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by Standard Chartered's Chief Investment Office

Are stop losses for wimps?

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When I started out in banking, I was based in a dealing room advising traders on potential positions to take. The positions were focused and short-term in nature. Therefore, risk management was not a 'nice-to-have', it was vital to job security. When entering a trade, a stop-loss – a level at which the position taken would be unwound if it was losing money – was a must.

It was against this backdrop that a former colleague quipped that 'stop-losses are for wimps'. He was referring to a stock in his portfolio which had fallen dramatically – he was probably justifying to himself why he should keep it! However, it raises an interesting question: **Should we employ stop-losses when we invest?**

Context is key. A stop-loss basically limits losses when your view is wrong. I would argue that there are two dimensions to consider when deciding whether a stop loss is appropriate or not: the nature of investments being discussed and your time horizon.

Let's take each in turn.

I have a much greater conviction level that a diversified 'foundation' allocation (which includes exposure to different asset classes such as stocks, bonds, gold and private assets), or even a diversified equity portfolio, is more likely to rise over a given period than any individual stock.

The reason is simple. The more you diversify, the more you reduce idiosyncratic risks. This 1) reduces the volatility of the portfolio and 2) reduces the risk of permanent or semi-permanent losses. Companies go bankrupt, stock markets generally don't.

PRINCIPAL #1 **The broader the investment, the less likely a stop-loss is warranted and a buy on dips approach makes sense.**

One pushback we sometimes get is whether a 'buy on dips' approach works for stock markets outside of the US. When we looked at major western and Asia markets, we found the following:

First, the historical probability of positive equity market returns across any given 12-month period, at around a two-thirds probability, is generally similar.

Second, we looked at what has happened after a 10% or 15% market pullback. Focusing on the 1-year time horizon, we can break the countries into 3 groups:

Group 1: either the probability of positive returns or size of average return (or both) increased significantly after a market sell-off. Markets falling into this group include the US, Germany, UK, India.

Group 2: there is no material change in either variable. This includes Hong Kong, Malaysia and Korea. Once you lengthen your time horizon to 5 years though, they all move into Group 1.

Group 3: the probability of positive returns or their average quantum declines after a sell-off. Japan and onshore China markets fit into this group. On a 5-year time horizon, China also moves into Group 1 but, interestingly, Japan stays in Group 3.
Hence the conclusion is: outside of Japan, the 'buy on dips' mantra has made sense, especially when held by long-term investors.

PRINCIPAL **#2** **The longer your time horizon, the less desirable a stop-loss is.**

Thus, for investors who are trying to trade the market and pick stocks, we believe a strict risk management framework including the use of stop-losses is critical to returns.

However, the majority of investors would be better served by building a foundation allocation with a 'buy on dips' approach. Investors can systematise this 'buy on dips' approach through regular portfolio rebalancing – say at least once or twice a year and especially after major market dislocations. Such rebalancing is akin to an investor systematically "buying low and selling high". For these investors, stop-losses are likely to get in the way of wealth accumulation.

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