Investment in Equity (Part 9)

It was mentioned in the preceding chapter that Reliance Capital formed a bottom of Rs. 319.80 on August 31, 2012. We had decided that we would buy the scrip at Rs. 335.80 if the scrip rose to that level. How do we make sure that the purchase gets made if and when the price rises to Rs. 335.80, when the current ruling price is at Rs. 319.80 or levels far below Rs. 335.80?

Similarly, there was also another mention in the same chapter that when the scrip formed a top at Rs. 458.25, we had decided that we would sell the scrip away if it fell to Rs. 435.35. Remember, we took that decision when the price was at Rs. 458.25. How we computed Rs. 435.35 is clear: we found out 5% of Rs. 458.25 and deducted it from Rs. 458.25, and we got Rs. 435.35. But my question is, how do we ensure that the scrip gets sold at Rs. 435.35 if and when the scrip fell to that level?

Let us consider the first case of our wanting to buy the scrip at Rs. 335.80 when the ruling price was at Rs. 319.80 or at some other level which was much below Rs. 335.80. It is here that something known as stoploss buy order becomes useful. A stoploss buy order is different from a normal buy order.

We shall consider an easier example. Let us imagine that the present price (current ruling price) of a scrip is Rs. 100.00. We believe (or expect or hope) that the price will fall to Rs. 95.00, and, if it does, we would like to buy the scrip at Rs. 95.00. So, we enter a normal purchase order for Rs. 95.00. Remember that when we are entering a purchase order for Rs. 95, the current ruling price is Rs. 100. Our order for buying the scrip for Rs. 95 will get duly entered and will remain pending until the price falls to Rs. 95. If the price falls to Rs. 95, and if sufficient quantity is on offer for sale at that rate, then the order to buy the scrip for Rs. 95 will get executed.

Let us imagine that the current ruling price is Rs. 100, and we enter a normal purchase order for Rs. 105. If sufficient quantity is on offer for sale at Rs. 100, the buy order will get executed at the current ruling rate of Rs. 100. If the quantity on offer for Rs. 100 is not sufficient to meet the buy order, and if more shares are on offer for sale at the next tick-price of Rs. 100.05, the remaining quantity will be bought at Rs. 100.05. And so on. The point is, a normal buy order will not be suitable if you want to make the purchase at a level which is much higher than the current ruling price. In such cases, where you want the purchase to take place only after the price rises to a certain level which is higher than the current ruling price, a stoploss buy order will be the most suited order.

Let us imagine that the current ruling price is Rs. 100 and that we want to buy the scrip for Rs. 105 if the price rises to that level. The reason why we do not want to buy the scrip at its present price of Rs. 100, and why, instead, we would prefer to buy it only after it climbs 5% from the present level of Rs. 100 to Rs. 105, could be that we believe that the upward price movement will gather a lot more momentum and shoot up further, if it manages to climb 5% to Rs. 105. The underlying principle is to “buy when price starts rising and sell when price starts falling.” In such circumstances, it is a stoploss buy order that you need to enter. Because you do not want to buy the scrip unless it shows clear upward momentum by rising at least 5% (or whatever you have chosen as the trigger). When the current ruling price is Rs. 100, you can enter a stoploss buy order for buying the scrip at Rs. 105.

Stoploss buy order is different from a normal buy order. A stoploss buy order needs two prices. One of them is known as the limit price or simply the price. The other is known as the trigger price. Before entering a stoploss order, you need to decide both the limit price and the trigger price. Because, the buy order window in the trading terminal will ask for both the limit price and the trigger price, as soon as you indicate that you intend the order to be a stoploss buy order.

In the instance on hand (where you would like to enter a stoploss buy order for Rs. 105 when the current ruling price is Rs. 100), let us decide both the limit price and the trigger price which are to be entered in the related window in the trading terminal. Rs. 105 itself should be the trigger price. Now, what will be the limit price? The limit price has to be higher or greater than the trigger price, in a stoploss buy order. For the purpose of illustration, let us select Rs. 106 as the limit price. Having decided both the trigger price and the limit price, we are now ready to enter the stoploss buy order with Rs. 105 as the trigger price and Rs. 106 as the limit price.

Let us imagine that you have entered a stoploss buy order for 1000 shares of a scrip when its current ruling price is Rs. 100; let us also imagine that the trigger price is Rs. 105 and the limit price is Rs. 106. So far as the current ruling price does not rise and touch the trigger price of Rs. 105, the stoploss buy order will not get executed. On the contrary, if the price rises and touches Rs. 105, the stoploss buy order will get triggered. When triggered, a stoploss order becomes active. Unless triggered, a stoploss buy order will be dormant. Only when it is triggered, will it come into reckoning.

A stoploss order has some inherent defects. Its full quantity may not get executed at exactly the trigger price. The execution of the ordered quantity may take place at more than one rate, ranging from the trigger price to the limit price. Thus if we order a stoploss order for buying 1000 shares of a scrip, with Rs. 105 as the trigger price and Rs. 106 as the limit price, the execution of the buy order can take place at any rate from Rs. 105 to Rs. 106. It is also possible that the whole purchase gets done at Rs. 106. If you want the whole stoploss buy order to get executed at the trigger price itself, it may not be possible. It may be possible, but it may also not be possible. Where you had intended to buy the scrip for Rs. 105, if the actual purchase takes place for Rs. 106, your cost of purchase will go up to that extent. This will either reduce the profit which you would derive in the future, or increase your future loss. One has to live with this risk. However, one solution to this is to select only those scrips which regularly have heavy volumes. When huge quantities are available at every tick price, the chance of the stoploss buy order getting executed at the trigger price itself increases. Stoploss orders will not be good for scrips whose volumes are meager, and should not be used for such scrips. Scrips with low volumes should not be selected.

On the NSE, tick prices are multiples of 5 paise. Examples: 100, 100.05, 100.10, 100.15, and so on.

Let us consider the second defect of a stoploss buy order. Let us imagine that the quantity ordered in your stoploss buy order is a massive one lakh shares (100000). Although you have entered the stoploss order, with a trigger price of Rs. 105 and a limit price of Rs. 106, you will get only those shares which get offered for sale at the rates ranging from Rs. 105 to Rs. 106. If the total number of shares which get offered for sale at the rates from Rs. 105 to Rs. 106 are less than the quantity you want to buy through the stoploss buy order, the execution of the stoploss buy order will be limited to that quantity which become available. Thus, if only 15000 shares become available for sale at the rates from Rs. 105 to 106, you will get that many shares only, even though your stoploss buy order was for one lakh shares. Such partially executed stoploss order will get automatically converted into a normal buy order for the limit price. If the price falls to the level of the limit price, and if there are sufficient quantity on offer, it will get fully executed.

Now let us come back to Reliance Capital. Let us imagine that its current ruling price is Rs. 319.80. As soon as you enter the stoploss buy order for Rs. 335.80 (with a trigger price of Rs. 335.80 and a limit price of, let us say, Rs. 338), the order will get entered, all right, but it will not get executed at that time. Instead, the order will remain intact unless the price climbs to the level of Rs. 335.80. The stoploss order for Rs. 335.80 will get triggered if and when the price rises to Rs. 335.80. If the price does not rise to Rs. 335.80, the stoploss buy order will not get triggered. If the price rises to Rs. 335.80 and triggers the stoploss buy order, the order will get executed provided sufficient quantity is on offer for the rates from the trigger price of Rs. 335.80 to the limit price of Rs. 338.

In a normal buying order, the buying price can be the same as the current ruling price, or it can be higher than the current ruling price, or it can be lower than the ruling price. On the contrary, the buying price in a stoploss buy order has to be higher than the current ruling price. A stoploss buy order cannot be entered for a price which is lower than the current ruling price. However, different trading systems have different rules. There are some trading systems which allow the trigger price in a stoploss buy order to be lower than the current ruling price.

Let us imagine that we have made the purchase at Rs. 335.80. As soon as we made the purchase, we had to consider Rs. 335.80 as the last formed high, and had to decide our next selling price. Our theory tells us that we must sell a scrip away if it falls 5% from its last formed high. We had made an imaginary purchase at Rs. 335.80, and that, as soon as we made the purchase, we also decided that our next selling price would be Rs. 319.00, which was the level 5% below Rs. 335.80. Having made the purchase, and having decided Rs. 319 as our next selling price, it will be better to enter a stoploss sell order at Rs. 319.00. In the next chapter, I shall deal with, inter alia, the stoploss sell order.