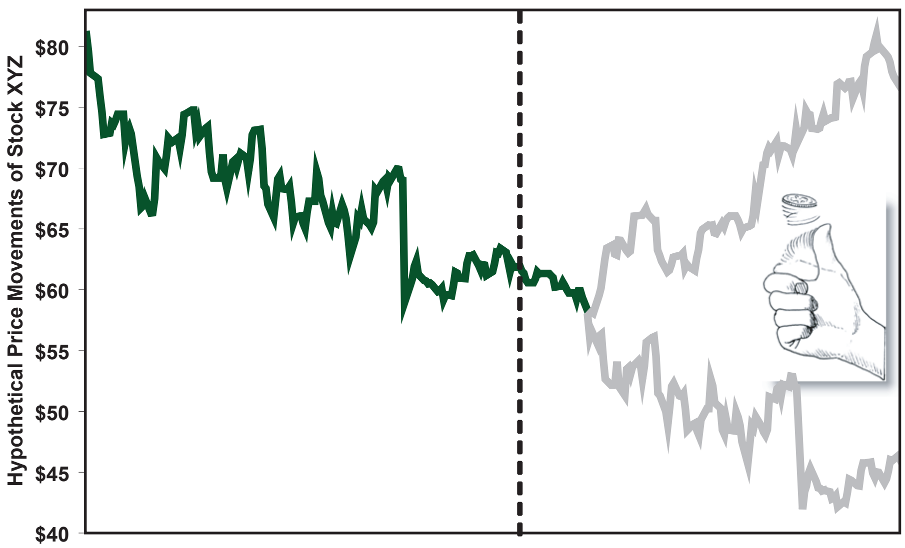
The Legend of the Stop Loss

The concept of a stop-loss seems appealing. A stop-loss involves an investor setting some percent (or dollar) amount of decline. When the stock drops to that level, it's sold. For example, setting stop-losses at 15%, in theory, means you'll never own a stock down more than 15%. No disasters. Sounds prudent, right?

Except we find no evidence the tactic works. Research has proven repeatedly that historical price movement by itself isn't predictive of future price movement. Stock prices are not "serially correlated"—you're trading on a coin flip that the stock price will continue its prior trend or reverse.



If stocks were serially correlated, you could just buy stocks that have risen and not buy stocks that have dropped—cut losers and let winners run. If that strategy worked, so-called "momentum" strategies would yield returns approaching infinity. But it isn't so. And what level stop-loss is right? What if you choose 20% and one stock drops 22% before shooting up 50%? You've garnered a 20% loss, paid a transaction fee to sell, missed that stock's future returns, and now must replace it—paying another transaction fee! But you can't guarantee the next stock will only go up. The replacement stock can drop too. You can keep buying 20% losers on the way toward zero.

Another way to look at this: Sue buys ABC stock at $50 and it rises to $100. Then Sam buys ABC at $100, and it falls to $80—a 20% drop from the high. Should they both sell at $80? Or just Sam with the 20% loss? Sue still thinks the stock is great, but Sam wants to sell. Who is correct? There's no right answer, because past price movement isn't indicative of future price movement.

Stop-losses divert your attention from fundamentals and can force sales during corrections in a larger bull market trend—a terrible time to sell. They make it seem possible to limit downside without having to closely monitor your portfolio, yet the only certainty with stop-losses is increased transaction costs. In an otherwise random process, this alone could make stop-losses a money loser.

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