How does a stop-loss order work, and what price is used to trigger the order?

A stop-loss order, or stop order, is a type of advanced trade order that can be placed with most brokerage houses. The order specifies that an investor wants to execute a trade for a given stock, but only if a specified price level is reached during trading. This differs from a conventional market order, in which the investor simply specifies that he or she wishes to trade a given number of shares of a stock at the current market-clearing price. Thus, a stop-loss order is essentially an automatic trade order given by an investor to his or her brokerage. It will only become active and be executed once the price of the stock in question falls to the specified stop price stated in the investor's stop-loss order.

For example, let's say you are long 100 shares of XYZ Corporation. You bought the shares at $20, and now they are trading at $30 per share. You want to continue holding the stock so you can participate in any future price appreciation it may see. However, you also don't want to lose all of the unrealized gains you have built up so far with the stock, and you would want to sell out of your position if XYZ shares fell to $25.

Rather than watching the market five days a week to make sure the shares are sold if XYZ's price drops, you can simply enter a stop-loss order to essentially monitor the price for you. You could input a stop-loss sell order to your brokerage to sell 100 shares of XYZ if its price falls to $25.

For most stop-loss orders, the brokerage house normally looks at the prevailing market bid price (i.e. the highest price for which investors are willing to buy the stock at a given point in time), and if the bid price reaches the specified stop-loss price, the order is executed and the shares are sold. The bid price is used for stop-loss sell orders - instead of the ask price or the market-clearing price - because the bid price is the price a seller can receive presently in the market. In our example, a stop-loss order placed for 100 shares of XYZ at $25 would effectively limit your potential losses, ensuring you are able to sell your shares for $25 should your stock head south.

Stop-loss orders can also be used to limit losses in short-sale positions. If you are short a given stock, you can issue a stop-loss buy order at a specified price. This order will be executed only if the stock's price rises high enough to reach the stop-loss price, triggering a buy order execution and closing out your short position in the stock. In these cases, the stop-loss order would be executed once the ask price level reaches the stop-loss price, since the ask price is the price at which an investor is able to buy shares on the open market.

Can a stop-loss order be used to protect a short sale transaction?

The quick and simple answer to this question is yes.

The major difference between the stop-loss order used by an investor who holds a short position and one used by an investor with a long position is the position in which it is placed. The individual with the long position wishes to see the price of the asset increase, whereas the individual with the short position wants the price of the asset to decrease and would be negatively affected by a sharp increase. To protect against a large price increase, the short seller can use a buy-stop order, which is an order that will turn into a market order once the upper price has been reached. Conversely, the individual who holds the long position can set a stop-loss to be triggered when the price falls below a certain level.

For example, if a trader is short selling 100 shares of ABC Company at $50, he or she might set a buy-stop order at $55 to protect against a move beyond this price. If the price happens to rise to $55.25, the short seller's order would be triggered, resulting in the trader buying the 100 shares back near $55. A word of caution: on an extremely large increase in price, the buy-stop market order could be triggered at a substantially higher price than $55.

A different way that a short seller can protect against a large increase like the one mentioned above is by purchasing an out-of-the-money call option. If the price does experience a move upward, the trader can exercise his or her option to buy the shares at the strike price and then provide them to the lender of the shares used in the short sale.