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UTILIZING SELL "STOP" ORDERS WITH LARGE STOCK POSITIONS

A "stop" order becomes a "market" order when its "stop" price is "triggered." For example, if a stock is selling at $50 and we enter a "sell stop" order to sell at $45 stop, we continue to own the stock as long as it sells above $45. If the stock goes to $100, we continue to own it. If, however, the stock subsequently trades as low as, or below $45, our "stop" order becomes a "market" order to sell on the next trade, no matter what the price. Typically, the sale would be at or very close to $45, but this is not always the case. In the "Crash of 1987," many stocks opened and sold well below their trigger prices.

The logic for using a sell stop order is the desire to sell a stock as soon as possible after bad news (or the anticipation of bad news) begins to affect its price. The problem with stops is that most of them get triggered, not because of specific company news but, rather, because of simple moves in the market, and this is usually the wrong reason for selling a stock.

There is, however, one instance in which I think we can justify utilization of a sell stop order. Let us suppose that we are in the fortunate position of having such a large gain in a stock that it has become an inordinately large position in our portfolio. Because of our large concentration in the stock, relative to the size of our portfolio, we no longer feel as well diversified as we think we should be.

Under normal circumstances, the conclusion would be that we should sell a portion of the stock to reduce our vulnerability. Furthermore, in most cases, we should probably act about as quickly to diversify as we would act if we discovered that the fire insurance policy on our house had lapsed and that we no longer had coverage.

But let us further assume that this stock in which we are so heavily concentrated is on a roll, with strong earnings momentum (an above-average *Value Line* "Timeliness" rating) and seems more likely to go up than down. In such a case, I think we can justify utilization of a stop on some portion of our position.

True, our stop may still get triggered by a temporary decline in the market. If, however, we are right in thinking that our stock is more apt to go up than down, maybe it will even buck the tide if the market stumbles, at least enough to avoid triggering our stop. On the other hand, if our stop is triggered by a temporary decline in the market, we should feel less regretful because the purpose of our sale was to hedge our bet in any case, and we still have a good portion of our earlier position. (We do not regret having purchased fire insurance, even if our house does not burn down.) Most of all, we are trying to avoid a catastrophic loss in the event that bad news befalls our company and, under these circumstances, this seems a prudent way of doing it. Needless to say, such a strategy could have alleviated much of the pain associated with the bursting of the high-tech bubble during the 2000-2002 bear market.

THE MECHANICS

I suggest that an appropriate place initially to set a stop is at a minimum of 5% and a maximum of 10% below the last sale price at the time the stop is entered (rounded to a whole number within this range to make it easier to remember). Logically the stop price should be raised if, when, and as the stock rises, but the stop price should never be lowered. One can ask his broker to monitor the stop on a "best efforts basis" and notify him when the stock makes new highs subsequent to the order's original entry.

Because stocks typically go down by the amount of a dividend payment on the day a stock goes ex-dividend, the exchanges normally automatically reduce a stop price by the amount of the dividend on the ex-dividend date. (If an order were left in long enough on a dividend-paying stock, the trigger price would eventually be reduced to zero.) To avoid this annoyance I suggest entering sell stops as "DNR" which stands for "Do Not Reduce."

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