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INSIGHTS FROM CFA SOCIETY SINGAPORE

## Why tight stop-losses often hurt investors



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ASK investors how they manage risk, and many will give the same answer: tight stop-losses.

Tight stop-losses are widely viewed as a cornerstone of disciplined risk management, but they can sometimes work against investors' long-term objectives.

A stop-loss is a predefined rule that forces the exit of an investment position when its price moves against the investor by a specified amount. Its primary purpose is to limit downside losses on an individual position without requiring continuous monitoring.

The rationale seems straightforward.

By limiting losses on individual positions, investors believe they are exercising discipline and protecting the portfolio from severe drawdowns.

More broadly, the issue touches on three related issues in risk management: the trade-off between precision and robustness, how trade-level rules aggregate into portfolio-level outcomes, and why controls designed for psychological comfort can impair long-term compounding.

In practice, many who rigorously apply tight stop-loss rules experience a frustrating pattern: frequent small losses, occasional gains, and little progress towards durable capital growth.

This raises a critical question for long-term investors, portfolio managers and fiduciaries alike: Can widely accepted stop-loss practices be structurally counter-productive? And what can they be replaced with?

### When trade-level discipline conflicts with portfolio outcomes

Viewed in isolation, tight stop-losses appear prudent. By defining a small, predetermined loss, invest-

ors feel they have transformed uncertainty into something measurable and controllable. Each trade appears safe in isolation, and losses feel disciplined rather than accidental. This provides investors with a level of psychological comfort.

Markets, however, do not reward isolated decisions. They reward sequences of decisions made under uncertainty.

In trend-based or breakout strategies – such as when an asset or stock moves beyond its target price – profitable opportunities rarely develop smoothly. Early phases are often volatile, marked by reversals and false starts. Narrow stop-losses systematically remove investors during precisely this stage, not because the underlying signal is invalid, but because short-term price fluctuations exceed arbitrarily tight thresholds.

Once stopped out, re-entry is difficult. Recent losses discourage commitment to the same trade, and prices may have already moved away from the original entry point. The result is a portfolio that avoids large losses, but also misses the handful of outsized gains that drive long-term returns.

What looks like good risk control at the trade level can become opportunity destruction at the portfolio level.

### The behavioural appeal and cost of tight stops

The case against tight stop-losses has become stronger as markets themselves have changed.

Modern markets are dominated by algorithmic trading, fragmented liquidity and automated execution. Prices now move faster; liquidity is more conditional; and short-term volatility is often driven by order-flow dynamics rather than information.

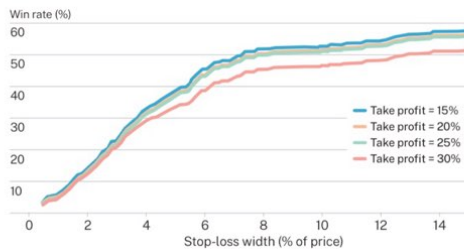
In this environment, stop-losses behave differently than they did in slower, dealer-driven markets.

The popularity of tight stop-losses reflects their psychological appeal. But this comfort comes at a cost.

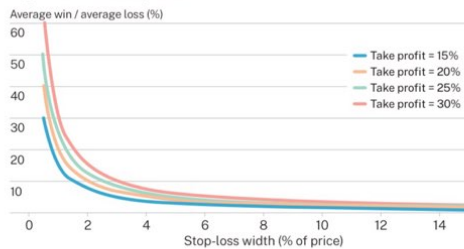
Tight stop-losses align closely with behavioural biases such as loss aversion and regret avoid-

### Stop-loss implications

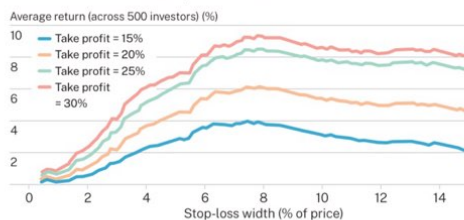
Win rate as function of stop-loss width



### Pay-off ratio vs stop-loss



### Cumulative return vs stop-loss width



SOURCE: CFA SOCIETY SINGAPORE GRAPHIC: HYRIE RAHMAT BT

ance. They are optimised for emotional relief rather than economic outcomes. Markets, however, reward sustained exposure to favourable return distributions, not psychological comfort.

### Time in the market

Discussions about stop-losses often focus narrowly on loss size. However, risk is not only about how much is lost when an investment fails, but is also about how long capital remains exposed to opportunity.

Exposure persistence matters because capital growth is multiplicative. Long-term performance depends not only on avoiding losses, but also on remaining invested

long enough to participate in sustained price movements. Truncating exposure too aggressively can be just as damaging as taking excessive losses.

To examine this trade-off more clearly, it helps to move beyond individual trades and deconstruct performance into three components:

- position size;
- win rate; and,
- pay-off ratio (average gain relative to average loss).

Stop-loss design directly affects both the win rate and pay-off ratio – often in opposing directions.

### What the evidence suggests

To make these trade-offs concrete,

it is useful to examine how stop-loss width affects portfolio outcomes when other variables are held constant. Specifically, consider a simple long-only trend-entry framework applied to a broad equity index.

Positions are initiated when prices cross above a moving average. Position size is held constant, while stop-loss thresholds vary from very tight to relatively wide levels.

Using the daily open, high, low and close prices on the S&P 500 index as a data source, I simulate 500 investors entering at random dates from 2000 to 2005 and compare outcomes under different stop-loss widths and take-profit targets (15 to 30 per cent). Each curve summarises the average result across investors.

The objective is not to identify an optimal trading rule or maximise historical returns. Instead, the goal is to examine how stop-loss width structurally influences win rates, pay-off ratios, and cumulative capital growth.

As stop-losses widen, win rates increase. Trades are given more room to absorb short-term noise, reducing premature exits.

At the same time, when stop-losses are set farther away from the entry price, the average size of losses increases relative to the average size of gains.

When these effects are combined at the portfolio level, cumulative returns plotted against stop-loss width reveal a striking asymmetry: a single peak surrounded by a broad, uneven plateau.

Performance deteriorates sharply when stop-losses are too tight, but declines only gradually when they are moderately widened beyond the optimal point. This asymmetry is especially evident when higher take-profit targets are considered.

### Robustness matters more than precision

The existence of an optimal stop-loss level does not mean that it must be identified with precision. Performance is highly fragile on the left side of the return curve, where stop-losses are too tight and small estimation errors, execution frictions or regime shifts can have outsized negative effects.

On the right side, cumulative returns form a broad plateau. Moderate increases in stop-loss width do not materially impair long-term

performance.

This asymmetry suggests a shift in perspective. Robust capital growth is achieved not by operating at the point of maximum expected return, but by remaining within a range of parameter resilience.

Accepting slightly wider stop-losses may increase single-trade drawdowns. But it also reduces sensitivity to noise, uncertainty and behavioural frictions – unavoidable features of real-world investing.

### Implications for long-term investors

Tight stop-losses are often perceived as disciplined risk control, but they can unintentionally undermine long-term performance by truncating exposure and amplifying behavioural frictions. In modern markets, robust risk management focuses less on where the stop is placed and more on how exits are structured, timed and executed.

Rather than asking how tight a stop-loss can be made, investors may benefit from reframing the question.

■ Does this stop-loss allow sufficient time for an opportunity to develop?

■ Am I optimising for precision, or for robustness?

■ Am I minimising losses, or maximising participation in favourable return distributions?

■ Can I tolerate larger individual losses in exchange for more stable long-term growth?

Risk management is not about eliminating discomfort. It is about choosing which discomforts are worth enduring.

By recognising the structural trade-off between win rate and pay-off ratio, and by prioritising robustness over narrow optimisation, investors can design stop-loss frameworks that better align with the realities of market behaviour and the mathematics of capital growth.

This column is adapted from an article that first appeared on CFA Institute *Entreprising Investor* at <https://blogs.cfainstitute.org/investor/>

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