Stop Order

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What Is a Stop Order?
A stop order is an order to buy or sell a security when its price moves past a particular point, ensuring a higher probability of achieving a predetermined entry or exit price, limiting the investor's loss or locking in a profit. Once the price crosses the predefined entry/exit point, the stop order becomes a market order.1

Also referred to as a "stop," a stop order to sell that is linked to a limit order is referred to as a "stop-loss order."

KEY TAKEAWAYS

- Stop orders are orders that are triggered when a stock moves past a specific price point. Beyond that price point, stop orders are converted into market orders that are executed at the best available price.
- Stop orders are of various types: buy stop orders and sell stop orders; stop market and stop-limit.
- Stop orders are used to limit losses with a stop-loss or lock in profits using a bullish stop.

How a Stop Order Works
Investors and traders can execute their buy and sell orders using multiple order strategies to limit the chance of loss. The basic market order fills an order at the ongoing market price of the security. A stop order is instead placed when an investor or trader wants an order to be executed after a security reaches a specific price.2 This price is known as the stop price, and it is usually initiated by investors leaving for holidays, entering situations where they are unable to monitor their portfolios for extended periods of time, or trading in volatile assets—such as cryptocurrencies, which could take an adverse turn overnight.

Traders often enter stop orders to limit losses or to capture profits on price swings. These types of orders are very common in both stock and forex trading, where intraday swings can equal big gains for traders but are also useful to the average investor with stock, option, or forex trades. There are two similar-sounding order types that are slightly different. The first, a stop order, triggers a subsequent market order when the price reaches a designated point. A stop-limit order, on the other hand, triggers a limit order entered when a designated price point is hit.3

Traders who use technical analysis will place stop orders below major moving averages, trendlines, swing highs, swing lows, or other key support or resistance levels.

Stop-Loss Orders for Bear Markets vs. Stop-Loss Orders for Bull Markets

A stop-loss order is essentially an automatic trade order given by an investor to their brokerage to trigger a sale when a certain price level is reached to the downside. The trade (either a market or limit order) then executes once the price of the stock in question falls to that specified stop price.4 Such orders are designed to limit an investor's loss on a position. The main risk involved with a stop-loss order is the potential of being stopped out. Stopping out happens when the security unexpectedly hits a stop-loss point, activating the order. The stop could cause a loss on a trade that would have been profitable—or more profitable—had not the sudden stop kicked in. This situation can be particularly galling if prices plunge as they do during a market flash crash—plummeting but subsequently recovering. No matter how quick the price rebound, once the stop-loss is triggered, it is triggered.

The strategies described above use the buy stop to protect against bullish movement in a security. Another lesser-known, strategy uses the buy stop to profit from anticipated upward movement in share price. Technical analysts often refer to levels of resistance and support for a stock. The price may go up and down, but it is bracketed at the high end by resistance and by support on the low end. These can also be referred to as a price ceiling and a price floor.

Some investors, however, anticipate that a stock that does eventually climb above the line of resistance, in what is known as a breakout, will continue to climb. A buy stop order can be very useful to profit from this phenomenon. The investor will open a buy stop order just above the line of resistance to capture the profits available once a breakout has occurred. A stop loss order can protect against a subsequent decline in share price.

Types of Stop Orders

For example, if on January 5, 2018, AAPL was trading for $175 per share at 1:00 p.m., a market order does not guarantee that an investor's buy or sell price will be filled at $175. The investor may get a price lower or higher than $175, depending on the time of fill. In the case of illiquid or extremely volatile securities, placing a market order may result in a fill price that significantly differs from $175.

On the other hand, a limit order fills a buy or sell order at a price (or better) specified by the investor. Using our example of AAPL above, if an investor places a $177.50 limit on a sell order, and if the price rises to $177.50 or above, their order will be filled. The limit order, in effect, sets the maximum or minimum at which one is willing to buy or sell a particular stock.

Buy-Stop

A buy stop order is entered at a stop price above the current market price. A sell stop order is entered at a stop price below the current market price. Let's consider an investor who purchased AAPL for $145. The stock is now trading at $175, however, to limit any losses from a plunge in the stock price in the future, the investor places a sell order at a stop price of $160. If an adverse event occurs causing AAPL to fall, the investor's order will be triggered when prices drop to the $160 mark.

Stop Market vs. Stop-Limit

A stop order becomes a market order when it reaches the stop price. This means that the order will not necessarily be filled at the stop price. Since it becomes a market order, the executed price may be worse or better than the stop price. The investor above may have their shares sold for $160, $159.75, or $160.03. Stops are not a 100% guarantee of getting the desired entry/exit points.

This can be a disadvantage since, if a stock gaps down, the trader's stop order may be triggered (or filled) at a price significantly lower than expected, depending on the rate at which the price is falling, the volatility of the security, or how quickly the order can be executed.

For example, assume that Apple Inc. (AAPL) is trading at $170.00 and an investor wants to buy the stock once it begins to show some serious upward momentum. The investor has put in a stop-limit order to buy with the stop price at $180.00 and the limit price at $185.00. If the price of AAPL moves above the $180.00 stop price, the order is activated and turns into a limit order. As long as the order can be filled under $185.00, which is the limit price, the trade will be filled. If the stock gaps above $185.00, the order will not be filled.

Buy stop-limit orders are placed above the market price at the time of the order, while sell stop-limit orders are placed below the market price.

Stop-Loss

Using this example, one can see how a stop can be used to limit losses and capture profits. The AAPL investor, if their order is filled at stop price of $160, still makes a profit from their investment: $160 - $145 = $15 per share. If the price spiraled down past their initial cost price, they will be thankful for the stop.

On the other hand, a stop-loss order could increase the risk of getting out of a position early. For example, let’s assume AAPL drops to $160, but goes on an upward trajectory to $185. Because the investor’s order is triggered at the $160 mark, they miss out on additional gains that could have been made without the stop order.