

# A Market Entry Method That Can Increase Profits and Reduce Risk

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## Introduction

Otherwise stated, the title of this article might have been, “Is the way you place your orders hurting your profits?” Many traders are diminishing their profits and increasing their market exposure (risk) by the manner in which they place their orders. We will discuss why this happens, and what can be done about it.

There are those who would have us believe that trading is a “zero-sum” game. They tell us that when we buy a share of something that someone else has to sell that same share; the stock or commodity just changes hands. The truth of the matter is that there are three other things going on behind the scenes that put many aspiring traders out of business - and hurt those traders who do making a living at trading.

While the things being discussed in this article may seem basic or elementary to most traders, the fact that many traders (I have spoken with over the years) do not assimilate these ideas into their everyday trading, speaks volumes that these ideas need to be stressed and repeated.

## The Problems

### ***Commissions***

The first of these three problems is commissions. Although you could sell your shares of (whatever) directly to another buyer, this is unrealistic in the real world of trading – especially day trading. Ordinarily, someone stands between the buyer and the seller. That someone is your “broker.”

Currently in the “e-markets” the broker’s fee is quite a bit smaller than it used to be in open outcry markets. There are, however, markets where the broker gets a big piece of the pie. Keep in mind that the broker makes his commission whenever you buy or sell – whether you win or lose. For the sake of this article we will assume the reader trades either through a discount stockbroker, or an e-mini futures broker, where the commissions are more reasonable. Nevertheless, commissions are still a cost of doing business that should be negotiated. (Most FOREX traders do not charge a commission, but have a larger spread.)

## **The Spread**

In today's eMarkets a price quote is given as "bid and asked" price. How this works is the buyer of the investment buys at the "ask" price, and the seller sells at the "bid" price. The difference between the bid and ask is the "spread." Depending on how large this spread is, a trader's losses are increased and the winnings reduced with each trade. This is how it can be illustrated:



The prices that range from 54 to 60 represent 1 tic (minimum move) of any stock, future or FOREX investment. In this illustration the spread is 2 tics (or "pips" in the FOREX markets.)

In trading, we obviously want to buy low and sell high. As you can see in this illustration, the market system (exchange) has it set so that you buy at the highest possible price of the spread and sell at the lowest possible price.

The spread value will vary, depending on the market. In the e-mini S&P the value is 1 tic. In very liquid FOREX markets the spread is generally 2-4 pips (depending on the broker, and the specific currency pair. FOREX markets generally do not have a stated commission, so the spread will be higher). In less liquid FOREX markets the spread can be 10 or more pips! (This is an extra cost when trading illiquid markets.) Check with your broker to see what the spread is in the markets you trade.

## **Slippage**

Slippage is the difference between where your order was actually filled and where you thought it would fill when you placed the order. Sometimes what you thought was the difference was actually the spread. Other times the difference between what you thought would be your fill price, and what it actually was, is increased by market volatility. (Volatility is when the market is jumping around atypically

because of market nervousness. This volatility could be caused by a news release with unexpected or unforecast news, or sudden indecision due to extenuating circumstances. This happens frequently.) Other times slippage is due to a lag in your data feed. In other words, you might be looking at your screen and seeing a price that was current 20 or more seconds ago.

The situation with commissions and slippage is much improved in the era of the electronic markets. (In the days of the open outcry market, or "pit" there were many times criminal elements of slippage, where pit traders manipulated the prices that outsiders would pay. Hopefully, all of these markets will go the way of the 19<sup>th</sup> century stagecoach bandits as we move into the near future.)

## **Types of Orders**

Here is where we go to basics for just a moment - but don't let me lose you because I will quickly make my points.

### ***Market Orders***

Market orders are where the problems discussed above come into play. Commissions are fixed (depending on the arrangement with your broker) but the spread and slippage can hit you hard with a market order.

Here is how a typical situation might happen: Two traders each trade 10 S&P e-mini contracts at the same price, with market orders. One buys and the other sells. As the market drops, the buyer bails and loses an expected 2 points. The seller jumps out at the same price (as the buyer) with an expected profit of 2 points. Since each point in the S&P e-mini is \$50, and each trader was trading 10 contracts, that means that the buyer lost \$1,000 and the seller made \$1,000, right? Not quite! Because they both used market orders on their entry and exit, they were hit with the spread and slippage. The buyer might have lost \$1,100-\$1,200 and the seller only made \$800-\$900. (The reader can see how this is not a zero-sum game, but rather a negative-sum game.)

### ***Limit Orders***

Although limit orders are not always filled (so you don't always participate in some winning trades), they limit exposure and reduce risk. In the above scenario (not including commissions), if both traders had used limit entry/exit orders instead of market orders, the buyer would have lost \$1,000 and the seller would have made \$1,000. (Commissions, at the time of this writing would be in the neighborhood of \$50 for both traders.) Note: The buyer would have used a limit entry and a stop exit, and this example assumes no slippage on the stop order, which may or may not be the case.

How do limit orders reduce market exposure and risk? Let's take the case of the seller in the above example. By placing a limit order instead of a market order he is stipulating an exact price. (With the market order he agrees to take whatever the market happens to throw at him.) Since the difference between the market and the limit order is the spread and slippage, the limit order reduces the cost of the trade by that amount from the very beginning. Then, we have the same opportunity on the exit side of the trade. If the seller takes his profits with a market order, he gets whatever the market wants to give him at the time he places the order. Alternatively, with the limit order the seller gets his price, or is not filled.

### Caution

Not being filled is tolerable (although certainly not pleasant) on a trade entry, but can be a bad situation if you are in the market and do not get filled on your exit. (More on this in the Tips section at the end.) For this reason the trader needs to monitor the trade until his broker confirms his exit. In other words, just because you see the price on the screen touch your limit price, does in no way ensure a fill. In most cases the price has to go through your limit price by the value of the current spread, to guarantee a fill.



Here is an example of a short entry that went well:

In the example on the left, a short limit order (at 1264.00) was placed at the close of the bar marked with the white arrow. On the next bar the market went up enough that the limit order was filled, before the market fell and the trade became profitable.



To the left is an example of when you would miss your trade entry.

The bar with the white arrow closed at 1267.00. If a short limit order was placed at the close of that bar, the trade was probably not filled because the market did not go up through the price of

1267.00 by the value of the spread, before the market fell. This would have been a case of missing a good trade. (Disappointing, but it happens when you use the extra protection of limit orders. Consider it the price of “spread and slippage” insurance.)

Here is an example of when the trader might be sweating his exit:



In the example to the left, if the trader had a sell limit order resting to sell at 1264.00, it would not be filled because the market briefly went to 1264.00 but did not trade through it. (More on this in the Tips section at the end.)

Here is an example of when the entry and exit is easy going.



In the example to the left, the short entry order was placed at the close and at the close price of the bar with the white arrow. On the next bar the market went up through that limit price, and it was filled. As the market fell, a limit order was placed to exit the position at 1262.00. The lower stem of the bar (shown in the example with a green arrow) went down through the limit buy price and was filled.

## ***Stop-Limit Orders***

First of all I want to assert that stop-limit orders have no place whatsoever in exits where the stop is placed in case the trade was a loser. (Although your broker will probably accept such an order). A catastrophe exit order needs to be relied on to get you out of the market. In the case of stop exit orders, it is a situation to get you out of a losing trade. The stop-limit might not be filled, and a losing trade could end up with a much larger loss. *Bottom line: never use a stop-limit order for a catastrophe stop.*

Stop-limit orders can successfully be used in circumstances where the trader might otherwise want to use a stop entry to begin a trade. (The stop entry becomes a market order as soon as price touches it, so that means we have the same spread and slippage problems as market orders.) The Stop-Limit order gives us the ability to have the best of both worlds. In other words, we can place an entry that will not be executed until the price is touched (the stop part of it) but guarantee a fill will not have slippage (the limit part of it.)

## ***Tips When Using Limit Orders***

Limit orders are placed in a waiting line. That means that the sooner you get your limit order into the exchange computer, the better place you have in line.

Try to place sell limits at a price 1-2 tics below “par” price. (Par prices are round number values. For example, 1264.00, 1265.00 and 1236.00 are par prices.) In the example of the failed long exit at the price of 1264.00, if the trader had placed the sell exit order at 1263.50 he is more likely to be filled. Why? As markets move (especially fast markets) they tend to stop at par prices. If price needs to move through your limit price by 1 tic to guarantee a fill, then placing your limit price 2 tics below par makes it much more likely to be filled than placing it at par.

The opposite would be true for buy limits. For example, if you were short, your exit would be to buy at limit to cover your position. Place your buy limit order 1-2 tics above par price.

**It is generally thought that if the market moves 1 tic thru the limit price in the S&P e-mini that the fill is guaranteed. The author has seen several instances where this has not happened. Because part of the “zero sum” saying is true (e.g. there must be a buyer for each seller) if there are 10,000 contracts offered for sale at one price but there are only 50 buyers, there will be many orders that did not fill at that price. General rule: Although limit orders are generally filled if price goes through by 1 tic, plan for price to go through your limit price by 2 tics. (Ask your broker what to expect in your particular market.)**

## Longer Time-frames

When trading chart time-frames of 15 minutes (or longer), you might want to consider placing your limit order even farther away from the close of your signal bar.

For example, when going short, instead of using the close of the signal bar as your sell limit price, add two tics to make the sell limit price even higher. When going long, instead of using the close of the signal bar as your buy limit price, subtract two tics to make the buy limit price even lower. (When using 30-60 minute time intervals, you can add even more.)

This gives several advantages:

- It makes your catastrophe stop closer, so you lose less on losing trades
- It makes your target closer, so your targets are hit easier, or
- If you choose to use the same target, it gives you more profit. (Even if you use a trailing stop, it gives you more profit because your entry was better.)

Sophisticated trading platforms like TradeStation 8 give the trader the flexibility to use limit orders, but add the option to automatically convert the limit order to a market order in N seconds after price touches the limit price – when using an automated system. We can use this idea and do the same thing (manually) when watching price approach our target limits. This is a perfect way to cover the exit on profitable trades when price keeps bouncing on the limit exit price, but doesn't trade through it. In other words, this procedure eliminates the horrendous possibility of getting "hung up" in a trade and missing the exit. (In cases like this the trader may experience slippage, but this is preferable to missing the exit altogether.)

The way the author places profit targets is to use this method along with a limit price that is 2 tics away from the nearest par price. (The number of seconds to wait after price touches your limit price is a personal decision. 10 to 30 seconds is generally used, while keeping an eye on the bid/ask.) Many trading platforms have an option to cancel the current limit order and convert it to a market order. (Check with your broker.) In this manner the (2 tics away from par) rule generally ensures that it is rarely necessary to (quickly) convert the limit to a market order. Slippage is usually avoided - if not on the exit, it is always avoided on the entry.

## CAVEAT

- Although the limit order can be used for all entries and profitable exits, the limit order cannot be used to exit from an unprofitable trade. Stop orders are still used in those cases.
- It is axiomatic that traders should always cancel any unfilled stop or limit orders.

**About the Author:**

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