A Handy Trader's Guide to Setting Your Stop Losses

01

Position Sizing Calculation in Forex Trading

Position sizing is a key concept in trading, and refers to the number of units of an instrument that you trade. Proper position sizing is crucial in managing risk, as it allows you to control your level of exposure to the market.

It's one of — if not THE most essential skill in trading. Traders manage risk, so if you plan on becoming a trader, you should be able to calculate position sizing with your eyes shut.

Position sizing also has an impact on your potential profits — more units traded means more potential profit (or loss).

To calculate position sizing, you need a few key pieces of information to properly do the math:

1. Account equity or balance
2. The forex pair or instrument you are trading
3. The percent of your account balance you'll put at risk
4. Stop-loss in pips/units
5. Conversion currency pair exchange rates

Calculating Position Size in Forex

We'll use a couple of scenarios to demonstrate how to calculate your position size — keeping in mind your account size and risk tolerance. Note that these calculations apply to forex trading. Position sizing will differ for other instruments, based on lot sizes and a few other factors.

Whether or not your account denomination is the same as the base or quote currency will affect your position size so be aware when doing the calculation.

Scenario 1:
Your Account Denomination is the Same as the Counter Currency

Here are the assumptions:

- Your account denomination is in U.S. Dollars.
- Your account has a $5,000 balance.
- You trade EUR/USD (or any other pair where the USD is the counter currency).
- You are a swing trader willing to risk 200 pips per trade.

Let's calculate your position size to stay within your risk parameters…

Using figures for account balance and the percentage amount you want to risk, we can calculate the dollar amount to risk:

$5,000 x 0.01 = $50

Next, we divide the risked amount by the stop-loss to find the value per pip.

$50 / 200 pips = $0.25 per pip

Finally, we multiply the value per pip by a known pip value ratio for EUR/USD. For this example, with 10K units (one mini-lot), each 1-pip move is valued at $1.

$0.25 per pip * [(10K units of EUR/USD)/($1 per pip)] = 2,500 units of EUR/USD

So, you should put on a trade with a position size of 2,500 units or less of EUR/USD to stay within your risk parameters.

Scenario 2:
Your Account Denomination is the Same as the Base Currency

Here are the assumptions:

- Your account denomination is in euros.
- Your account has a €5,000 balance.
- You trade EUR/USD (or any other pair where the EUR is the base currency).
- The exchange rate for EUR/USD is currently €1 = $1.20.
- You are a swing trader willing to risk 200 pips per trade.
- You only want to risk 1% of your account per trade.

Let's calculate your position size to stay within your risk parameters for the same trade example above…

€5,000 x 0.01 = €50

The difference here though is that we have to convert this figure to USD first since the value of the pair is calculated by the counter currency. According to our assumptions, the exchange rate is €1=$1.20.

To find the value in USD, we must invert the exchange rate for EUR/USD and multiply by the number of euros you want to risk.

($1.20 / €1) x €50 = €60

Next, divide your risk in USD by your stop-loss in pips.

€60 / 200 pips = $0.30 per 1-pip move

Now you have the pip value with a 200-pip stop to stay within your risk parameters.

Lastly, we multiply the value per pip move by the known unit-to-pip value ratio.

$0.30 per pip x [(10K units of EUR/USD)/($1 per pip)] = 3,000 units of EUR/USD

Thus, to risk €50 or less on a 200-pip stop-loss of EUR/USD, your position size should be no bigger than 3,000 units.

Next, we divide the risked amount by the stop-loss to find the value per pip.

$50 / 200 pips = $0.25 per pip

Finally, we multiply the value per pip by a known pip value ratio for EUR/USD. For this example, with 10K units (one mini-lot), each 1-pip move is valued at $1.

$0.25 per pip * [(10K units of EUR/USD)/($1 per pip)] = 2,500 units of EUR/USD

So, you should put on a trade with a position size of 2,500 units or less of EUR/USD to stay within your risk parameters.

Using the risk management formula to calculate position size for different forex pairs is a critical skill for any successful trader. Position sizing based on this formula involves assessing the total amount of capital at risk and tuning it to your risk preferences.

What other factors to consider when determining your position size in trading?

When you're trading markets, understanding and managing your risk is essential. When determining your position size, one important factor is how much you can afford to lose. Trading small amounts with careful risk management will help keep your losses low and improve the chances of profiting over time. Additionally, it's wise to base position sizes on a percentage of your starting capital as this allows you to scale up or down your trades if needed. Furthermore, you should factor in the effects of leverage when setting a position size which can greatly magnify risks, though can also provide returns far greater than what would have been possible without it. Ultimately, doing some research ahead of time and paying close attention to your risk parameters will help ensure that you make better-positioned trades in the market.

02

What is a Stop-Loss in Trading and Why Should You Use One?

A stop-loss is a crucial tool for traders to manage and preserve their capital. It is a limit that you set on your trade to protect yourself from losing too much money. When the market moves against your position, your stop-loss will automatically sell (or buy) to limit your losses. In this blog post, we will discuss what a stop-loss is and why you should use one in your trading strategy!

What is a Stop-Loss in Trading?

A stop-loss is an order that you place with your broker to automatically close a trade when the market moves against you by a certain amount. The market can respond quickly to geopolitical news, economic releases, and lots of other factors. Sometimes, you're just on the wrong side of a trade and a stop-loss helps mitigate that risk. It's essentially an insurance policy that allows you to limit potential losses if the market goes against your position.

See below for an example. Let's say that you bought EUR/USD at 1.2160 and placed a stop-loss of 1.2090. If the market moves beyond that level, your trade will be automatically closed to limit your losses.

And you live to fight another day... You've cut your losses and eliminated the anxiety of trading without a plan, throwing caution to the wind. The stop-loss serves as the invalidation point of your trade idea.

Why Use a Stop?

Having a stop-loss in place is important for any trader. The volatile nature of the markets means that they can move quickly and unexpectedly. By placing a stop-loss, you are protecting yourself from large losses should the market turn against your position.

Let's look at an example of two traders and how their stop-losses can affect their accounts.

Trader #1 always places their stop-loss very far away from the open price — **at a spot that represents 10% of their account balance**.

Trader #2 always places their stop-loss tighter to the open price — **at a spot that represents 2% of their account balance**.

If both traders go on a losing streak and lose ten trades in a row... Trader #2 is down 20%. Trader #1 has blown their account and is out of the game.

The moral of the story is that a reasonably-placed stop-loss helps lower the risk of blowing your account and protects your capital.

Stop-losses also help to keep emotion out of trading decisions. If a trade doesn't work out, it's much easier to accept the loss if you have a pre-determined limit in place rather than trying to stay in the trade and hope for a turnaround.

Stay tuned for more on the four types of stop-loss methods to choose from: percentage stop, volatility stop, chart stop, and time stop.

03

What is a Percentage-Based Stop-Loss?

The most elementary way to set your stop loss is based on a percentage of your account — the percentage-based stop loss. This method uses a fixed percentage of the trader's account to set the stop. For example, a trader might specify in their trading strategy that they are willing to risk 3% of the account on a trade.

Determine What Percentage of Your Account You're Comfortable Losing

Determining how much of your account you're comfortable losing is an important part of risk management. Losing a certain portion of your account with each trade is a difficult concept to face, but it's an essential element for preserving long-term bankroll stability.

The percentage that a trader specifies is entirely up to them and can vary from trader to trader. Some of the more aggressive traders decide to risk 10% of their account, for example, while more conservative traders have 1-2% risk per trade.

The Danger of Using a Percentage-Based Stop-Loss

When setting a stop loss, it is important to always consider the market environment and the system rules rather than what you are willing or able to risk.

What do we mean? Think about this scenario…
In a previous article, we talked about position sizing, which can impact a percentage-based stop-loss if position sizing is too large.

Imagine you have a mini account with a $500 account balance. The minimum size you can trade is 10,000 units. You want to take out a short trade on EURUSD because you see a resistance zone holding around the 1.0657 level.

Per your risk management rules, you decide that you are only going to risk 2% of your account maximum. At 10,000 units of EURUSD, each pip is worth $1, and 2% of your account is $10. According to your percentage-based stop loss, the largest stop you can put on is 10 pips, which is what you do on this trade below, setting your stop at 1.0667.

Wait... EURUSD can move 50 to 100 pips in a day. You are running the risk of getting stopped on the smallest move — which is exactly what happens. Your trade hits the stop and you miss the entire downward move that you correctly predicted.

That is the danger of basing your stop loss solely on how much you want to lose instead of the prevailing market conditions of EURUSD.

Take a look at what happened to your trade. As you can see, the danger of using a percentage-based stop loss is that you are setting your stop at an arbitrary price level, giving no mind to market conditions. If you want to stay within your 2% stop-loss parameters, you are going to have to adjust your position sizing.

04

What is a Support and Resistance Based Stop Loss?

In the previous article, we talked about how to set a stop loss by using a percentage-based amount of your account balance. A second way to set a stop loss that we will be discussing is a chart-based approach — a support and resistance based stop loss. This method involves using support and resistance levels to find a good stop-loss level for your trade.

Stop-loss orders can be an essential tool for any trader, as they help to protect your money from big, unexpected losses. An important part of trading is understanding the concept of a support or resistance level and how to use it to set your stop loss. A support level is an area where sellers seem unwilling to push prices lower, while a resistance level is exactly the opposite; an area where buyers are unwilling to push the price higher. By understanding these levels, you can help identify key points where you may want to place your stop-loss order, providing more security and assurance that you will not experience undue losses on a trade.

Place your stop loss just below the support level if you’re buying, or just above the resistance level if you’re selling.

Using a support and resistance based stop loss at the right points is critical to any successful trading strategy. With this method, a stop loss should be placed just below the support level if you’re buying, or just above the resistance level if you’re selling to protect your position against volatility and/or an invalid trade idea. Setting a stop loss at these key areas allows you to get out of a bad trade without significant losses, giving you an important safety net in an unpredictable market.

If the price action breaks through this level, it's likely to continue moving in that direction, so you don't want to be in the way!

With all the uncertainty in the markets, it's important to keep an eye on the price action and be aware of current levels. Knowing just how far prices could shoot up or drop down can help you make wise decisions for your trades. For example, if the price action breaks through a certain level, then it's likely to continue moving in that direction. Therefore, you don't want to be in its way, as it will be more difficult to come out ahead. So, by setting your stops just beyond support or resistance levels, you are safeguarding against a bad move against you.

A Support and Resistance Based Stop Loss Example

As we mentioned, support and resistance levels are where price action continues to test the same level or zone, struggling to break beyond those levels. By setting your stop loss just beyond these support and resistance zones, you are playing within the areas that the market is dictating.

Think about it. If there is a break of a support or resistance level, many traders will continue to play the break and push price action against you. By having a stop loss just beyond that level, you ensure that a market move against you does not wipe you out.

Let's take a look at a quick example…

You look at the EURUSD hourly chart and notice that price action has broken through the trendline and so you decide to put on a buy trade.

But where could you place your stop? What are the market conditions and past price action telling you? You also notice that there is a strong support zone and so you place your stop right below that zone. If the price moves into the support area, you can be sure the trendline had no support and the sellers took over — and your trade was invalidated.

But, you let the trade run, and — voila — you bank a nice healthy profit.

05

Using Volatility Indicators to Place Your Stop-Loss

Let's talk a little bit about a third method for placing a stop loss on your trades. This method looks to measure volatility using technical indicators to find good zones for a stop loss.

Just to recap, volatility refers to the amount that a market can potentially move over a given time. If you already know how much a particular market can tend to move, you'll have a better idea of where to set your stop loss to avoid being impetuously taken out of a trade on random instabilities of price action.

Think about it this way. If you are taking a trade on USD JPY and over the last couple of weeks, it has moved around 80 pips a day, setting your stop loss 20 pips away from your opening position runs a huge risk of getting stopped out way early on a slight intraday move that goes against you.

By having a good grasp on market volatility, you can get a better handle on where to set your stops to give your trades a little bit of wiggle room to move.

Using Bollinger Bands to Measure Volatility and Set Your Stop-Loss

We've already spoken about the Bollinger Bands as a measure of volatility. They are a great technical indicator to help you determine a range wherein price might fluctuate.

Bollinger Bands can give you a great guideline on where to set your stop-loss, especially if price action lends itself to range trading.

Simply set your stop loss beyond the bands, whether it is above them or below them.

Using Average True Range (ATR) to Measure Volatility and Set Your Stop-Loss

You can also use the Average True Range (ATR) to find volatility and a good place to set your stop loss. The ATR requires you to enter the period or number of candlesticks that the ATR references to calculate the average range. For example, if you are looking at an hourly chart, and you use the number fifty as an input, then the ATR indicator will tabulate the average range for that market over the past fifty hours.

The idea then is to place your stop loss either above or below the average true range that you have specified to give your trade enough wiggle room to account for recent market volatility.

06

Setting Time-Based Stop-Losses in Trading

When it comes to setting a stop loss, there are a lot of different approaches that traders take. Some base it on a certain percentage of the entry price, some use Fibonacci levels, some use volatility indicators, and others simply set a hard limit on how much they're willing to lose. But what if there was a way to set your stop loss based on time instead of price? In this blog post, we'll explore how you can do just that. By using a simple technique, you can tailor your stop loss to fit your own trading style and increase your chances of success. So whether you're a day trader or a swing trader, this method could be worth trying out.

Time stops are a unique type of stop-loss strategy that involves setting a predetermined time period to exit a trade. This is in contrast to the more traditional price-based approach.

Time stops are a great way to manage risk and increase the chances of success for any style of trader. Instead of basing the stop loss on price, this strategy involves setting a predetermined time period in which to exit a trade. This could be a set time such as open limit hours, days, weeks, or even months, specific trading sessions, or a combination of time-based and price-based elements.

Let's say you're an intraday trader and you place a long trade on USDCAD.

After lots of waiting and very little movement, you get out of that trade after a set amount of time and get into a EURUSD trade with a bit more movement and opportunities:

Since you have predetermined rules which dictate that you will not hold trades overnight, you decide to close the position at 4 PM EST upon market close, when you are done for the day.

Another example of a time-based stop would be if a swing trader always closes their trades on Friday to avoid gap risk and weekend event risk.

A final example of a time-based stop would be setting a time limit on dead trades that aren't going anywhere so that you can find a better setup elsewhere.

What to Consider When Setting Time-Based Stops

Time stops are simple to set up, but there are a few key points to consider when using them. Firstly, it's important to understand that time-based stop losses can be more difficult to manage than a standard price-based one, as you will need to actively monitor the time period in order to ensure you are sticking to your strategy.

Additionally, it's important to have an understanding of the markets and be aware of factors that could affect the price during the predetermined time period. For example, if you plan on exiting a trade at a certain time but there is a news announcement or some other market event that could cause a drastic price movement, then you may need to adjust your time stop accordingly.

Finally, it's important to manage your risk and make sure that your time stops are in line with your overall trading plan and risk management strategy. This will help ensure that you are able to stay in the game and make the most of your trades.

Overall, time stops are an interesting and potentially useful strategy for managing risk in any trading style. By using a predetermined time period to exit a trade instead of relying on price-based stops, you can tailor your stop loss to fit your own trading style and increase your chances of success.

07

4 Common Mistakes Traders Make When Setting Stops

Trading involves making decisions on when to enter and exit a position based on the current market conditions to make a profit. One of the most important aspects of successful trading is setting an effective stop-loss. A stop-loss set too tight can result in premature exits that cost potential profits, while one set too wide or far may allow losses to mount quickly and significantly. Here are four common mistakes traders make when it comes to setting their stop-loss:

Placing Stops Too Tight

It's easy to panic and set your stop loss too tightly, but this often results in premature exits from profitable trades. When setting stop-losses, traders often make the mistake of placing them too tightly. This is because they panic and don't allow enough "breathing room" for the price to fluctuate before ultimately moving in their favor. This leaves no room for movement in the direction that may ultimately result in a winning trade. As a result, even if they have correctly identified a potential opportunity, their stop-loss triggers too soon and they are forced to exit the trade without unlocking any profits. In order to avoid this costly mistake, traders should allow for a wider range of movement before setting their stop-losses and factor in other variables such as volatility and volume when assessing how much breathing room is necessary.

In addition, traders should be aware that different currency pairs behave differently so it is important to consider these factors when determining appropriate stop-loss levels. For example, some pairs may exhibit less consistent motion than others making it more difficult to identify an adequate amount of "breathing room". By understanding the behavior of certain currency pairs, traders can better assess when tighter stops may be appropriate or when allowing for additional flexibility may be beneficial.

Placing Stops Too Far or Wide

Just like placing them too tight, placing your stops too far away from your entry point can result in missing out on potential profits if the trade moves in your favor quickly. Set your stops based on what is reasonable given the current market conditions, but keep in mind that setting them too wide can result in large losses if the trend moves against you.

After all, if you set your stop too far hoping the market will eventually turn, what's the point in having one in the first place?

Using an Arbitrary Position Size Instead of Relying on Solid Technical Analysis

Using arbitrary position sizes like "X number of pips" or "$X amount" instead of relying on technical analysis is another mistake traders often make when setting their stop-loss. When trading, it is important to consider multiple factors such as the overall trend of the market, potential support and resistance levels, current volatility and volume, as well as the time of day. Traders should not simply rely on an arbitrary position size, but should instead use technical analysis to assess the situation and come up with an appropriate stop-loss level.

Setting a stop-loss without taking into account the current market conditions can be risky, as it's not based on any actual data or evidence of where the market may go. Make sure to always analyze the data before setting a stop-loss and consider technical factors. It's advisable that traders should think about their position size after they have already determined where to place the stop-loss.

Placing Stops Exactly on Support or Resistance Levels

This is often a mistake made by traders who don't understand how to properly use technical analysis when setting their stop-loss. Support and resistance levels are typically used to identify where trends may reverse, so placing your stop-loss exactly at these points could cause premature exits from profitable trades. When using technical analysis for setting stops, make sure to place them above/below significant support/resistance levels instead of directly on them, to give your trade a little breathing room.

Following these tips can help ensure that your stop-loss will be effective and minimize the potential losses associated with trading. Remember to always carefully analyze the data and use technical analysis when deciding where to set your stops in order to maximize your profits.

08

3 Best Practices for Placing Your Stop-Loss Orders

When it comes to trading in the markets, stop-loss orders are essential tools that help traders manage risk and protect their capital. While they can be a great way to limit losses, they must be used correctly in order for them to work effectively.

The name of the game is to follow your trading strategy. This means sticking to your stops. If price action has met your stop, your trade is invalid. It's that simple. Accept it and move on to the next trade. Having a "mental stop" — having a price in your head where you will decide you'll get out — opens the door to mistakes and bending of your rules. Use that limit order to create your stops.

Here are three key best practices you should consider when using stop-loss orders:

Never under any circumstances should you widen your stop-loss orders.

By widening your stop, you increase the risk of a bigger loss if the market moves against you, so it should be avoided. If the trade idea was invalidated by your stop-loss, then that's it. Move on to the next one.

Your emotions should NOT be your guide when it comes to moving stop-loss orders.

It can be tempting to adjust a stop-loss order because you are upset that the market isn't moving in your favor, but this should always be avoided. Doing so will only increase the risk of a greater loss if the market suddenly moves against you after you make the adjustment. Your stop should be predetermined by your trading plan and you should not vary from it.

Consider a trailing stop.

This is a great way to ensure that you stay in a trade for as long as possible and maximize your gains. Trailing stops can be adjusted as the market moves, allowing you to protect profits while still giving the potential of making more money if the market continues to move in your favor.

Many brokers offer a trailing stop. This is how you lock in profits. As the trade moves in your direction, so does your trailing stop.

By following these three rules, traders can use stop-loss orders to control risk and maximize profits. While stop losses can provide peace of mind for traders, they must be used with caution in order for them to work effectively. The key is to remain patient and disciplined when making your trades and follow the best practices outlined above. With a bit of practice and dedication, you can use stop-loss orders to protect your capital and ensure consistent profits in the markets.