Finally!

You've got the trading setup you've been waiting for.

So, you put an order into the market and wait for it to get triggered. It's not long before you're in a long position.

Then, the market moved slightly in your favor and you're feeling good about it.

Suddenly, the market stalls. It stopped moving higher.

Instead… it turned the other way round.

Now, it's moving against you.

Your breathing gets heavier and you start having thoughts like…

"Is this still a good trade?"

"Should I hold onto this trade?"

"Should I take a loss now?"

Nonetheless, your stop loss in place and you say to yourself: "what's the worst that could happen?"

The next thing you know… the market tanked and triggered your stop loss.

The weird thing is… after you got stopped out of your trade, the market reverses back into your intended direction.

Now, you felt cheated as though the market is rigged against you. *Wait a minute, what the heck is going?*

Some traders call it "stop hunting", "stop raiding", or even blame their brokers for it.

In fact, it's simply the market moving from one area of liquidity to the next area of liquidity (which I'll explain later).

For now, understand it's not possible to completely avoid this scenario.

But, if you know how to place a proper stop loss, you can reduce the likelihood of it occurring.

So, in this section you'll learn:

- Why you need a stop loss on every trade
- Is your broker against you?
- Why "stop hunting" occurs (it's probably not what you think)
- How to set a proper stop loss

Are you ready? Then let's begin…

Why you need a stop loss on every trade

In the earlier chapter, you have learnt that trading is not about how often you win. Rather, it's how much you make when you're right, and how much you lose when you're wrong.

And here's the thing:

Most traders have the need to be right.

So they look for trading strategies and systems with a high win rate.

Now, if you think about it, it's easy to achieve high win rate. All you need to do is have no stop loss and small profit target — and you can expect to win often.

But, do you know what the problem is?

You're only one trade away from losing your entire trading account.

This usually occurs when the market moves in a single direction aggressively and you're caught on the wrong side of the trade.

This eats up all the little profits you've accumulated earlier.

This is not a matter of if, but when.

This is the reason why you must have a stop loss on every trade because you don't want such an event to happen to you.

Now, you're probably thinking: "But having a stop loss will reduce my win rate".

That's true but, trading is not about how often you win. It's how much you make when you're right, and how much you lose when you're wrong.

Having your stop loss is like paying for insurance.

It's annoying to pay the premium regularly but, you are glad you did it when the shit hits the fan.

Is your broker against you?

I'm sure you have thoughts like…

"Is my broker hunting my stop loss?"

"Why is my broker always widening the spread, are they against me?"

Well, here's my take on it.

Generally, most brokers don't hunt your stop loss because it's not worth the risk.

What's the risk you think?

Think about this… if the word gets out that ABC broker hunts their client stops loss, it's only a matter of time before existing clients pull out of their account and join a new broker.

If you are a broker, would you want to risk doing that over a few measly pips? I guess not.

So, in my opinion, I believe most brokers don't hunt your stops as the risk far outweighs the reward.

Now, you are probably thinking…

“But my broker widens the spread and stops me out of my trade.”

There is a reason for this.

Let me explain…

A broker widens their spreads during major news release is because the futures market which they hedge their positions in has low liquidity prior to a major news release.

If you look at the depth of market (aka the order flow), you’ll notice the bids and offers are thin just before major news release (like NFP) because the “players” in the market are pulling out their orders ahead of the news release.

Thus, you get thin liquidity during such period, which results in a wider spread. And because of this, the spreads in spot forex is widened as well (because if it isn’t, there will be arbitraging opportunities).

So, it’s not that your broker is widening their spread for fun, but they are doing it to protect themselves.

Anyway, the bottom line is, most brokers don’t hunt your stop loss because it’s bad for business in the long run.

And they widen the spreads during major news release because the futures market is thin during this period, and they need to protect themselves.

Why stop hunting occurs

In trading, stop hunting refers to the scenario where a trader’s stop-loss got triggered, only to have the markets go back into its original direction.

Most traders think it’s because their broker is against them, or the “smart money” somehow know where their stop loss is.

The truth is, brokers don’t have the incentive to hunt your stop loss (as we’ve discussed earlier).

And the “smart money” doesn’t need to know where your stop loss is since you’re likely to put it together with the rest of market participants, which provides liquidity for the “smart money”.

Let me explain…

First, you must understand the purpose of a marketplace.

It’s to facilitate transactions between buyers and sellers.

The more efficient buyers and sellers transact, the more efficient the market will be, which leads to greater liquidity (the ease which buying/selling can occur without moving the markets).

If you are a retail trader, liquidity is hardly an issue for you since your size is small.

But for an institution, liquidity becomes the main concern.

Imagine this…

You manage a hedge fund and you want to buy 1 million shares of ABC stock.

You know Support is at $100 and ABC stock is currently trading at $110.

If you were to enter the market you will likely push the price higher and get filled at an average price of $115.

That's $5 higher than the current price. So what do you do?

Well, you know $100 is an area of Support, and chances are, there will be a cluster of stop-loss underneath (from traders who are long ABC stock).

So, if you can push price lower to trigger these stops, there will be a flood of sell orders hitting the market (as traders who are long will exit their losing position).

With the amount of selling pressure coming in, you could buy your 1 million shares of ABC stock from these traders. Giving you a favorable entry price, instead of hitting the market and suffer a slippage of $5.

In other words, if an institution wants to long the markets with minimal slippage, they tend to place a sell order to trigger nearby stop losses.

This allows them to buy from traders cutting their losses, which offers them a more favorable entry price.

Go look at your charts and you'll often see the market taking out the lows of Support, only to trade higher subsequently.

Now, you're probably thinking…

"What can I do to avoid being caught?"

Well, there's no way to avoid it completely but, you can learn how to place a proper stop loss, so you can reduce the likelihood of it occurring.

And this is what we'll cover next…

How to set a proper stop loss

Now, to set a proper stop loss, you want to give it enough room to breathe so you don't get stopped out unnecessarily.

At the same time, you don't want your stop loss to be too wide because it affects your position sizing (and offers a poor risk to reward).

So, here is how you can set a proper stop loss:

1. Identify the structure of the markets
2. Place your stop loss beyond the structure (and give it a buffer)

Let me explain…

1. Identify the structure of the markets

The structure of the market refers to Support & Resistance, swing high, swing low, higher highs and lows, lower highs and lows, and etc.

Here is what I mean:

These are important points in the market because that's where most traders will place their stop loss.

Why?

Because if price trades beyond it, it will invalidate their trading setup as they know they are wrong on their trade.

But, the problem with placing your stop loss near these levels is, it gets triggered easily.

Instead, you want to give it some "buffer", or wiggle room, so you don't get stopped out unnecessarily.

2. Place your stop loss beyond the structure (and give it a buffer)

Now you're probably thinking…

"How much buffer should I give?"

Well, you can use the Average True Range (ATR) indicator to help you.

The ATR indicator measures the volatility of the markets by averaging the range of the earlier candles.

So, if the daily ATR value is 100 pips over the last 20 days, it means the market has an average range of 100 pips over the last 20 days.

And with this information, you can set a proper stop loss. How?

First, identify the structure of the markets that invalidates your trading setup (like Support & Resistance, swing highs/lows, and etc.)

Next, give your stop loss a buffer away from the structure (using the ATR indicator).

You can use 1ATR, 2ATR, 3ATR, and etc.

For example:

The market finds Support at $100. The current ATR value is $5.

Assuming you want to use 2ATR ($10) below support, your stop loss will be $90 (100-10).

Here's what I mean:

Here's the thing:

If you use a large ATR multiple, then you will have a large stop loss. And this requires a smaller position size (to keep your risk constant).

After a stop hunt

Alternatively, you can set your stop loss after other traders get stopped out.

This means you're entering the trade after price spiked through the structure of the markets (creating a false breakout).

When this happens, you can place your stop loss beyond the highs/lows with the expectation the level should hold.

It's never 100%, but the odds are in your favor since the earlier traders have been stopped out.

An example:

Now, you can be more conservative and still give your stop loss a buffer. But at the expense of having a larger stop loss and smaller position size.

Summary

- A stop-loss limits your downside risk and preserves your trading capital
- Generally, most brokers want to be in this business for a long time and they will behave accordingly
- "Stop hunting" occurs because you set your stop loss at an obvious level which is easy to target
- Ideally, you'd want to give your stop loss some buffer away from market structure (like Support & Resistance)