The Stop-Loss Order - Make Sure You Use It

What with so many facets to look at and brood over when weighing a stock buy, it's easy to forget about the little things. The stop-loss order is one of those little things, but it can also make the world of difference. Just about everybody can benefit from this tool in some way. Read on to find out why.

What Is a Stop-loss Order?

It is an order placed with a broker to buy or sell once the stock reaches a certain price. A stop-loss is designed to limit an investor's loss on a security position. Setting a stop-loss order for 10% below the price at which you bought the stock will limit your loss to 10%. For example, let's say you just purchased Microsoft (MSFT) at $50 per share. Right after buying the stock you enter a stop-loss order for $45. This means that if the stock falls below $45, your shares will then be sold at the prevailing market price. (For further reading, see *A Look At Exit Strategies*.)

Positives and Negatives

The advantage of a stop order is you don't have to monitor on a daily basis how a stock is performing. This is especially handy when you are on vacation or in a situation that prevents you from watching your stocks for an extended period of time.

The disadvantage is that the stop price could be activated by a short-term fluctuation in a stock's price. The key is picking a stop-loss percentage that allows a stock to fluctuate day to day while preventing as much downside risk as possible. Setting a 5% stop loss on a stock that has a history of fluctuating 10% or more in a week is not the best strategy: you'll most likely just lose money on the commissions generated from the execution of your stop-loss orders.

There are no hard and fast rules for the level at which stops should be placed. This totally depends on your individual investing style: an active trader might use 5% while a long-term investor might choose 15% or more. (For further reading, see *Limiting Losses*.)

Another thing to keep in mind is that once your stop price is reached, your stop order becomes a market order and the price at which you sell may be much different from the stop price. This is especially true in a fast-moving market where stock prices can change rapidly.

A last restriction with the stop-loss order is that many brokers do not allow you to place a stop order on certain securities like OTC Bulletin Board stocks or penny stocks.

Not Just for Preventing Losses

Stop-loss orders are traditionally thought of as a way to prevent losses thus it's namesake. Another use of this tool, though, is to lock in profits, in which case it is sometimes referred to as a "trailing stop". Here, the stop-loss order is set at a percentage level below not the price at which you bought it but the current market price. The price of the stop loss adjusts as the stock price fluctuates. Remember, if a stock goes up, what you have is an unrealized gain, which means you don't have the cash in hand until you sell. Using a trailing stop allows you to let profits run while at the same time guaranteeing at least some realized capital gain. (For further reading, see *Trailing-Stop Techniques*.)

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