Chapter 7: Aspects Of The Trade

You are now versed in the functionality of the stock market and have decided that you are willing to accept the risk factors involved. However, you want to know everything you can about balancing that risk with intelligent investment options. How can you be sure that the risks you take are more likely to be rewarding in the long run than destructive?

Long and Short

One of the most important parts of making money on the stock market is to determine your position. The long position is basically the purchasing position – you are about to take on a long-term commitment for ownership of some stock, security, or other traded commodity. The short position, by contrast, is the selling position – you are shortly going to dispose of the same sort of ownership and any responsibility toward it.

The best time to take up the long position is when stock prices are low. This will get you into the market at a reasonable price and increase your chances for profitability as new offerings go up in price and older investment options recover or rebound.

In fact, as others take the long position and purchase at the same time you do, this will actually drive the value of securities up through the standard rule of supply and demand, causing the beginning of what could be a bull market.

You may equate this with the end of the month at a car dealership. The prices tend to drop on any cars left on the lot for sale, and the dealer is more often willing to bargain because he or she wants less inventory on the lot.

Likewise, when stock prices are low, some will panic and dump all of their holdings at these low prices, thinking that their shares will never recover the value. This can only be of assistance to you.

When prices are high, it is likely time to turn around and sell your shares to bring in a profit, not losing anything on unrealized gain (profit that cannot be counted in liquid assets or cash because it is still invested in a volatile stock option).

You should never sell for a price that is below your cost, as this brings negative equity and loss of funds. You should always sell for the greatest amount of profit that you feel is safe.

In other words, if you buy a security at fifteen dollars per share, and it quickly rises to twenty-five dollars per share, you may very well feel that it could hit thirty dollars per share within a week.

However, you must determine if you are willing to risk losing your already secured earnings of ten dollars per share to wait that long, should the price actually fall, so you may decide to sell at the current high price.

Market-Makers And Selling Short

What if the stock values are up incredibly high, but you did not get in on that particular commodity and own no shares? Your first step should be to visit a market-maker or to make a deal with a broker for a short sell.

A market-maker is literally a stockbroker who purchases keeps a certain amount of shares of several securities or stocks on hand, which are purchased during a time when the market rates are low.

The firm will then turn around and sell those shares to an individual at that low price, regardless of the market rate, in effect making its own market (thus the name). The individual who purchases from the firm can immediately sell the commodities on the open market at market rate (which is higher), making an incredible amount of profit in a short period of time.

A short sell is another option for a quick profit. In this scenario, you will borrow a particular number of shares from a stockbroker to sell when the market value is high. Your job is to then wait for the stock price to go down, purchase the same quantity of stock, and return the holdings to the broker, keeping the profit from the sale, minus the broker fees.

The way that a car dealer works with trade-ins is very similar. They will purchase the car from you at a very low price, then turn around and sell it on the lot for a high profit margin.

One of the most positive aspects of a short sell is that you never actually take possession of the stock, meaning that you are never in a position to lose money. Because you have sold shares for a high price, you have already profited, and in the worst-case scenario, the particular stocks will not drop in price.

Rather than return the stocks to the broker from whom they were borrowed, you can simply pay back the amount for which they were originally purchased, along with the premium.

How can you be sure that you will not overshoot the best price options or miss a good rate because you are unavailable to place a buy order or sell order with your broker? Is there a way to set limits on your trades? Next, we will discuss ways to protect your investments and limit your risk factors.

Chapter 8: Risk Management

One of the most important aspects of protecting your investments is balancing your risks with reassurances. There are several ways to do this, and we will discuss those in this chapter.

Limit Orders And Balancing Risks

A limit order is a standing amount at which you have agreed to buy or sell a particular security or other commodity. For instance, you have designated to your stockbroker that you will not sell X Security until its value reaches a minimum value of Y dollars. At the same time, you will not purchase the same X Security if it exceeds a value of Z. Setting limits for the price you pay for a particular security, as well as the price you will accept to sell it, protects you and your investment in several ways.

First of all, you are maximizing your gains, but mostly, you are avoiding loss. Any loss that occurs with limit orders will always be unrealized loss, or a loss that is not measurable in liquid assets or cash.

In other words, until you sell the stock and reap the net loss, it will not affect your net worth. Since you have set a limit that does not allow your commodities to be sold for less than the original cost, you cannot possibly have a loss in your net worth.

At the same time, you are also assuring at least a certain amount of profit by setting your sell point high enough to reap that particular profit.

Another way to protect your assets is to hedge. This means that you create and sell a futures contract stating that, when your shares reach a certain value in the future, you will sell your holdings at this predetermined price.

When that price is reached, the order will be processed and the transaction completed. Of course, if you ever change your mind about a limit that you have set, you can place a stop order with your broker, which designates that you no longer wish to trade at the specified dollar amount.

You can also buy on margin. This is very similar to short selling, but instead of borrowing stocks to sell, you are essentially borrowing money to purchase stocks on your own when the market value is down.

Then, when the value of the securities you have purchased rises and you are able to sell for a profit, you repay the loan and keep the excess from the sell, minus the broker fees.

Of course, all dealings with a stockbroker incur a premium, or fee for services rendered, and it is nearly impossible to trade without a broker or broker service. However, online services are often less expensive than live agents, but you can research to determine what your best option is.

How Do I Handle a Whipsaw?

No, we are not referring to anything in the garage, the bedroom, or a country band. A whipsaw is market trend that defies the odds. It can be thought of as the “fender bender”.

Despite how careful you are as you learn to drive a car and become coordinated, sometimes you cannot do anything to avoid being rear-ended.

Whipsaw is a term for what happens when everything points toward a specific direction in market trend, causing you to buy (if it looks as though prices are going to rise) or sell (if it seems they are about to fall), then the opposite effect occurs.

For example, if you purchase a security at five dollars per share because the stock seems to have fallen as far as it can go and appears to be starting an upward trend, then unexpectedly, the stock plummets to one dollar per share, this is considered a whipsaw effect. If this happens to you, as it surely will if you play the market long enough, the best thing to do is wait it out.

The stock will do one of two things – it will either dissolve entirely, and the company will go bankrupt (this is what you do not want to happen), or it will rebound, and you can opt to wait for a chance to turn a profit or you can get out as soon as the purchase rate is reached.

Whipsaws are not the end of the world, and no one can expect to gain with every stock market purchase. However, if you find that you are involved in several of these instances, you should seriously reconsider your investment options.

You may be reading the signs incorrectly, or you could be picking bad stocks. You should seek advice for any future investments you expect to make prior to purchasing any further stocks or securities.

Another way to overturn a bad investment like this is to proceed with an offset transaction – a purchase or sell that offsets the loss of a previous transaction.

You could either purchase additional stock in the same company at the lower price if you expect it to recover, or you can opt for another hot commodity that is about to explode in price, either of which will help you offset your loss. You could also sell shares of a security in which you have a large amount of unrealized gain – gain that cannot be measured in liquid assets or cash due to increase in value of stock and security holdings – in order to replace the lost cash value.

All of these are viable options to recover a loss, but waiting for the share value to rebound is always the first choice. It avoids the loss of funds already invested, retains the option to pursue profit, and reduces the risk of further investment into the market.

As you grow and learn about these various options, you will need to feel more comfortable when surrounded by financial gurus and geeks who speak what sounds like gibberish, muttering words you have never heard left and right.

The following chapter will take you through some of the meanings of the major “buzz” words used in the stock market and the international financial district.