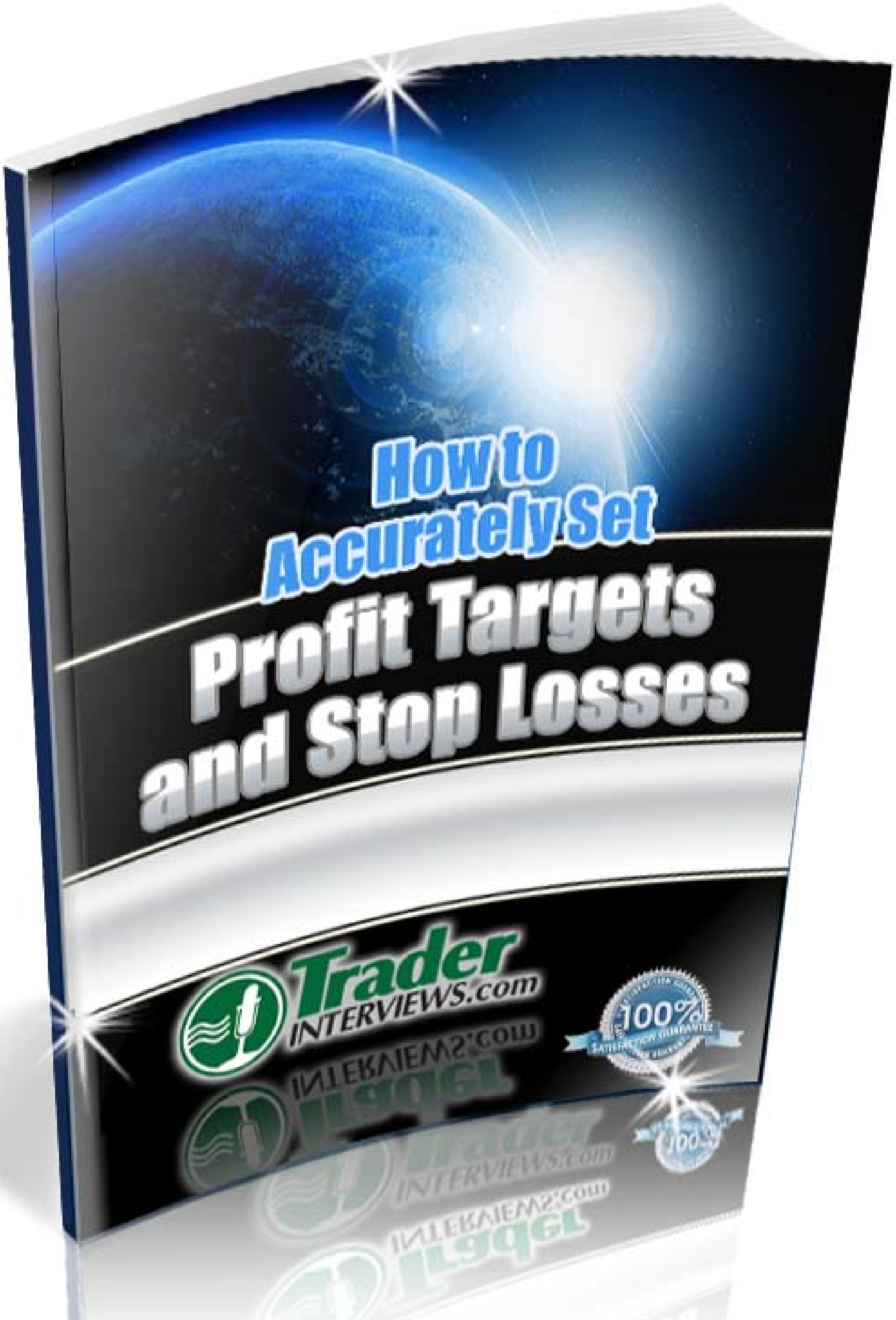
How to
Accurately Set
Profit Targets
and Stop Losses
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How To Set Your Stops and Profit Targets Accurately (aka "How To Know It's Time To Take Money Off The Table")

"Bread and Butter" or "Bread Crumbs"?

I am fortunate enough to mentor a diverse group of traders, some of them professionals, some of them just starting out. It's a fascinating experience as a teacher to teach each of these traders one on one, because the goal is not to make them clones of me, but to develop them into successful traders with their own style of trading.

Each of them has different strengths and weaknesses and different ways to look at the market; they all progress at their own rate. Some of them manage other people's money [I currently mentor two different CTAs, a Hedge Fund Manager and the Manager of the Midwest branch of a stock brokerage firm, along with a handful of individual traders] and some of them are just starting out, so they are trading very small accounts. Some of them make 5-10 trades in a day and some of them make 2 or 3 trades a week.

I recently was interviewed by Tim Bourquin at TraderInterviews.com where we talked about 'Getting Paid to Trade by the Market' where I highlighted a profit taking technique four of my students use, although each has their own variation on it. We call it 'Bread and Butter', because it's much like 'Making Donuts' or 'Slicing Sausage'. The first is a phrase I use to call my intraday 'cookie cutter' trades because they are basically doing the same thing over and over [repetitious, not exciting and profitable equals 'Making the Donuts'.]. The second is a phrase a friend of mine uses when he speaks of how he approaches the markets. He says he 'slices sausage' each day and at the end of the month, all the slices add up to a mountain of sausage.

The four students use variations on the same theme. Regardless of the market you trade, the technique you are about to learn works very well. For example, in the currency futures, one student uses a maximum stop loss of 10 ticks. As soon as price has gone 7 ticks in his favor, he moves his initial stop loss to break even. If price goes 14 ticks in his favor, he takes off 1/3 of his position and moves his break even stop up to a 7 tick stop profit order. If price goes on to reach 21 ticks in his favor, he takes another 1/3 of his position off and moves his 7 tick stop profit up to a 14 tick stop profit.

Then he tries to manage the last 1/3 using market structure, meaning if he is long, he will hide his stop profit orders at higher and higher levels as price leaves higher swing lows, because there will be Limit Buy Entry orders at each of the Swing Lows left by traders that missed getting long or traders looking to add to their position. His goal is to get to break even fast and get to his first two profit targets the majority of the time—and catch a much larger move on the final 1/3 of his position about 20 percent of the time.

Another student who trades stocks and the ES takes ½ his position off just below the first overhead market structure if he is long, then moves his initial stop loss order up to break even. Then he treats the remaining ½ as a 'runner', trying to maximize the profit on the remaining half by hiding his stop profit orders below market structure as it unfolds.

Another takes 1/3 of his position off at 10 ticks and then moves to break even, takes 1/3 off at 20 ticks and leaves his stop profit at break even. He takes the final 1/3 of his position off at 40 ticks, a level he has seen as a statistical 'node' or regularly reachable profit target in the currency futures he generally trades.

The final trader of the four bases his targets on the percentage of the average range of the past 20 trading days: He takes his first profit at 10 percent of the recent range and moves his initial stop loss order to a break even stop. Then his second profit order is at 25 percent of the recent range and his final target is at 60 percent of the recent range; once he has moved his stop loss order up to break even, he leaves it there, trying to let the trade mature.

Let me show you a few chart examples, because a chart often makes things much clearer. Take a look first and continue reading below:

You can see that this particular chart shows that one of the traders I mentor takes half his position off just before the first overhead market structure when he is long and then moves his initial stop loss order to break even. On the chart above, you can see that he moved to break even after price reached his first profit target, getting him out of half of his position for a nice 75 tick profit, but it then came back down and stopped him out at break even on the second ½ of his long position.

Do these four traders net make money? They do indeed. One of them is a very active CTA, one is an experienced trader that likes to book profits to reinforce the methodology he is using when he trades and the other two are fairly new traders with smaller accounts. These two traders like ‘Bread and Butter’ trading as a style because they are trying to build the size of their accounts as they master this methodology, so moving to break even quickly and taking frequent smaller profits is more comfortable to them.

Now you should know that I did not teach any of these students this exit method—they each developed their own exit strategy on their own; four of them developed a similar twist without my input that I eventually named ‘Bread and Butter’. But I mentor other traders as well and one of them read the ‘Bread and Butter’ article on Moneyshow.com and at his next mentoring session, told me that in his opinion, I wasn’t really helping these traders by encouraging them to take frequent quick profits.

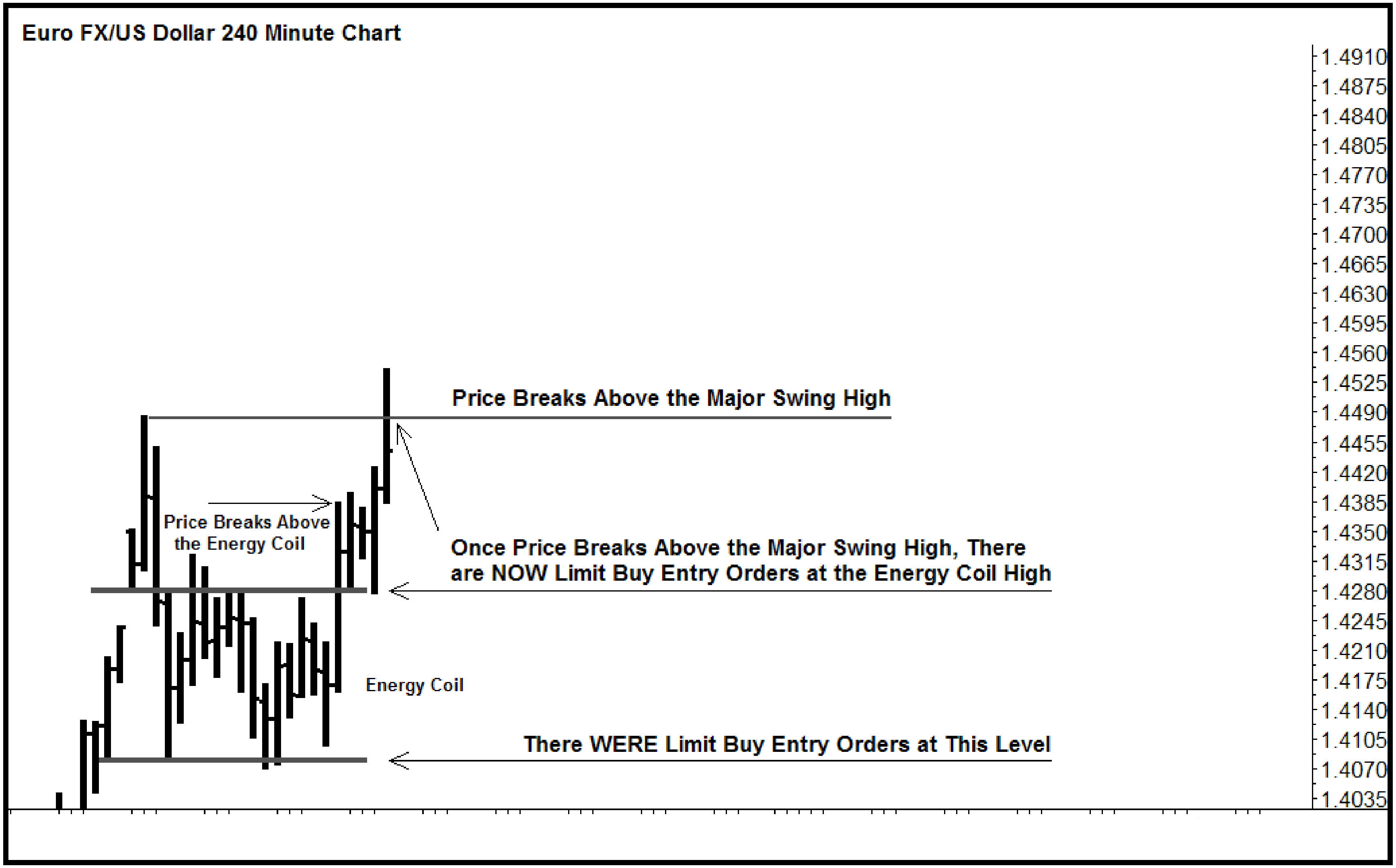
We discussed the reasons each of these traders had for choosing the ‘Bread and Butter’ method of relatively quick exits and though this trader acknowledged that each trader should embrace a style they are comfortable with, he wanted to continue the discussion: He wanted to know if I had made a trade that day and if so, what did MY trade look like?

In his mind, after studying my articles and the posts I made on own web pages and free forums over the past six or seven years and having been in my mentoring program for more than five months, he felt my trade would look vastly different than the ‘Bread and Butter’ trades. In fact, he said that if I had a position on, in his opinion, it would show that the ‘Bread and Butter’ traders were really only taking the ‘Breadcrumbs’.

I chuckled at his analogy and then admitted I had indeed taken a trade that day, after the ‘Bread and Butter’ traders had been stopped out at break even on the remaining portion of their trades. Let’s take a look through my eyes at what was happening in the market at that point, what caused the market to move the way it moved, and how I entered and managed my trade.

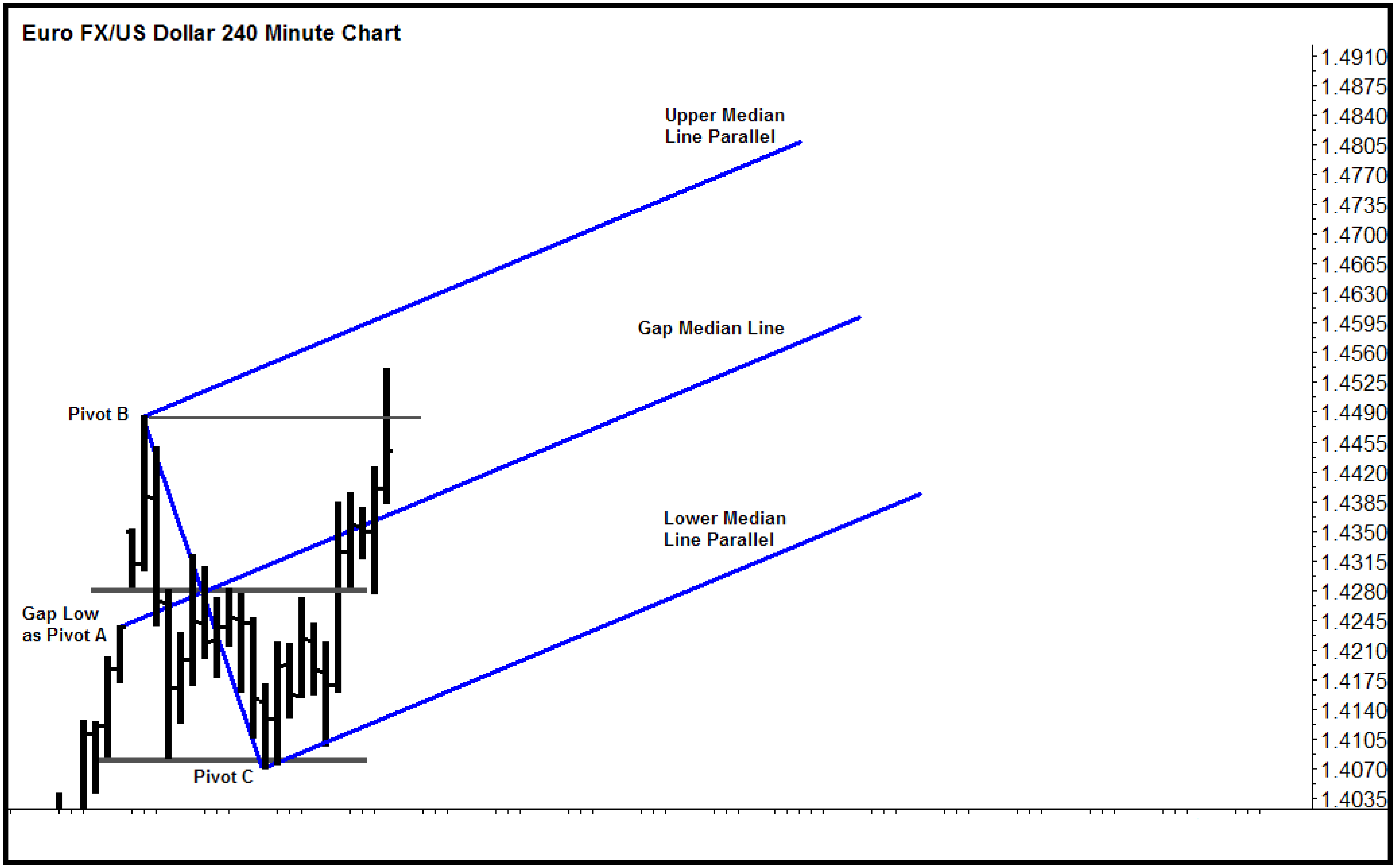
Now, it’s important to note that the ‘Bread and Butter’ chart used by the trader in the original article was a 60 minute chart of the Euro FX/US Dollar cash FX pair.

I generally trade on 240 minute charts, so some of the price action appearing on the first chart [a 60 minute chart] disappears on a 240 minute chart, because each 240 minute bar contains the price action of four 60 minute bars.



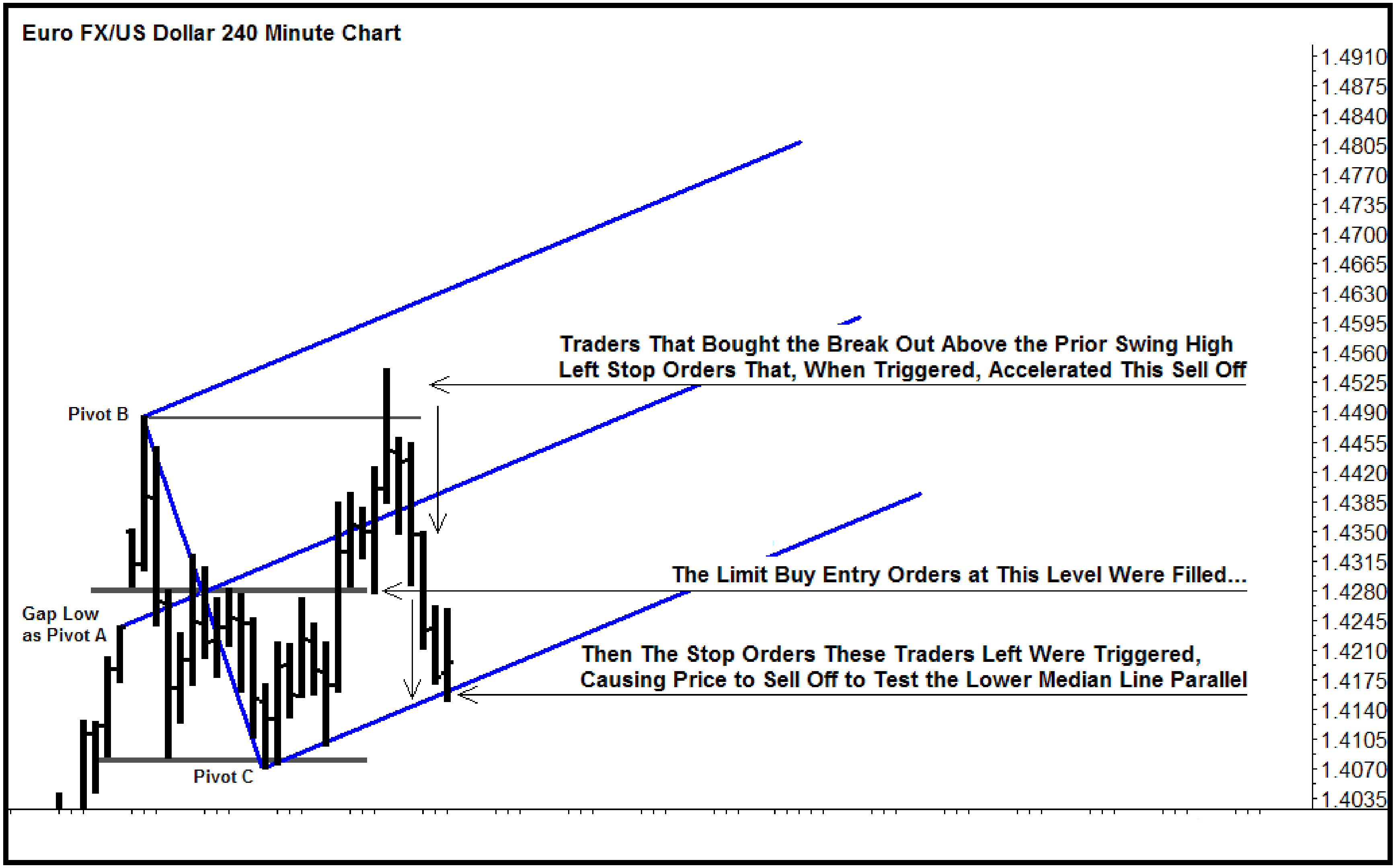
Price gapped open higher on Sunday night, leaving what became a Major Swing High before trading lower. Price then formed an Energy Coil, an area of congestion where price re-stores its Energy; the low of the Energy Coil was just above 1.4070 U.S. Dollars per Euro and the high of the Energy Coil was at roughly 1.4280. Price was unable to close above or below the Energy Coil for 14 bars, but it finally showed a change in behavior by breaking and closing above the Energy Coil. It then consolidated its gains, leaving a pair of bars that had lows that tested the highs of the Energy Coil. But after four closes above the Energy Coil, price shot higher and broke above the Major Swing High made early Sunday night.

There had originally been Limit Buy Entry Orders at the low of the Energy Coil, left by traders that were willing to get long at the multiple bottoms just above 1.4070. But once price broke above the Major Swing High was taken out, the majority of the Limit Buy Entry Orders moved higher, to the multiple tops of the Energy Coil near 1.4280 that had been resistance but was now most likely support. These Limit Buy Entry orders were left by traders that had failed to get long when price was bottoming at 1.4100 and now were watching new highs being made above 1.4500 and they were not long—the train had left the station without them, as they say.



When price broke above the Major Swing High at 1.4483, I add a blue up sloping Median Line. Note that like the 'Bread and Butter' traders, I used the low of the Sunday night gap as Pivot A when drawing my Median Line set [This particular type of Median Line is called a Gap Median Line because one of the extremes of an open gap is used as a pivot].

At this point, I had a pretty good feeling for where the Limit Buy Entry Orders were sitting and though price had taken out the major Swing High, I was not ready to enter a trade—I did not see any sign of what I consider to be a high probability trade entry set up. Nor did I see any trade set up that had an initial stop loss that was within my own acceptable range. I was mildly bullish but I saw nothing interesting enough to get me to enter the market at this point.



Then an interesting thing happened—One of those market moves that occur when you least expect them. When price broke above the prior Swing High at 1.4483, a good deal of traders went long on the break out to new highs. Though price made it up to 1.4542, note that the break out bar closed well below the prior Swing High and in the lower half of the break out bar.

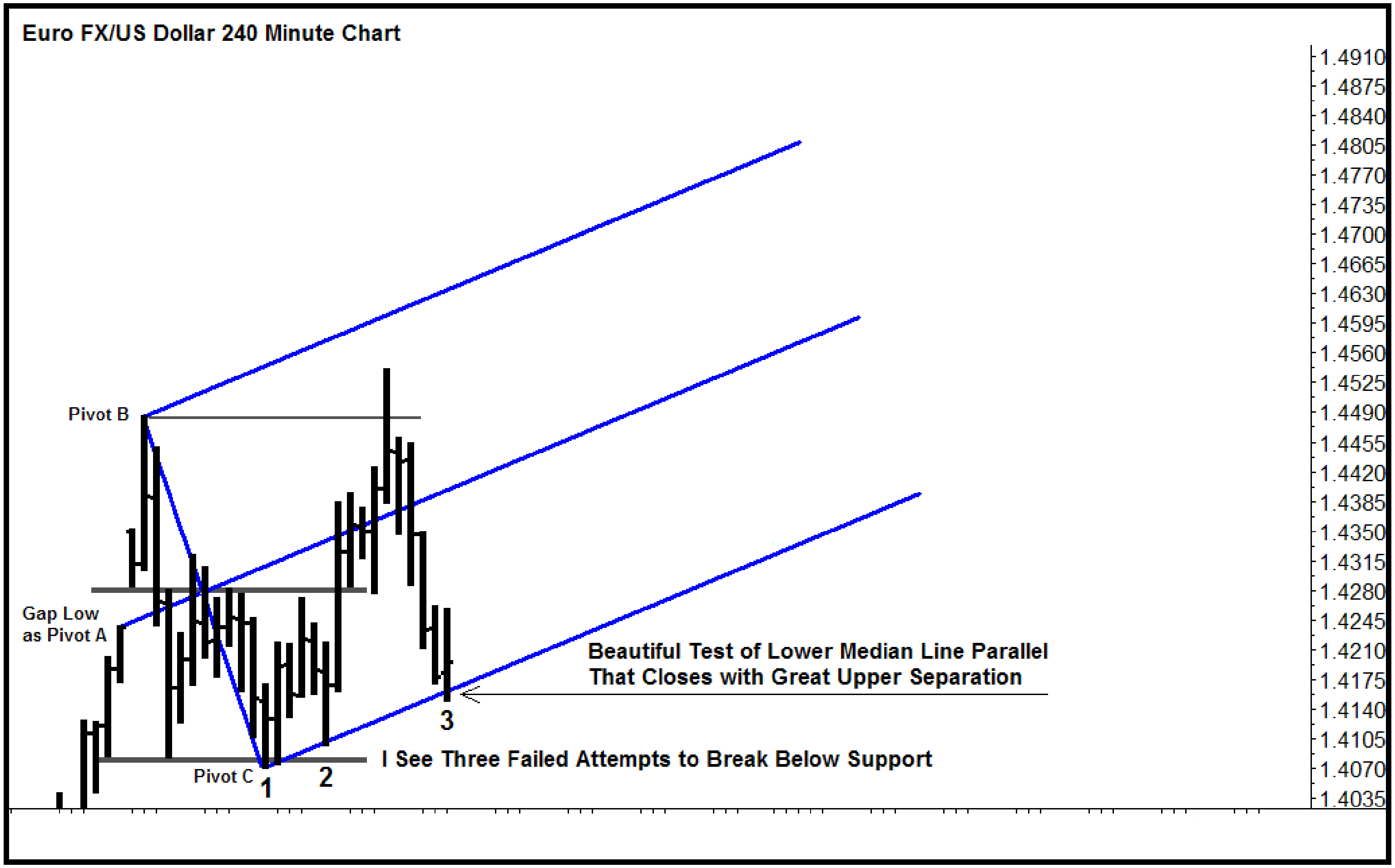
That meant that all those traders that went long on the move to new highs had losses in their positions at the close of the same 240 minute bar they had entered on. And looking at the next five bars, you can see that the news did not get better for these traders. There WERE Limit Buy Entry

Orders at the high of the prior Energy Coil, at about 1.4280, but by that point, the break out buyers were liquidating their long positions and price ran right through these resting buy orders.

And the traders that had patiently left Limit Buy Entry Orders at the 1.4280 area quickly found that once their buy orders were filled, they, too, were holding losing positions and so the sell off continued as the second set of stop loss orders began to be triggered.

The outcome of this break to a new high followed by a sell off through multiple areas of support left price testing the up sloping Lower Median Line Parallel; in fact, the test bar pushed through the Lower Median Line Bar. To this point, few traders likely got out of their long positions with a profit unless they were using 'Bread and Butter' style orders to take profits on the way up and moving their stop loss orders to break even.

As this last bar closed, here is what I saw:



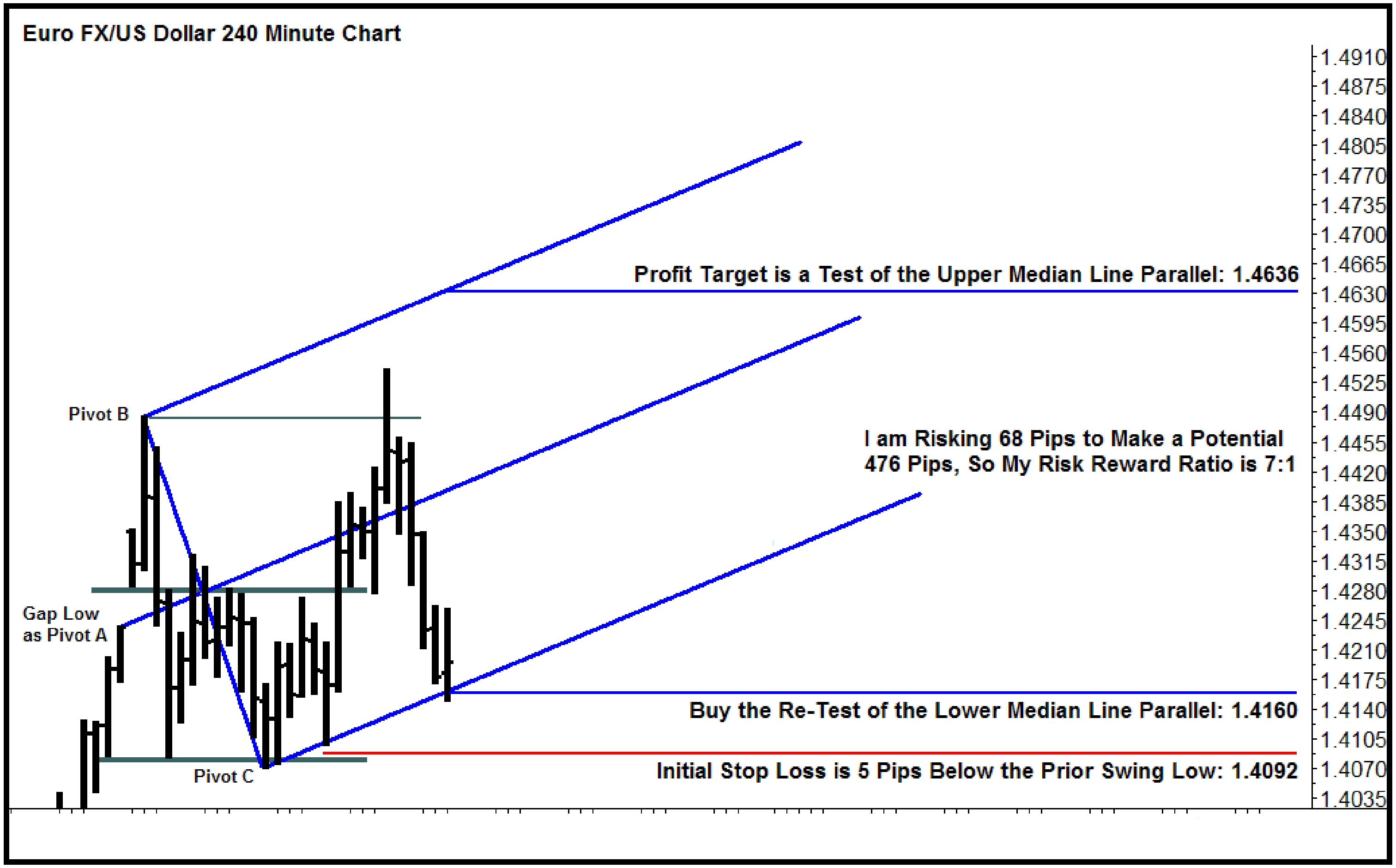
As the last bar closed, I took a very close and careful look at this formation and at its interaction with the up sloping blue Median Line set.

I immediately saw that the last bar had tried to break and close below the blue up sloping Lower Median Line Parallel. But price closed well above the Lower Median Line Parallel, with great up side separation. This is a sign of strength, a sign that there are buyers below the market.

As I looked to the left of this formation, I noted that price had already tested this blue up sloping line and failed to break and close below it. Finally, looking just a little further to the left, I noted that the low I used as my Pivot C tested the multiple lows just above 1.4070 but was unable to break below them—and in fact closed with great up side separation above these multiple lows. Now I looked at the entire formation and saw three failed attempts to break below areas of support.

And note that each failed attempt to break support was at a higher and higher level. This formation is not talked about much these days, with the advent of all the pretty computer generated indicators, but when I was first learning to trade, it was called 'Three Drives to the Bottom'. And generally if the three drives to the bottom had higher and higher lows, price tended to move higher after the third drive lower.

Take a look at what I now had in mind:

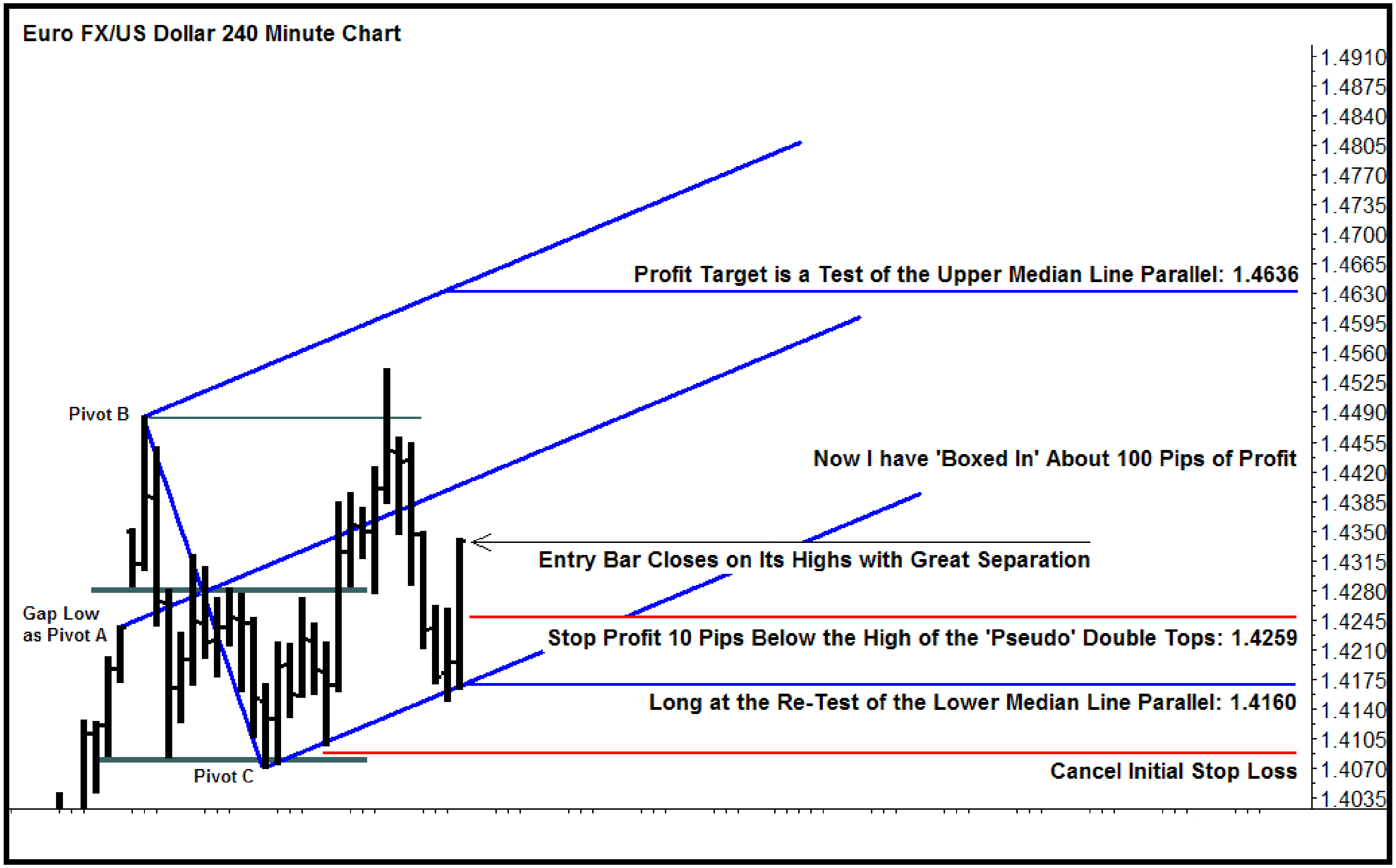


I was unwilling to get long when price broke out to new highs—there was no high probability trade set up that I recognized and there was no acceptable stop loss. But this formation was quite familiar to me and I had this in mind:

1. I wanted to buy a re-test of the blue up sloping Lower Median Line at 1.4160
2. My initial stop loss would be 5 pips below the prior swing low that had tested the Lower Median Line Parallel, at 1.4092.
3. My profit target was a test of the Upper Median Line Parallel at 1.4636

What made me think price would make it past the Median Line if it turned higher from here and make it up to the Upper Median Line Parallel? If the market re-tested the Lower Median Line and allowed me to get long, there were two possibilities: 1) I'd either get stopped out very quickly because I would be wrong about the three higher lows and the great up side separation at each test being a sign that there were good buyers below the market; or 2) The market would go significantly higher, because the long positions had all been liquidated at this point. Only the market knows where it is going, and the market is always right.

Let's see what the market did next:

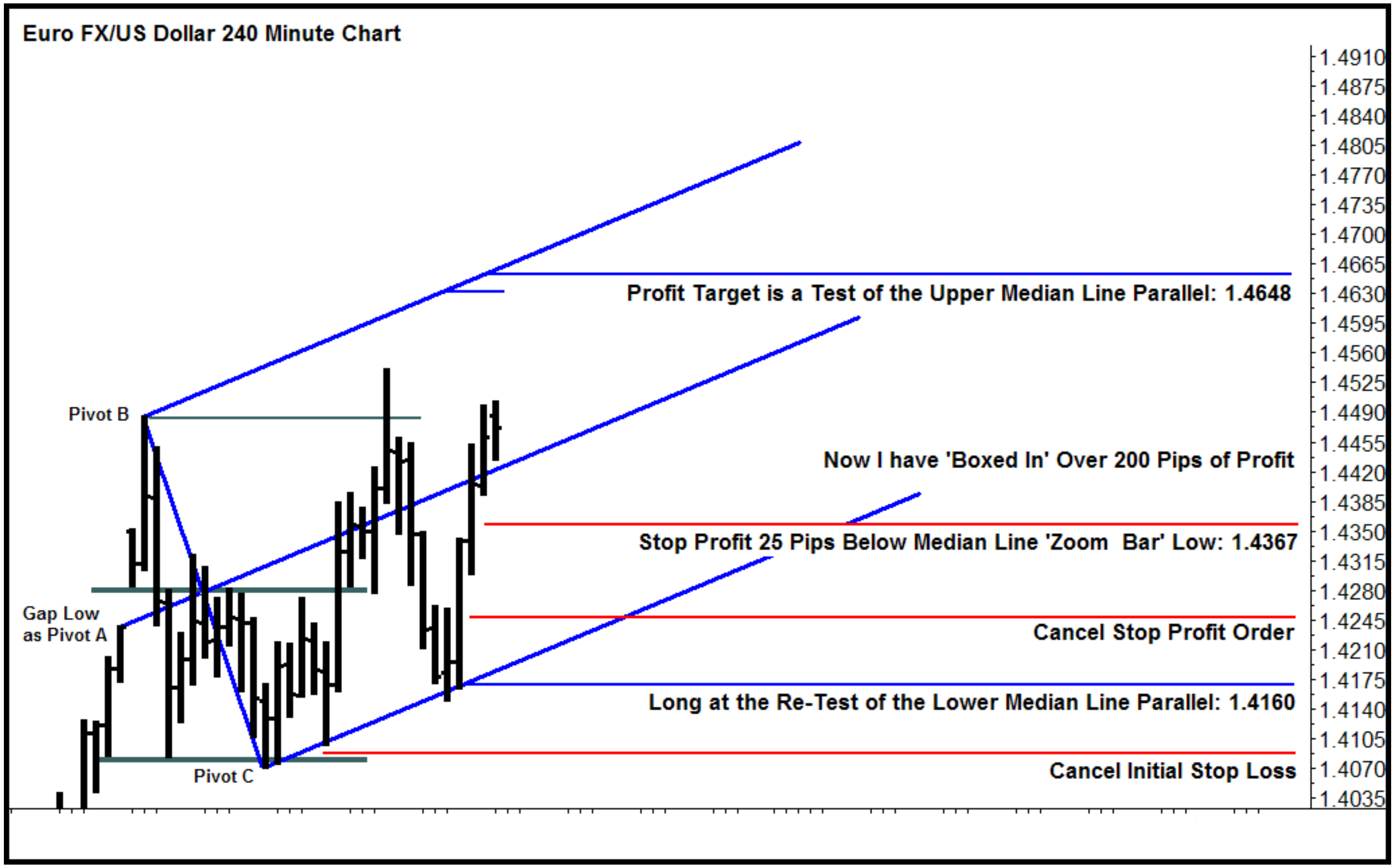


Price did indeed come down and re-test the blue up sloping Lower Median Line, getting me long at 1.4160 in the process. And look where the re-test bar closed: On it's highs, with great up side separation, another sign of strength [so far, so good!].

As my entry bar closed, I noted it was a wide range bar that closed on its highs, and at this point, from where I entered my long position to the close of the entry bar at 1.4341, I had a potential profit of 181 pips! I certainly couldn't let this much profit turn into a loss. I could move my initial stop loss order to break even but I didn't want to leave 181 potential points of profit on the table unprotected either.

When I am long, I generally place my stop profit orders underneath market structure, because there are generally Limit Buy Entry Orders sitting at these structures that will act as some protection for my stop profit orders. But there was no conventional market structure for me to hide my stop profits below this time--the recent sharp sell off had destroyed all semblances of structure, other than the bottoming formation that was still intact.

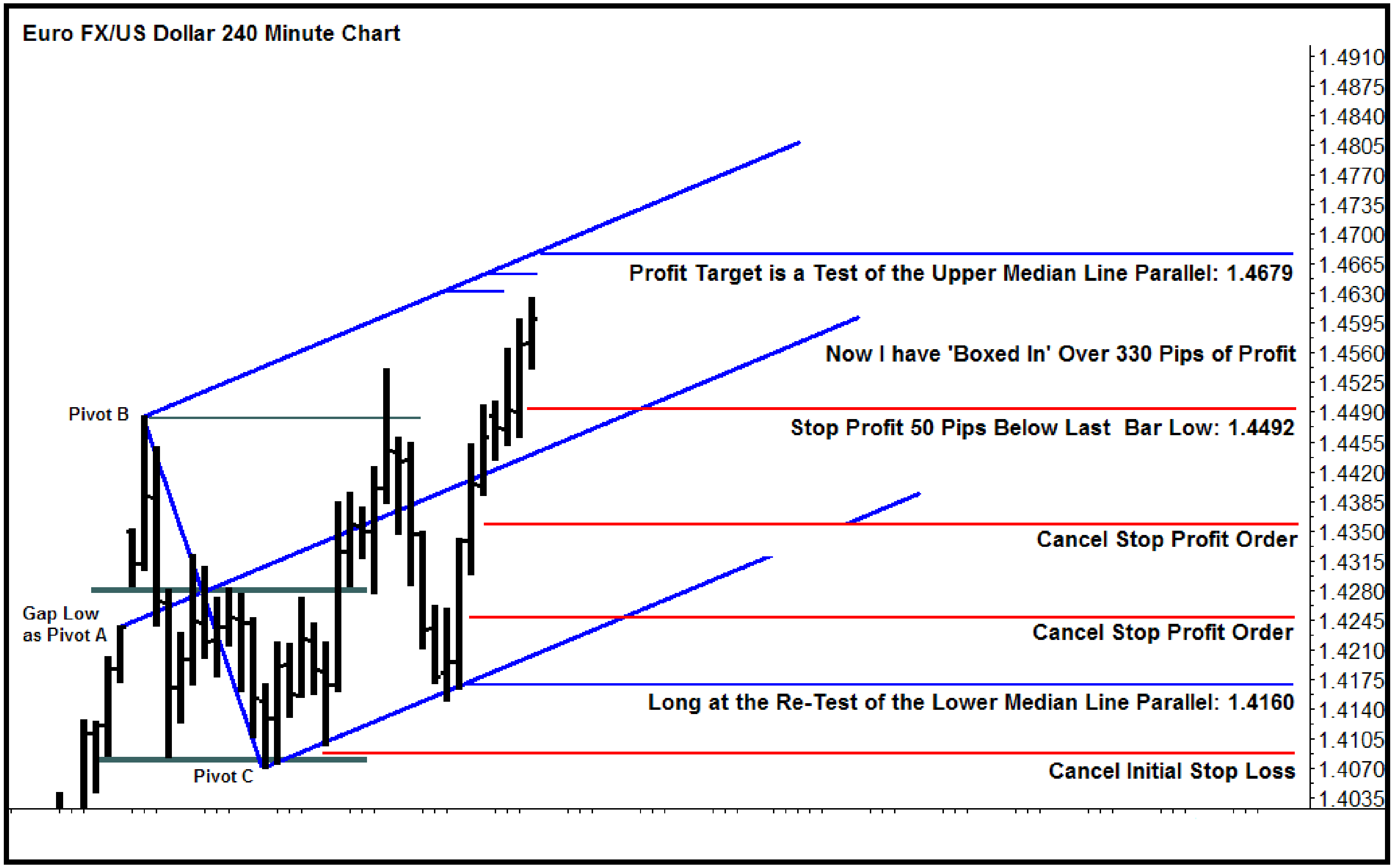
After a bit of thinking, I decided to put a stop profit order 10 pips below the tops of the pair of bars with nearly the same highs the current bar had just run above. I cancelled my initial stop loss order at 1.4092 and entered a stop profit at 1.4259, locking in roughly 100 pips should price turn on a dime and sell right back off.



The next three bars were also higher and each had a higher close. There was still no obvious market structure for me to hide any stop profit orders beneath, but with price closing at 1.4472, I now had a healthy potential 312 pips of profit in the position. I had no choice but to be creative: I placed my stop profit order 25 pips below the low of the bar that had zoomed above the Median Line, at 1.4367.

In reality, these are nothing more than ‘cash profit stops’ because they are not using any widely used market structure as protection. I never use cash stop loss orders, but I now had so much profit in this position that I had to keep ‘boxing in’ profits, using what amounted to a cash profit stop—to me, using cash profit stop orders is quite different from using cash stop loss orders, though I seldom ever use cash stop profit orders. It’s very unusual for me to find myself with a position and no structure to hide my stop orders above or below, but the market is always right! I was here with a great deal of profit in my open position and I had to protect it.

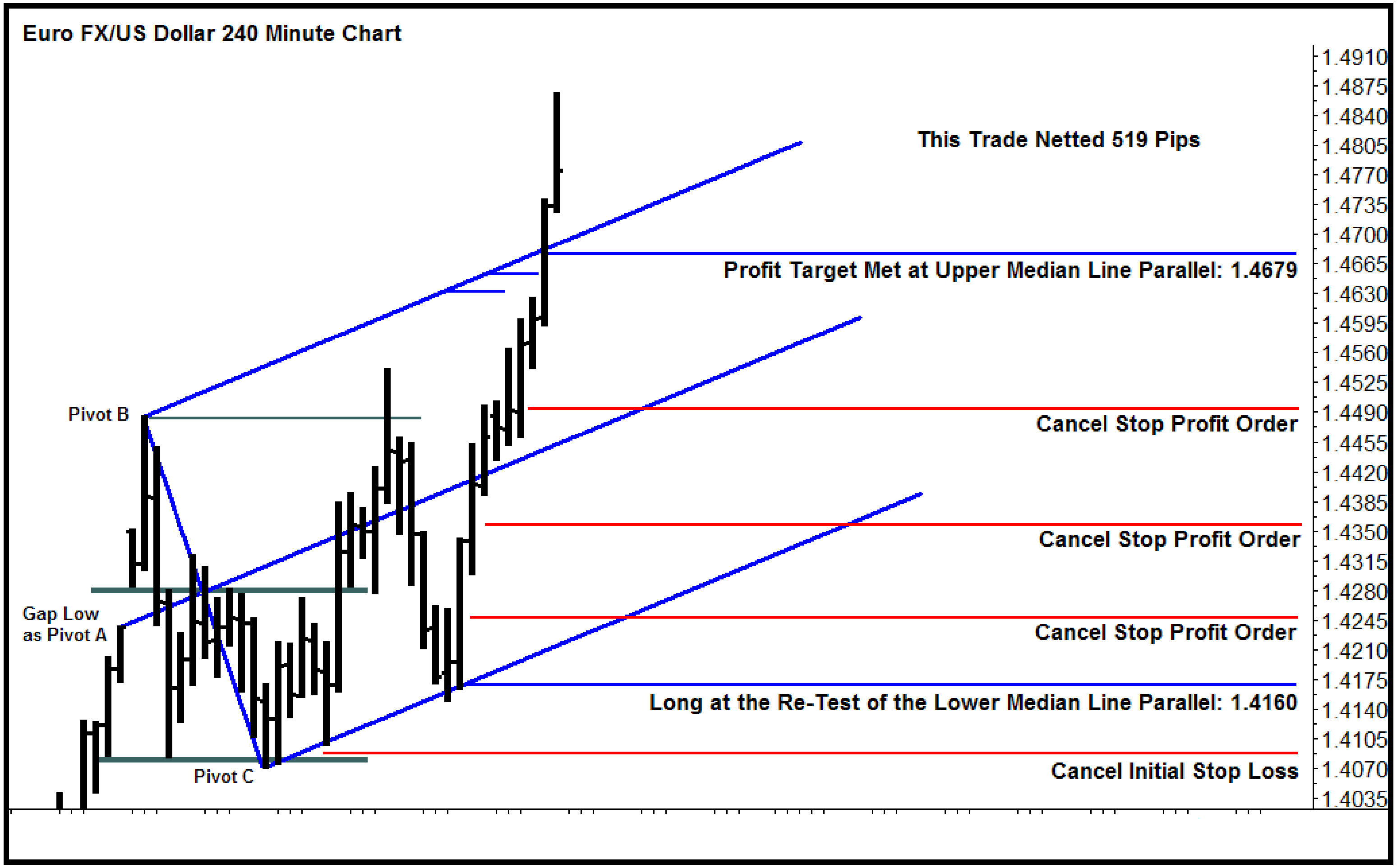
Note that I ran my cursor along the Upper Median Line Parallel and found that because of the upward slope of the line, my profit order should now move higher, to 1.4648. I am trading with the trend, because I am long against up sloping lines, so I get paid more the longer I hold this position as long as I move my orders higher.



Three more bars unfold and again, all three closes have higher highs and close higher. There is still no discernable market structure—this is what I refer to as a 'chimney formation', though it's not yet clear if it is just the opposite side of the downward chimney formation from the prior highs. I am on the right side of the market and at the close of the last bar on this chart at 1.4600, I have a potential profit of 440 pips.

I cancel my prior stop profit order and move it higher, to 50 pips below the low of the just-closed bar at 1.4492. If price turns around at this point, I will be stopped out for a very nice profit of 332 pips. Once I move up my stop profit order, I check where price would intersect with the Upper Median Line Parallel when the next bar forms: that price is 1.4679 and so I move my Limit Sell Order, my profit target, accordingly.

This part of trading is the hard part—doing the little things without making mistakes. But it's the attention to detail and the logical movement of stop orders and profit orders that can maximize your profitability. It is fun to look at the newest multi-color computer generated lagging indicator in the magazines, but it is truly the work once you get in a trade, managing the trade correctly, that can make all the difference in the world—but it isn't fun to look at and most traders don't really want to talk about it or read about it. New indicators are fun toys! Money management is…well, boring. But a good understanding of money management really drives your profits, in my opinion.



The next bar ran higher, taking me out of my long Euro FX position at 1.4679, for a total net profit of 519 pips. Price did go higher, but that didn't bother me in the least. I had a plan, I traded my plan, and now I was flat with a nice profit. The market would go where it wanted to go, but my planned ride was over. And it ended quite nice, thank you.

As a mentor, how do I compare my style of trading this market with the style used by some of traders, namely those using 'Bread and Butter' style trading to approach these markets? Certainly I made much more on my trade than any of them did. But my capital was exposed for a great deal longer than their capital was exposed.

And I was willing and able to be very patient when looking for an entry: If I go three or four days without a trade, it doesn't bother me in the least. My focus is on producing a smooth capital appreciation in my account, not building my account from $10,000 to $15,000 in XX months. Nor do I have clients looking over my shoulder asking me to trade frequently. I have the luxury of only 'swinging the bat at the pitches I recognize', as Ted Williams used to say. If I don't see a trade set up I like, I'll wait patiently; one will eventually come along in one of the markets I watch.

And if you look closely at my stop profit movements, there was a little 'Bread and Butter' order placement going on as well. In the end, I feel that each trader must master their tools, master themselves and find a trading style that suits their strengths and weaknesses. In mentoring, I do my best to help each of my students become the best trader they can be by developing a style that suits their own strengths and weaknesses. Only then can they become the best trader they can be.

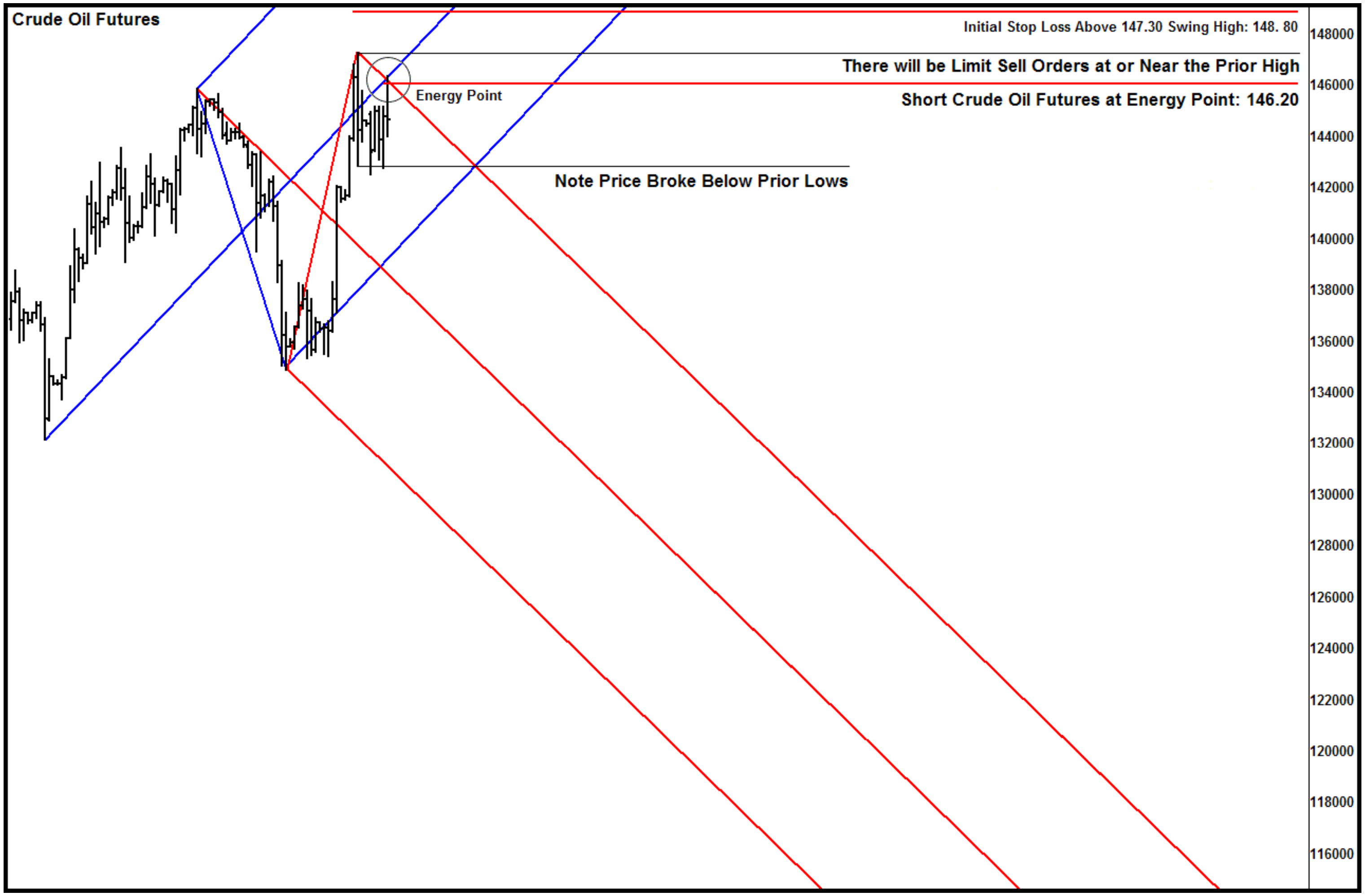
Supercharge Your Stop Orders!

Let's face it: Most traders hate stops. They just know in the back of their mind that if they put a stop above [or below] their position, the market will find their stop loss order, fill it, and then return to the trend, leaving them feeling they had the right idea but not no profit to show for it. This is such a prevalent belief, it must have some basis in fact. Or does it?

I have been a professional trader for more than 37 years. I am known for two things:

1) I am probably the world's authority on Median Lines [or pitchforks]
2) I am a master at using surgeon-like money management techniques when managing trades to 'box in' and milk the most profit out of my trades. I want to show you some examples of how I use the market action and YOUR orders sitting in the market to maximize MY profit.

As we look at these images, I am not going to focus on the entry or profit target technique; instead, I want to show you how YOU can use market formations and OTHER TRADER'S orders to greatly improve your profitability. These techniques will work in any market, but let's look at a chart of Crude Oil Futures:



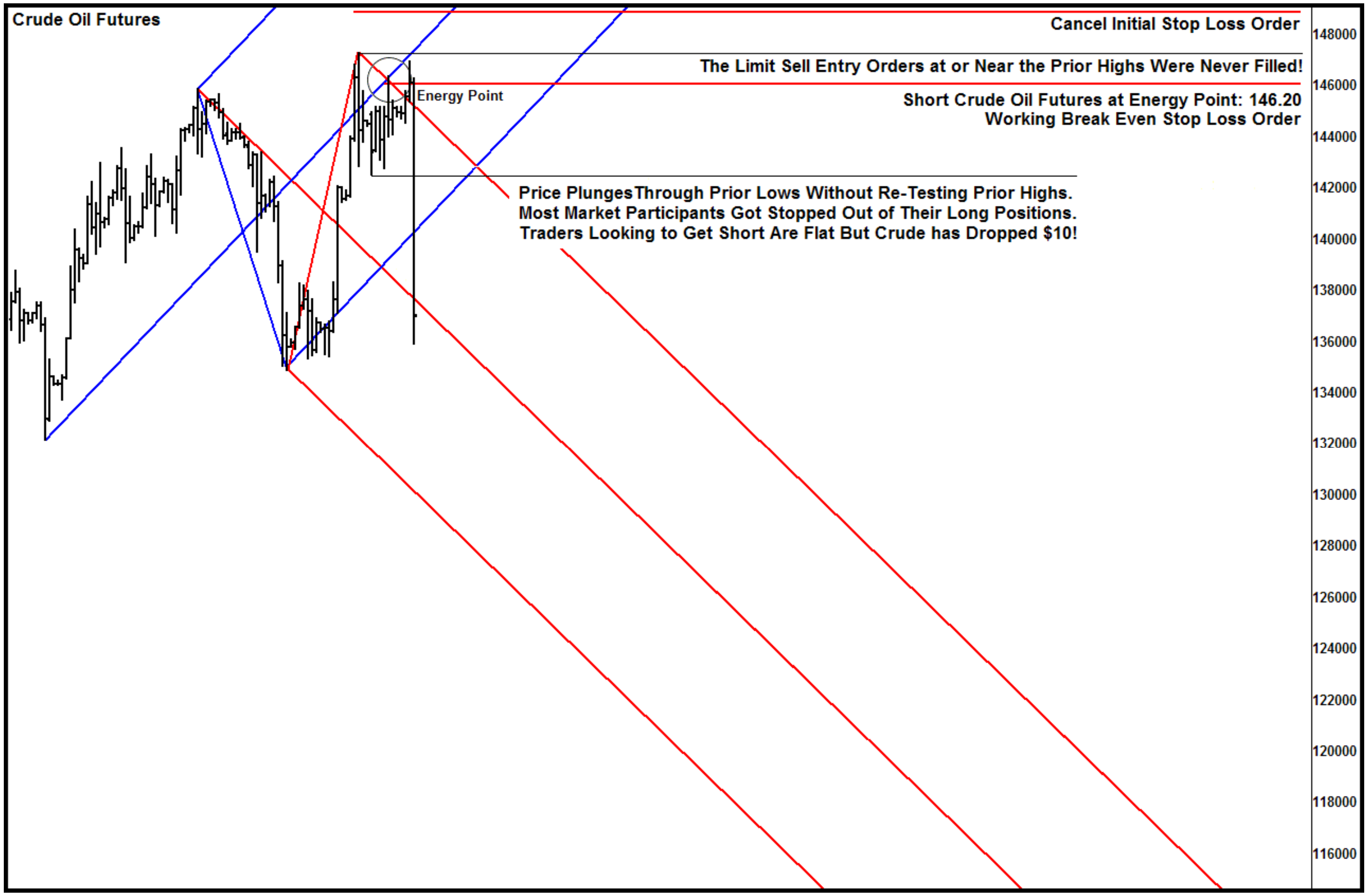
Looking at the first chart, Crude Oil Futures have come off their high of $147.30 a barrel. Once price began breaking through prior lows, I added in a down sloping red Median Line Set and its Parallel Lines. This left me with an up sloping and a down sloping set of lines—and an Energy Point, where two Lines of Opposing Force meet, just below the high for the move.

I know from my research that Energy Points act as Price attractors and are also high probability areas for changes in trends. Because oil prices seem to be showing some weakness and have come so far to the upside so fast, I put an order in the market to get short Crude Oil Futures at the Energy Point with an initial stop loss order $2.50 a barrel above the prior high.

Since the majority of traders either use lagging indicators [MACD, oscillators, moving averages, CCI, etc.], at this point their indicator have yet to turn lower; the majority of the traders in this market are long or flat. And the few traders that use other methods are most likely working limit sell orders at or near the recent Swing High, the all-time high for the move.

I use Median Lines because very few traders use Median Lines as their main trading tool. Not only are they are a leading indicator, they also have a known statistical probability the moment they are drawn from three alternating pivots. The leading indicators I use, Median Lines, tell me there is a good probability that a major turn in oil futures has just occurred. I am short at the Energy Point, where an up sloping Median Line and a down sloping Median Line Parallel meet. But why put my stop loss order where I put it?

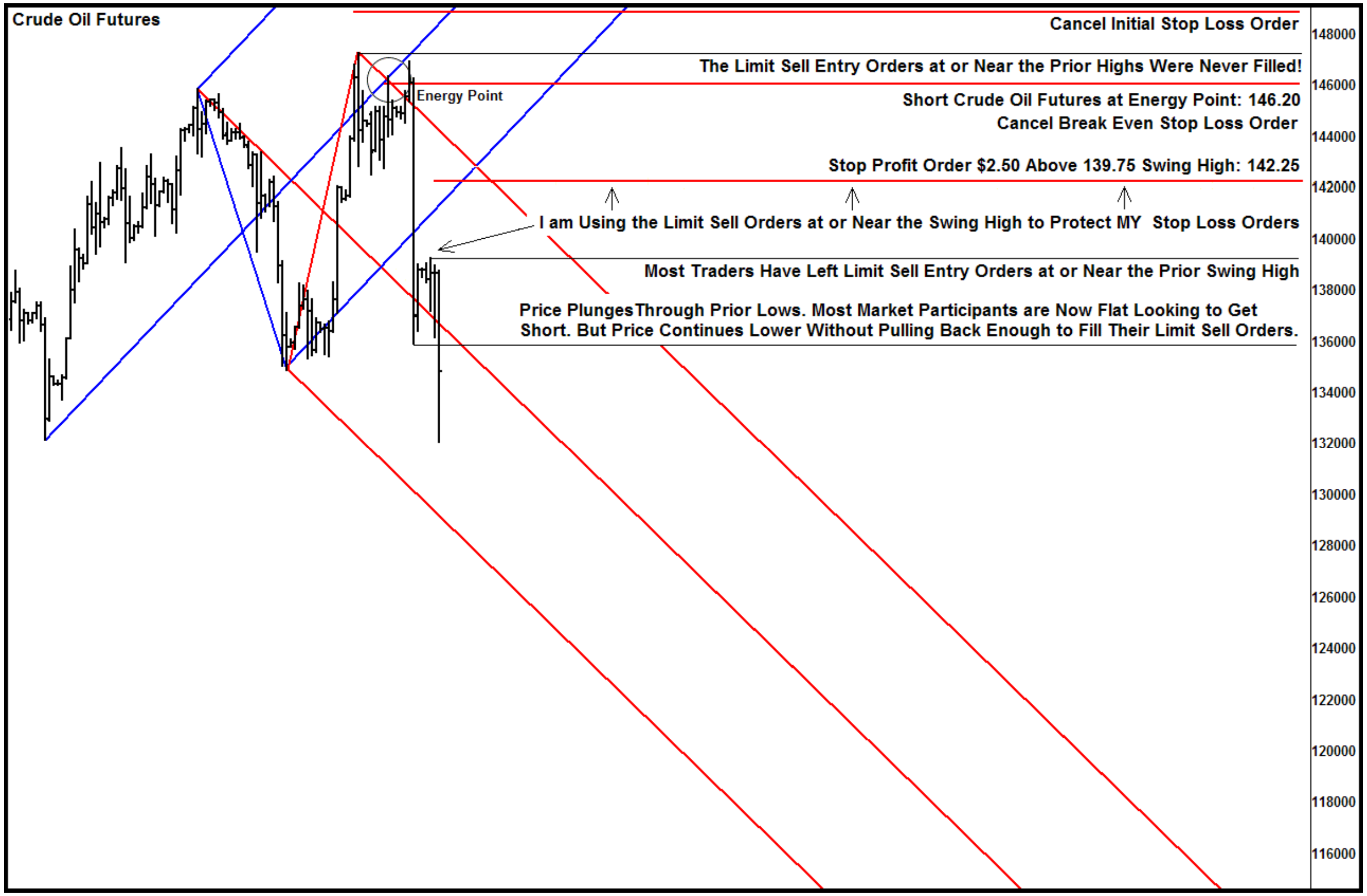
As I pointed out earlier, any traders willing to go short are most likely working limit sell entry orders at or near the prior high. These orders will act as a buffer if price approaches this level. If I am correct, either price will never make it high enough to test this level OR the resting limit sell entry orders will slow or stop price's advance, protecting my stop loss order hiding several dollars above these orders; if I am wrong, I'll be stopped out and that is a normal part of trading.



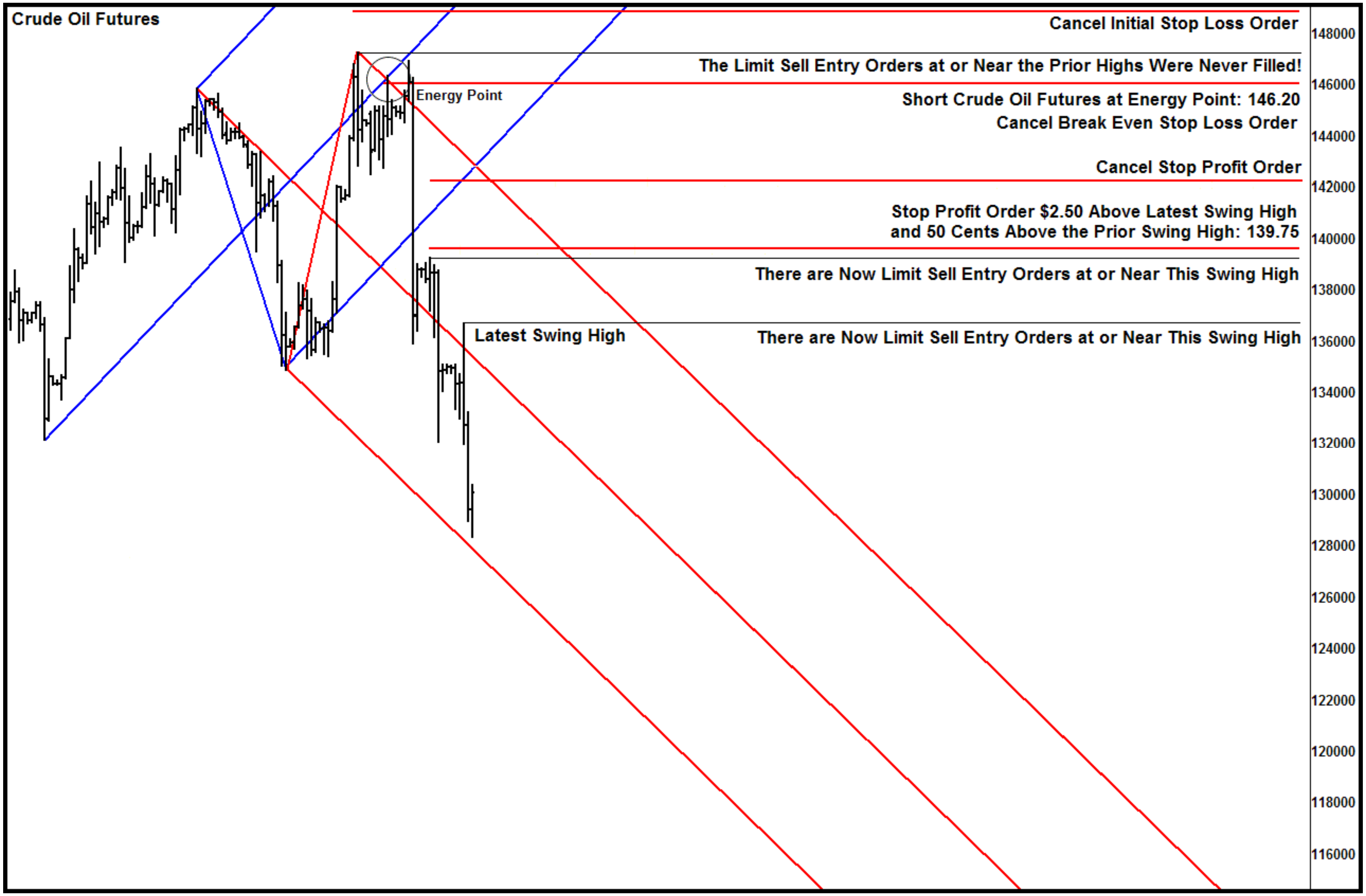
Price consolidated a bit and then headed higher. It ran right into the limit sell entry orders in this case and those orders slowed the advance of price—Price failed to make a new high. Several bars later, when some of the traders that had left limit sell orders became frustrated at not being filled, sell orders began to flood the crude oil market. Once prior lows were taken out to the downside, the sell off became swift and steep as traders that were long scrambled to dump their position and as traders that had tried and failed to enter short crude positions at the prior high now looked for areas to get short.

At the close of this wide range bar lower, I canceled my initial stop loss order and put in a break even stop loss order. As soon as market structure gave me an opportunity, I would try to box in some profits.

After a huge $10 dollar wide bar lower, price pulled back up about $2 ½ dollars a barrel and then consolidated in a trading range for four or five bars before starting to sell off again. Once price made a new low for the move, it confirmed a new Swing High at the top of the consolidation. This new low in price is extremely important, because the aggressive sellers that had been working limit sell orders at the prior highs now move their limit sell entry orders at or near the new Swing High.

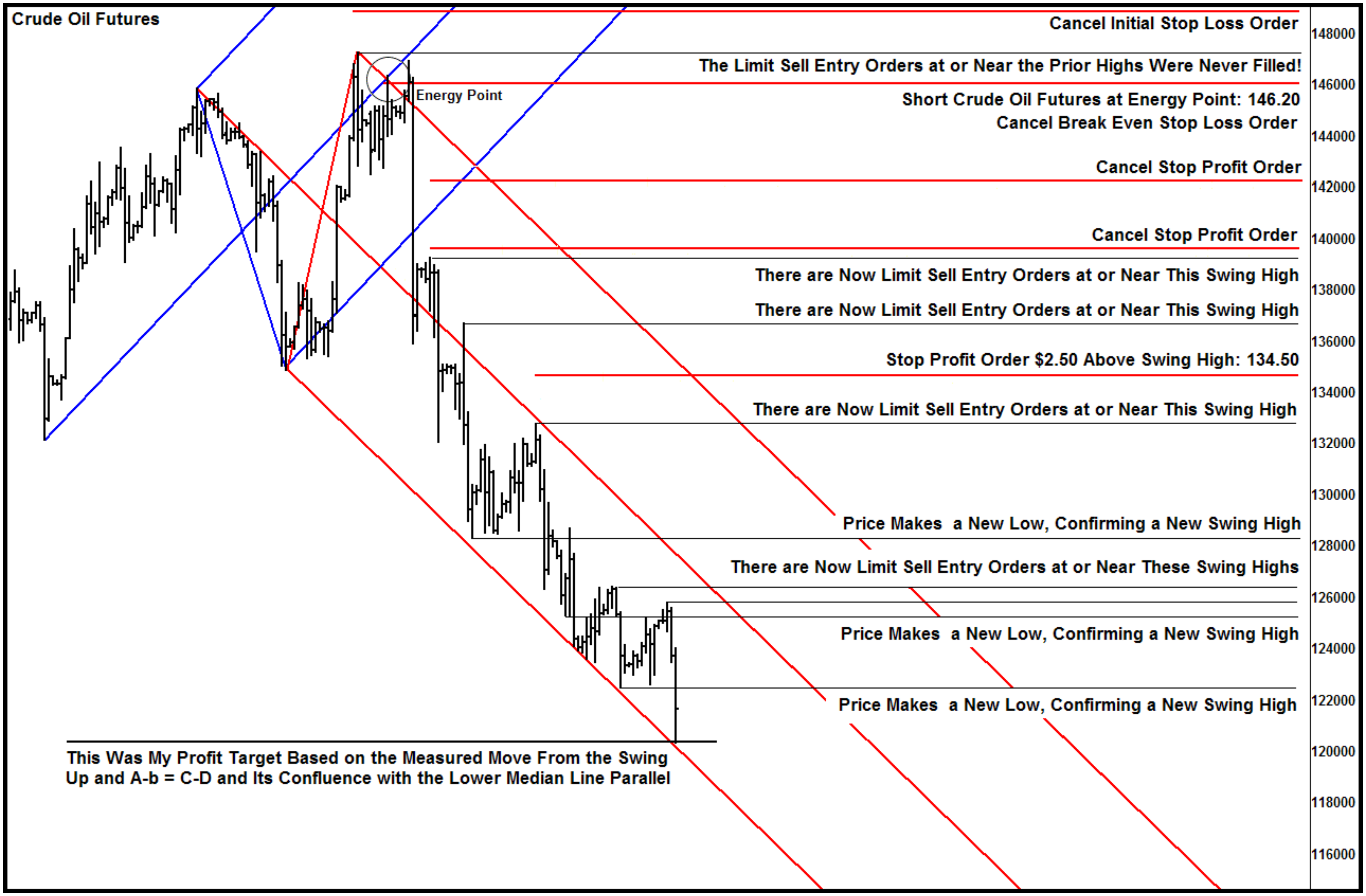


Because these traders have now lowered their limit sell entry orders, I am now able to move my own break even stop loss order to $2 ½ dollars above the just made Swing High—because these new orders will be my new protection! Once again, these orders will act as a buffer if price approaches this level. If I am correct, either price will never make it high enough to test this level OR the resting limit sell entry orders will slow or stop price's advance, protecting my stop loss order hiding several dollars above these orders; if I am wrong, I'll be stopped out for a profit.



Once again, price plunges lower and then consolidates. This time, it spikes $2 dollars above the consolidation but then sells off hard again. Once price makes another new low for this move, a new Swing High is confirmed again. Again, this new low in price is extremely important, because the aggressive sellers that had been working limit sell orders at the prior highs now move their limit sell entry orders at or near the new Swing High.

Because these traders have now lowered their limit sell entry orders, I am now able to move my own break even stop loss order to $2 ½ dollars above the just made Swing High—because these new orders will be my new protection! Once again, these orders will act as a buffer if price approaches this level. If I am correct, either price will never make it high enough to test this level OR the resting limit sell entry orders will slow or stop price's advance, protecting my stop loss order hiding several dollars above these orders; if I am wrong, I'll be stopped out for a profit.



You can see that this pattern continued over and over and I took my profits just above $120 a barrel. After staying away from the crude market for a few weeks, I was able to initiate another short position and rode it lower for more than another $45 a barrel using the same techniques.

The key lesson here is using OTHER trader's orders as protection for YOUR OWN orders. You can hide your orders above limit sell orders or below limit buy orders. These orders may be clustered at a certain area because of prior highs or lows, Swing highs or Swing Lows, Geometric Ratio Levels [most of you call them Fib ratios] or even simple trend lines. But the most important thing is that you need to practice to anticipate where market orders are bunched—both limit entry orders and stop loss orders—and then learn how to use those orders to your advantage. I work with the few traders I mentor one on one with market context and anticipating where orders are likely clustered during a part of each session.

These orders are free protection—you need to learn how to use them to your advantage if you want to learn to improve your money management abilities. Money management topics are not as sexy as entry techniques or flashy new indicators, but quality money management can truly make the difference between being a winning trader or being in the majority of traders that open $10,000 accounts and lose all their money within three months.

Take the time to learn to supercharge your stops. It will make a tremendous difference in your trading. Once you begin using technique like these, you'll stop getting 'washed and rinsed' at the tops and bottoms of moves by a tick or two; instead, price will get near your stop orders and the majority of the time, turn back towards the trend because the resting limit entry orders protected your stops.

Thanks to the author: Timothy Morge of MarketGeometry.com