# Beginning Investor

*A series providing guidance for new investors on how to become successful investors. See AAII.com for the other articles in this series.*

# The Many Ways to Place a Buy or Sell Order

Placing an order to trade a security is as simple as telling your broker to buy or sell. But the type of order you place impacts transaction costs and the odds of having the order completed or filled. Depending on your broker, your order can be routed to more than 40 different execution venues where trades occur, and prices between those venues can change very quickly. Therefore, it is important to understand the exact instructions you are giving to your broker.

This article reviews the various types of order instructions. Though we use stocks as an example, the information also applies to exchange-traded funds (ETFs) and closed-end funds (CEFs).

## Investing Long Versus Trading Short

The most basic way to invest in individual securities is to buy, or "go long." When you enter into a long position, you purchase shares; you actually own stock in a company. In order to lock in your profits, you sell the stock you own and receive money in return. This works in the same way as profiting off of any asset you own—you hope to sell it for more than you paid. When you are buying stock, or going long, you are betting that the share price is going to increase. Why would you buy shares of a stock if you thought it would go down in price?

A more risky way to enter the stock market is to "sell short." Through your brokerage firm (e.g., Scottrade, TDAmeritrade, etc.), you set up a margin account. A margin account is essentially a credit line backed by the securities and the cash in your account. With a margin account, the broker lends you a portion of the funds at the time of purchase and the security you purchase acts as collateral. To sell short you essentially sell shares of a stock on the open market that you don't own. The stock you are selling short comes from the broker's inventory and it works similar to a loan. Eventually, you must close the short position, or "buy to cover." In this step, you use your actual funds to buy the stock in the open market in order to pay back the broker. When you sell short, you are betting that the stock price is going down. You want to pay back less than what you received from the short sale. Theoretically, it doesn't sound difficult, but selling short is risky business with finite upside (a stock can only fall to $0) and the potential for unlimited losses.

## Market Orders Versus Limit Orders

Buying and selling stocks works similar to an auction. Buyers set a bid price based on the amount they are willing to pay for a given security. Sellers feel that their investment is worth a specific amount, so they choose the lowest price they are willing to sell it for and that becomes the ask price. However, buyers will pay the ask price and sellers will accept the bid price. The difference between these two prices is the bid-ask spread. When you are trading highly liquid securities, like a popular large-cap stock, the bid-ask spread will tend to be narrow (often one cent). This reflects both the high level of competition among orders and the fact that buyers and sellers generally agree on the current market value of the security. On the other hand, less liquid securities such as small-cap or micro-cap stocks have greater bid-ask spreads. This is because there are fewer competing orders to buy or sell. The lack of investors willing to step in the middle or place market orders gives buyers and sellers more room to disagree about what the prevailing market value is.

Market orders are orders that investors place to buy or sell an investment immediately at what is known as the "national best bid and offer," meaning the best available price. If it is a highly liquid stock, the chance that your market order will get filled is essentially guaranteed. If you are a buyer, you are agreeing to pay the best ask price available. Since high-liquidity stocks typically have a high trading volume and buyers and sellers generally agree on a price, the ask price you pay will be relatively close to the bid price. Investors must remember that the last traded price doesn't necessarily equate to the price at which a market order will be filled. Also, you are not guaranteed that the total amount of shares you desire will be purchased at one price. Investors typically use market orders when price is less important, when they want a quick entry or exit point and when they are trading highly liquid securities.

Limit orders, conversely, specify a price to be received or paid for a security. This is done by stating the minimum price at which a stock will be sold (if you are selling a security) and the maximum price at which the stock will be bought (if you are a buyer). Limit orders are used to remove slippage costs and exercise more control over a trade. Slippage refers to the difference between the expected price of a trade, and the price at which the trade actually executes. Investors open themselves up to this type of risk when using market orders.

For example, say you want to purchase 100 shares that cost $20 a share. You submit a market order for this trade. Only 70 shares are available at the "best price" of $20 a share. The rest of your order (30 shares) will be purchased at the next best ask price, which could be $21 a share. In this example you pay more than you expected for part of your order.

Limit orders eliminate this problem by specifying a price. The trade will be executed at the specific price you set or at a better price. One major caveat with limit orders is that they aren't always filled. A limit order can go unfilled if the trade price moves away from your specified price (above your buy limit or below your sell limit). The further away from the bid-ask spread you set your limit price, the less likely it is that your order will be filled. In addition, if the total amount of your order cannot be filled at the specified price, a portion simply goes unordered. For example, if you wanted to buy 100 shares, and only 70 are available at the limit price you set or better, only 70 shares will be filled.

## Stop Orders

Stop orders make a market or limit order live once a specified price (the stop price) has been reached. Stop orders essentially act as triggers; once the desired price level is reached, it instructs the broker to execute a market order or a limit order. These trades are often referred to as "stop-market" or "stop-limit" orders. A stop-market order tells the broker to seek the best execution, even if the current price has moved away from the trigger price. This is one of the major caveats: There is no guarantee that the execution price will be equal to or near the activation (stop) price. A buy stop-market order should be placed above the market price, and a sell stop-market order should be placed below the market price.

When you place a stop-limit order, you must specify a stop order price as well as a limit price. A buy stop-limit order price should be placed above the ask price and a sell stop-limit order should be placed below the current bid price. A stop-limit order gives the trader precise control over when the order should be filled. The downside is that a stop-limit order will not be filled if the stock's price moves beyond the boundaries established by the order. If the trigger price isn't reached, the trade will never be activated. On the other hand, stop orders have their benefits. Sometimes stocks don't rise above a certain price level. A buy stop order allows you to avoid owning the stock until there is enough momentum to push the stock to a new higher price level. A sell stop order also allows you to activate a sell trigger when the stock begins to decline below an undesirable price level.

Stop-limit orders can protect you when a big price move occurs. A stop-limit order will prevent a buy order from being filled at too high a price or a sell order from being executed at too low of a price if the stock makes a big, fast move. This restriction may give an investor time to reevaluate the situation and to see if a more favorable price is reached in the days ahead. It is entirely possible that the stock will continue to move further away from the desired price range, however.

## Order Customization

Online brokers will typically give you a few options to customize your order. The most common involve duration and how the order is filled. Duration refers to how long the order should stay open. The default setting is typically the current trading day, or the next trading day if the order is placed after the market has closed or on a weekend. You can also choose a duration of "good until canceled" (GTC). This means the order will stay open until you instruct the broker to cancel it or until your broker's preset limit is reached (for example, six months). GTC orders are particularly useful when placing stop or stop-limit orders. You can also elect to have the order filled as "all or none" (AON). An AON instruction tells the broker not to fill the order unless all of the shares can be bought or sold in one single trade. This results in fewer transaction prices to keep track of for tax purposes, but can cause your order to either go unfilled or be filled at a less than favorable price.

## How to Choose

Most investors should just use regular buy and sell limits set within the bid-ask spread. Other options give you even more control, but can raise transaction costs and result in unwanted executions. Before placing an order, consider the benefits and the downsides of each option and choose the order type that makes the most sense for your long-term financial goals. ▲

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