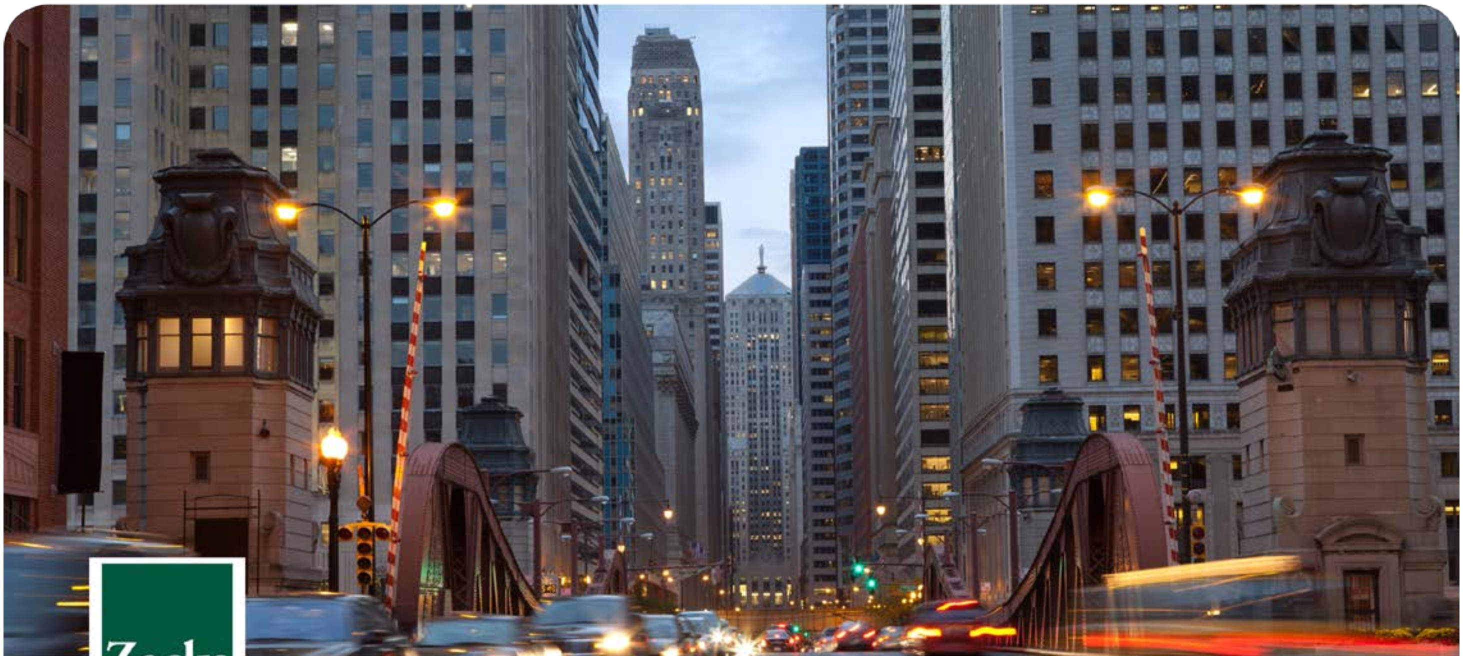

Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

They're Eliminating One of Your Investing Tools

By Mitch Zacks
Senior Portfolio Manager

The New York Stock Exchange (NYSE) announced in mid-November the decision to eliminate stop orders and "good-till-canceled" orders from the investor playbook. When used correctly, stop-loss orders can be a resourceful tool to curb losses, and they can also be used to prevent a stock from falling back to its cost basis – which theoretically ensures you make a profit.

The key word here is 'theoretically.' What the NYSE ultimately found was that stop orders were only being minimally used (3% of all orders) and they were also being used incorrectly more often than not. This has created unintended losses for investors and, in some circumstances, triggered more broad-based selling. The NYSE had seen enough, so as of February 26, 2016, stop orders are off the table.

Why the Rule Change?

The 'straw-that-broke-the-camel's-back' came on August 24th, right in the midst of the global equity correction. Stocks were exhibiting high degrees of volatility for several days (not unusual), but on August 24th hundreds of securities posted unusual moves to the downside. Though not fully proven, studies since by the NYSE and other firms have shown that stop-loss orders most likely played a role in exacerbating those losses.

Additionally, many investors lost a lot more than they bargained for when they set their stop-loss price points. Here is an example of how stop-losses work and can go awry – if you own security 'ABC' at $30, set a stop-loss for $20 but ABC opens trading the next day at $10, you are going to end up selling for around $10 a share. It's quite possible that you totally miss your $20 stop-loss price point because, once the stop price is reached or lower, your stop-order is converted into a market order – executed at whatever the available price is. In some cases, like August 24th, that can mean selling your stock for a significantly lower price than you intended.

The NYSE received several inquiries from retail investing firms concerning stop-loss orders and their impact on pricing and, after analyzing the matter, decided that they are so infrequently used – and so often misunderstood – that they are better off not existing at all.

Pros and Cons of Not Having Stop-Loss Orders

I'll start with the biggest con I'm seeing, which is that investors have a shrinking playbook for tactically managing their portfolios. When used effectively, stop-loss orders can have productive utility, particularly if they are triggered early in a bear market. Removing an investor's ability to exit a stock at a certain level implies a 'less free' market which, I think in that context, is a negative.

However, the pros probably outweigh the cons. The reality of stop-losses, as the NYSE and others found, is that they carry too large a risk. The risk is that the retail investor using them will absorb a greater loss than intended and/or will be whipsawed when the stock bounces back quickly from a low while the investor is sitting in cash. What retail investors often see as an 'insurance policy' in stop-losses can actually assure they will lock in a loss. It erroneously assumes that the stock price will continue to fall when, in fact, there is an equal chance of the opposite being true.

Another pro (that's yet to be determined but is implied by the rule change) is that we may see fewer instances like August 24th, where stop-losses beget stop-losses and securities plummet in value in a short period of time. The NYSE rule would take away one form of automated selling, which may reduce downside pressure in certain instances.

Bottom Line for Investors

Stocks are not serially correlated, which means that what happens in any given day does not necessarily have any bearing on what happens the next. And since we know that stocks go up significantly more often than they go down, it follows that stop-loss orders inherently have a low probability of being repetitively successful. The fact that they're leaving soon shouldn't have much bearing on your approach.

- **Mitch**

About Mitch Zacks

Mitch is a Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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