DOW THEORY FORECASTS®

Stop orders don't stop all the trouble

Subscribers often ask us about the merits of stop-loss orders. Spoiler: We don't use them, and you should probably think twice before using them as well.

On the surface, stop orders sound good. They allow investors to automatically sell a stock if it falls to a given price, with the object of getting out of a losing position before the situation gets worse.

Of course, stop orders don't always work. If a stock tanks on bad news and falls below the stop price, you'll sell -- at market rates. Setting a stop order on a stock at $50 per share doesn't guarantee that you'll be able to sell for $50. You can set a stop-limit order that only sells at $50, but then you risk not getting out at all if the stock gaps lower.

However, the biggest problem with stop orders is that selling stocks on weakness can lead to weak returns, getting you out of stocks right before they rally to new highs.

In rolling periods since 1994, investors who purchased all stocks in the S&P 1500 and held them for 12 months averaged returns of 14.6%. If they instead sold any stock after it declined 10% or 20% from its purchase price, the average 12-month return falls to 13.3%.

Based on the above numbers and others gleaned from our research, here are three issues to consider before you rely on stop orders to make sell decisions:

- **Market participation.** Markets rise and fall constantly, as do most stocks. If a stock falls about 10% along with a 10% decline in a broad index, there's a good chance the stock will share in the good fortune when the index recovers. The superior return of buy-and-hold strategies suggests that many decliners end up roaring back -- at least enough of them to make hard-sell-target strategies suboptimal.

- **Turnover.** In the portfolios we studied, selling all 10% losers would result in the disposal of more than half of the portfolio, on average, at some time during the 12-month period. Selling only after a 20% decline resulted in the sale of just over one-third of the stocks. Our returns assume the sale of a stock if it ended a calendar month at least 10% or 20% below the purchase price. We also assumed monthly rebalancing, so the proceeds from any sales were reinvested in the remaining stocks.

- **Fire and forget.** Just like buy-and-hold strategies, hard-sell strategies can build bad investing habits. If you plan to let the market's whims determine whether you hold a stock, why bother to pay attention to company and market developments? Such complacency can be dangerous, because conditions change. Once you put a stop order in place, you often feel protected, which makes it easier to abdicate the responsibility to keep up with your investments.

Does this mean you should just hold on to every stock you buy? Not hardly. In our Quadrix-related back tests, we sell every stock after 12 months if its Overall score dips below 80; none of our strategies assumes indefinite holding periods.

If one of your stocks plummets after delivering the type of bad news that could translate into a substantial decline in earnings, consider selling it. Some stocks that go down continue to go down. But be careful about setting a hard target for stock sales, as even the best stocks can easily hit such targets during temporary market downturns, costing you dearly over the long haul.

As always, the key to success is paying attention to the reasons behind any price decline. Rather than assuming that the current decline will always devolve into a disaster, assess each stock's moves individually. Most of the time, a little research into the reason for the weakness will provide guidance about whether or not to sell.