price charts can help?

If we remember that the opinions of the market participants are summarised in the price charts, and provided we can interpret the simple stories in the charts, then we can understand the right time to consider selling down, or closing, a position. This will protect our investment capital from further downside risks, and potentially lock in some of the profits.

This eBook Article

The eBook Article **ST-6115, *"Strategies for entry and exit"***, provides a more basic and investor-focused introduction to this subject. However, this particular Article in Brainy's series on Technical Analysis (number TA-6030) provides an introduction to the technical analysis aspects of *exit strategies* (there are many to choose from), with more detail in other eBook Articles.

Refer to other eBook Articles numbered ST-6xxx for more comments and ideas on *exit strategies* (with little reference to technical analysis), and also to the relevant technical analysis Articles for more detail (numbered TA-603x). See a list at the end of this Article.

Overview

Before getting into the nitty-gritty details of *exit strategy* possibilities, let's look at some important considerations.

The ideal strategy

For the investors and traders who use price charts to assist with investing decisions, the ideal investing / trading strategy for efficient results will comprise a number of elements including:

- The condition(s) that trigger our action to enter. This might be a single condition (observed on a price chart, or from an indicator, or based on some computational analysis), or it might be a multiple-condition scenario such as a chart pattern set-up situation followed by a trigger.

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- The possible condition(s) that will trigger our exit action. To be a complete and prudent approach, this can be more than one condition.
- Some money and risk management rules to do with the portion of total capital to be invested in any one position, and the portion to "risk" in any one position, amongst other considerations. (Look for more details regarding *money and risk management*.)

Several reasons to exit

There are a number of reasons why we might exit an investment position. They include:-

- For a new investment position, the price has fallen, and our investment decision on this occasion was not a good one, so we sell based on our pre-determined *exit strategy* or a simple *Stop Loss* approach.
- The money is needed elsewhere, so we liquidate in order to redeploy the cash.
- The investment value has risen significantly, making it somewhat sensible to liquidate some or all of the position, perhaps to re-balance the allocation of our funds or to reduce the risks of this particular investment — all based on a pre-defined *exit strategy*.
- The investment has risen to a pre-determined *price target*, so we want to lock in some, or all, of the profits and exit the position (either exit completely, or perhaps only partially).
- The investment position is not going anywhere and our money is not working hard enough (opportunity cost), so we liquidate in order to redeploy the capital elsewhere for a better performance.
- The price has risen much higher than our *Initial Stop Loss* level, so we have raised the stop loss to be a *Trailing Stop Loss*, so that if the price then falls we will be able to sell and capture more profits and preserve the remaining capital.

The *Stop Loss* options and methods for exit that are mentioned here are not covered in detail in this Article; but are covered in other eBook Articles. One important point to note regarding the *Stop Loss* approach is that many of the stop loss methods tend to set the Stop Loss at a price level somewhat lower than the recent trading price, and might therefore give back a significant amount of profit. Hence an alternative exit approach to exit earlier and capture more profit can be worth considering.

Price weakness

It is worth writing a special note on the topic of *price weakness*. Depending on the aggressiveness of our approach and strategy, we might not want to risk giving away too much profit. After a strong price rise, a stock can pause for a while before either advancing further, or falling away. Some people can readily see *price weakness* in a price chart, either in the candlesticks and volume alone, or in conjunction with a chart indicator. So some people like to lock in the profit, rather than run the risk of it being whittled away.

We could have an exit strategy based purely on an observation of price weakness. If so, then the price weakness condition needs to be clearly specified in order to remove any subjectivity from the decision.

The following tools (discussed further in other eBook Articles) can be used to help identify price weakness:-

- Trend weakness and trend line breaks — The humble trend line drawn under rising prices can give a good indication of a weakening trend when price falls below the rising trend line, as shown in the early portion of the weekly chart of BHP in Figure 1 below (the trend weakening in January 2011).
- Weakening trend — using an indicator like ADX (Directional Movement Index).
- MACD — A strongly rising MACD (the two curves) can start converging on each other, and roll over to indicate price weakness (which may, or may not, be just temporary weakness).
- Momentum and Moving Average of Momentum — These two indicators together, and whether they are rising or falling, can indicate price strength, and forewarn of price weakness.

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- Bearish divergence — Look for divergence of an indicator from the share price. For example: MACD, RSI, Momentum, Money Flow and more.

Some of these topics are discussed in other eBook Articles, otherwise readers should seek out specific details elsewhere.

Figure 1: BHP weekly chart + 30week MA, and a rising trend line.

Avoid haphazard exits

It is important to avoid exiting positions in a random or haphazard manner. The intended exit method needs to be included in the written investing/trading strategy, and ought to have been tested to ensure a degree of success, and to gain confidence with the approach. Almost every possible reason to exit is predictable, so there should be no surprises, and no unplanned or unforeseen actions. When a particular situation occurs, we need to be clear about the action.

Taking early profits?

"You can't go broke taking a profit!" — FALSE!!

> You can go broke taking a profit.

Many people close out positions, or close out part of a position, when it is in a reasonable profit situation. They think that taking the profit won't send them broke; but this is far from the truth. A given investing/trading strategy needs to have been tested and quantified so that the *Win/Loss Ratio* can be seen to be reasonable, and the final equity position can be seen to be profitable.

> A Win/Loss Ratio of 40% means that for every 100 trades, 40 will be winners, and 60 will be losers.

A Win/Loss Ratio of as low as 40% can be profitable, provided the few large profits outweigh the many small losses. So when taking profits we need to be confident that our strategy will perform as expected in order to realise the ultimate profits.

So, be cautious about taking profits too early. Much can be said about the adage *"let the profits run"*.

> Let the profits run

Take profit

Let's remember that we might be using a risk management approach that says: "no more than 20% of my capital in any one position", and we might also be using the "2 Percent Rule".

Now, if one particular position sees the share price rise significantly (perhaps double), then the position might no longer conform to our risk management rules. If this is the case, then we can mitigate the growing risk by reducing the size of the position — by taking some profit. This action can re-balance the position and the portfolio, as well as lock in some of the profits.

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How much profit to take? One approach is to do a calculation as though we are about to enter a position in the stock, and work through the position sizing calculations according to our strategy. Then reduce the position down to this level. (Of course, we do have a process for calculating position size.)

Exit strategy options

There are many different approaches that can be considered for *exit strategies*, and exit trigger conditions, and they can be considered under the following categories with more detail in additional eBook Articles as listed further below:-

(a) Time, clock or calendar-based exits;

(b) Price target exits;

(c) Money-based exits (based on the share price value);

(d) Price chart feature exits;

(e) Chart indicator exits.

These are all discussed in separate eBook Articles (see below for a list).

CAUTION: If using any sort of trigger to identify and action an exit, it can be very prudent to utilise two separate triggers so that one can confirm the other. Of course, testing of the intended approach would be a good idea.

Summary

In this article in Brainy's series on Technical Analysis (TA-6030) we have considered some of the possible methods for exiting a position. Readers should also refer to other Articles in this series for more information, as mentioned above. In particular:

- eBook Article **ST-6115,** ***"Strategies for entry and exit"*** — an introduction, especially for investors as it doesn't include much on technical analysis.
- eBook Article **TA-6030,** ***"Exit strategies — Introduction"*** *(*this eBook Article)
- eBook Article **TA-6031,** ***"Exit strategies — Part 1 — Time, price and money exits"***
- eBook Article **TA-6032,** ***"Exit strategies — Part 2 — Price chart features"***
- eBook Article **TA-6033,** ***"Exit strategies — Part 3 — Chart indicator exits"***.

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Technical Analysis, or BullCharts,
look for more of Brainy's articles, or the other resources, in
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