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FOREX TRADING
YOUR ESSENTIAL GUIDE

By Greg Secker

Important information

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Essential Guide to

TRADING FOREIGN EXCHANGE

The world's biggest market at your desk

CONTENTS

Chapter 1

WHY TRADE FOREIGN CURRENCY?

Foreign exchange is the world's largest and most active market. It's where banks and dealers exchange large amounts of foreign currency, mostly to facilitate trade and investment between countries. It's open all day and night – except at weekends – and its volume amounts to about $4 trillion a day.

High liquidity means there is always someone to trade with, and there is little risk of a single player being able to move the price, as can happen in other markets.

The foreign exchange market also offers the ability to profit from a large position in the market for a small upfront cost, known as the initial margin. This is called leverage, which in the foreign exchange market is a ratio of at least 100:1. In order to buy $10,000 worth of US dollars, for example, you only have to pay $100 to enter the trade, because you effectively borrow the remainder, or $9,900. But leverage goes hand in hand with risk, which means it's essential to have a strict risk management plan, and to follow it without fail. Leverage can be dangerous for investors, but for traders it's a useful tool when used with caution and understanding.

Provided you have learned how to trade like a professional – using sound risk management principles and using the tools of analysis that give you a trading edge – and provided you can keep to the rules you will learn here or in a more advanced study course, the foreign exchange market has the potential to allow you the freedom of earning a living from home.

With experience and persistence, and with the right guidance from courses and trained coaches or mentors, you might even be able to build your capital to the point where trading offers you the opportunity to become independently wealthy.

EASY TO UNDERSTAND

Dividends, price-earnings ratios, takeovers, quality of corporate management, deciding which shares are likely to move in which direction – the learning curve in the sharemarket is fairly steep and the amount of analysis required can be daunting.

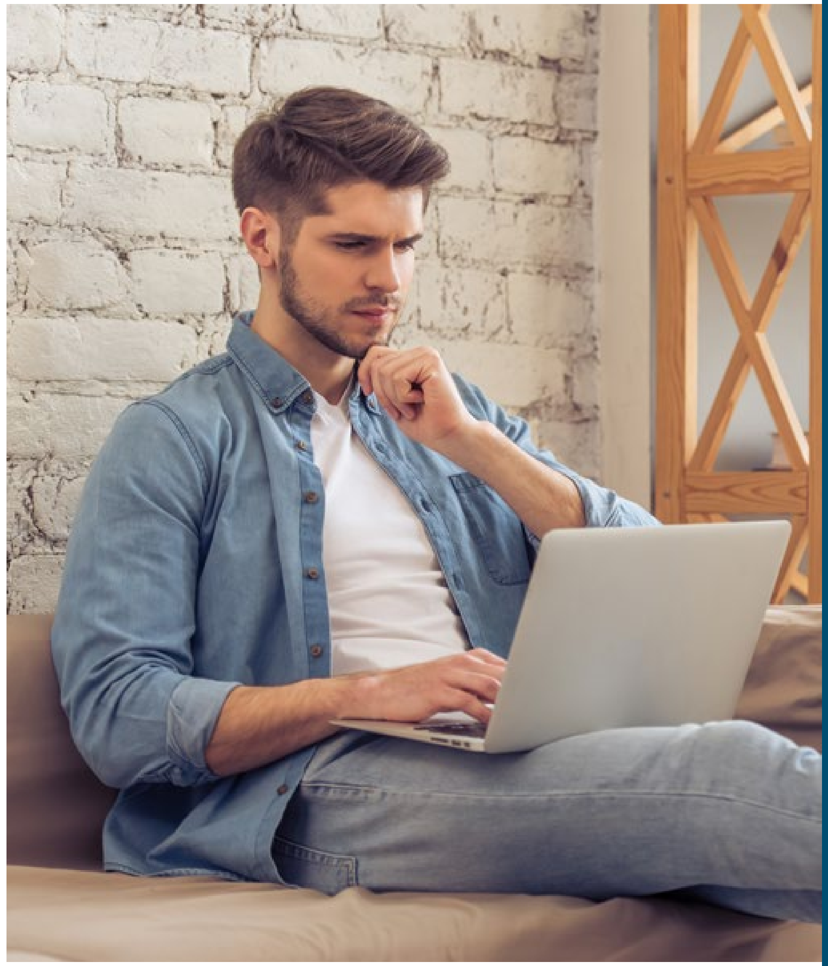
By comparison, foreign exchange is relatively straightforward. You take a currency you're familiar with (say, the Australian dollar) and look at its value against just one other currency at first (for example, the US dollar). This is known as a currency pair – one currency valued in terms of another. There are only a few major currencies that lend themselves to Forex trading. You don't have to pick stocks and then follow their fortunes individually.

This guide will help you learn what influences movements in a currency pair and, just as importantly, show you how the most successful traders use technical analysis such as price charts and technical indicators to improve their chances of success.

TRADE AT HOME OR ON THE MOVE IN YOUR OWN TIME

One of the features of foreign exchange trading that makes it so popular is that markets are open 24 hours a day, and you can trade directly from your desk, or even while sitting in your favourite cafe with your laptop and a wireless internet connection. Some traders even take it a step further by trading on their mobile phones.

This flexibility means you can trade after work, early in the morning, during lunch or even overnight – whenever suits you. Foreign exchange providers give you more or less direct access to the markets. This means you can do your analysis, make your trading decisions, set a stop-loss order to help protect yourself against big losses, and execute the trade without ever needing more than your computer and a broadband connection.



WORLD'S BIGGEST MARKET – NO WAITING

Because the foreign exchange market is global and includes all of the world's largest banks, you can be sure that there's always someone to trade with – unlike the sharemarket where you might want to buy a particular share, but no one wants to sell (or vice versa).This ability to trade at any time is called liquidity. The size of the global market is variously estimated at $4 trillion a day – by far the world's biggest, deepest and most liquid market.

LOW TRANSACTION COSTS

The cost of trading in Forex varies depending on your provider and whether you are trading the spot Forex market or a derivative such as a CFD, option or warrant. The spot market refers to the primary foreign exchange market. This is the interbank market in which financial institutions deal directly with each other.

In the Forex market, trading directly or through derivatives, the cost of trading currencies is determined by "the spread", which is the difference between the price at which traders can buy a particular currency pair and the price at which they can sell. This spread can vary from time to time, depending on market conditions, and is different depending on the currency pair and which provider you use. For most trading purposes, the cost of each trade is not vitally important to its success. An exception applies to some intraday strategies that aim to capture small profits.

On a trade size of $10,000, for which you need an initial margin of $100, the spread will usually average around three pips or approximately $3. (A pip is the smallest move in the Forex market; see Chapter 3). The spread can vary from as low as one pip for high-volume major currencies to five or more pips for minor currencies.

If you hold a position for longer than 24 hours, there may be a small interest charge, depending on the interest rate differentials between the two currencies. At other times, you may be paid a small amount of interest on your position. This interest amount is credited or debited as your position is rolled over to the next day, and is made so that you can keep the position open without actually taking delivery of the currency.

HIGHER LEVERAGE THAN SHARES

Leverage is the ability to pay only a small amount of the value of a currency as an initial payment to open a trade. Leverage can be a double-edged sword, as using the maximum leverage can give you the maximum possible profit on a winning trade – or the maximum loss on a losing trade.

The maximum leverage in the sharemarket is usually 20:1, which means your contract is for 20 times the initial margin (deposit) you pay. In contrast, the foreign exchange market offers leverage from 100:1 and up to 400:1 with some providers. With 100:1 leverage, to enter a trade involving $100,000 worth of US dollars, you need only pay an initial margin of $1000.

With this amount of leverage, even very small moves in the value of a currency can result in quite large gains and losses. You will need to learn how to place stop-loss and stop-limit orders (that is, orders to close a position when the price reaches a set level) and the basic rules of risk management to trade safely in the market. This guide will get you started, but unless you are an experienced trader, you will need to take some time to learn about trading plans, risk reward ratios, money management, position sizing, fundamental analysis and technical analysis before you begin.

To show you the kind of returns this level of leverage can offer, suppose you buy Australian dollars and the Australian dollar's value rises from $US1.00 to $US1.02. A currency can move by this amount, or more, in a matter of a few days when markets are moving swiftly. It represents a change of 2.2 percent, but since you have leverage of 100:1, your profit on the upward move will be 100 times 2.2, or 220 percent, based on the initial amount you pay.

To put it another way, if you were trading one standard or full-sized lot, your original $US100,000 is now worth $102,000, an increase (profit) of $US2000, which is worth $A2200 This is the profit you made on your $1000 initial margin. Our simplified example does not take into account the spread or costs to carry your transaction. For a more detailed example and typical costs of trading, see Chapter 4.

High leverage also brings with it a large level of risk compared to ordinary trading. We give you some pointers in how top traders manage this risk in Chapter 6.

NEED TO KNOW

Foreign exchange trading can be extremely risky yet highly rewarding because of leverage.

It's easier to begin trading Forex than shares, but you still need some guidance before you start.

Register for our FREE Workshop here

Chapter 2

WHAT IS FOREIGN EXCHANGE?

Suppose we want to buy something online from overseas, such as a book that's not published here. We pay by credit card, and although our payment is debited to our account in Australian dollars, the bookseller in the United States receives US dollars.

How does the transfer happen? Ultimately, it goes through a bank, which charges a fee for changing Australian dollars into US dollars. The fee is actually built into the exchange rates (see Chapter 3 for more on this).

Banks also trade currencies between one another, so that if they have more customers wanting, say, British pounds than they have in their reserves, they go to another bank and buy from them to make up the difference (this typically happens in very large volumes). They generally keep cash reserves in a wide range of currencies on the understanding that a currency can only be exchanged for real value – that is, for goods or services – in the country in which it was issued. For example, Australian dollars are only acceptable as payment for overseas goods on the understanding that they can later be spent and you can get value for them in Australia.

Today, trading in foreign exchange is no longer reserved for the privileged, thanks to the development of the internet, online trading platforms and the availability of real-time foreign exchange prices from participating banks and spot Forex or other providers.

Access to the necessary information and the means to trade directly into the same market as the big banks is available to nearly anyone with minimal risk capital, an internet connection, an account with a provider and access to a Forex trading platform.

Chapter 3

HOW FOREIGN EXCHANGE PRICES WORK

CURRENCY QUOTES

An exchange rate is the price of one currency in terms of another. The one most familiar to you is probably the Australian dollar's value in US dollars; for example, one Australian dollar ($A1) has at various times in the recent past (the year ending June 2012) been worth between $US0.95 (95c) and $US1.10.

But if an Australian dollar is worth, say $US0.98, it also means that $US1.00 is worth about $A1.02 – to be exact, it's $A1.0204, or the reciprocal of $US0.98 (the reciprocal can be calculated by dividing 1.0 by the rate, that is, 1.0/0.98 = 1.0204). Because it's vitally important to know which currency you're buying and which you're selling, there is a convention in the Forex market to quote exchange rates on the basis that the first currency specified is the base currency (the one being valued).

Each currency has a universal three-letter code (the ISO code) that all foreign exchange participants use to identify it. The code for the Australian dollar is AUD and the US dollar is USD. Currencies are normally valued in terms of their US dollar equivalent. A rate involving two currencies other than the US dollar is called a cross rate (arrived at by comparing each one's value with the US dollar) but the same convention applies. The base currency is the first of the pair, and the quote is always for one unit of the base currency.

When you see a quote that looks like this: AUD/USD 0.9836 you know that what is being valued (the base currency) is one Australian dollar ($A1) and that its value is being given in terms of US dollars (the counter currency). From this we can be sure that $A1 = $US0.9836 (this is the same as an Aussie dollar being worth 98.36 US cents).

Most currencies (Japanese yen, Swiss francs, and Canadian dollars to name a few) are quoted with the US dollar as the base currency, that is, pricing the US currency in terms of its value in the other currency, but there are four notable exceptions: British pounds (GBP), euros (EUR), Australian dollars (AUD) and New Zealand dollars. These are quoted the other way around; for example: GBP/USD 1.5511 means that one British pound is worth $US1.5511.

Remember it is the base currency that you are buying or selling when you trade in foreign exchange. You buy British pounds if you think they will rise in value against the US dollar, for example, and you sell them if you think they will fall in value. Although buying British pounds is the same as selling US dollars, if you always think in terms of how the base currency will move when placing your trade, you are less likely to get confused.

SPREADS AND PIPS

When you go to the bank and request a foreign exchange transaction, the bank will give you two prices. It will sell you US dollars at one price, but if you want to sell them straight back the price offered will be lower – you will get less from the bank than what you paid for them.

The difference is called the spread. In foreign exchange terms, the spread is the difference between the price bid (price at which you can sell) and price asked (price at which you can buy). Other names for the same thing are the bid-ask spread or buy - sell spread.

It's the same in the spot Forex market, the primary market for foreign exchange, as well as Forex derivatives, although the spreads are much smaller than you'll get at the bank counter for small amounts of foreign currency. For example, if you see a quote written EUR/USD 1.3100/03 this means the dealer or bank buys euros at $US1.3100, and you can sell at that price. It also means that the bank or dealer is willing to sell euros at $US1.3103. The spread is the difference, equivalent to three pips in this case.

Quotes are normally given to four decimal places (one exception is the yen, a unit which has much less value than the base units of other currencies). So the smallest amount the Australian dollar, for example, can move against the US dollar is $US0.0001. Suppose the Australian dollar is moving up in value and rises from US97.05 cents to US97.06c. In the Forex market, this is expressed as a move from $US0.9705 to $US0.9706. This is the smallest move that a currency can make against another and is known as one pip. In the quotation we looked at above (EUR/USD 1.3100/03) the spread is three pips. This is the cost of making a trade; it means the market must move by at least this amount before you begin to make a profit. Quotes can look a little different depending on the provider and type of software (or trading platform) you are using. The quote with the three-pip spread for euros might appear in any of the following ways:

EUR/USD 1.3100–03
EUR/USD 1.3100–1.3103
EUR/USD Buy 1.3100 Sell 1.3103
EUR/USD Bid 1.3100 Ask 1.3103
These all mean the same thing.

MAJOR CURRENCIES

The term "major currencies" is used to refer to the seven most liquid (most actively traded) currencies in the market. These are the US dollar (USD), British pound (GBP), Eurozone euro (EUR), Japanese yen (JPY), Swiss franc (CHF), Canadian dollar (CAD) and Australian dollar (AUD).

MINOR CURRENCIES

Minor currencies are all currencies other than the majors.

COMMODITY CURRENCIES

Commodity currencies are those whose home countries rely heavily on commodity exports for a major share of their export income. According to IMF studies, there are 58 countries which could be included here, but the most active ones are the Australian dollar, Canadian dollar and New Zealand dollar.

MAJOR CURRENCY PAIRS AND MAJOR PAIRS

The term currency pairs often specifically refers to any pairs that include the USD, while a pair that doesn't include the USD is a cross currency. Major pairs are the seven most liquid pairs: EUR/USD, USD/JPY, USD/CHF, GBP/USD, AUD/USD, NZD/USD and USD/CAD.

TRADE SIZES

STANDARD CONTRACT

In the spot Forex market, the typical size of a trade is the equivalent of $US100,000, where the base currency is US dollars. This typical trade unit size is known as a standard lot or standard contract. For Australian dollars, the base currency is the Australian dollar itself and the size of a deal is $100,000 worth of the counter currency. At this contract size, an initial margin of $1000 is required and the value of a one-pip move is $US10 against that currency.

MINI CONTRACT

Many Forex trading providers offer smaller contract sizes, including a mini contract or mini lot, for the equivalent of $10,000, where an initial margin of $100 is required and the value of a one-pip move is $US1 against that currency.

MICRO CONTRACT

Becoming more readily available are micro contracts for the equivalent of just $1000 and requiring an initial margin of $10. This allows traders with small accounts to enter into trades without exceeding their maximum loss limits, which are related to position size. A one-pip move at this lot size is equal to US10c against that currency.

CONTRACT SIZE	VALUE	INITIAL MARGIN	VALUE OF ONE-PIP MOVE*
Standard contract	$100,000	$1000	$US10
Mini contract	$10,000	$100	$US1
Micro contract	$1000	$10	US 10c

*Against the US dollar

NEED TO KNOW

Currencies are always quoted as a base currency (the first of a given pair), valued in terms of the counter or term currency (the second of the pair).

The cost of trading is the spread (the difference between the buy and sell price).

Always think in terms of whether the base currency, not the second currency, will rise or fall. In the AUD/USD pair, you might expect the US dollar to fall, but you need to translate this into what this means for the $A. (If you think it will rise, you buy $A.)

Chapter 4

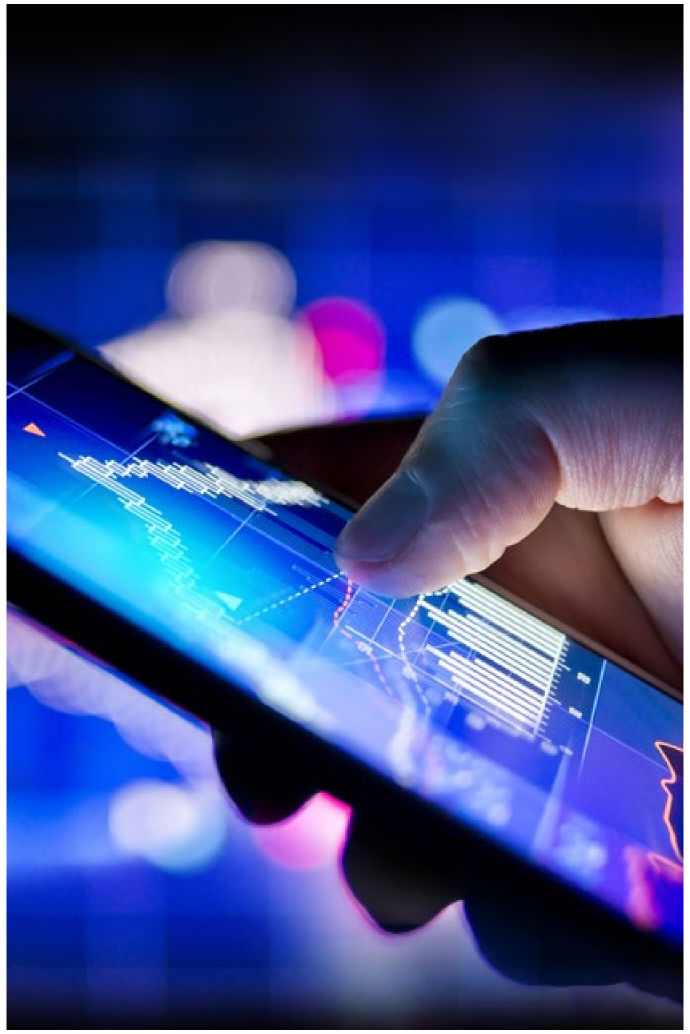
HOW TRADING WORKS

MOST FOREIGN EXCHANGE TRADING IN AUSTRALIA OCCURS EITHER IN THE SPOT MARKET (INTERBANK MARKET) OR VIA CURRENCY CONTRACTS FOR DIFFERENCE (CFDS), BUT THERE ARE OTHER WAYS TO TRADE. AMONG THEM ARE INSTRUMENTS LISTED ON OFFICIAL EXCHANGES, SUCH AS CURRENCY FUTURES.

SPOT FOREIGN EXCHANGE AND CFDS

By far the biggest volumes of trades in foreign exchange in Australia occur through the spot or primary market – the interbank market. In this market you can deal either through a foreign exchange dealer who has access to the primary market, or through a Forex provider, who in turn trades with a primary market participant.

So how does a CFD or spot trade happen? For most users there will be no real difference between the two. Margins, or initial payments, costs and outcomes will be very similar. In the spot market, any position held for more than two days must be rolled over (closed out and replaced) to avoid having to deliver actual foreign currency. Your provider will arrange this for you so that it happens automatically, and you should clearly understand this from your account statement. Your position will typically be closed and reopened at a slightly different price, which is determined by the interest rate differentials between the two currencies. This will result in a credit or debit to your account based on the interest rate and whether you have sold or bought the relevant currency pair.



Both spot trades and CFDs require an initial margin to start with, and further margin payments on a daily basis if the market moves against you (down when you have bought, for example). This means you need more than the initial margin in order to trade, and it's possible for you to lose more than the initial margin if the market moves rapidly against you. Stop-loss orders help you keep losses to a minimum on each trade.

For technical reasons relating to the variety of methods providers use to hedge their positions, [many find it] preferable to trade Forex on a specialised Forex trading platform. Almost all currency CFD providers also offer spot Forex-styled trading platforms, even if the actual instrument is a CFD and you are trading micro or mini lots.

EXAMPLE TRADE

Here's an example of a profitable trade in the Forex market. Suppose you think the Australian dollar is likely to rise against the US dollar because Australian interest rates are increasing. In the market at the time, the Australian dollar is quoted at
AUD/USD 0.9278–0.9281 and you open a trade to buy $A100,000 at $US0.9281.

A few days later, the Australian dollar has moved up and the new quote is AUD/USD 0.9354–0.9358. You close the trade by selling Australian dollars at $US0.9354. Your profit is the difference between the two $US values, or a profit of $US730, as illustrated below.

1 MARCH

Buy AUD$100,000 at USD$0.9281	USD $92,810.00 (value) –
Pay initial margin	AUD $1000.00
Commission	nil

5 MARCH

Sell AUD$100,000 at $US0.9354	USD $93,540.00 (value) +
Initial margin returned	AUD $1000.00
Commission	nil
Profit	USD $730.00
Interest* received: (5 days at 2%)	AUD $5.48
Profit in AUD (USD $730/0.9354)	AUD $780.41
Net profit	AUD $785.89

* Based on the difference between a high interest rate in the base currency and a lower interest rate in the counter currency. Interest rates are based on official rates plus or minus a margin, and are variable.

Note: If the Australian dollar had moved in the opposite direction by a similar amount, or if you had sold Australian dollars instead of buying, there would have been a loss of similar proportions unless reduced by a stop-loss order. The interest received on the trade occurred because the interest rate on Australian dollars (the bought currency) is higher than the interest rate on US dollars (the sold currency). If you sell Australian dollars (the same as buying US dollars), you would pay the interest-rate differential between the two instead of receiving interest.

Chapter 5

ANALYSIS METHODS

FUNDAMENTAL ANALYSIS

Analysing economic information that indicates which direction a currency is likely to move is called fundamental analysis.

What makes a currency move? A host of factors can affect the relativities between two currencies, but remember that if demand for a country's goods or services is increasing, or the number of people wanting to invest there is growing, they must buy that country's currency (at the same time selling their own) before they can buy its goods or invest in its companies. As more people buy, the currency tends to rise in value.

Investment in Australia, for example, is attractive when our economy is strong, when share prices on the stock market are expected to move higher, when companies are paying good dividends and when interest rates are rising. When these things are happening, the Australian dollar tends to move higher against other currencies.

The Australian dollar is like a tiny share in the wealth of the nation as a whole. The economic indicators that show how healthy the economy is include:

- Interest rates – the dollar tends to move up when interest rates are rising.
- Global growth and demand for resources – Australia produces many of the commodities the rest of the world uses, including metals, coal and agricultural products such as wheat and wool. When demand for these goods is increasing, as it has been for most of the current century, this supports the currency. Any expected slowdown would tend to reduce the dollar's value.
- The economic cycle – economies tend to have a phase of strong growth followed by a phase when growth slows. Share prices boom during the growth phase and tend to move lower (or move up only slowly) during the contraction phase. Growth tends to increase demand for the dollar; the dollar is more likely to fall in a slower phase. Indicators include housing statistics, retail and automotive sales figures and employment levels.
- Budget and trade deficits and surpluses – surpluses indicate strong growth and a rising Australian dollar; deficits the opposite.
- Inflation – inflation reduces investment returns, and rising inflation tends to reduce the long-term value of the currency. Governments tend to react to inflation by increasing interest rates, which can support the currency in the short term by restoring the return on investment. Indicators of inflation include the consumer price index and the money supply statistics.

Note: This is merely a beginning guide to a large subject. Ask your Forex educator or foreign currency trading provider for further information.

SENTIMENT ANALYSIS

Analysing market sentiment means looking at all the information we have about the market that is not the price itself. If there's one thing that's constant about the market's behaviour, it's that traders tend to overreact, pushing prices to higher levels than their true value, and then overreact in the opposite direction, pushing them to levels below true value. Sentiment analysis is all about picking these reactions.

Volume of trade is one indicator that can help determine which direction the weight of trading money is flowing, and this can help reveal what the market believes is going to happen, which is market sentiment. It's the difference between what the charts indicate the market is likely to do based on its past behaviour, and what it actually does as each unique market situation unfolds.

Although the indicators of market sentiment, such as moving averages and a currency's average true range (ATR) are traditionally thought of as technical analysis tools, technical analysis focuses on past price movements. Sentiment analysis attempts to understand what is driving trader decisions for now and the immediate future.

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TECHNICAL ANALYSIS

The market is like a balance that's set in motion as new information about fundamentals comes to hand, swinging in one direction and then another, and from time to time finding a point where it might rest briefly until more new information is available. As all this happens, prices show patterns that tend to be repeated. Identifying these patterns by examining charts of past price behaviour is called technical analysis.

Technical analysis provides the basis on which most traders make their trading decisions. Fundamentals cannot be ignored, especially if you're trading very short term (opening and closing positions on the same day), or holding positions at a time when economic news likely to affect the markets is about to break. As fundamental factors always show up in price formation, many traders make their decisions based on technical analysis alone. Expected news, such as the release of employment or inflation figures in a major economy, is often preceded by heavy trading as traders back their expectations, and a sudden move can follow the announcement if expectations are exceeded or unmet.

You will need to study technical analysis in some detail if you haven't traded before. A recommended book is Charting Secrets by Australian author Louise Bedford. Your Forex educator should focus on technical analysis, and your Forex provider might also have information on the topic, but there is a wide range of resources available on the internet (see Chapter 8).

Some providers include technical analysis, either within their software platform or as a separate add-on package. Charts allow you to analyse market pattern and trend data and provide a visual representation of price and volume levels that you can use to determine the next likely move for a currency.

There is no such thing as absolute certainty when forecasting price movements. The market can do anything, and often defies both logic and the forecasts of charts. Among the patterns and indicators traders use to forecast the way a market is likely to move are:

- Trend lines – lines joining higher and higher low points (uptrend) or lower and lower highs (downtrend). Prices breaking through these lines can indicate the beginning of a possible change in price direction.
- Moving averages – smooth out past movements and indicate a possible new trend if the price moves through the average.
- Reversal patterns – such as head-and-shoulders, tops and bottoms, triple tops and rounded tops.
- Support and resistance – price points that a market has had difficulty moving through in the past.
- Relative strength indicators – show whether the market can be considered overbought (ready for a price drop) or oversold (ready for a rise).
- Fibonacci levels – levels that indicate a continued move in the current direction if breached.
- MACD – used to help spot early trends and trend reversals.
- Cyclicity indicators – markets go through cycles of bullish and bearish phases with periods in which they tend to return to their average. Cyclicity indicators help reveal such cycles.

NEED TO KNOW

Although many traders use only technical analysis, they do need to pay attention to news that might dramatically affect exchange rates.

Technical analysis is an essential tool to help you predict which way the market is likely to move.

It's essential to have a basic understanding of chart patterns and indicators before starting to trade.

Chapter 6

YOUR TRADING PLAN

Trading in foreign exchange can be risky, especially if you haven't traded before. Most people who lose money trading in leveraged markets (such as the Forex market) do so because they haven't undertaken the essential learning, have no trading discipline and no set trading plan. Finding strategies that actually work and then preparing a trading plan takes some research and time to ensure it covers every essential aspect of keeping your risk capital safe and maximising your chances of success.

Of those who read this, some might ignore it and just jump into trading, eager to begin making money. The odds are very great (something like 20 to one) that those people will end up losing not only the risk capital they have set aside but even more as they try to recoup losses that could have been avoided in the first place.

The essential trading rule is: Cut losses, let profits run. In other words, make sure you quit a losing trade before you lose too much, and make sure a favourable trend is over before getting out. This might involve coming to terms with unexpectedly strong emotional reactions to the inevitable losing trades. Those who begin with the understanding that some trades (and perhaps even a majority at first) will involve losses, will stand a better chance than those who expect to win on every trade.

YOUR TRADING PLAN SHOULD HAVE THE FOLLOWING AS ESSENTIAL ELEMENTS:

- Your objective in trading – this might be a target return on risk capital or an expected percentage gain on winning trades. Many traders in Forex target a number of pips per week as their trading objective.
- Use of trading strategies that have been proven to work in the past.
- How you will decide when to enter (buy or sell) – this will come from your understanding of proven trading strategies and proper use of technical analysis and chart patterns.
- Use of stop losses – stop losses are essential for risk management, and require close study so that you use them appropriately for your position size and amount at risk.
- How you will decide when to exit, that is, sell back your bought position or buy back a sold one. This is also a result of your understanding of proven trading strategies and proper use of technical analysis and chart patterns.
- Definition of your risk-management system – risk-management rules are designed to preserve your risk capital by limiting the amount you put at risk on any one trade. There's more to it than this, so find a good course or do some reading on money and risk management before starting.

MONEY MANAGEMENT

Sound money management is essential to the success of your foreign exchange dealing. It's fundamental. The reason so many potential traders fail early in their attempt is that they ignore this simple discipline that, if followed, will keep any trader from the disastrous losses that often spell the end of their trading endeavours.

Here are some of the guidelines successful traders follow. They are stated as rules because their aim is to protect your trades from needless losses as well as to obtain the maximum benefit from winning trades.

If you don't follow them, your risk of overall loss increases.

1. Don't risk more than 1 per cent of your capital on any one trade. This rule, along with correct position sizing (see point 3 below) will keep you from risking too much of your capital at once, and from showing a disproportionately large loss on any trade. It works by putting capital preservation ahead of all other priorities. Since you can't trade without capital, that's as it should be.
2. Learn about stop losses and how to use them. A stop-loss order (known as a stop) is an order to exit your position at a particular price as a means of either limiting losses or helping to protect profits already made on positions that are still open. Determine the price level of your stop-loss by reference to the specific currency pair you are trading and its past behaviour, as indicated by charting signals, rather than by simply placing it to keep losses to a known dollar amount. Pay particular attention to support and resistance, trend lines, and recent volatility when placing stops.
3. Know how to calculate your risk-reward ratio, or the ratio of how much you are likely to gain to how much you have at risk. The reward, or possible gain, is based on the target price for the currency, which is the level you expect the exchange rate to reach based on your technical analysis. The risk is the total amount at risk based on where you place your stop, also calculated by reference to chart signals and patterns. Unlike shares, where a minimum risk-reward ratio would be 3:1 – a possible gain of $3 for every $1 risked – the minimum acceptable ratio in the Forex market is 1:1. As an example, suppose you expect the Australian dollar to move from $US0.9700 to $US0.9900, a move of 200 pips. Your potential reward is $200 on a mini contract. You set your stop-loss according to your technical analysis based on how far the currency

must move before you consider it has turned against the direction of your trade. This might be, say 150 pips, giving you a theoretical maximum loss of $150. Your risk-reward ratio is 200 divided by 150, or 1.3:1, which is acceptable. (The ratio, despite its name, is of reward to risk). The target price, by the way, is not necessarily an exit point but simply the price you expect the currency to reach at a minimum. Depending on your strategy, the exit criteria could be separate from the target price and allow for the possibility that the target might be exceeded.

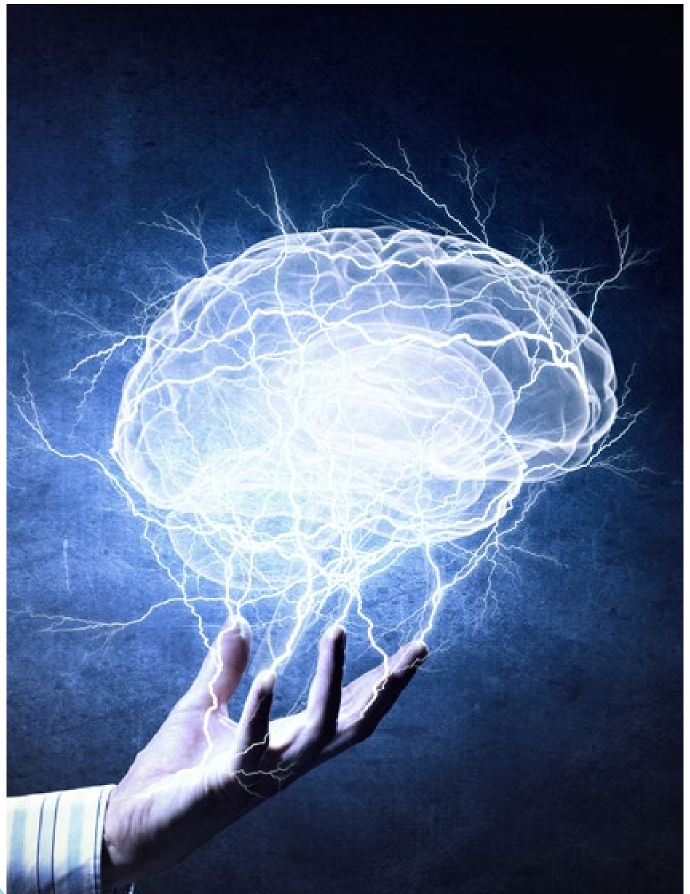
4. Determine your position size (number of contracts to buy or sell of what size) based on how much you will lose if the stop is triggered at the indicated level, and the 1 per cent rule. You should know in advance how much the likely maximum loss will be on the trade. In practice, if your capital is $50,000, your maximum allowable loss is $500 on any trade. Suppose you determine that your stop-loss should be placed 120 pips below the current level for an AUD/USD trade (Australian dollars valued in US dollars). If you trade a mini contract size of $10,000, 120 pips is equivalent to $120 of profit or loss. Divide this into your maximum allowable loss of $500, and your position size is a maximum of four contracts, with a likely maximum loss of $480, which is within your limit. Don't ever forget that if you change your stop-loss price level, you must adjust your position size accordingly, especially if it takes you over the limit of your maximum allowable loss. A tighter stop-loss reduces total risk and might indicate a larger position size.

5. Realise that no matter how well you know the rules, emotion can step in and overrule that rational knowledge. Hesitation through uncertainty before entering a trade, and the tendency to hold on to a losing position in the hope that it will turn around and prove you right, are among the most common trading errors. The only rational response to a loss on any trade of more than the 1 per cent allowed is to exit, re-entering if the market does turn in the other direction. The only rational response to a profit is to hold the position until the market has clearly turned.

TRADING PSYCHOLOGY

The psychology of trading relates to how well a trader manages his trading capital and the risks involved in leveraged trading. The only successful traders are those who keep strictly to the money management rules that have been found to work. The psychology of trading examines why there is a conflict, if any, between what we think and understand about the markets and what we go on to do. The reason traders – especially beginners – don't follow the rules is that they have not understood their own relationship to money and to greed. Leveraged trading in Forex will challenge you to know yourself better and to learn what you really think about money and greed. It will also challenge you to accept responsibility for your results in the knowledge that there is no one else to blame.

There is no substitute for experience in learning about your own ability to keep from overtrading, hesitating, risking too much, from adjusting stop-loss levels without sound reasons or from holding a losing position past the maximum loss level. But awareness of these possibilities and the reasons for them in your own mind – everyone being different in this regard – can make the experience more valuable. A good place to start is Mark Douglas's book, Trading in the Zone, which is written for traders generally, and is directly applicable to Forex trading.



DATA AND SOFTWARE!

To know whether the entry and exit rules in your trading plan will work, you will need to test them on actual trading data. The best way to do this is through software designed for the purpose using past data from actual foreign exchange markets. Your Forex provider might be able to help you with a practice account that includes many of the tools you'll need, or an internet search will help you track down the appropriate tools. Only when you are confident your system will work – providing bigger profits on winning trades over time than the losses on losing trades – should you begin trading with real money.

Usually more reliable than data from Forex providers is that from third parties, which you can find by conducting an internet search for top financial data vendors and trading software firms. In this area it's a pretty good guide that you get what you pay for, and reliable data improves your analysis. Data providers also offer accompanying software, but software firms don't always offer the accompanying data.

NEED TO KNOW

The golden rule of speculative trading is to cut your losses (quickly exit from losing trades) and let profits run (stay in the trade until the market changes direction).

Every successful trader has a trading plan setting out objectives, the entry and exit signals to be used, and risk and money management parameters.

Confidence is key. You need to know that the chart signals you use, combined with your money management regime, can provide profits that outweigh losses over time.

Chapter 7

BEFORE YOU START

CHOOSE A FOREX DEALER

Choosing a suitable foreign exchange dealer is not as easy as it sounds. One of the best ways is on a recommendation from other traders, but as a guide you should look for a dealer that:

- is reputable and offers secure handling of clients' funds, in particular segregating them from their own and ideally offering protection for those funds – including unrealised profits, and cash on deposit – against their own financial failure. Check that your Forex provider holds a licence from the Australian Securities and Investments Commission (ASIC), the regulatory body for Australian financial markets.
- honours stop-loss orders at the price you specify;
- offers not only the best spreads between bid and ask prices, but also consistent spreads that aren't widened significantly during times of market volatility – remember this is the cost of trading;
- does not requote prices, unless there are exceptional conditions, but allows you to trade at or very close to the price quoted on the screen;
- allows you to deposit funds and withdraw earnings smoothly and speedily;
- has a responsive, fully featured and easy- to-use trading platform;
- is backed by adequate capital and supportive professionals, and;
- offers competent, easily available account and technical support, especially after the account is opened.

Retail Forex trading is a comparatively new phenomenon in Australia. Contrary to some media reports, the majority of them want their clients to do well, or to at least break even, so that they keep trading. Providers who consistently offer poor performance in the areas of order execution, price, trading platform versatility and support will find that they lose clients to more competitive firms.

LEARN THE TRADING PLATFORM

Trading platforms come in two main varieties. You either download the software and run it on your own computer, or you trade via the internet using remotely operated software. Internet (web-based) platforms give you the flexibility of trading from any computer, anywhere and at any time by logging in to your account on the provider's website. Software you download has to be available on the computer you wish to use, which could mean downloading and installing it again if you change computers. Web-based platforms are not necessarily better, however. What's more important is the features they provide in terms of charting tools, trading features (for example looking at a chart and being able to execute an order directly from the chart itself), ease of use, screen legibility and speed of execution. Before beginning to trade, take some time to learn how the software works by trading the smallest possible trade sizes or, if possible, trading on a practice account where no real money is involved. This will help prevent the occurrence of trading errors because of unfamiliarity with the way the software works.

PRACTICE VS LIVE ACCOUNTS

Using a practice account is one of the best ways to prepare for trading with real money. However, there are differences that you should keep in mind when making the transition from a practice account to a live account.

- **Delayed vs live data feeds:** Some practice accounts use delayed pricing information in their demo trading system, which could affect the timing of trades and any impact of fundamental news announcements.
- **The way orders are executed:** Demo platforms can execute some orders differently than the way they are executed in a live account – particularly stops and limits. It's important to understand how the executions might differ.
- **Features available:** Demo systems often only include basic features, and you will receive full access to all features only after opening a live account. Examples include available charting tools and indicators, and you should make sure you understand what will be included with a live account.
- **Emotions:** Because you are not trading with real money in a practice account, your emotion will not be a factor. Be sure to develop a disciplined trading plan so you do not let your emotions get the better of you.

Chapter 8

FURTHER INFORMATION

Use these resources to help you learn more. Without the essential information on trading plans and strategies, Forex trading is more of a gamble than a source of income. Further resources can be found by typing keywords such as headings below into your internet search engine.

Important information

The Complete Idiot's Guide to Foreign Currency Trading by Gary L. Tilkin and Lita Epstein (USA, Australian edition)

FX Trading: An Australian Guide to Trading Foreign Exchange by Alex Douglas (Australia)

Forex Revolution: An Insider's Guide to the Real World of Foreign Exchange Trading by Peter Rosenstreich (USA)

Technical analysis

www.smartchartsfx.com

Broker

www.Forexcfds.com.au

Trading plans

Art of Trading by Christopher Tate (Australia; also covers charting)

Better Trading by Daryl Guppy (Australia)

Trading Psychology

Trading in the Zone by Mark Douglas (USA)

Traders

Market Wizards by Jack D. Schwager (USA)

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