

# The Myth of the \$8 Trade

By Keith Cummings

This evening I was watching TV with my brother when we saw a very clever television commercial. An obviously hardworking stockbroker was closing out his busy day with his final trade. Pacing the room with his telephone headset, he declares how he's going to make his move on a particular stock depending on how it moves. In the background, we see the professional, "institutional" trading program he's running. Finally, he calls Lily and informs her he's done for the day, can she come in? The office door opens, the man is in his home and Lily is his daughter. How adorable. This touching scene brought to you by a company who offers you institutional quality trading tools for only \$8 per trade.

Who's falling for this? Many people, I'm afraid. There are too many people in the world who don't really understand that there is no way that any brokerage firm can offer such cheap trades and such extensive trading tools. Admittedly, the real expense in software is in the development, and once it's writ-

ten, there is very little cost in subsequent copies. However, recouping the costs of software, trading staff and trading systems is a major concern of every brokerage firm in the nation. Everyone talks about the advantage of discount brokers, but are they really that inexpensive?

Most people don't read the fine print on these accounts, and even when they do, they don't fully understand the meaning of some of the terms in that fine print. The most important of all is the statement that the least expensive trades are "market" orders. This is the key to how "discount" brokers make their money.

A market order is the simplest order for any trader to place. As the name implies, a market order is an order to purchase (or sell) a stock at the market price. If I give the order to buy a share of stock XYZ at the market price, it's simple and straightforward. My broker will buy the stock as soon as possible at the best price available, right?

Wrong. The simple fact is,

the minute you issue a market order, control is out of your hands. You've agreed to pay whatever the market price for the stock is at the time you issue the order. If you're trading in an account that doesn't guarantee immediate execution, your vulnerability is even higher. When an investor makes a market order, the brokerage isn't under any obligation to get the investor the best price for the stock. They need only execute the trade



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## Financial Affairs



Keith D. Cummings is the author of *Opening Bell* and other novels. Reviews say *Opening Bell* is "...a thriller that will keep you guessing and demand your full attention until the last page is read."

Visit Author's web site at:  
<[www.keith-cummings.com](http://www.keith-cummings.com)>

The Bid price is the price that someone looking to buy a stock is offering to pay. The Ask price is the price for the seller of the stock is offering to sell the stock. These are rarely the same price. As with a house or a car, no one actually pays the amount that the seller is asking for the stock. When an individual investor is looking to sell a stock, the shares always sell at the Bid price. When an individual investor is looking to buy a stock, the shares are always purchased at the Ask price. This is where your broker makes the real money.

When I ordered my XYZ shares, the market price I saw when I placed my order was \$22.50, the Bid price. However, when my broker makes the trade, they buy the stock for \$22.55 per share, the Ask price. My broker pocketed 5 cents per share on the difference between the Bid and Ask price, the spread.

in a reasonable period at the market prices. What most people don't know is that there are a lot of market prices at any given time. Depending on the stock, these prices can vary greatly, several cents per share.

Now, most people think a few cents aren't really a big deal. But consider my hypothetical market order on stock XYZ. I'm watching my "institutional trading software" and I see that XYZ is trading at a low price relative to where it has traded in recent months. XYZ is quoted at \$22.50 per share and I order a simple purchase of 100 shares. I think I am going to be paying \$2,250 for the stock plus \$8 per share. \$2,258. Great deal!

When my statement shows up in a month, I see that I did, in fact, buy XYZ, but not for the \$22.50 per share. I paid \$22.55 per share. I paid \$.05 more per share for my stock. No problem, I think. My broker was just not able to execute the trade quickly and the stock came back up. When I look back at the trading range of the stock on the day in question, it turns out that my purchase was in the middle of the range. Everything is honest. I got my stock for close to the price I wanted and my broker got his \$8.

But my broker actually made much more than \$8. How did they make more? Well, that's simple. There are multiple prices for every stock for sale.

Most brokers use electronic trading systems. Computers interconnecting each brokerage house enable them to trade stocks between themselves. Often, the stock exchanges aren't involved in these small transactions. Only the larger transactions attract the interest of specialists on the stock exchange floor. So, when I ordered my 100 shares of XYZ, my broker's program checked the market prices of stocks. The program looks at two very important numbers, the "Bid" and the "Ask" prices.

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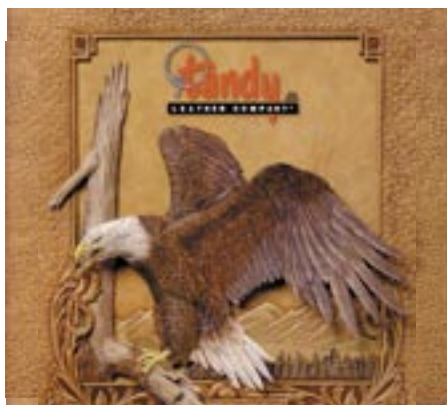
You may be thinking that this isn't such a big deal. But let's consider a 5 cent spread. Additionally, let's say I am working with my vast wealth I have earned from my job writing this column and I am buying 1,000 shares of XYZ. Now, when my statement comes next month, I see that I paid \$22,558 for 1,000 shares of XYZ, \$50 more than I expected to pay. My discount broker made \$58 on my \$8 trade!

I am not saying that discount brokers aren't a great opportunity for people who want to invest on their own. It is important, however, that before you begin any investment program you understand what your broker is really charging you. You should understand that, while your discount broker is going to charge you less for your trades, this might come at the cost of paying a higher price for the security. If two investors, one with a full service broker and one with a discount broker, execute the exact same trade at the exact same time, the full service customer will be paying less for the stock, although more for the trade.

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