

The trailing stop is more flexible than a fixed stop loss, since it automatically tracks the stock's price direction and does not have to be manually reset like the fixed stop loss. Like all stop orders, the trailing stop enforces trading discipline by taking the emotion out of the "sell" decision, thus enabling traders and investors to protect profits and investment capital.

The following example illustrates how a trailing stop works. Assume you purchased a stock at \$10. You could place a 15% trailing stop order (good 'til canceled or GTC) on it right away to protect your principal. This means that if the stock declines by 15% or more, the trailing stop will be triggered, thereby capping your loss. Suppose the stock moves up to \$14 over the next few months, and while you have enjoyed its appreciation, you are a little concerned that it could retrace its gains. Recall that your GTC trailing stop is still in place, so if the stock plunges 15% or more tomorrow, it would be triggered. You decide to tighten the trailing stop to 10% to protect as much profit as you can, while still giving the trading position room to run.

Let's assume the stock moves up further to \$15, and subsequently declines 10% to \$13.50. The 10% price drop would trigger your trailing stop, and assuming you were "filled" at \$13.50, the gain on your long position would be 35% (i.e. the difference between \$10 and \$13.50).

Note that if the stock drifts down in up-and-down fashion, with single-digit declines every other day, the trailing stop would not be triggered since you have set it at 10%. The key is to set the trailing stop percentage at a level that is neither too tight (to prevent the trade

being stopped before it has a chance to work) nor too wide (which if triggered, may result in leaving too much money on the table).

Trailing stops can also be used for other asset classes such as currencies. Like other stop orders, trailing stops can be set as limit orders or market orders. But unlike conventional stop orders that are held on the market book at the exchange, trailing stop orders are stored in the brokerage's computerized system.