Limit Order

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Ever overheard a typical conversation between a broker and his client? Here is an excerpt of what it is usually like?

Client: What is the market rate of Infosys?
Broker: Quoting Rs7,500/505?
Client: OK, buy 100 shares of Infosys?

What will the broker do now? He will buy Infosys shares in the market at any (the best) available price till he has a 100 of them.

By buying shares for his client in this manner, the broker just executed a 'Market Order'.

What is a Market Order?
A 'Market Order' is an order to buy or sell a stock immediately at the best available price in the market. Sometimes it is referred to as an 'Unrestricted Order', since it comes with no conditions attached from the client.

Hence, it is the simplest order that can be placed in the market. The client just informs his broker to execute the trade and the broker executes the trade at the best price available in the market.

Interestingly, it is the only order that guarantees execution unless of course the 'circuit breakers' set by the exchanges come into play!

Hmm! Could anything go wrong here?
Imagine a situation where just as our client is placing his market order, a big fund places a 'market order' to buy 20,000 shares of Infosys!

The price is soaring through the skies and in the melee our client manages to buy his 100 shares of Infosys at Rs7,700! Our client is caught completely unawares.

Since the client thought that he was buying just 100 shares, he would

have assumed that his trade would get executed very close to the market price of Rs7,550. In the end, he bought 100 shares a good Rs150 higher than expected. What if the client was playing it tight and cannot fork out the extra Rs15,000 that his 'market order' resulted in...?

Is there any way of avoiding these hazards while placing an order?

Hallelujah! Thank God for small mercies like the 'Limit Order'.

What is a Limit Order?
An order placed with a broker to buy or sell at a predetermined amount of shares at a specified price or better than the specified price.

So how would the conversation of our client with his broker have gone if our client knew about 'Limit Orders'?

Client: What is the market rate of Infosys?
Broker: Quoting Rs7,500/505?.
Client: OK, buy 100 shares of Infosys at Rs7,550.

What will the broker do this time around? He will buy 100 shares for our client at a price of Rs7,550.

In case a fund places a big 'market order' to buy 20,000 shares of Infosys on the same day and in the process takes the price to Rs7,700, our broker will wait for the price to come back to Rs7,550 before buying shares for our client.

Know the limits of a Limit Order
A good question may crop up at this stage: What if the price does not drop below Rs7,700 at all? Well, what can we say? Our client missed an opportunity to probably make a decent profit on Infosys? ! Too bad.

In other words, there is a flip side to using a 'Limit Order' vis-?is a 'Market Order'.

Which one, when? That depends on your timeframe
This depends on your time horizon. In case of our client, it depends on what he is buying the 100 shares of Infosys for. If he is buying

these 100 shares with the intention of selling them within a month at Rs8,500, then it makes a lot of difference whether he buys it at Rs7,550 or Rs7,700.

On the other hand, if he is buying these 100 shares with the intention of holding it for the next five years during which time he hopes to sell it at Rs15,000, then the difference of Rs150 a share he sacrifices now pales in comparison to the profit of Rs7,450-7,300 per share he hopes to make over this long period.

In case the price never drops below Rs7,700, our client would have missed out on a Rs7,300 profit in 5 years because of insisting on saving Rs150! Reminds us of the proverb " Penny wise, pound foolish."

Of course, the knowledgeable amongst you would have figured out that 'Limit Orders' are more useful for the traders whereas the 'Market Orders' are more useful for the investors.

The tricky question is how do you set the limit for a 'limit order'? The limit can be set based on your perception of what is the right value. After all, we have our own perception of value when we buy shirts or vegetables. This goes for stocks as well!

For traders, the limit price depends on the potential profits they see from that level, and their risk-reward playoff.

By the way, limit orders allow an investor to limit the length of time an order can be outstanding before cancelled. A quick look at the various limit orders that can be placed:

End of Day: Any order to buy or sell a stock that automatically expires if not executed on the day the order is placed.

Good till Date: Any order to buy or sell a stock that automatically expires if not executed on the date specified when the order is placed or the end of the particular settlement on the exchange, whichever comes first.

End of Settlement or Good Till Cancelled: Any order to buy or sell a stock that automatically expires if not executed by the end of the settlement on the exchange unless the order is cancelled during that period.

Now that we have understood the basics of 'Limit Order', it is time to move on. Next, we will understand the 'Stop Loss' order better.