Chapter 28

LIQUIDATION

Knowing when to liquidate a trade is at least as important as knowing when to enter a trade. Since most traders are on the right side of a trade going in, then the problem would seem to be knowing when to get out. Too often traders are on the wrong side of a trade when exiting the market.

We are constantly amazed that traders will stay long when the market is giving a clear-cut sell signal. The opposite of that is true as well. Traders who would normally go long on a buy signal will try to stay short through that very same signal once they have taken a short position.

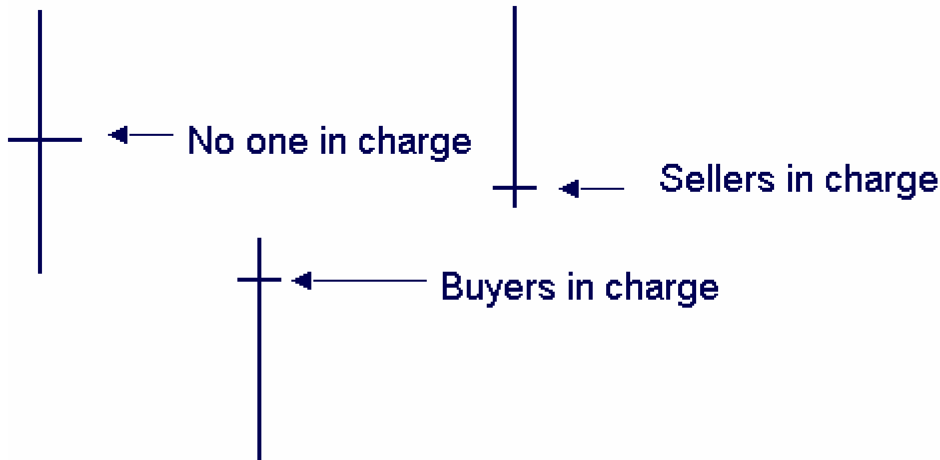
If you are short and are looking at the breakout of the number 2 point of 1-2-3 low formation, then surely it is time to think about getting out of your short whether you have won or lost.

Large pattern signals such as 1-2-3's are a good way to exit trades. But there are finer points of market action which can indicate that it's time to exit.

There are tell-tale signs that inform us that it's time, win or lose, to take our money and run. In this chapter we will share with you some thoughts about liquidation and exiting.

WHO HAS CONTROL

One way to determine when it is time to exit is to ascertain who has control of the market, buyers or sellers?



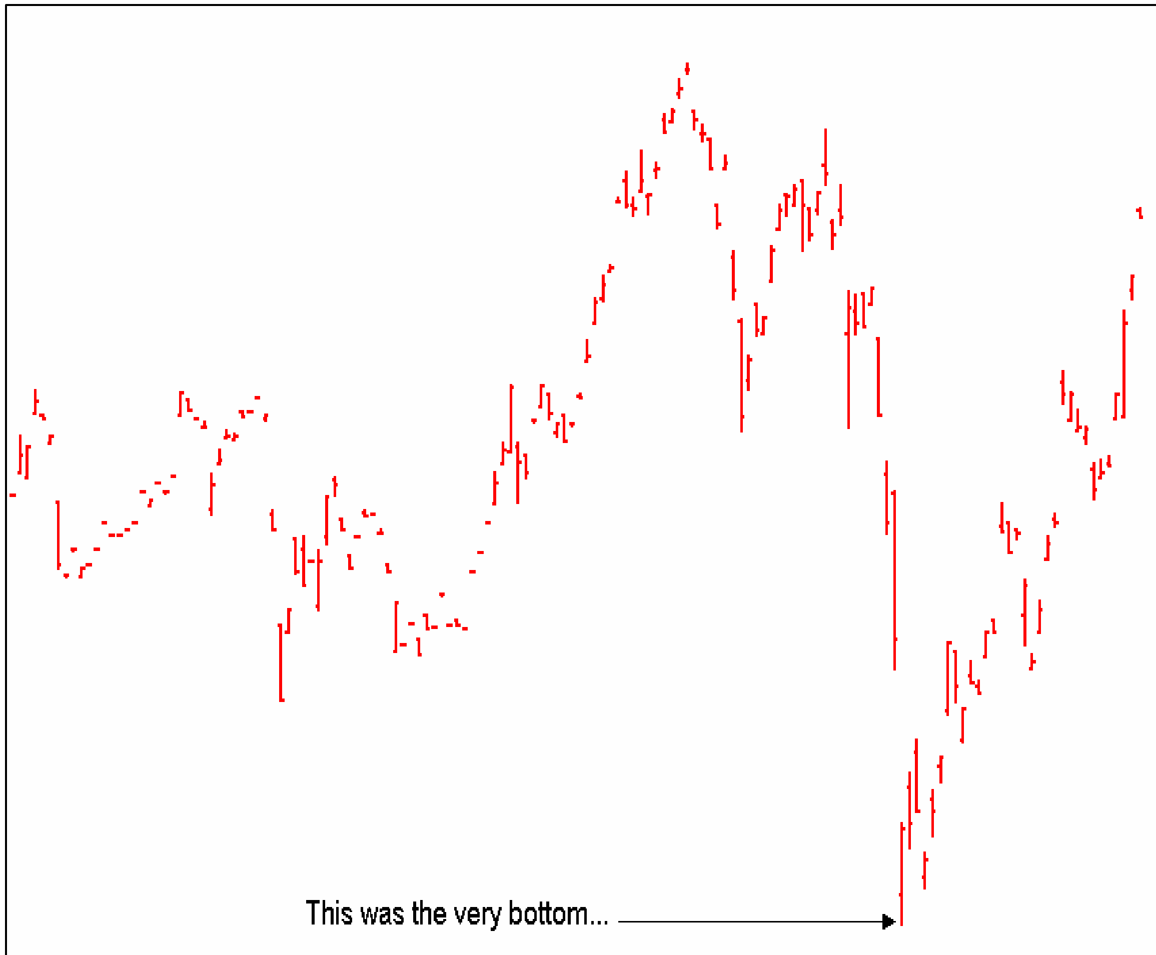
Regardless of time frame, if you are long, and you begin to see a number of bars that tell you the sellers are in control of the market, you should be quite anxious to exit. More than that, you should begin to get nervous the moment the buyers lose control of a market.

That means that as soon as you see price bars no longer closing in the upper 1/3 of the price bars, begin thinking about protecting yourself – win or lose!

The opposite is true when you're short. Regardless of time frame, if you no longer see prices closing in the lower 1/3 of the price bars, you should strongly consider exiting the trade.

Usually a number of bars is required to notice that the trend is no longer intact. Sometimes a single bar is sufficient. A very large bar can be quite convincing. In an uptrend, a large bar with a very low close may be the blow-off bar, a complete reversal of the way prices have been trending. The momentum is clearly down on that bar. Exit as soon as possible.

A very large bar in a downtrend with a very high close may be the very bottom. Prices will usually rally. Exit all shorts. See the example on the following page.



A gap may be sufficient to cause you to notice that a trend is no longer intact. A large outside gap, with a very low close in an uptrend or with a very high close in a downtrend may be a signal that prices are now ready to move in the opposite direction – the direction that will go against your position. (See the example on the following page.)

This type of very close analysis is much more important at the beginning of a trade, before you've made a profit, than it is after the trade has become profitable.

A TIME RULE

If you're able to watch the price action, and prices have not enabled you to cover costs within a certain number of minutes, then exit, win or lose. It is important to have either or both a time constraint or number constraint. It is vital to encode in your mind that, "*I will be out of this trade win or lose within such and such a time period*."

The period chosen should be selected so that it suits your temperament, trading style, and personality. You must choose your own time parameter. We want to make it clear that we did not do extensive statistical testing that would have proved that any particular number of minutes is the ideal time. You have to find ***your*** time by trial and error and by experience. Once you've discovered it, use it regardless of the time frame in which you trade. This includes taking

an intraday trade from a weekly or daily chart signal. If you have not covered costs in your selected time period, exit.

Here's another rule you might like to try. We call it a 3 bar rule. It states that if you have not at least covered costs by the time three bars appear on the chart, you get out of there. Which rule you apply must depend on both the price action and what you see. You might favor the time rule because you are looking for almost immediate confirmation that you are correct.

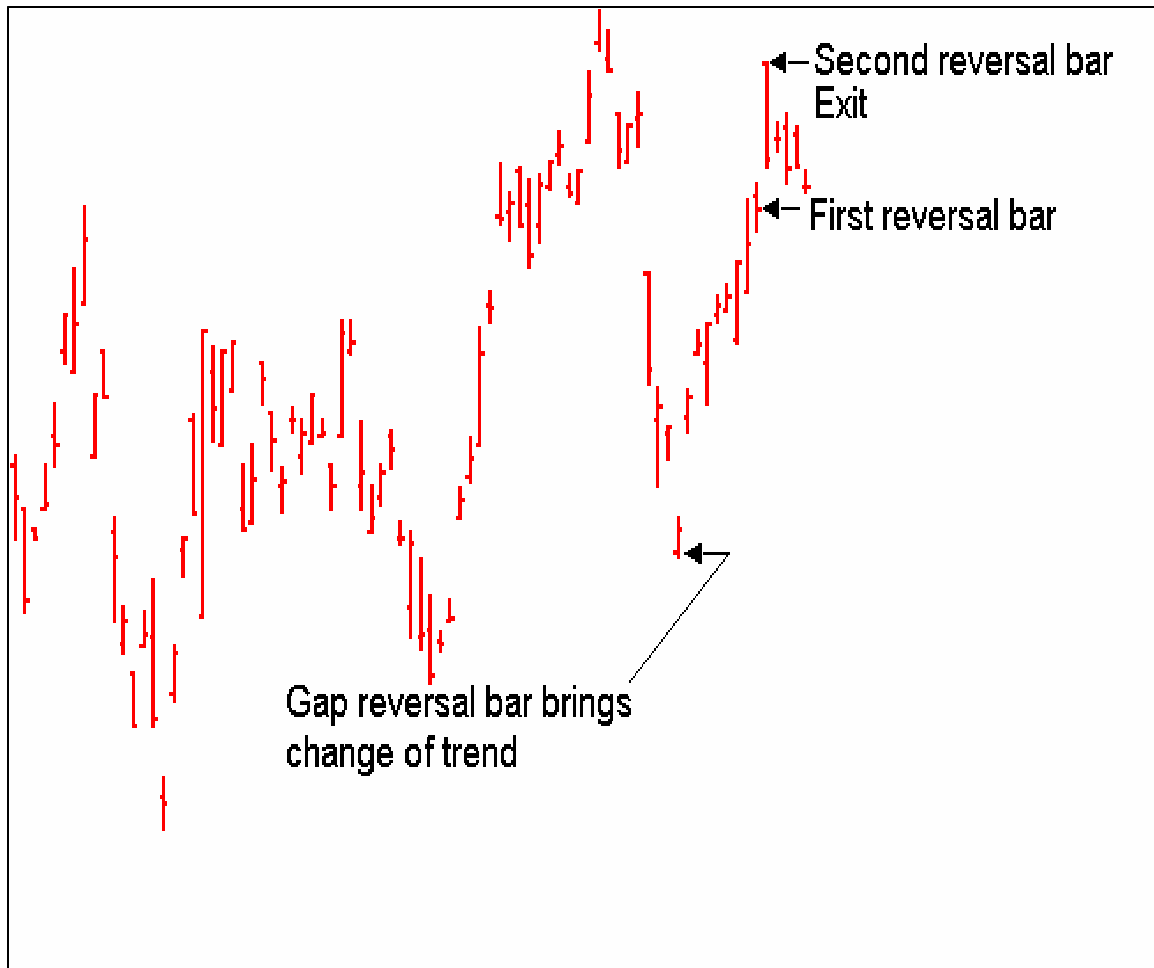
Perhaps in your own case, you would do better with a 4 or 5 bar rule. That is your decision to make.

We've been asked, "Does it make sense to use a time rule for all markets?" The answer to that is, "perhaps." Certainly "yes," if your trading style and entry techniques presume an explosive move upon entry. If you don't get it, you know you're wrong, at least for the time being. Therefore, you exit. You can take many small hits and still survive.

One of the great differences noticeable among successful traders, and which separates them from unsuccessful traders, is that successful traders are not afraid of losses. They may not like them, but they consider them to be the cost of doing business. They don't get emotionally involved, and they don't take losses personally as though losing reflected on them and their abilities as a trader or as a human being. Unsuccessful traders do take losses personally. They feel as though they've failed. They feel losses are a reflection upon themselves. Truly, losses are only a cost of doing business. Your job is to keep those costs as low as possible.

COMBINING THE TIME RULE WITH WHO'S IN CONTROL

In the early stages of a trade, before having covered costs, even before the set number of minutes for your time rule have transpired, if you see two bars in a row that open and close in opposition to your trade, you should exit.



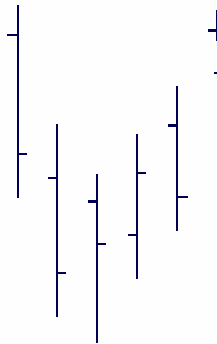
If you are short, and you see two consecutive bars that close higher than they open, you should begin your exit procedure. If you are long, and you see two consecutive bars that close lower than they open, get out. You no longer want to be in the trade.

When you are using a three bar rule, regardless of time frame, if you see two consecutive opposite-side closes as just described, exit without waiting for three bars to register on your chart.

MARKET BREAKS

Market breaks can be a signal. They are a minor signal intraday, but they are a major pattern signal on daily charts, and on very active five minute or greater time interval charts.

Here's what a Market Break looks like:

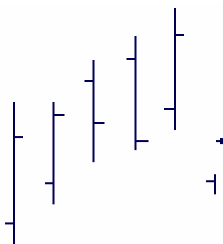


When you see the lowest close, followed by two higher closes, then a lower close, and then a break, unload your short positions, you have a buy signal.

The important thing is the pattern of the closes. Obviously, this pattern could have taken place with an infinite variety of high-low-open relationships.

The opposite pattern is also true. If you are long when this happens, you must immediately exit your long position. It wouldn't hurt at that point to sell short as well.

The pattern is: the highest close, followed by two lower closes, then a higher close, and then a break.



Remember, it is the pattern of the closes that is important. The relationship of the opens, highs, and lows is meaningless when looking for this pattern.

That is not to say that the relationships of open-high-low are not also important, but with Market Breaks we are interested only in the relationship between closes and the fact that the market then breaks on the open.

PRICE VERSUS VOLUME

What can be done with volume? What does it show? The most important thing to know is **whether or not price increases or**

decreases relative to volume. The level of volume, other than for the way it affects getting decent fills, is meaningless if prices do not move. In fact, volume relative to price movement or non-movement can tell you a great deal about what is happening among inside traders. If prices are not moving, no matter how great the amount of volume, you can be pretty sure that nothing more is going on than the insiders trading among themselves.

Insiders are quite content for the market to stay within tight trading ranges. They can safely scalp out their money within those price ranges wherein you dare not tread. They have the benefit of low, or no commissions, and the benefit of their insider status. The time delay on their trades is minuscule as long as the market is not too thin. The same is true of the slippage they incur. As long as there are sufficient traders, the insider's slippage will be little if any.

In general, trend is not caused by insiders. Real trend movement is brought about by the outsiders who come into the trading arena to intentionally move or engineer the market to their own liking.

Therefore, when you see volume drying up, you can expect little price movement. If it happens apart from a major report of some kind and after price has been trending, you can safely assume the move is over and it's time to get out of the trade. Volume is not an absolute indicator, because of the engineering that can take place in a market, and because price may not move on increased volume when position squaring ahead of an earnings report or other important announcement is taking place. But it can act as a tie-breaker when you are not sure. It can be a filter that says, "get in" or "get out." Remember, very often the signal to enter a trade can be your signal to exit a trade.

MENTAL VERSUS PHYSICAL STOPS

One of the most frequent questions we are asked is, “**Where** do I put my stop?” Equally important but rarely asked is, “**When** do I put in a stop?” We will now raise another question in your mind, “**Why** put the stop where you do, or why put it there at all?”

Let's look at these together. We will give you something to consider in your trading from now on.

The insiders want to see your stop loss. It is in their best interests. When your stop is in the market it becomes part of the market. It is an additional order in the market. This is good for business. The exchange likes it. The insiders love it. It gives them something to fish for. When your stop loss is in the market they can see and take your money.

Therefore, we submit that whenever possible, your stop loss should be mental, but only until you decide to hold beyond a day trade and replace it with a profit protecting stop. *NEVER CARRY A LOSING POSITION OVERNIGHT!*

There are different types of stop loss that center around your mental perception and thoughts about what is happening: a stop loss that says, "*I'm not completely wrong yet, I'm going to give this trade more room,"* one that says, "*I'm totally wrong, and I ought to either be out or going the other way,"* and one that says, "*Wow, what if I have a heart attack while I'm trading and I get wiped out before anyone realizes I'm in?*"

- "*I'm not completely wrong yet.*" This thought, of course, is like saying to yourself, "I'm only half pregnant." If you are wrong, you are completely wrong. Get out! Do it now!

- "*I'm totally wrong and I ought to either be out or going the other way.*" Isn't it amazing how our minds can play tricks on us. The above thought is really illogical. When you are wrong, you are automatically "totally wrong." However, the second part of the thought falls into the area of a hunch whose lead you should learn to follow. "*I ought to be going the other way*" calls for a reversing stop – a double order. One part to take you out of being wrong, and the other part to enter you into a position that is hopefully right. Intentionally waiting to take a loss doesn't make much sense. You should never allow prices to come that far against you. If you are that wrong, and you have structured the trade properly, then you should reverse – the market is going the other way.

- "*Wow, what if I have a heart attack while I'm trading and I get wiped out before anyone realizes I'm in?*" This situation calls for a catastrophic stop. The catastrophic stop should be just as it says, the one you have in the market in case you have a heart attack or a stroke while in the midst of trading, or are called away, or are in some way prevented from exiting a trade at the appropriate time. Normally, you will have exited long before prices hit your catastrophic stop.

ADDITIONAL LOSSES

Ask yourself how many times have you been right about a trade only to see yourself stopped out of the market before the trade materialized. You wanted to get back in. You knew you ought to get back in. But because you were so demoralized by the loss you took, you do not go back in.

At that point you have lost a lot more than your money. You have lost your self-esteem. You have lost your confidence. You have lost the courage of your convictions, and you have lost your nerve.

Many times, having been stopped out of a trade, you will find it virtually impossible to get back in. The price action will not give you an entry point. You will be waiting for prices to correct so you can reenter. It never happens. Apart from throwing yourself to the wolves with a market order in a fast market, there will be no opening for you to get back in. In that case, you must learn to live with your loss. In this case, you have lost opportunity.