How to Trade Out of a Losing Position

One of the most important lessons any trader needs to learn is how to effectively trade out of a losing position. Although this is usually the realm of money management techniques, at some point in their careers traders may find themselves with a trade that is deep underwater and that has the potential to wipe out their account.

Although it would be easy to note that if proper money management rules are followed this situation should never arise, in the real world traders do sometimes find themselves in these positions because of a slip in judgment, technical problem, or simply stubborn behavior. In any case, most traders do at some point find themselves with a run-away position, and what they do in such a scenario determines their longevity in the market.

When holding onto a big loser, most traders have two choices: cut the position immediately for a huge loss, or try to average down and hope for a turn around. Neither approach is particularly attractive, seeing as how you take a big monetary hit with one, or place all of your chips on the table and hope for the best with the other.

There is a third way: trading yourself out of the market. Great traders simply refuse to take an outright loss by way of a stop, and instead once they realize that the market has proven them wrong they begin to "lighten up" by slowly trading their way out of a losing position.

Once you realize your position is dead in the water, your mission then becomes to better your average cost *without* adding to the position. Adding to the position (averaging down) only creates more pain, and can quickly take away your flexibility as the loss grows and becomes unmanageable. So instead of adding, we need to cut part of it on a dip in order to gain more breathing room and be able to trade out of the rest.

Chart A.9 The key to this strategy is flexibility.

Take a look at the chart at left to better illustrate this technique. Assume that you are short against the trend and you want to get out. You are faced with these options:

- Get out of everything and take a substantial loss.
- Hold onto it and hope the pair will collapse before you run out of margin.
- Cut part of the position on any reasonable dip.

The benefit of cutting part of your position on a dip is two-fold. First, although you are forced to take an initial loss, you free up liquidity and give yourself more flexibility to react to future price moves. Any move now is a good move. If the USDJPY bounces higher, you can re-load at better selling levels to improve your average cost. On the other hand, if it immediately collapses then great, it's moving in your direction.

The other great thing about cutting part of your position is that you instantly take some of the stress away. Keep in mind that one of the most stressful aspects of trading is the psychological impact a running loss may have on your trading. Faced with big losses, most traders are keen to stop the pain immediately, and thus take needless hits.

Once you have cut part of your position, you then proceed to make small trades and slowly better your average cost. Using intra-day volatility, you make small trades to effectively trade out of your position.

THE RUN-AWAY TRADE

To better illustrate this technique, let's look at an example of the same USDJPY move that surely caused a lot of pain to many traders not following a flexible trading strategy (refer to chart A.10).

1. Around the beginning of October, we believe that USDJPY is overbought and in the process of topping out. We think the rate may fail near the 113.70 resistance level, so we take an initial short at 113.50. Our plan is to scale into the position and this is our first shot – always stay flexible.

In this swing trade, we are looking for a move back down to the 109 support level in the coming weeks. We are willing to risk 150 pips total, for a very reasonable 1:3 risk/reward ratio (risking 150, looking for around 450pips,). We realize that the market may overshoot the previous top (searching for stops), so we remain flexible and are prepared to add two more shorts higher.

2. After initially failing at the 113.70 resistance, the dollar rallies and takes out stops to print a new high of 114.20. So far it's no surprise, we knew this could happen and we take advantage of the higher levels to set our second short @ 114.10.

We are now short 2 at an average of 113.80 (113.50+114.10). Stop is 75 pips away (150 pips divided by 2 lots). Always keep an eye on your *total* exposure, since that is what is most important.

3. The dollar begins to sink as planned and the trade is now in the black. We are looking to add a third short if it breaks below the figure (113.00), since that will be an indication that momentum is picking up steam to the downside. Unfortunately the pair does not break the figure, but instead rebounds and is soon testing the highs once again.
4. During this rebound we can choose to either cut the trade at cost, or stick with it. Our gut is telling us that something is not right, but we believe the pair is still ripe for a reversal so we stick with the trade. The move might be taking longer than we thought, but techs still point to a decline and there seems to be some good supply near the previous highs. We decide to take our third (and final) short @ 114.40. We are now short 3 lots average 114.00, (113.50+114.10+114.40). Stops are set 50 pips away (150 pips divided by 3).
5. The dollar proceeds to tank, taking out stops and quickly jumping another big figure. At this point you decide to disregard your money management rules and remove your stops – *it's already up almost 600 pips, it can't go higher! The pair is so overbought that it has to correct, and I will cut my position when it does*.


Price
USDJPY Daily Chart
121
120
119
118
117
116
115
114
113
112
111
110
109
5
4
2
6,7
113.70
1
3
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Jul
Aug
Sep
Oct
Nov
Dec

Chart A.10

Trying to out-think the market is never a bright idea, since the market doesn't *have* to do anything. Whenever the market is faced with something it *can't* do, it quickly proceeds to do that exact thing. This is because the traders hoping for a reversal are all sitting on the same trade, and vulnerable.

We know we are in trouble. We are short average 114.00, and with dollar-yen printing 115.50 we have an unrealized 450 pip (150 × 3) loss ... well above the initial 150 that we were willing to risk. This simple trade is now looking like it may very well take a large chunk out of our account, and the stress level increases. We are tempted to simply stop the pain, get rid of it all and regroup. Stubborn traders may be tempted to double up and bet on a decline.

Chart A.11

Shrewd traders do neither. After getting over the initial shock of the situation we take a deep breath, some aspirin, and decide to take control of the situation; we're going to fight tooth and nail until we come out of this trade alive.

We re-analyze the situation from an objective point of view and realize that the market has effectively proven us wrong. Pride has no place in FX trading; the market proved us wrong and we move forward. The USDJPY is not going to reverse lower to 109, and if anything, it looks like it wants to go higher.

The one thing that saves us during these bad trades is the same thing that saves dealers, namely the fact that that currencies do not move straight up (or down), but rather have a tendency to make a move, consolidate, then continue. This stair-case pattern is evident in most financial instruments, and simply indicates the accumulation/distribution stages of a move. Longs may take some profit and shorts may get stopped out, and both need time to set new positions. You should consider these consolidation periods as your window of opportunity (box 6-7).

With our new understanding of the situation we look for a dip to free up part of our position. This soon happens and the pair dips to test the 115 level.

6. We get rid of one lot at 115.10. We take a realized loss of 160pips (first in, first out). Now we are short 2 lots avg. 114.25, with an unrealized loss of 170 pips. Taking the loss hurts, but we have now given ourselves more flexibility (and margin).

The flexibility we have given ourselves means that whatever the yen may do at this point, we can handle.

7. We wait for a range to develop. This soon takes place as a rough 100 point range develops and trades for almost 10 straight days. We recognize that a range has developed and begin to actively trade the third lot that we freed up. Shorting near 116, we buy it back near 115. This technique proves effective and we are nimble enough with intra-day trades to quickly pocket a good amount of pips to offset some of the loss. With some quick range-trading we have put on 7 trades averaging 30 pips each which wipes out our realized loss and brings our unrealized loss to a much more manageable 120 pips. Depending on our outlook, we can then choose to either cut the whole position (in accordance to our original 150 pip stop) or continue to trade this way until a good amount of pips have been pocketed to offset the loss.

The key here is to never *add* to your total exposure, but to manage it instead. By pocketing all of those small amounts, you are effectively bringing up your average cost and making it easier for you to get out with a reasonable loss. Getting out with a small loss when originally faced with a position deep in the red often feels better than taking a profit, since you know that you fought in a market that was against you; and survived. Further satisfaction comes from the fact that you know retail traders are getting wiped out as the pair moves higher!

Remember these simple steps to trading out of a bad position

- Unload part of your position on a dip
- Wait for a consolidation to take place and a range to form
- Trade the range with multiple quick ins-and-outs
- Minimize your loss and get out. Don't try to turn a losing trade into a winner!

WHEN TO CUT AND RUN

Although you may be able to trade yourself out of most positions, there are times when you should take a loss and simply get out. If a sharp move happens for some unexpected reason (9/11, political event, etc.) then it's best to get flat as soon as possible. No one has time to evaluate the ramifications of such an event, so it is better to get out and re-evaluate later.

Chart A.12 Political decisions can have long-lasting effects on a currency and should not be faded.

In general, if a trade feels off at some point, then you should think about getting out. It will probably save you much heartache in the long-run. The "gut" simply represents your subconscious mind, which is constantly processing and storing information that you may not be aware of. The longer you trade, the more reliable your gut reaction will be, since it will have accumulated a vast knowledge base of charts and patterns over all those years. You've probably seen similar set-ups before but cannot remember them, and your gut feeling is your subconscious flashing warning signs. This information should not be taken lightly and good traders learn to trust their instincts.