



Cover Page

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THE RELEVANCE OF TECHNICAL INDICATORS AS THE RISK MINIMIZATION TOOLS DURING THE COVID-19 PANDEMIC

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Abstract

This paper builds a conceptual framework for minimizing risk in equity markets during the Covid19 pandemic. The paper assigns more weightage for risk minimization and the least importance for generating excess returns because survival is more important than outperforming the markets during the covid19 pandemic. The paper contributes to the ongoing discussion on whether technical indicators are relevant in detecting trading signals in equity markets. The attention in the paper is its confidence in function more willingly than the school of thought as the abstract 'anchor'. Thus, the research paper can be viewed from the functional viewpoint and ignore whether it is a fundamental analysis or technical analysis of stock markets. Certainly, it is not our fascination to reinforce the relevance of technical indicators in stock market activities.

Keywords: Technical Indicators, Risk Minimization, Probability, Volatility, Stock Markets, Exit Approach, Stop Loss Strategy, Average True Range, Covid19 Pandemic.

Introduction

Background and Rationale

Stock market investment has caught the attention of many across the world. Though most of the traders are aware of the success equation i.e., buy-low-sell-high, hardly traders hit the winning trades (Vezeris, Kyrgos, & Schinas, 2018). The stock market mathematics and its prediction remain to be a mystery, yet the number of people attempting to outperform markets has grown exponentially for decades (O'Shaughnessy, 2011). The stock market analysts themselves split into two broad categories i.e., fundamental analysts and technical analysts (Vervoort, 2009). The fundamental propagator believes that fundamental factors related to the stock trigger trading signals (Tharavanij, Siraprasiri, & Rajchamaha, 2015). The practitioners like traders, investors, and arbitrageurs consider technical analysis for their trading decisions (Shah, Isah, & Zulkernine, 2019). Academic studies have tested fundamental factors in understanding market behavior while practitioners deliberate historical data to understand markets with the help of charts (Morck, Shleifer, & Vishny, 1990). Still, neither of them has established the precise elements that perceive trading signals in the stock markets (Reddy & Narayan, 2016). Markets have repeatedly shown that it is impossible to make consistent profits and what a trader can do is just an educated guess based on the probability factor and known information (Vervoort, 2009). The investigators argue that stock market movements are not predictable in the way prediction largely works (Shah, Isah, & Zulkernine, 2019). This can be illustrated with a simple example of how far an individual can live dependent on many factors (Tharavanij, Siraprasiri, & Rajchamaha, 2015). It may include current health conditions, genetic patterns, ongoing pandemic (Covid19), changes in lifestyle and environmental factors, and many more (Liu, Manzoor, & Manzoor, 2020). The person can only make an educated guess based on what s/he consider that impacts the life span of an individual (Vervoort, 2009). Similarly, in stock markets, though investors can anticipate the stocks would yield good returns in long run, they cannot afford to foresee what would happen in the next five minutes (Reddy & Narayan, 2016). The best they can do is making wagers based on the information handy for tracing market signals (Shah, Isah, & Zulkernine, 2019). If a company is expanding progressively over the years, investors can safely presume that it will have analogous growth in the coming year if other micro and macroeconomic factors remain unchanged (Vezeris, Kyrgos, & Schinas, 2018). The markets are unpredictable in either direction or intensity since the number of variables that have bearing on stock prices is infinity (Preen, 2010). Yet, the time-series data used to plot a graph is believed to be giving a fair idea of how a stock performed in past and the pattern in which is expected to continue (Morck, Shleifer, & Vishny, 1990). The Technical Analysts establish that there is a pattern in each activity or an event we witness in our lives which questions the relevance of random walk theory in the contemporary world. For example, when we encounter a situation in which we are asked to identify the colour, an average individual would be able to identify roughly 10 to 15 colours. Beyond that, he would not be able to name any colour since he is not accustomed to identifying them (Vervoort, 2009). Just because he is unable to recognise colour, does not mean that the colour not exist. The same holds when we use technical indicators to understand market behavior (Preen, 2010). Hence, it is crucial to be careful while approaching technical indicators or fundamental for detecting market signals (Nayak, Pai, & Pai, 2016). The traders consider investing in the right stock at the right time and often overlook the importance of leaving markets from time to time (Reddy & Narayan, 2016). It is a well-established fact that rarely stock market assets yield the same return during its entire lifetime (Nayak, Pai, & Pai, 2016). Thus, it is an intelligent move to exit a stock before it turns out to be an opportunity loss. Frequent exits from markets save traders from downfall (Tharavanij, Siraprasiri, & Rajchamaha, 2015). Therefore, the study broadly discusses risk minimization rather than giving excess importance for outperforming the stock markets. Skeptics argue that the risk minimization approach in the stock market may also



Cover Page

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make the returns insignificant thereby leaving no scope and motivation to assume additional risk. Despite the speculations around predicting equity returns in the market, we propose a model to overcome that would ensure investment safety.

Review of Literature

There has been pervasive research on the importance of risk management in equity trading and the application of technical indicators in trading determinations. But barely investigations have been undertaken to view technical indicators from the crystalline lens of risk minimization. The technical indicators have been regarded as the magic formulas to outshine the markets. In this section, we review some of the most distinguished research works undertaken to study technical indicators as the risk minimization stance.

Gregor et.al (2003) conducted a study on using technical indicators as the risk minimization tools. They have thrown light to what extent the technical indicators help a trader in risk minimization. They have focused on the risk dimension of the markets under the consideration of volatility. The study examined how to leave and re-enter the market using technical indicators. They have concluded that technical indicators as risk minimization tools are the least dangerous activity in which a trader can confidently implement and test markets. **Bruce (2008)** tried to establish an approach using a stop loss that minimises risk in equity trading. He found that the stop-loss strategy used for minimizing the risk negatively impacted the overall returns of the investment. The study has questioned the very reason of fixing stop-loss for equity trading. But the study is incomplete as a stop-loss has a multicentered dimension. **Richard (2010)** conducted a study to identify trading entry and exit points using technical indicators and established the application of technical indicators for market exit decisions. Though, when brokerage is factored in the proportion of performance appeared insignificant. In the same lines, **Rommye et.al (2020)** studied the market to trace sell signals to safely exit when markets are moody. They have used the Relative Strength Index to trace the sell signals and understood it is impractical to use one indicator to get precise market signals. The results were impressive they applied Bollinger Band and Moving Average Convergence Divergence. The sell signals were precise but transaction cost made the trading results insignificant.

Research Methodology

An exploratory study approach has been adopted to acquire new insights into how technical indicators can be leveraged to minimise downside risk in equity trading. Secondary data such as conference proceedings, research papers, books, and case studies have been investigated to trace a new perspective for designing a framework for risk minimization. The research has been investigating the means to approach technical indicators for risk minimization rather than considering them as magic formulas for profit maximization in the stock markets. Especially during the covid19 pandemic while markets being choppy, protecting precious capital in the market is more important than earning excess returns (Liu, Manzoor, & Manzoor, 2020).

Objectives of the Study

The focus of the paper is on exploring methods to minimise risk in equity trading without losing opportunities to capitalise on the upside potential of the stock markets. On those lines, the paper intends to achieve the following objectives:

- To contribute to the ongoing discussions on whether technical indicators can be used in risk minimization.
- To propose a model that treats technical indicators as the risk minimization tools.
- Validating the practicality of using ATR stop-loss in exit strategy

Analysis and Discussion

The Necessity of Short-Term Aspirations in Equity Markets

The equity markets are becoming more complex and volatile over the decades. The frequent discussions on equity markets seem to have focused more on earning a profit, maximization of profit, and very little on risk management (Jorion, 2003). The differences between profit maximization and risk management are not just semantics, they go to the heart of modern investment management. The traditional stock market arguments favouring long term orientation seem to be fading away. Anticipating good stock market returns in the long term is a debatable aspect in the investor's community. The traditional investors have considered that the stock markets are suitable for long term investments since they are believed to be generating returns more than the risk-free returns. In the dynamic business world, we have witnessed a series of failure stories in which the most trusted companies like Kodak, Nokia, Xerox, and Yahoo have failed to impress their investors though they have established brand names and successful business track records. Certainly, the question arises what about those who had long term interest in those stocks? The long-term aspirations of these companies have been faded and contemporary situations pose serious questions about their ability to survive the business conditions. Another example, let us consider the case of Yes Bank- a private sector banking company. For a fundamental investor who invested in this stock, since Yes Bank is a new age private sector bank with strong growth potential, an investor would have been surprised when results for the quarter ended March 2019 were announced (NSE, 2020). While the Bank generated a Net Profit of Rs. 1,736 Crores for the Quarter ending March 2018, then the situation changed drastically and the bank booked a loss of Rs. 2,338 Crores in March 2019. Certainly, this will have an impact on the stock price. The stock peaked at Rs 404 in August 2018. The bank had continued to show



Cover Page

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growth and profits every quarter till then March 2019 quarter. By the time results came in, the stock was down 43% from its peak. The day after the results were out, the stock tumbled another 30%. The fact is that for fundamental analysts, the number of data points is limited to four (quarterly results). On the other hand, the technical analyst will have access to 252 days of points per day (NSE, 2020). More the data points faster would be the analysis and output. Continuing with Yes Bank example, there was a way to exit the stock before it cracked post the results using technical analysis and minimise downside risk. The long-term analysis of stock markets has been losing relevance as the very basic ground rules of business have been altered in today's business organizations (Jorion, 2003).

Volatility is a Souvenir for Traders

The sudden spike in the stock price of certain industries while another industry crashing generally looks scary for the investors. When we turn-on the stock market-related news channels on the day of a market crash, yes bank crisis days or during Covid19 escalation times, the market graphs exhibit high volatility often a few hundred percent changes in previous prices (Liu, Manzoor, & Manzoor, 2020). But, a sharp rise in the prices witnessed on trading screens need not be scary all the time (Raju & Paldon, 2019). Many market onlookers talk about volatility as a detriment to investors and markets, but smart traders understand the benefits of volatility. Those who understand the core of stock market operations consider volatility as a gift and do everything needful to capitalise on market actions (Bhowmik & Wang, 2020). Generally, investors panic about volatile markets. Nevertheless, Hedge investors welcome them since they know the means to convert them into opportunities. To be more precise, those who are good at-risk management welcome volatility. Market volatility scares investors and traders since it can swipe away precious capital. Abnormal changes in the market push many investors into financial traps. If planned properly, scary volatility can be converted to a golden opportunity to optimise trading results. In derivative markets, the price of the derivative instrument is directly proportional to the level of volatility embedded in the instrument (Raju & Paldon, 2019). Higher the volatility, the bigger the premium to be paid on the instrument and vice versa. For example, the straddle position entails 'At-The-Money' Call and Put Options, and the strangle position implicates 'Out-Of-The-Money' Call and Put Options (Raju & Paldon, 2019). These can be structured to benefit from increased volatility. The trading logic is simple and straight. When the system enables the derivative trader to lock the downside risk in the financial instrument at a certain level, then the funds are safe. When the market plummets below that level, the derivative trader will be forced to exit the market since the stop-loss is already fixed. Due to this reason, the loss incurred in the trade will be limited to the stop-loss pre-decided by the trader, and hence, they need not bother even when the stock is crashed indefinitely. On the other hand, assume that they are trading with an adequate stoploss arrangement, and the stock moves up in the market. This is an opportunity for a derivative trader to tap unlimited profit in the market.

The same holds in stock market operations. When stock markets are volatile, traders can fix stoploss comparatively farther to market prices so that volatility does not bother the position for minor sharp corrections in the market (Raju & Paldon, 2019). When market shoot-up, a trader can capitalise on those unlimited market opportunities until the market stabilises and comes back to normal position (Bhowmik & Wang, 2020). The investors can make money in the stock market only when the market moves in either of the directions else there will neither be an opportunity to make money nor the fear of losing money in the market (Raju & Paldon, 2019). But in an ideal world, the stock markets witness the changing prices that keep traders active on their trades. The prices move in different degrees and traders attempt to understand those movements to make money in the market (Raju & Paldon, 2019).

Risk Minimisation Perspective for Equity Trading

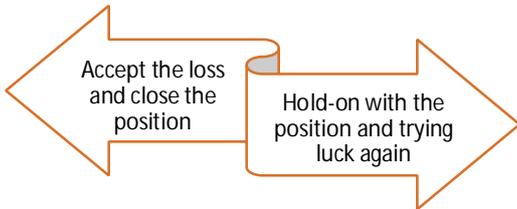
Risk management is one of the most critical yet, least discussed topics on the trading floor. It is important to manage the risk, otherwise, a trader cannot trade without a strong risk management foundation. It is important to understand that the amount of losses is the only parameter which you can control in your trading There is no point in drawing nice technical lines when there is no mechanism to protect money deployed in the stock market. A robust risk management mechanism can be developed by having a refined and practical approach to the markets.

In stock market investments, risk minimization is as important as maximizing the returns. It would be more practical to mention that risk minimization is more important than earning excess returns (Preen, 2010). Some scholars claim that only risk minimization matters in investment management and profit generation will take care of itself when risk is efficiently managed (A.M & Janabi, 2007). The losing investor must stay back in the market to recover losses and hit winning trades based on the probability factor (Doreitner & Klein, 2003). But it requires patience and an ability to tolerate risk in the market. When an investor is unable to hold a position in the market, a bunch of winning opportunities pop-up, the whole purpose of trading decisions will be under a question mark (Motamen, 2005). Additionally, when a trader gives more emphasis for-profit and ignores the relevance of risk minimization, it would give scope for gambling and infiltration of human emotions in market activities which further ruins the rationality of a trade (D&C,2017). There are several methods to manage equity risk including portfolio diversification, hedging, stoploss strategy, pairs trading, buying non-seasonal stocks, and many more (VARSITY, 2016). Among all the risk minimization methods, a stop-loss strategy has proven to be the most effective one (Pramudya & Ichsani, 2020).



Stop-Loss Based Technical Indicator for Designing an Exit Strategy

Trading is largely considered as a game of probability. Hence, trading decisions may not be precise in all the circumstances. When a trading decision goes wrong, there are two options left for a trader (Snorrason, 2009).



When a trader books loss and closes the position, they may not have further chance to capitalise on the stock when it rises above the bar (Lo &Remorov, 2017). On the other hand, when a trader holds on with the position and tries his luck, the market may further go down due to unforeseen reasons (Snorrason, 2009). Either way, the decision would affect the trader. Though, a stop-loss strategy would rescue a trader under such circumstances (Thomakos,2018). The mathematics behind the stop-loss arrangement was quite simple and straightforward. Generally, stop-loss is set with percentage change or in terms of absolute terms like rupee value (Kaminski & Lo, 2013). Still, traders implement stop-loss arrangements with extensive back-testing. Generally, stop-loss placed with extensive back-testing and stress testing is expected to yield better results since, at the bare minimum consideration, this stop-loss has been set under logical reasons (Thomakos,2018). Often, some traders enter the market and then set-up stop-loss on definite rupee amounts or in terms of the percentage change in the market price of a stock. But this kind of stop-loss is generally hit most frequently since the logic behind stop-loss are human emotions and not the obvious considerations (Lo &Remorov, 2017). The moment human emotions intervene in any type of trading decision, we tend to take wrong decisions resulting in the loss of precious capital (Vezeris, Kyrgos, &Schinas, 2018). Setting stop-loss is one of the most complicated decisions in equity trading since it works like a double-edged sword (Kaminski & Lo, 2013). Both decisions have their limitations. For example, setting up stop-loss too close to the price may force traders to exit markets for every minor correction in the market (Pramudya&Ichsani, 2020). Similarly, in a volatile market condition, setting-up stop-loss far away from price may end up with a huge opportunity loss when the market move in the opposite direction (Lo &Remorov, 2017). There is a plethora of hypotheses on stop-loss placement (Thomakos,2018). Some theories propose a flat placement of 6-10% below stock prices while some theories propose a trailing stoploss of 6% on all securities. However, a few traders prefer to use pattern-specific stop-loss placement using an average true range percentage stop (Vezeris, Kyrgos, &Schinas, 2018). It is completely based on their belief system rather than backing their decision on empirical evidence (Pramudya&Ichsani, 2020). Largely, there are two categories of stop orders used in markets (Thomakos,2018). The initial stop loss (also known as fixed stop-loss) and trailing stop (Kaminski & Lo, 2013). The fixed stop-loss is put as soon as a trader takes a position in the market (Preen, 2010). The fixed stop-loss is normally fixed under market price and it works like insurance when the market moves downward after a certain point (Vezeris, Kyrgos, &Schinas, 2018). Let us consider, a sell order is initiated since the closing price was just above the moving average. In this case, a sell order is placed since the market price reached a pre-determined point (Lo &Remorov, 2017). Another example is that the trader takes position when the market traversed a swing top and placing a fixed stop-loss under the last swing bottom or buying on a definite uptrend line with a fixed stop-loss under a trendline (Thomakos,2018). In both cases, fixed stop-loss is associated with an entry signal. A trailing stop loss is generally placed after the market moves in the direction of your trade. That means the market is moving as you expected, and hence trailing stop-loss is moving according to a movement of the market (Kaminski & Lo, 2013). For a long position based on swing chart entry, a trailing stop would be set under each following higher bottom (Vezeris, Kyrgos, &Schinas, 2018). Ultimately, if a buy signal is triggered on an uptrend line, then a trailing stop would go along with a trend line up at a point (Thomakos,2018). In the above-mentioned exemplars, stop-loss was set-up a price considering a pre-defined amount with reference points like swing, trendline, and moving average. Average True Range based technical indicators solve problems that generally arise when trader's set-up fixed stop-loss or trailing stop-loss (Yamanaka, 2012).

Cash Management Strategies for Equity Trading

The cash management strategy demands a clear differentiation of total capital, trading capital, and risk per trade. When the risk per trade is known and less than 1%-2%, the probability of winning trades will be clear to the trader.

For example,

Total Trading Capital (Per Stock)	Rs 20,000
Available Risk Capital (Per Stock)	Rs 15,000
Risk Per Trade (Per Stock)	Rs 225



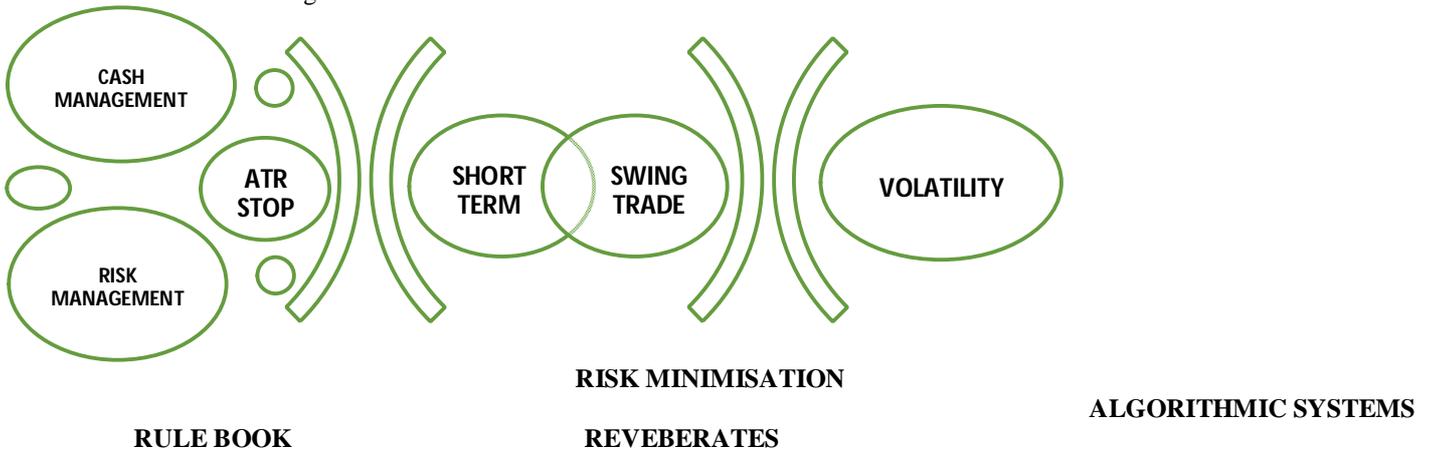
Therefore, Total no of Risk trades available 67 (It is approximately 1.5% of total trading capital). In this case, the number of risk trades available is 67. That means in 67 trades the investor would lose his risk capital. Put it in simple words, the investor will have 67 opportunities to hit correct trade. The method applicable to ten stocks with a beta more than two. In simple terms, in a single trade, you are offered to lose money up to 225.

ATR Based Stop Loss to Handle Volatile Markets

A series of market studies have found that stock markets often exhibit a predictable pattern of performance (Reuters, 2019). Every market will have its unique style of volatility that can be traced through back-testing. When we analyse time-series data, we can observe that markets follow certain patterns (Vervoort, 2017). The markets often exhibit certain abnormal movements and changes that are not regular. In statistical terms, we call them ‘the noise’. It is important to note that practical trading systems respect market noise, and place stop-loss outside the noise (Reuters, 2019). There are several statistical measures available to eliminate noise in the market data. One of the most popular measures of volatility is the Average True Range (ATR). Generally, the volatility stop-loss strategy takes multiples of the ATR, adds or deducts it from the close, and places a stoploss at this price consequently, a stop-loss can only move higher during uptrends and lower during downtrends and sideways market conditions (Vervoort, 2017). The idea behind volatility stop-loss is that a trader acknowledges the fact that the market will encounter noise against a particular trend, but by multiplying this noise as calculated by the ATR by a factor, for example, two or three, and adding or subtracting it from the close, the stop-loss will be preserved out of the noise (Reuters, 2019). By reaching this stage, a trader can maintain the position longer than the regular. Therefore, the trader will have a superior chance of success (Vervoort, 2017).

Proposed Model for Risk Minimisation in Equity Trading

The proposed model has expended five factors for managing downside risk in the market. Cash management, risk management with the ATR stop-loss for efficient handling of volatility. The short-term aspirations of traders have been encouraged due to their inherent advantages. The model blends the inherent abilities of each of these factors in risk minimization.



Cash management strategy help trader in understanding the risk per trade and the probability of hitting the winning trades while risk management using an efficient technical based stop-loss method protect capital from downside risk. When the trader is ready to manage the downside risk with a strong risk management strategy, the scary volatility will become a gift for a trader since it brings unlimited profit potential during booms. The burst in the market will only force you to exit the market and cause no serious damage to the precious capital deployed in the capital markets.

Findings of the Study

Below are a few important findings of the study:

- Equity risk minimization is more important than outperforming markets. Because, when the downside risk is managed, the probability factor takes care of profit
- Volatility is a gift in equity trading since it is possible to control negative volatility using ATR based stop-loss strategies.
- In the dynamic business world, anticipating business to perform better, in the long run, is a highly multifaceted task. Therefore, short term aspirations in stock markets are better than having long term return goals.
- The ATR based stop-loss strategy works efficiently in volatile markets since it can ignore insignificant noise that often forces the trader to exit the market.



Conclusion

This research contributes to the body of knowledge in several ways. The research integrated and expanded upon the previous research undertaken in market efficiency, stop loss arrangement, technical analysis, and risk management areas. The results indicate that volatility is a gift in the equity markets when handled with the right combination of exit strategies. The research also established that the ATR based stop-loss arrangement is more suitable while dealing with volatile markets since they manage the downside risk more effectively than the traditional fixed or trailing stop loss arrangements. During the ongoing pandemic Covid19, an efficient risk management framework in equity trading is critical since protecting funds in the volatile market is more important than generating excess returns.

Limitations of the Study and Scope for Further Research

No research work is without curbs, as edges open the way for further expansion of the body of knowledge. This research also captivates certain shortcomings. The study has focused more on integrating technical indicators, short term market perspectives, risk minimization mind-set, and swing trading benefits to help equity traders. The study has centered more on triggering exit signals to save precious capital and ignored means to outperform markets. Future researchers can plug-in profit maximization parameters to grow the funds that have been protected by risk minimization strategies used in this study. Future researchers need to understand that risk minimization is more important than profit maximization in markets. Also, future researchers can build an algorithmic system to test the model proposed in this research.

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Cover Page

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