WILEY Trading

THE SENSIBLE GUIDE to FOREX

SAFER, SMARTER WAYS *to* SURVIVE *and* PROSPER *from the* START

CLIFF WACHTEL

Contents

Cover

More Praise for The Sensible Guide to Forex

Series

Title Page

Copyright

Dedication

Read This First

- CURRENCY RISK: EVERY INVESTOR'S DILEMMA
- THE SOLUTION
- SOME BACKGROUND
- WHY ANY TRADER OR INVESTOR NEEDS THIS BOOK
- VISIT THESENSIBLEGUIDETOFOREX.COM FOR ADDITIONAL ONLINE CONTENT

Acknowledgments

Chapter 1: Three Must-Know Forex Facts

- FACT 1: EVERYONE NEEDS FOREX DIVERSIFICATION EVEN IF YOU DON'T TRADE ACTIVELY
- FACT 2: POTENTIAL FOR BETTER RISK-ADJUSTED RETURNS

FACT 3: YOU CAN DO THIS

Chapter 2: Forex Basics

BASICS OF CURRENCIES AND CURRENCY PAIRS
CURRENCIES TRADE IN PAIRS AND WHY THAT MATTERS
SIZE MATTERS: TYPES OF CURRENCY PAIRS
PIPS: THE UNIVERSAL CURRENCY OF CURRENCIES
LEVERAGE AND MARGIN: THEIR RELATIONSHIP AND IMPACT ON RISK
THE THREE FACETS OF RISK AND RISK CONTROL
THE CORE FOUR: THE MOST IMPORTANT SKILLS FOR SUCCESS

Chapter 3: Technical Analysis (TA) Basics

CANDLE CHART BASICS
SUPPORT AND RESISTANCE (S/R) BASICS
CANDLE CHART TIME FRAMES: LENGTH MATTERS
IDENTIFYING SUPPORT AND RESISTANCE (S/R) TO BUY LOW, SELL HIGH, OR VICE VERSA

Chapter 4: Technical Analysis

PRICE LEVELS
TRENDS AND TREND LINES
FIBONACCI RETRACEMENTS (FIBs): THESE FIBs DON'T LIE
BOLLINGER BANDS (BBs): USE AS S/R IN RANGE-BOUND MARKETS
INTRODUCTION TO JAPANESE CANDLE CHART PATTERNS
INTRODUCTION TO WESTERN CHART PATTERNS

THE MORE S/R INDICATORS, THE BETTER

Chapter 5: Trader Psychology and Risk and Money Management (RAMM)

RAMM: PRESERVING CAPITAL IS YOUR TOP PRIORITY
THE INNER GAME: TRADER PSYCHOLOGY BASICS
WHY TRADE LONGER TIME FRAMES
THE ESSENCE OF GOOD RAMM
THE THREE PILLARS OF RAMM
ACCOUNT SIZE AND AFFORDABLE LOSS PER TRADE
SETTING STOP LOSSES: BASIC TECHNIQUE AND PSYCHOLOGY
LEVERAGE AND MARGIN
POSITION SIZING
AVOID HAVING TOO MANY OPEN POSITIONS
ENTRIES NEAR STRONG SUPPORT, EXITS NEAR STRONG RESISTANCE
ENTRIES AND EXITS: SINGLE VERSUS MULTIPLE
RISK-REWARD RATIOS (RRRS)
IF YOU FAIL TO PLAN, YOU PLAN TO FAIL
WHAT CONDITIONS DO YOU NEED FOR SUCCESS?
SAFETY IN NUMBERS: BUILD A TEAM

Chapter 6: Essentials of Fundamental Analysis

USING FUNDAMENTAL ANALYSIS (FA) AND TECHNICAL ANALYSIS (TA) TOGETHER
AN OVERVIEW OF FA: MAIN FUNDAMENTAL DRIVERS OF FOREX TRENDS
MACROECONOMIC DATA AND INDICATORS
NEWS TRADING: DAY TRADING BASED ON SHORT-TERM FUNDAMENTALS

FA BASICS: EASY TO UNDERSTAND AND HARD TO APPLY
THEREFORE, GET THEE TO AN ANALYST
COMBINING FA AND TA: AN EXAMPLE

Chapter 7: Pulling It All Together with Trade Examples

IDENTIFYING AND EXECUTING LOW-RISK, HIGH POTENTIAL YIELD TRADES
TYPES OF TRADES
TRADE EXAMPLE 1: A SWING TRADE
TRADE EXAMPLE 2: A BREAKOUT TRADE
MORE KEY TRADER PSYCHOLOGY: DISTINGUISHING BETWEEN GOOD TRADES AND WINNING TRADES

Chapter 8: Technical Analysis

DOUBLE BOLLINGER BANDS (DBBS)—USE AS MOMENTUM INDICATORS
MOVING AVERAGE CROSSOVERS
OSCILLATORS
MOVING AVERAGE LAYERING INDICATES TREND STRENGTH

Chapter 9: Technical Analysis

CATCH A WAVE: TIMING OR CYCLE INDICATORS
COMBINING TECHNICAL INDICATORS: WHICH ONES AND HOW MANY?
BACK TESTING: LEARNING FROM THE PAST
INTERMARKET ANALYSIS: READING INTERMARKET CORRELATIONS AND DIVERGENCES
WHY THESE RELATIONSHIPS MATTER
CURRENCIES VERSUS COMMODITIES

THINKING LIKE A PRO, ONE STEP BEYOND TECHNICAL ANALYSIS

Chapter 10: Alternatives to Traditional Methods

AUTO-TRADING SYSTEMS: WELCOME TO THE MACHINE

CURRENCY FUNDS: FOREX ETFS, ETNS, AND MORE

MANAGED ACCOUNTS: SHOULD YOU SEEK PROFESSIONAL HELP?

Chapter 11: Newer, Smarter Methods

FOLLOW THE LEADERS: FOREX SOCIAL NETWORKS AND TRADING

GREAT TOOL, BUT REQUIRES SKILL TO USE

BINARY OPTIONS: TRADING MADE EASIER

Chapter 12: Forex for Income

RIDE LONG-TERM FOREX TRENDS FOR LOWER RISK, HIGHER INCOME

CASE STUDY: CANADA 2000–2011: APPLYING FOREX TRENDS TO EQUITIES INVESTING

THE CARRY TRADE: USING DIRECT FOREX TRADES AS AN INCOME VEHICLE

Chapter 13: Now What? Next Steps

WHERE YOU’VE BEEN

WHERE YOU’RE GOING

Appendix A: Recommended Free Online Resources

FOREX SITES

OTHER FAVORITE FINANCIAL SITES

INDIVIDUAL ANALYSTS

Appendix B: How to Calculate Pip Values and Examples

DEFINITION
CALCULATION
EXAMPLE: EURUSD
HANDY RULE OF TENS
EXAMPLE USDCAD
EXAMPLE USDJPY: RULE OF TENS DOESN'T APPLY WITH THE JPY

Appendix C: Forex Trading Time Zones, Liquidity, and Why These Matter

THREE MAJOR TRADING SESSIONS AND WHY THEY MATTER
MARKETS TEND TO FOLLOW EACH OTHER
WHAT STOPS THE FOLLOW-THROUGH?

Appendix D: More on Leverage and Margin

Appendix E: How the Mathematics of Loss Demands Keeping Losses Per Trade Low

Appendix F: Choosing a Forex Broker

SUGGESTED SEARCH TERMS TO FIND BROKER REVIEWS

Appendix G: Low Correlations to Other Markets via Social Trading Means There's Always a Bull Market Somewhere

TRADE LEADER NONCORRELATIONS TO THE MARKETS
MARKET CORRELATIONS
LOOKING AT THE TRADE LEADERS
DIVERSIFICATION OF APPROACH

About the Author

Index

More Praise for The Sensible Guide to Forex

"This is the one forex book aimed at conservative mainstream investors who might never otherwise consider forex, but should because we all need currency diversification. Even those who never plan to trade will find a wealth of information that will make them better investors. This step-by-step guide to less demanding and lower-risk ways to trade or build a currency-diversified investment portfolio offers a less intimidating path to forex profits."

—Yohay Elam, Founder of Forex Crunch

"Cliff Wachtel's book provides pragmatic counsel and guidance. A must read for serious investors seeking to diversify beyond stocks, bonds, and gold."

—Dave Lemont, CEO, Currensee

"A must read for *any* informed investor or trader that deserves to become *the* classic introduction to forex. This book is the ideal shortcut to simpler, safer forex trading or investing. As Cliff succinctly puts it, 'The need for currency diversification is one of the most important lessons of the Great Financial Crisis.' This book details—with genuine respect for his readers' money and intelligence—a range of solutions, offering something for readers of every skill level and risk tolerance. Wachtel provides full details and illustrations to show you how to actually make money, without overloading you with secondary details or information you can find elsewhere."

—Eric Harbor, CEO, Caesartrade.com

"One of the best starting points I have read about forex. Understanding both the big picture and the essential, practical details of how to identify, plan, and execute a profitable trade is the manna of successful traders. Cliff delivers both. He explains what e. e. cummings called 'the root of the root and the bud of the bud and the sky of the sky of a tree called life,' but applied to the forex world. A really good tool, whether you're a newbie forex trader or a long-term traditional investor trying to build a diversified portfolio. Read it and you will get ‘forexpertise.’”

—Mauricio Carrillo, FXstreet.com U.S. Manager, @MCarrilloFX

“This book is an insightful introduction to the world of forex. Wachtel leads the novice trader on a journey of discovery from the most basic concepts in the forex market to more sophisticated trading strategies. What stands out is his honesty. Wachtel doesn't sugarcoat the FX market; instead he shares the idiosyncrasies of this market and debunks a few FX myths along the way. He also introduces some of the latest developments in the retail forex market, from social trading to binary options. Wachtel's broad knowledge of this market makes this book an interesting read for those who want a thorough insight into the world of FX.”

—Kathleen Brooks, Research Director, Forex.com

“In an ever-evolving field, it's rare to find a guidebook so helpful and timeless as Cliff Wachtel's *Sensible Guide to Forex*. This book gives both current traders and new traders the perspective they need to take their forex trading to the next level.”

—Tal Holtzer, CEO, DailyForex.com

“This is a fantastic, comprehensive, and up-to-date overview and practical guide to succeeding in the foreign exchange market, with an insightful, qualitative, and nonintimidating approach. Whether you are a novice considering a move into the foreign exchange market or an experienced trader looking for a deeper understanding of various concepts or some new approaches, Cliff's book does a stellar job of covering all the bases.”

—Joel Kruger, Currency Strategist, FXCM

“Cliff's book is a must-read, cogent, cohesive compendium of the realities of forex. I've been in the trading business for 35+ years and believe that success is all about intelligent risk management. The book's relentless emphasis on risk and money management is the reason that this is the first investment book I've bothered to finish in the past 20 years. For the novice, first he arms you with the relevant information to keep you from immediately losing your shirt, so that you survive the learning process with most of your cash and confidence intact. Then he takes you step-by-step through a number of paths to profitability. For the professional, he reminds us of the rules we all strive not to violate every day because we're human. He also provides the first in-depth coverage of two new and potentially very useful ways to tap forex—social trading and binary options. This book is the only source I've found for in-depth and objective coverage of either of these intriguing new ways to trade forex markets with potentially less effort and better returns."

—David Israel, Chief Market Strategist, White Wave Trading Strategies, Ltd.
www.whitewavetradingstrategies.com

Founded in 1807, John Wiley & Sons is the oldest independent publishing company in the United States. With offices in North America, Europe, Australia and Asia, Wiley is globally committed to developing and marketing print and electronic products and services for our customers' professional and personal knowledge and understanding.

The Wiley Trading series features books by traders who have survived the market's ever changing temperament and have prospered—some by reinventing systems, others by getting back to basics. Whether a novice trader, professional or somewhere in-between, these books will provide the advice and strategies needed to prosper today and well into the future.

For a list of available titles, visit our Web site at www.WileyFinance.com.

The Sensible Guide to Forex

Safer, Smarter Ways to Survive and Prosper from the Start

CLIFF WACHTEL

WILEY

John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our web site at www.wiley.com.

Library of Congress Cataloging-in-Publication Data:

Wachtel, Cliff, 1959

Wachtel, Cliff, 1959–
The sensible guide to Forex : safer, smarter ways to survive and prosper from the start / Cliff Wachtel.
pages cm. – (Wiley trading series)
Includes index.
ISBN 978-1-118-15807-4 (hardback); ISBN 978-1-118-26403-4 (ebk);
ISBN 978-1-118-23745-8 (ebk); ISBN 978-1-118-22605-6 (ebk)
1. Foreign exchange market. 2. Foreign exchange futures. I. Title.
HG3851.W324 2012
332.4′5–dc23
2012005565

This book is dedicated to:

The Almighty, for everything
My wife, Michelle
My parents, Dr. Arthur and Phyllis Wachtel My children, Sarah, Binyamin, Eliana, Gavriel, and Maayan To Rabbi Noach Weinberg, OBM

Finally, it is to you, dear readers, the sincere, serious traders or investors who seek the prudent path to currency diversification via conservative forex, either as active traders or as passive investors, that this book is ultimately dedicated.

Read This First

What You Absolutely Must Know

Read this first … or at least skim it. There are things you must know here.

First, congratulations! You've just found something few forex (foreign exchange or currency) beginners ever find—an ideal starting point.

CURRENCY RISK: EVERY INVESTOR'S DILEMMA

You can't live with them, and you can't live without them. They're often complex, exasperating, unreasonable, and irrational, and they always want more of your time and money. I am referring to trades or investments that give you currency diversification, of course. We all need it, but few succeed in currency markets. The methods commonly used are too risky, complex, and time-consuming for most people.

Unfortunately, it's very hard to find the right guidance for getting started. Virtually all of the so-called "Beginners' Guides" are either:

- too superficial to give you the practical skills needed to start making money, or
- too complex and detailed to provide clear step-by-step ways to actually start making money
- too focused on the usual methods of forex trading that are too risky, complex, and time consuming for most people to use successfully.

We've dedicated years to creating a book that avoids these pitfalls. It gives you a variety of approaches to get started via safer, simpler, more profitable ways to lower your risk and increase your returns, either as a conservative forex trader or as a more passive longer-term investor seeking exposure to assets in the best currencies.

Unlike other beginners guides, this book has the right balance of practical information and methods you use to actually make money, without burdening you with too much information or the wrong kinds of information. It provides the shortest path to actually making money as soon as your circumstances allow; or in the worst case, to avoid the mistakes and losses that drain your cash and confidence before you have had enough time to find your path to success.

Currency Risk and How to Fight It

Currency risk is today's great hidden portfolio risk. The governments behind the most widely held currencies are trying to inflate away their debts via low interest rates and “stimulus” (technically not money printing!) programs. It's unclear whether these policies serve the “greater good;” however, they are likely to devalue their currencies, and any portfolios denominated in them. So, for your own financial self-defense against that risk, you obviously need to diversify into assets exposed to sounder currencies, or those currencies themselves.But it's very tough to find solutions suitable for most traders or investors.

- For aspiring forex (foreign exchange) traders, most of the material available is about complex, demanding, time-consuming, high-leverage, high-risk methods unsuitable for the average risk-averse trader seeking steady profits rather than gambling thrills. Yet the materials aimed at beginners tend to be far too superficial to prepare anyone to actually make money. This book seeks to bridge that yawning gap with safer, smarter, and less demanding ways to trade forex, with the details and examples needed to get you ready to start trading or investing as quickly as your personal circumstances allow.
- For longer-term investors, there's plenty out there about foreign stocks or bonds, but almost all of it ignores the prospects of the currency behind these. A falling currency can turn a good investment into a bad one. This book shows you how to identify the currencies most likely to hold their value and provides ideas about how to apply that knowledge to a long-term portfolio for both income and capital appreciation.

THE SOLUTION

I'm not the only one to recognize the problem of currency risk.[1] I'm just the first to offer a book with the most cost-effective solutions to the problem that will actually work for most people, not just the few who are suitable for short term high risk trading. I'm not seeking to manage your money for a high fee (typically unconnected to actual performance), nor am I trying to sell you an expensive newsletter subscription or trading system.

Here is one source to take you step-by-step straight from ignorance about forex markets to competence needed for profiting from them, either as:

- A trader: using safer, smarter techniques than those usually advocated. These will allow you to survive the learning period with your capital and confidence intact, and to become profitable sooner. Those with some background can cut straight to the parts they need.
- A longer-term passive investor: Most sensible investors practice asset and sector diversification, yet ignore this basic principle of diversification when it comes to currency exposure, and have almost all of their assets denominated in a single currency, be it the USD, EUR, GBP, JPY, and so forth.

  This failure to diversify into assets in the strongest currencies is uniquely reckless. That's because the governments behind these and other currencies are pursuing stealth inflation to cut their debt loads. They'll never admit it, but historically low interest rates combined with repeated stimulus programs betray their true intentions—they want to slash the real value of their debt load through inflation (rather than more responsible but politically harder policies like cutting spending or raising taxes), even if they gut your net worth in the process. We'll teach you how to identify the currencies with the strongest long-term trends, and the kinds of assets that will ride them, for lower risk and higher, for more reliable returns.

The need for currency diversification is one of the most important lessons of the Great Financial Crisis that began in 2007. Ignoring it involves some toxic combination of ignorance, foolishness, laziness, or recklessness.

I can help cure the ignorance, though if you're reading this book the other three probably don't apply to you.

SOME BACKGROUND

Decades ago, while settling in as a U.S.-trained accountant and new immigrant to Israel, I started teaching English to earn some extra money. Teaching anything I understood well always came easily, but I was frustrated because the available textbooks were neither especially clear nor efficient. Teaching with them just made the whole process more painful and time consuming. I kept finding so many shortcuts and better ways to organize the learning process that I soon started writing my own materials. Over the years these evolved into a full set of courseware.

With these in hand, I was able to take absolute beginners to a sixth-or seventhgrade level (per standards of the Israel Ministry of Education) in under 30 hours, instead of the hundreds of hours typically required by our local school system or private teaching companies, and had a successful and fun teaching practice.

Years later, while working with forex traders, I found the same situation but worse. There was no Education Ministry to certify the materials, no structured program of what to learn in what order. There were plenty of training materials, some quite good, but most would just waste your time and money spent acquiring, studying, and applying them without success. Even if you were lucky enough to catch some of the better materials, after countless hours, books, articles, courses, you got some useful information and trading techniques, but you still had to figure out how to integrate it all into a plan of action. You still lacked a clear step-by-step roadmap toward actually making money, or at least not losing much while you learned and practiced.

Figuring out how to get started with forex, either as a trader or as a long-term investor looking for conservative ways to profit from forex trends, can be frustrating.

Still, you've got to start somewhere. Welcome to somewhere.

WHY ANY TRADER OR INVESTOR NEEDS THIS BOOK

The following expands upon, and at times repeats, what I've said above. The repetition is intentional because it's needed to get the message through.

As governments sacrifice the value of their currencies, and your savings, to further their own policy goals, currency diversification is no longer optional for prudent investors; it's critical for your financial survival. With both the U.S. dollar and Euro suffering wild swings over recent years, this lesson is beginning to reach mainstream investors.[2] You have to do something. Unfortunately, most forex materials focus on time consuming, complex, high-risk, high-leverage trading strategies. The majority of forex traders fail with this approach within a matter of months, while an elite few prosper.[3]

So where to turn? There are so many books, courses, blogs, and webinars, but most will waste your time and money because they're either too complex or too superficial.

Relax—you don't have to become another lamb to the slaughter.

If you're serious about succeeding in forex, you just need the right guidance toward the trading or investing style that best suits you. Welcome to that guidance.

Finally, here's a sane, conservative approach to forex for rational adults interested in gains, not gambling, either as traders or even just longer-term investors with no interest in directly trading currencies.

Unfortunately, forex's reputation has been tarnished by too many books and brokers pushing high-risk, reckless trading methods that are unsuitable for most of us. While most new traders fail within months, the elite 20 to 30 percent enjoy a lucrative, stimulating part-time or full-time career. Most of them aren't geniuses or connected insiders. You can join them, but you need the right start.

Welcome to that start. You're going to need it.

Do one or more of the following sound like you?

- I'm a short-term forex trader seeking to lower my risks and improve my profits.
- I'm an aspiring forex trader but I'm uncomfortable with the time-consuming, high-leverage, high-risk day trader methods and mentality that permeate most of the forex world. I want guidance on how to trade longer-term positions that ride the exceptionally stable longer-term trends with less risk and less need for constant monitoring.
- I'm a conservative, longer-term traditional equities or income investor with less interest in short-term trading. I'm seeking to diversify my currency exposure in order to lower my risk and boost my capital gains and income by having my growth-and income-oriented assets in the currencies most likely to appreciate over the long term.
- I'm too busy to waste weeks on books that are unclear, lack detailed explanations, or bury me in too much information to use. I just want that one book that provides:
  - What I need to get started actually making money while controlling risks.
  - Fully detailed, well-illustrated explanations.
  - Explanations of the different ways to profit in forex markets in addition to the standard methods.
  - Guidance about how to continue my education and development as a trader.
- I need a clear introduction to forex basics and the different ways to play this market, and enough analytical and risk management tools that are

sufficiently explained so that I know how to combine them into simple trading systems that I can quickly start applying without too much complexity.
- I'm intimidated by forex, though I know I should tap into it somehow. I hear a lot about how most people lose money in online currency trading, and how it is riddled with brokers who just want to push you into risky, high-leverage trading before you're ready, so before you know what you're doing you've already lost everything. I'm looking for low-risk ways to break into forex, but don't know:
  - How to get started.
  - What trading styles are right for me.
  - How to locate the right online broker and sources of further training and market analysis.
- I want currency diversification before the @# %*! government destroys the purchasing power and value of my dollars/yen/euros through endless money printing and inflation, but I don't want to trade.
- I'm seeking an asset that isn't correlated to all the other markets, and where there's always a playable trend or trading range regardless of what stocks or bonds are doing.

If any of these needs are yours, then you've come to the right place.

What This Book Offers

Here's what you get.

- An intelligent introduction to forex. Instead of time-consuming, high-risk methods unsuited for most people, this book provides:
  - Focus on a variety of lower-risk, simpler, less time-consuming trading methods, styles, instruments, and time frames to suit different personalities and needs.
  - Detailed coverage of the key aspects of trader psychology, risk, and money management that are in fact the real foundation of trader success.
  - Unique, exclusive, in-depth coverage of new, alternative ways and instruments for forex traders that are less risky and demanding—social trading and binary options.
  - Ways for longer-term passive investors to identify the most stable, reliable long-term forex trends and the best assets for riding them for higher returns and lower risk via currency diversification.

- A practical introduction to forex. Going beyond simplifications and theory, it provides a practical, well-illustrated, step-by-step guide to actually identifying, planning, and executing lower-risk, higher-yield trades and investments for a variety of traders and investors.

Why Listen to You, Cliff?

The short answer is: As trader, writer, advisor, and chief analyst in one form or another for over 30 years, I've been both ringside seat spectator and combatant in the markets. You can find further details through a simple online search from various online profiles.

Rabbi Noach Weinberg once told me that a fool learns from his own mistakes, but a wise man learns from the mistakes of others.

Here's my offer to help you learn like a wise man, from my mistakes and experience. Credentials aside, let the ideas speak for themselves.

What This Book Will Not Do

- Pretend to teach you hidden secrets of trading.
- Suggest that forex trading or investing is a likely road to fast riches requiring little effort.
- Focus on the high-risk, overly complicated, or very short-term hyperactive trading styles typically advocated in so many forex books. These strategies alone virtually guarantee failure for all but the few with exceptional experience, powers of concentration, temperament, risk tolerance, and capital. The only positive thing these strategies reliably produce is high trading volume fees for the brokers. In one recent survey, most online forex brokers reported that only 20 to 25 percent of their traders were profitable.[4]
- Burden you with interesting but unnecessary historical background information about forex.
- Overload you with more kinds of fundamental and technical analysis tools than you can use, and leave you without guidance about which tools to start with and when to add or use others. That, in turn, risks causing traders to:
  - Abandon attempts to learn how to methodically combine different kinds of indicators into simple systems and how to test them. Instead, they attempt random combinations of analytical tools without any controlled method for evaluating which work and which don't.
  - Succumb to paralysis from analysis, unable to act under the weight of a vast flow of often conflicting information.

- Include long tracts of pages repeating information that's been said better elsewhere and is easily available. Where possible I've tried to strike a balance between comprehensiveness and brevity, referring you to quality, free, online resources when appropriate.
- Focus exclusively on leveraged spot market trading. From other forex books, you'd think there's no other way to play forex. Hardly. For both traders and longer-term investors, there are worthy alternatives to consider in the right conditions, like forex binary options for simple shorter-term trend trading, and forex exchange-traded funds (ETFs) for those seeking exposure by means of an unleveraged instrument that behaves like a stock and can be accessed via a standard equities account.

What This Book Will Do

- The short version is pretty much the opposite: It will provide an alternative introduction to forex, one aimed at the sensible, rational investor and trader, instead of the madcap gambler or get-rich-quick sucker.
- Virtually every investor needs this kind of guidance, because today, the hard fact is that everyone needs currency diversification.
- We can't afford to ignore currency markets any longer, so we need to learn sensible ways to benefit from them.

For traders or aspiring traders, that means it will:

- Teach you how to find and execute only the lowest-risk, highest potential yield trades via relatively simple tools and easily available information. In other words, you'll learn to be a successful beginner with the right tools for your level, rather than a failed imitation of an experienced, prepared professional.
- Show how to use forex to profit in bear markets more easily than with other asset classes like stocks.
- Counteract the get-rich-quick day trader mentality that pervades so many other forex books and leads most traders to failure. Instead, we'll set you up to succeed by showing you how to keep losses low relative to your gains so you make money even when most of your trades don't. We'll push you to make defensive trading your top priority.
- In place of purported secrets, give you the best of what's been said distilled from over 30 years of experience and a small library's worth of study.
- You'll get enough details and tools so that you can identify, plan, and execute relatively simple, low-risk, high-potential yield trades, while

avoiding information overload. These include plenty of step-by-step examples of each step of the trading process, including the critical risk and money management so you avoid fatal damage to your capital or confidence. The idea is to give you enough information to make smart but simple trades with relatively low risk and high reward so, in the shortest time possible, you're trading and, if not making money, at least not losing much while you are learning.

- Give you more than enough of the core skills you need to get started, and then offer guidance on how to continue your education—what to cover next and where to learn it.
- Focus on trading styles, methods, and time frames that are best suited for less experienced traders, the kind that increase the odds of keeping your capital and confidence intact while you gain skills and suffer the normal setbacks.
- Provide a full toolbox of technical and analytical tools and guidance on how to combine them into a variety of simple trading systems that you can back test before risking your cash.
- Show how to combine your analytical risk and money management (RAMM) tools into a complete trading plan.
- Demonstrate how to record and organize your trading plans so you can review every trade and learn from your successes and failures.
- Offer alternative ways to benefit from forex markets beyond the usual leveraged spot market trading of most online forex brokers. Even those who ultimately don't have the inclination or time for forex trading will find there are multiple ways a more passive, long-term investor can benefit from nonleveraged forex exposure.
- In what may be the most important section of the book, present the first widely published objective look at the two newest ways to profit in forex:

  1.Forex social networks and social trading: Use a community of fellow traders and ranked experts with published performance data to improve your skills. Or even better, let the best traders trade for you and earn better, more reliable returns with far less work. This is probably the most reliable way for those new to forex to get started actually making money, because you're using proven pros.

  2.Binary options: We present the pros and cons of a new, little known, and potentially very useful new forex trading instrument when used properly, binary options. In the right circumstances, these simplify your trading, give you more control over risk, and can up your odds of success.

For longer-term investors with little interest in trading, we show you how to use your knowledge of currency markets to:

- Enhance your capital gains and income.
- Reduce the risks from lack of currency diversification.
- Achieve all this without ever needing to directly trade currency pairs.

For both traders and investors, the book will:

- Guide you to some of the best free online sources of information on a wide range of forex topics, like trade advice, continuing trader training, broker reviews, and daily and weekly fundamental and technical analysis of specific currency pairs and overall markets.
- At the end of the book, leave you with specific ideas on what to do next to get started trading forex.

Yes, I'm offering you a lot. If you're investing your valuable time to read this, I owe you no less.

In sum, this is the forex book for:

- Profit-maximizing, risk-averse traders: Those seeking a sensible introduction to forex trading, who are more focused on steady monthly profits rather than gambling, via safer, easier, more profitable ways to trade than the short-term, high-leverage, high-risk methods most people associate with forex trading.
- Long-term investors with little or no interest in trading forex: Those seeking to lower currency risk and increase returns by diversifying into assets denominated in the currencies most likely to hold their value and appreciate over the long term.
- Anyone seeking an asset class that works in any market condition: Unlike stocks or bonds, the very nature of forex markets means there's always a bull market in some currency pair.

Whether you're a trader or a traditional, conservative, long-term investor seeking capital gains or steady income, this is the one forex book written specifically for you, not the wild-eyed action junkie day trader so beloved (and quickly fleeced) by many in the forex industry.

FOR ADDITIONAL ONLINE CONTENT

Additional related content resides on the book's companion website at www.thesensibleguidetoforex.com. This website provides:

- Updates and additional content.
- Much clearer versions of the charts, in color and with much better resolution.
- Trade simulation exercises to practice what you've learned with the option for interactive feedback.
- More in-depth information on a variety of topics found in the book.
- A continual stream of articles on ideas for trades or investments for currency diversified income.

Go to www.thesensibleguidetoforex.com. The breadth and depth of the site's content will expand over time. We hope the site becomes a must-read for those seeking currency diversification, either as traders or investors seeking capital gains and/or income denominated in a variety of currencies.

Notes

1. Peter Schiff, “Currency Is the Hidden Porfolio Risk,” *Business Insider* (October 2011), www.businessinsider.com/currency-the-hidden-portfolio-risk-2011-10.

2. Andrew J. Johnson, “Small Businesses Try Hand at Forex,” *Wall Street Journal* (August 2011), http://online.wsj.com/article/SB10001424053111903639404576514560310571

3. Joshua M. Brown, “Inside the Currency Boiler Rooms” (August 2011), www.thereformedbroker.com/2011/04/09/inside-the-currency-boiler-rooms/; also, Michael Greenberg, “U.S. Forex Brokers Account Profitability Comparison” (October 2010), http://forexmagnates.com/us-forex-brokers-account-profitability-comparison/.

Acknowledgments

Zack Miller, Managing Director of Lighthouse Capital Ltd, publisher of NewRulesofInvesting.com, and author of the seminal work on social networks and social trading, *TradeStream Your Way to Profits*. In addition to repeated and invaluable mentoring when I needed him most, he provided the first contact with…

SeekingAlpha.com CEO David Jackson and his editorial team. Together they've provided me and so many with the chance to prove ourselves with nothing more than our writing as a credential. That led to connecting with…

John Nyaradi, publisher of WallStreetSectorSelector.com and author of *Super Sectors: How to Outsmart the Market Using Sector Rotation and ETFs*, who in turn who introduced me to…

Senior Editor Laura Walsh of John Wiley & Sons, who paired me up with Senior Development Editor Judy Howarth, both of whom merit special thanks for their expert guidance, insight, and enormous patience in shepherding the manuscript into its finished form.

Anna Olswanger, my agent, guide, and interpreter throughout the journey through the world of publishing.

Longtime friend and wise counsel Shelly Freedman, Esq., for support, advice, and a special assist on the title.

Those whom I've met only through their writings:

In no particular order, Kathy Lien and Boris Schlossberg (Bkassetmanagement.com), John Kicklighter and Joel Kruger (d=DailyFX.com), Brian Dolan (Forex.com), Kathleen Brooks (Forex.com), John Mauldin (www.johnmauldin.com), Marc Chandler (Brown Brothers Harriman, marctomarket.com), James Chen (FXDD.com), Dr. Alexander Elder (Elder.com), Ed Ponsi, and the others referred to as resources for further information in Appendix A.

Samantha McGarry (Inkhouse Media and Marketing), and Alon Levitan (eToro), for their help on the forex social networks and trading chapter.

Shay Ben Asulin, CEO of Anyoption.com, for his cooperation in freeing up the time needed for this project.

It's easier to stand tall on the shoulders of giants.

Finally, my deepest thanks in advance to you, dear reader, for spreading the message contained herein. It's through you that we'll strike a blow against governments that want to steal our money through inflation, and brokers who seek a quick buck at our expense.

CHAPTER 3
Technical Analysis (TA) Basics

If you understood most of Chapter 2, you now have enough background so that we can begin to cover the analytical skills that will help you succeed in forex or any other kind of trading or investing. This chapter will cover:

- What is technical analysis (TA).
- Understanding the basics of candle charts and the simple goals and theory behind all those complex looking lines, charts, patterns, and more.
- How to understand and use some of the most important of these, including various ways we identify support and resistance (s/r) and trends.
- Examples to illustrate and apply what we've covered.

Those with some experience in TA from other kinds of trading will be glad to know that nearly everything they know applies to TA of forex markets. The charts, their common patterns, and their indicators work the same way. The main difference is the unique fundamentals driving these charts. These readers can feel free to just skim the following for anything they may have missed or want to review.

TA is typically defined as the study of price behavior, which is a reflection of mass trader behavior. Repeating chart patterns or persistent support or resistance levels don't form from thin air, but rather from the repetitious nature of how traders respond to past experience, each other, new information, and how each tries to anticipate how the other will react to that information. Trader behavior is based on unchanging human psychology. It's logical, then, that the repetitive nature of chart patterns and other technical indicators simply reflects that repetitive nature of human and crowd behavior in similar circumstances.

However, even the best TA is often wrong for various reasons, and the signals it provides often conflict.

That's why we obsess over risk management. We can't control the outcome of a trade. However, we can control what we risk and can make sure that we keep our losses affordable, and only enter trades that have both a high probability of being profitable, and a high risk-to-reward ratio (explained later).

Unlike fundamental analysis, TA ignores speculation about what may be influencing supply and demand. Instead it focuses purely on how (not why) prices move and what that movement suggests about future price behavior.

Of all the four core skills mentioned in Chapter 2, we'll cover TA first because it's the basis for much of our risk control decisions, such as:

- Defining what trades offer the lowest risk, highest potential yield entry and exit points, so that we can buy low and sell high (or vice versa in the case of short positions).
- Identifying price levels for cutting losses or taking partial profits if the trade threatens to turn against us.
- Deciding position size and partial position entry or exit.

TA occurs mostly on charts, which are pictures of trader behavior over a given period, regardless of what fundamentalists may speculate is the reason behind that behavior.

So, the first step in learning TA is to read and understand the price charts.

CANDLE CHART BASICS

To understand a book, you need to be able to read the words. To understand sheet music, you need to be able to read the notes. To understand price behavior, you need to be able to read and interpret the charts.

Candle Anatomy and Meaning

Charts come in different styles, but we will focus on Japanese candlestick or candle charts, which have become by far the most popular because they provide the quickest visual grasp of price action and the market sentiment behind it. Much has been written about the advantages of candle charts and why they've become the dominant charting style since they were first introduced to the West by analyst Steve Nison in 1989, and popularized in his seminal book, *Japanese Candlestick Charting Techniques*, nearly a decade later.[1] However, we'll stick to an overview of what you need to know to make money. So, let's get to one of the cornerstones of TA, which is understanding candle charts.

First, study the parts of each candlestick, shown in Figure 3.1.

FIGURE 3.1 Anatomy of Chart Candles

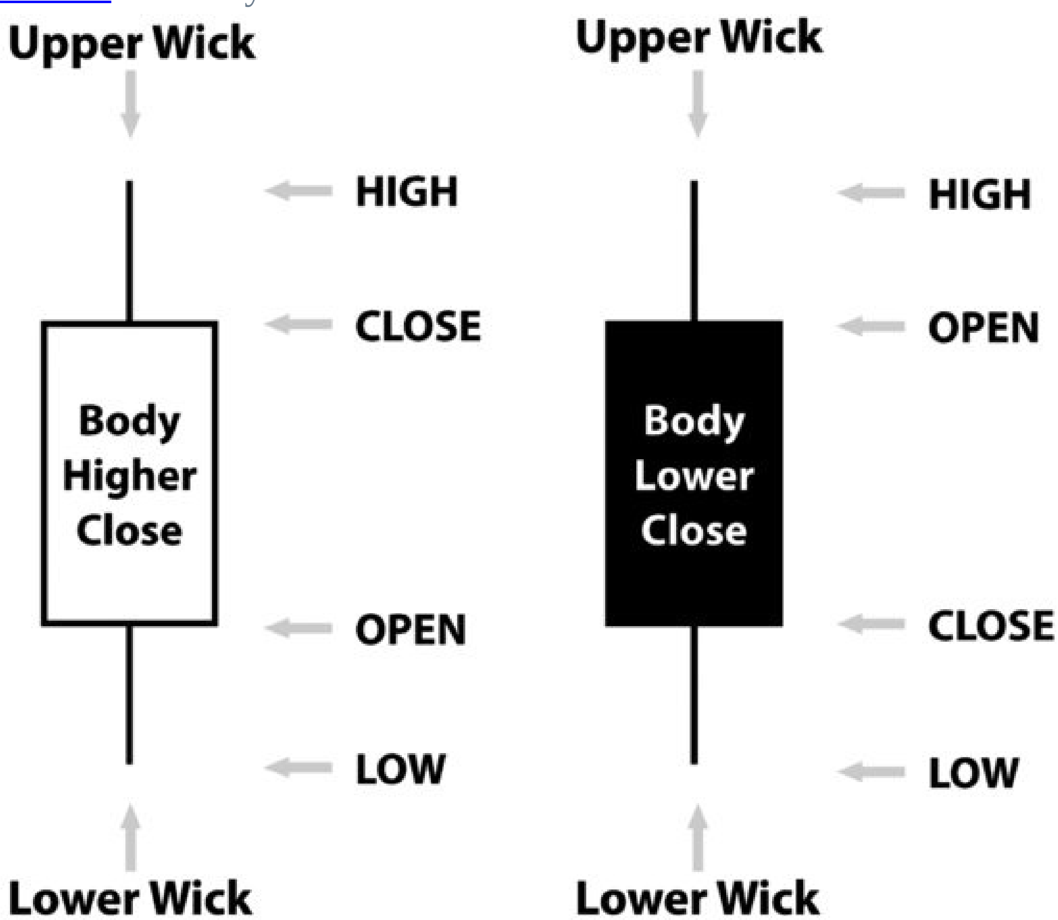


Figure 3.1 is self-explanatory, but here are the key points to understand about candlesticks:

- Candles usually have a body and wick (called a shadow) on both ends; however, any of these individual parts may be missing from a given candle as we'll see below. Together, they cover the entire price range over the given period the candle represents. The body alone represents the range between the open and closing price for a given period, and the wicks, or shadows, show the upper and lower price ranges.
- Each candle displays all price information: the high, low, and open and closing prices for a given period, depending on the chart's time frame. Here are two examples of candle information:

  1. Each candle on a one-minute chart covers the opening, closing, and high and low prices for one minute.

  2. Each candle on a daily chart shows this price information for an entire day.
- Any good trading platform should provide candlestick charts ranging from one second to one month.
- Body color tells us the price direction for the given period. The most common color coding is green bodies for higher closes and red for lower ones. In this book, we generally use dark gray for higher closes and light gray for lower ones, as seen in Chapter 2, Figures 2.3, and 2.7.

Relationship between Body, Wick, and Its Significance

The length of the bodies and the wicks, in absolute terms and relative to each other, can tell us a great deal about market sentiment over the duration of a given candle. That can be significant for candles covering longer periods like an entire day, week, or month. As with any technical indicator, candles and their patterns over shorter durations are less meaningful because price movements within a given day or less often can be caused by random money flows unrelated to any real market sentiment.

Here's the key to understanding the relationship between wick (or shadow) and body length and the meaning of an individual candle: The longer the wicks are relative to the body, the greater the indecision and the greater the back and forth struggle between buyers and sellers, and the more likely the current trend will cease or reverse. Conversely, the shorter the wicks are relative to the body, the more decisive the move up or down, and the more likely that the move will continue in the same direction.

Figure 3.2 represents the Bullish “Marubozu” Type and suggests strong buying pressure. A long higher close body with few or no shadows shows buyers outnumbered sellers and were in control during the entire period covered by the candle, steadily pushing price higher. The longer the candle body, the greater the buying strength.

FIGURE 3.2 Bullish “Marubozu” Chart

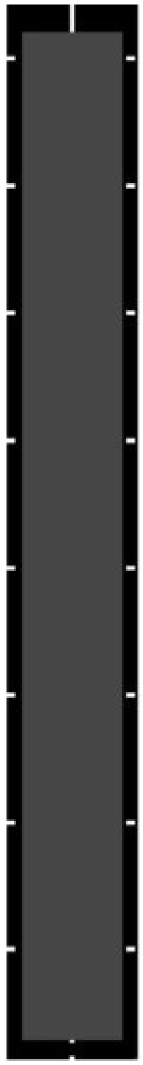


Figure 3.3 illustrates a Bearish “Marubozu” Type and suggests strong selling pressure. A long lower close body with few or no shadows shows that sellers outnumbered sellers and were in control during the entire period covered by the candle, steadily pushing price lower. The longer the candle body, the greater the selling strength.

FIGURE 3.3 Bearish “Marubozu” Chart

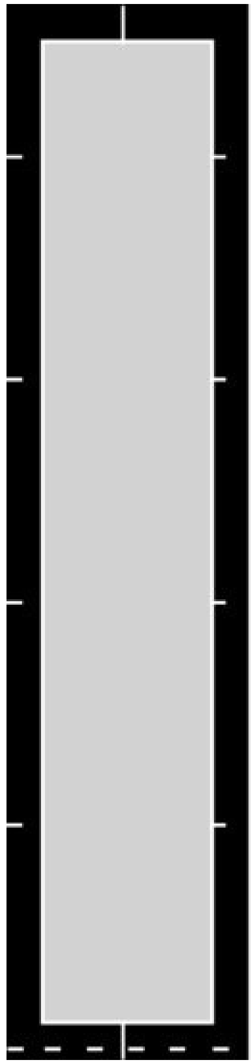
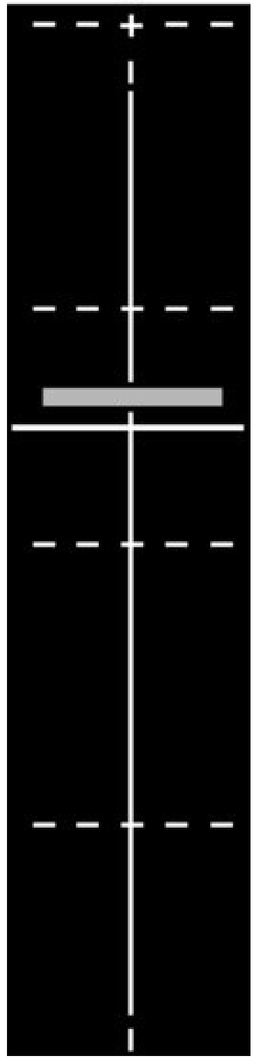


Figure 3.4 illustrates the Doji Type which is neutral or indecisive, with sellers and buyers evenly matched. Similarly, small body relative to the wicks suggests the same indecisiveness to a lesser degree. If the body was red, the sellers were modestly stronger; if green, the opposite is true.

FIGURE 3.4 Doji Chart



Lower Wicks

A relatively long lower wick suggests initial strong pessimism and selling which reversed as buying increased at the lower bargain price, and short sellers took profits. In other words, a lower price level was tested and held firm, turning back attempts to drive price lower. A short lower shadow suggests less indecision, less testing of lower prices, and lighter selling pressure that required few buyers to reverse it.

If the currency pair closes at its low for the period covered, the candle won't have a lower wick.

Upper Wicks

Conversely, a relatively long upper wick suggests initial optimism or buying pressure that reversed as sellers stepped in and buyers took profits. In other words, a higher price level was tested and held firm, turning back attempts to drive price higher. A short upper wick shows less indecision, less testing of higher prices, less struggle between buyers and sellers.

If the closing price is the high for the period covered, the candle won't have an upper wick.

SUPPORT AND RESISTANCE (S/R) BASICS

Before proceeding, you'll need a basic understanding of s/r. We'll deal with these both in greater depth later, but for now just understand that when we discuss price support or resistance, we mean exactly what these terms imply. For the sake of simplicity, assume we're referring to long positions, that is, trades for which the goal is to buy low and sell high. As we'll discuss further on, definitions of support and resistance are reversed for short positions, so we'll ignore those for now.

- Support, as the name suggests, is a price level, trend line, or other indicator that acts like a floor, preventing price from falling lower. It's where buying tends to occur repeatedly over a given period. Support draws in new buyers because it's seen as the lowest, bargain price for a given period. If support is breached for more than a brief period, that usually means market perception of the asset's value has fallen, and price will continue lower until the next support level. The stronger the support, the more bearish (pessimistic) the signal if that support level is breached.
- Resistance is just the opposite of support. It is a price level, trend line, or other indicator that acts like a ceiling, preventing price from rising. If resistance is breached for more than a brief period, that usually means price will continue higher until the next resistance level. The stronger the resistance, the more bullish optimistic the signal if that level is breached.
- Support or resistance (s/r when discussing these together) are rarely exact price points, but rather are defined zones or areas, with their range depending on a variety of circumstances covered later.

S/R can be as simple as a price level at which price tends to reverse direction, or it can be made up of multiple trend lines or other technical indicators (that we'll learn about later) that all converge on an area and mutually reinforce the s/r zone

The strength of an s/r area depends on various factors, such as age (older is better), how often it has been tested and held firm, the number and quality of various kinds of s/r indicators that converge on a given price level, and whether or not it's near a large round-number price level. Let's look at some real-life examples.

As shown in Figure 3.5, the EURUSD daily chart of June 10 to July 25, 2011, you will see the following:

A. June 21–22: The pair of long upper wicks (a “tweezers tops” pattern, covered in Chapter 4) showed strong resistance level around 1.4400, caused by selling pressure from some combination of those who were long the pair taking profits and short sellers opening new positions. The June 14–15 candles show prior resistance around 1.4400. Round numbers have a psychological appeal as natural buy or sell points, so certain round numbers tend to become significant s/r points.

B. June 23: The lack of much upper wick tells us that prices mostly fell from the start of the day. The long lower wick indicates that the pair managed to recover over half of its losses before the official close of the day's trading in the New York session. The lower wick shows sellers tested all the way down to around 1.4130 before buyers stepped in and short sellers took profits. Think of the long lower wick as a blind man's cane, probing for obstacles.

C. June 23–26: This 1.4130 support level was tested each day as selling continued, but this level held firm. The June 24 (Friday) candle's lower opening and even longer red body shows continued firm selling pressure, but roughly equal upper and lower wicks reflect some indecision about how low to go. The June 26 (Monday) candle is a small light gray (this would be shown in red) body with small wicks, meaning price direction was mostly straight down but with weakening selling pressure. This weakening selling pressure was confirmed by the rally that followed.

D. June 27: A strong reversal as prices rebounded off this support level. The long dark gray (this would be shown in green) body shows decisive buyer control, with prices closing near the top of the day's range, and it “engulfs” or retakes the prior two days' losses. Such candles are called “bullish engulfing” patterns because they “consume” and recoup the prior days' losses.

E. June 30: Long upper wick again serves like a blind man's cane hitting an obstacle as the market gropes around to locate near-term resistance. Combined with the short dark gray (green) body near the bottom of the daily price range, which means there was little gain on the day, suggests the uptrend is weakening, as indeed it was.

F. July 3–4: Taken together, we see that the market opened above the 1.4550 resistance level twice but couldn't advance. On July 4th, after six straight days of gains and having hit resistance, sellers began taking control, probing lower before buyers stepped in, but could not prevent a lower close on the day. In Chapter 4, we'll learn that this kind of candle, with a small body, little or no upper wick, and a long lower wick relative to the overall candle range is a bearish sign when it occurs during an uptrend and is confirmed by the next candle closing lower (as was the case on July 6th). It's called a “hanging man.” Its long lower wick, topped by a small body, combined with a lower close in the next candle, presents an intuitively clear picture of the market rejecting higher prices.

G. July 12: This is essentially the same form of candle as on July 4; however, during a downtrend (and especially after an eight-day long downtrend and close at what was strong long-term support around 1.4000), this is considered a bullish reversal sign, called a hammer, as sellers probe lower support but buyers send sellers retreating and recover most of the day's (or any other period's) losses. In other words, this long lower shadow is a graphic image of the market rejecting lower prices. Once again, the lower wick may have hit bottom. Like the bearish hanging man shown on July 4th, this bullish twin hammer required confirmation from the next candle and got it with the next day's bullish engulfing candle (it engulfed or recouped the prior day's move). It signaled the start of a move higher over the coming sessions.

H. July 17: The candle had a mere line instead of a body, meaning that the opening and closing prices were the same or nearly so—price unchanged. The market ruled undecided, a tie between buyers and sellers. Such candles are called dojis. As signs of indecision, they often suggest a possible reversal of the current trend. This form of doji, with its prominent lower wick, that occurs after a downtrend near strong support around 1.4000, suggests a market groping for a bottom. That was the case, as the following days confirmed this bullish sign and buyers took over and sent prices higher.

I. July 25: This doji, with equidistant wicks, shows complete indecision or perfect balance between buyers and sellers.

FIGURE 3.5 EURUSD Daily Chart, June 10 to July 25, 2011

Source: MetaQuotes Software Corp.

Analyze This!

What do you think happened to the EURUSD after the indecisive doji of July 25 (H)? Consider the following evidence:

- The EURUSD has had five straight days of gains, the last three with increasing strength.
- Looking at the month covered by this daily chart, the current price level of 1.4409 has served as near-term resistance because looking at the far left, middle, and far right sides of the chart, the pair has failed twice before to make a sustained move above it.
- The current price level of 1.4409 is essentially the same as 1.4400. As we'll learn in greater detail when we study s/r, round numbers tend to serve as natural support or resistance because humans are psychologically wired to think in terms of round numbers. The more zeros, the more psychologically significant the number. That's why $4.99 feels cheaper than $5.00.
- July 25 (H) shows a doji candle, a classic sign of indecision.

For the sake of simplicity, we'll ignore the overall bearish fundamental factors that were behind the July price declines.

So, what do you think happened? Do you think the pair finished the day higher, lower, or the same? Here's what happened. If you thought the price would pull back, you were right. In Figure 3.6, after the undecided doji, the pair made a head-fake higher and pulled back (note the 2 candles that follow H). We'll talk more later about these “false breakouts,” why they happen, and what you can do to protect yourself against being fooled by them.

FIGURE 3.6 EURUSD Daily Chart 20, June 3 to August, 2011

Source: MetaQuotes Software Corp.

Ideally, your reasons should have gone something like this.

The pair was at a significant near-term resistance level and was showing indecision. The more likely move is a pullback as long positioned traders take profits from the prior solid run higher. Markets expect some pullback, so unless new bullish news arrives, the element of self-fulfilling prophecy operates. Traders create the reality they expect.

CANDLE CHART TIME FRAMES: LENGTH MATTERS

Before concluding this section on candle charts, you need to know more about chart time frames and which ones you should use when starting out. As in other areas of life, longer is better.

We mentioned earlier that each candle presents the price action over a specific period, or to use traders' jargon, a time frame. Most trading platforms' charting modules allow you to view candles representing time frames ranging anywhere from a second to a month.

As you'll see, the time frame of the chart from which you trade matters. It matters a lot. The short version—stick to trading off of longer time frame charts, like four hour, daily, weekly, or monthly candles, until you are successful trading moves over these longer periods. Only then should you even consider trying to day trade currencies.

Different Time Frames, Different Trading Techniques, and Styles

The following is an overview of the differences in trading techniques and styles:

1. Those trading over short time frame charts, that is, short holding periods and trading off of charts with candles that form over a matter of minutes or hours:

- They rely almost exclusively on TA and especially risk management. In these time frames, prices move with unpredictable large block trades of big players, most fundamentals except for news items are irrelevant, and most technical indicators are less reliable, so keeping the frequent losses low is key.
- They actively monitor their positions more closely, so be on the lookout for breaking news that could change everything. They must make many real-time decisions quickly and must not let emotions shake them from their trading plan.
- They allow only small losses because gains over short periods are smaller than over longer periods.
- They tend to stick to trading highly leveraged spot (cash) market instruments, that is, trading currency pairs themselves via an online broker's trading platform because they need:
  - 24/5 access in order to catch opportunities that come and go quickly.
  - High leverage in order to earn adequate profits from the small price moves that occur over a matter of minutes or hours without needing to commit six-figure sums that would be beyond the means of most traders.

2. Those holding positions over weeks, months, or years, using charts with daily, weekly, or monthly candles:

- In addition to using technical analysis to plan entries and exits, will add a heavy dose of long-term fundamental analysis involving the health of the underlying economies of the currencies they trade, like trends in rates of interest, growth, employment, consumer spending, and so on. These factors can matter, and because they don't change quickly, multimonth trends are reliable; they don't reverse often.

- Allow larger total pip losses and looser stop losses because of the larger moves that occur over longer periods, and because riding established, reliable long-term trends requires looser stop losses.
- Don't need to actively watch positions. They can plan trades and enter orders to enter and exit in advance and thus can monitor trades less frequently.
- In addition to directly trading currency pairs with online brokers, they have the option of trading unleveraged instruments like currency exchange-traded funds (ETFs) or monthly binary options, or other instruments. They are playing longer-lasting, larger price moves, and so may neither want leverage (which makes it harder to stay in a position for a long time and wait out the moves against you) nor need it (because the price moves are large enough already). As we'll discuss later, that absence of leverage makes it simpler to trade because you don't need the same degree of risk and money management.

Different Time Frames, Different Trends

The trend, meaning the overall price direction, that you'll see on any chart depends greatly on your time frame. Seeing a variety of trends nested within longer-term trends is common.

For example, look at this AUDJPY monthly chart shown in Figure 3.7.

FIGURE 3.7 AUDJPY Monthly Chart, October 1, 2007, to June 1, 2011

Source: MetaQuotes Software Corp.

During this period risk assets like the AUDJPY were in an overall downtrend. The AUDJPY is a classic risk pair, meaning that it tends to move in the same direction as other risk assets, like stock indexes or oil, because the two currencies occupy opposite ends of the hierarchy of risk currencies. The AUD is the number one risk currency, and the JPY is typically the ultimate safe haven. In times of optimism or risk appetite, the AUD is usually strong and the JPY is weak, so the pair tends to move sharply higher. In times of pessimism or risk aversion, it moves firmly downward because the JPY tends to be strong and the AUD tends to be weak. Remember, pairs move in the direction of the base currency.

Note how the picture changes for someone viewing a daily chart anytime from September 2010 to February 20 2011, as shown in the chart in Figure 3.8.

FIGURE 3.8 AUDJPY Daily Chart, July 12, 2010, to February 20, 2011

Source: MetaQuotes Software Corp.

Although the pair was in a long-term downtrend, embedded within this downtrend was a shorter term, multimonth uptrend that was tradable even for conservative longer-term (multiweek or month) forex traders. In particular, note:

- By November 2010, the AUDJPY was in an established uptrend because it had formed a series of both lower highs since August 2010 and higher highs by early November.
- As shown in the chart in Figure 3.9, by late December, the pair had formed an ascending channel (two parallel trend lines) that was formed by three higher highs and two higher lows. As we'll see later, these upper and lower channel lines are useful indicators of s/r that we use (usually in combination with other indicators for confirmation) to select low-risk, high-yield entry and exit points when planning and executing our multiday, weekly, or monthly trades.

FIGURE 3.9 AUDJPY Daily Chart, July 12, 2010, to February 20, 2011

Source: MetaQuotes Software Corp.

In sum, the time frame you choose to trade will influence every aspect of your trading. As we'll discuss in Chapter 5, longer time frames can help put the odds of success in your favor and, when used properly, will reduce your risk.

IDENTIFYING SUPPORT AND RESISTANCE (S/R) TO BUY LOW, SELL HIGH, OR VICE VERSA

Here's another useful oversimplification. The whole point of TA is to help us buy low, sell high, or vice versa when shorting a currency pair. That is, we use TA to more precisely identify the likely low and high prices for a given period. These become our low-risk entry points and high-yield exit points.

Definitions of S/R Are Reversed for Long and Short Positions

Definitions of s/r can get confused when discussing short positions, so let's clarify this now. Though definitions of s/r are reversed for long and short trades, they are conceptually the same:

- When we're buying (or going long) the pair, the likely low price is support, and the high price is resistance.
- When we're selling (or going short) the pair, the likely high price is support, and the low price is resistance.

In other words, we define support as the area where you want to open a position because it's the floor that you hope will *support your trade* and protect you from losses. Resistance is the area where you want to close positions because it acts like a ceiling that *resists further gains*. *You always enter near support (whether that's the high or low price) and sell near resistance (whether that's the high or low price). Conceptually, s/r are the same regardless of whether you're long or short. Understand this, and you'll avoid a lot of confusion.*

With these definitions of s/r clarified, we can now state the general principle for locating low-risk, high-yield trade situations.

The General Rule for Identifying Low-Risk High-Yield Trades

Once we know how to use TA tools to identify likely s/r in a given time frame (for example daily, weekly, or monthly candle charts), we can scan charts for situations where the distance between the support and resistance is the greatest and where price is approaching support, which allows us a low-risk entry point to buy or sell the currency pair.

We then:

- Place entry limit orders to open positions near support. For long positions, support is near the likely low, and for short positions support is near the likely high for a given period. We enter near support because the odds of price moving against us are lower, and if support is breached, that's a signal to exit while our losses are small.
- Place exit limit orders (for taking profits) near resistance. For long positions resistance is near the likely high, and for short positions it's near the likely low.

There are details and exceptions, but that's what you're seeking when you scan charts looking for opportunities. Whether you choose to enter slightly before or after price hits support is a judgment call that is influenced by a variety of factors. For example, if you're more worried about missing the trade and are confident it will work as planned, or think support is very strong, you might want to jump in earlier. If you feel the opposite, you'd set your entry limit order a bit below support.

Finding S/R Is Key to Identifying and Executing Low-Risk High-Yield Trades

Identifying s/r is arguably the most important goal of TA. Here's why. If you can find situations that allow you to enter at strong support zones and plan exits near strong resistance that is a much greater distance away from your entry point than your stop loss, then you will have a low-risk, high-yield setup that even a beginner can turn into a profitable trade.

Some would argue that identifying trends, momentum, or cycles of price movements (all discussed later) are equally or more important. However, trends are sequences of s/r levels, and trend lines are mostly used as a type of s/r. Momentum is the speed at which trend lines change, and cycle analysis like the Elliott Wave Theory is the timing of when these change. Granted, momentum and timing indicators can have important predictive value beyond their relationship to s/r.

In other words, by using TA to find likely s/r at which to enter and exit, we can hunt for trades that offer both the lowest probability of loss and highest probability of gain:

1. **The lowest probability of loss:** For example, we open long positions near what our TA tools tell us is the likely support or low price for a given period we set an entry limit order to open a long position near support. We also enter a stop loss order to close the position a short distance (in pips) below this estimated low price because if the price breaks below this level, that's our signal that we were wrong about support and that in fact the pair could fall much lower. With the stop loss order, our trading platform automatically closes the position for us with only a small loss. Similarly, we want to open short positions by entering a sell limit order near what our TA tools indicate is support. With short positions, support is the high price for a given period. As part of good risk management, we enter a stop loss order a short distance (in pips) above this level, so that if we were wrong and the price breaks higher, that stop loss automatically executes and closes our position with an affordable small loss.

How we choose where to place our stop losses will depend on a number of factors that we'll discuss in more detail later. For now, know that we'd consider these factors:

- Money management criteria: What size loss can we take and not lose more than 1 to 3 percent of our trading capital.
- Risk management criteria: Aim for a 1:3 risk-to-reward ratio. In other words, the distance in pips from our entry point to stop loss should be no more than about a third of the distance from our entry point to our profit-taking point (near the high in the case of long positions, near the low in the case of short positions). That way our winning trades produce gains that make up for multiple losses.
- Normal or average price fluctuation or candle length is for the given time frame so we don't get “stopped out” of our position by random market noise.
- Market conditions: For example, if we have a lot of confidence in the prevailing trend, we might compromise on certain RAMM criteria because we believe the chance of a loss from the trend stalling or reversing is exceptionally low.

2. The highest probabability of gain: Using our TA tools to identify s/r, we hunt for and trade situations where the distance from our entry point to the likely resistance or high price is triple (or more) the distance (in pips) from our entry point to our stop loss point.

Good Risk Management Requires Good TA

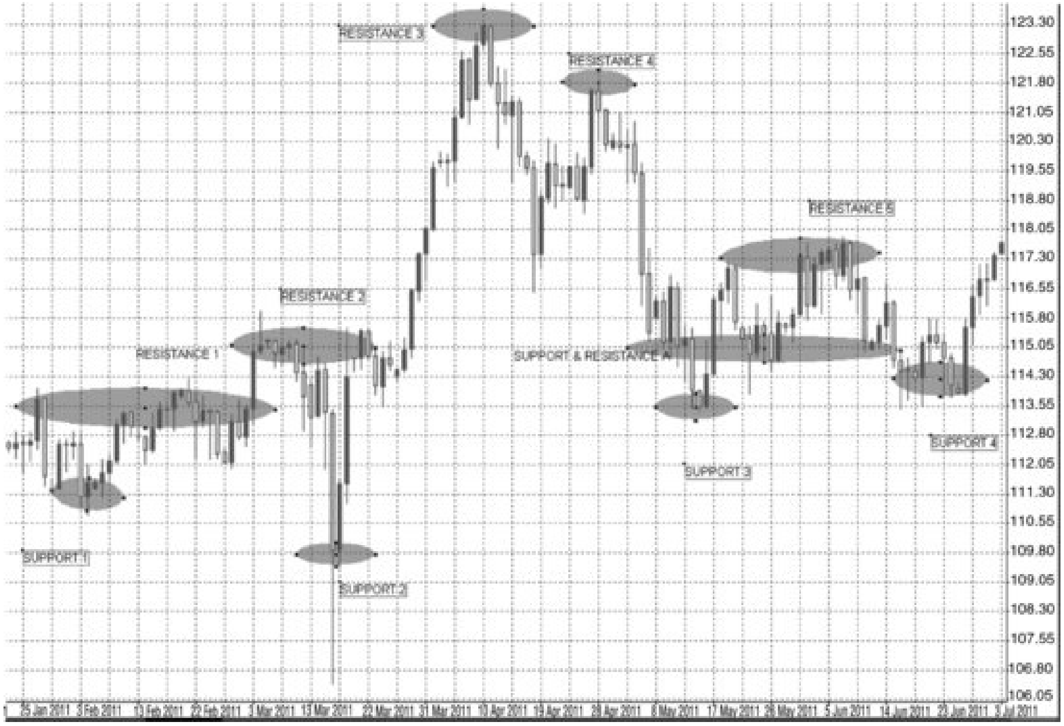
Do you see why technical analysis is so, well, fundamental to good risk management? You need good TA to determine likely s/r to identify situations that offer low-risk, high-yield entry and exit points. In short, TA tells you when you're buying low and have a good chance of selling at a much higher price (or the opposite in the case of short positions).

Think of S/R as Zones or Areas

As we mentioned earlier, support and resistance are not precise prices but rather price ranges. For example, in Figure 3.10, our labels assume a long position on the EURJPY. If we were short the pair, the labels would be reversed. For example, SUPPORT 1 would be labeled RESISTANCE 1.

FIGURE 3.10 EURUSD Daily Chart, January 16 to July 3, 2011

Source: MetaQuotes Software Corp.



Support and resistance are not precise points but rather areas. Depending on circumstances, some may determine s/r points based only on opening or closing prices, while others will consider the wicks as well.

There are many reasons for why s/r should be viewed as zones rather than precise points, including:

- Differences in perception of s/r: The application and use of many s/r indicators depends on human judgment and is to varying degrees subjective. For example, different traders will draw the same trend line a bit differently. These differences will cause some variance in where traders chose to buy or sell.
- Trader temperament: Buy and sell orders tend to cluster around popular s/r levels, so the effects of these are felt above and below them. For example, as a currency pair rises toward resistance, more conservative traders will have exit orders to take profits set somewhat before resistance (or what they think it is) is hit in order to beat the crowd and exit before price might start to reverse. More aggressive traders will place profit-taking sell limit orders closer to or above resistance in hope of getting a few extra pips of profit.
- Large institutions and brokers are aware of key s/r levels and will often use their ability to place huge orders to move prices so less savvy individual

traders get fooled into making premature buy or sell decisions from which these players reap profits. The mechanics of this are beyond the scope of this book, but the point here is that there are those who can and will try to influence very short-term perceptions of s/r, thus further blurring where an objective s/r point lies. These attempts at short-term price manipulation are part of the reason why so many seemingly random, unpredictable intraday price movements are seen on the short time frames (1 to 60 minutes, one-to four-hour charts, etc.). More on how to deal with these attempts to fool you later when we discuss topics for further study.

So Stick to Trading Longer Time Frames—They're Safer

This is another reason we urge less experienced or profitable traders to avoid day trading forex until they're consistently profitable on a monthly basis with multiday/week/month positions. They avoid becoming victims of random price movements or attempts at short-term price manipulation. That happens in any kind of short-term trading and not just forex. As noted earlier, stock markets are ruled by market makers for a given stock, who, ahem, have been known to succumb to similar temptations, all for the sake of maintaining an "orderly market, of course" Your Honor.

Few beyond the central banks of sovereign nations have the ability to exercise longer-term influence on prices, so longer-term trends are far less subject to manipulation by even the most powerful players.

Reasons to Consider Using Multiple Entry and Exit Points

When you enter a position, support might not appear exactly where you think it should be, and you could find your trade moving against you. Similarly, resistance might appear earlier or later, causing you to miss a profit-taking opportunity or to exit too soon (if you're not using a trailing stop).

So, consider entering positions and taking profits in stages. For example, consider closing half of your position when your profit equals the size of your stop loss (plus a few pips extra to cover transaction costs). Then move up your stop loss order to this first exit or break-even point so even if the trade reverses, you break even. If it continues to move in your favor, switch to a trailing stop loss to ride the move for whatever gains you can get.

More on this in Chapter 5, when we discuss the value entering and exiting positions in stages rather than all at once. Staged entries and exits are another aspect of trade planning, risk management, and trader psychology because if you've taken some profits or will at least break even, this relieves some of the stress of trading.

Once Broken, Resistance Becomes Support and Vice Versa

Markets are comprised of human traders who study past support and resistance levels. Look again at Figure 3.10 for reference.

Note how often former resistance becomes support and vice versa. For example, compare:

- Resistance area 1 and support area 3 both center around 113.55.
- Resistance area 2 and s/r area A both center around 115.05.

Why Resistance Becomes Support and Vice Versa

The short answer is that traders remember recent highs and lows and are watching charts like the one in Figure 3.10. They tend to perceive breaks above resistance as a sign the asset has hit a new plateau, and they treat former resistance as support until proven otherwise. At least part of the reason for this is that those who sold near resistance and regret having sold too soon see a return to that price as a chance to reverse their mistake.

The same holds true when support is broken. If prices rise back toward that former support area, traders who are still holding the asset, who had expected price to move higher and are sitting with losing positions, see this level as a chance to get out and break even.

Don't “OD” on TA

It's easy to get carried away with TA in your early years of trading and to clutter your charts indicators in the hope that more is better.

It isn't, so don't. Here are two reasons:

1. While I'm oversimplifying a bit, most indicators measure s/r, trend, trend strength (aka momentum), or the cyclical movements of prices, so the marginal benefit of additional indicators drops after you have one or two of each kind because they're tracking the same thing in different ways. So, stick to around five (plus or minus 2) of them as a rough guide. By all means experiment with various tools for various asset classes or pairs, but limit the number you're using at any one time.

2. You risk the common beginner's malady of paralysis from analysis, as you struggle to reconcile conflicting or ambiguous signals. For example, though a group of trend or momentum indicators may be attempting to track the same thing, the difference in how they do it could be enough to send conflicting signals.

It's far better to focus on mastering a limited number of technical tools (four to seven as a rough maximum), mixing trend, momentum, and timing indicators, as discussed in Chapter 9. Together these give you enough information about likely s/r points and where to enter and exit for best results.

Therefore, know that you'll put the odds more in your favor by first focusing on building expertise with the tools we'll be covering and applying them to a limited number of currency pairs and time frames. For example, some traders will gravitate toward how a given currency pair responds to moving averages or other kinds of trend lines. Others will focus more on Double Bollinger bands or Fibonacci retracement and extension levels. In Chapter 9 we'll show you how to test the forecasting power of different combinations of indicators through a process called back testing. Over time you can then expand your repertoire of tools used as well as pairs and time frames traded.

Why Specialize in a Few Currency Pairs and Time Frames?

When starting out with forex, you'll progress faster by becoming familiar with the price behavior and fundamentals of a few pairs in a few time frames, preferably longer ones for reasons cited above. As each economy and currency has its unique characteristics, so too do individual currency pairs. For example, different kinds of events impact some more than others. Correlations can be different. The EUR and USD tend to move in opposite directions because the EURUSD comprises 25 to 33 percent of all forex trade, so every time three to four EUR are bought, a USD is sold, and vice versa. That means the pair can be subject to wild swings depending on which currency is in favor at a given moment. However, the USDCAD tends to be less volatile because the Canadian economy is more closely linked to the fortunes of the USD, a destination for about 75 percent of Canadian exports. We'll go deeper into intermarket correlations and how to use them in Chapter 9.

By specializing, you'll develop expertise faster, and you won't be sacrificing much in terms of trading opportunities because, as we'll see, there are only two kinds of currency pairs: risk currencies and safe haven or safety currencies. Members of each group behave similarly relative to the overall market movements, so you can ride bullish or bearish market trends with only a few currency pairs.

What Determines Whether a Currency Is a Risk or a Safe Haven?

In Chapter 2 we said that there are 2 kinds of currencies, risk and safe haven, which respond in opposite ways to market sentiment.

- The higher the risk ranking (think AUD, NZD, CAD, EUR and GBP in that order), the more the currency tends to appreciate versus those lower on the risk spectrum in times of optimism, when markets seek risk assets like stocks or industrial commodities. In times of fear, the opposite happens.
- The higher the safety ranking (think JPY, USD and CHF in that order) the better the currency performs versus those lower on the safety spectrum (or higher on the risk spectrum) in times of fear, when risk assets sell off and safety assets, like quality bonds, rally.

Once again, here's the general ranking.

RISK							SAFE HAVEN
RISK CURRENCIES					SAFE HAVEN CURRENCIES		
AUD	NZD	CAD	EUR	GBP	CHF	USD	JPY

What causes a given currency's risk ranking?

The main reason is interest rates. The higher the currency's benchmark short term yields, the more closely it moves with other risk assets, and so the higher it tends to rank as a risk currency. That's because in times of optimism, high-yielding currencies are in greater demand due to carry trading. In other words, carry traders buy higher-yielding currencies and sell lower-yielding ones to fund these purchases, with a view to profiting on the interest rate differences. In times of fear, carry traders close these positions, causing a sell-off in risk currencies and a rally in their safe haven counterparts. If you're confused, don't worry; all this is explained in Chapter 6.

For now, just know that a currency's short term benchmark interest rate, set by its central bank, is the most important reason behind a given currency's ranking.

There are other factors that can affect risk ranking, but their influence can vary with multiple factors. Interest rates provide most of the explanation for whether a currency behaves like a risk or safety asset, that is, like a growth stock or like a quality bond.

Understanding the Risk/Safety Asset Distinction Is Lucrative

Whether the base currency (the one on the left) of a forex pair has a higher risk or safety ranking than its counter currency determines whether the pair is a risk or safety currency pair, and thus determines how it correlates with other kinds of assets. When we see a divergence in that correlation (that is, the pair isn't behaving like other risk or safety assets), that's usually a warning of a possible change in market direction or in the currency pair.

For example, forex and bond markets tend to pick up changing conditions before stock markets, so those who watch forex or bond markets can often see advanced warnings of what may happen with stocks or other markets. That advanced knowledge can be very profitable.

The opportunities to spot these divergences from the normal correlations between currency pairs and other asset types is one of the best reasons why everyone needs some awareness of forex markets.

With experience, you'll become increasingly sensitive to any divergences from normal correlations between asset types. The study of these relationships is called intermarket analysis, and we'll explore this critical topic in Chapter 9.

Note however, that because currencies trade in pairs, the significance of currency's risk ranking is in how it affects the behavior of one of its pairings. The farther apart a given pair's component currencies are on the above risk spectrum, the more sensitive the pair will be to market movements. We'll explain that in much greater depth later on.

Note

1. Steve Nison, *Japanese Candlestick Charting Techniques* (New York: New York Institute of Finance, 2001).

CHAPTER 5

Trader Psychology and Risk and Money Management (RAMM)

Now that you know some foreign exchange (forex) basics and technical analysis (TA), you have the background needed to understand the real foundation of successful trading and investing: proper trader psychology and risk and money management (RAMM). No matter how skilled and compelling your analysis, it will often be wrong. Worse, you'll endure losing streaks that can irreparably damage your account balance and confidence unless you've got the right preparation.

Welcome to that preparation. This chapter covers these core nonanalytical aspects of trading:

- Basic trader psychology issues like mindset, attitude, expectations, discipline, finding a trading style that fits your personality, and understanding the conditions you need to succeed.
- Top RAMM issues, including:
  - Why trading longer time frames lowers risk.
  - Risking no more than 1 to 3 percent of your account per trade with your stop loss.
  - Proper risk-to-reward ratios (rrrs) for each trade.
  - How to set stop losses.
  - How account size influences RAMM issues like stop loss settings, position size, and leverage used.
  - Planning trades in advance to remove emotion from your decisions in a trade journal.
  - Learning from your victories and losses via your trade journal.
  - The importance of having a business plan.

In this chapter, we'll review the key elements of proper mindset and RAMM because they are intimately related.

RAMM: PRESERVING CAPITAL IS YOUR

TOP PRIORITY

Warren Buffett is considered one of the greatest investors ever. Here are his top two rules for success:

> Rule No. 1: Never lose money. Rule No. 2: Don't forget Rule No. 1.[1]

Paul Tudor Jones, the founder of Tudor Investment Corporation, has an estimated net worth of $3.3 billion and is ranked as the 336th richest in the world by *Forbes* magazine as of March 2011.[2] Here's his take on the key to trading success:

> At the end of the day, the most important thing is how good are you at risk control.[3]

Cliff Wachtel doesn't deserve to be mentioned on the same page as these giants, but heck, it's my book, so here goes:

> The key to succeeding is controlling your bleeding.

In other words, your ability to survive long enough to succeed is less a matter of how much you make when you're right than how little you lose when you're wrong. That's because while you're learning (and often afterward), you're likely to be wrong at least as often as you're right, probably more often.

The reason RAMM is so essential is this: Your losses hurt you more than your gains help you. That's not just because of the damage losses do to your confidence and motivation. After you suffer a drawdown, you're working with a smaller principal. For example, let's say you start with $1,000. If you lose 10 percent, you will need to earn over 11 percent on your remaining $900 to recover your losses. If you lose 15 percent, you will need to earn almost 18 percent on your remaining $850 to get back to $1,000. Though profits are the goal, it's the losses that can stop you from achieving it. See Appendix E for more on this.

Having this professional trader's risk aversion is a key part of trader psychology that will determine as much as anything else whether you survive your mistakes like a professional or get killed by them like an amateur.

Mastering the psychological component of trading is the root of success because ultimately trading is based on having the right mindset, attitude, expectations, discipline, and trading style that fits your personality and doesn't drain your energy.

So, let's begin by reviewing what you must know about the psychology of successful trading. Getting it may take a long time, but at least you know what you've got to do, and that puts you ahead of most investors.

THE INNER GAME: TRADER PSYCHOLOGY BASICS

In Chapter 2, in the section on the Core Four Skills, we said that the psychological aspects of trading are the basis of trading success because otherwise:

- There won't be proper RAMM, without which traders are doomed no matter how brilliant their analyses, strategies, or trading plans. The inevitable mistakes will eventually inflict too much damage on their capital, confidence, or both.
- You won't know how to handle the dangers of both losing streaks and winning streaks. Both can be fatal. Losing streaks obviously can drain your capital and confidence, either of which is fatal to your trading career. Winning streaks can lead to overconfidence, which encourages sloppy habits that ultimately hit your bottom line, possibly permanently.
- There won't be realistic profit expectations, so you could get discouraged too soon when in fact you're doing fine.
- Minimizing risk (versus fastest or largest potential profits) won't be your primary criteria for choosing trading styles and durations. For example, you may attempt to day trade for faster profits before you're ready.
- There won't be proper focus on finding trading styles that suit your personality, and that could cause you to burn out from stress even if you're successful. For example:
  - High-leverage, short-term day trading will drain the energy of those who are risk-averse or lack the time and concentration needed to constantly monitor intraday trades.
  - Action junkies who have the time, risk tolerance, and ability to stay focused will find longer-term positions boring and frustratingly slow.
  - Many extroverts will need contact with others to feel energized and stimulated, and they may find trading rooms and online forums are a better way to learn than hours of study in isolation, which they may find tiresome.
  - Introverts may find such venues distracting and draining. They need

quiet and will learn better via self-study resources, and via more limited personal an online contacts.

As you gain experience, you'll realize how the following basics of trader psychology are the true foundation of success. Until you're psychologically ready to trade, until you've got the right attitudes, expectations, trading methods, and environment, all the analytical skills in the world won't help. This topic is worthy of a book in itself, but here are the basics for further study.

Lesson 1: Seek Trading Styles and Methods That Fit You

Regardless of what kind of trader you fantasize about being, the cold truth is that you're far more likely to succeed by finding trading styles and techniques that fit you, rather than trying to fit yourself to the wrong kinds of trading.

What to Consider When Seeking Trading Styles and Methods

In other words, find ways to trade that suit your:

Skill level: Those with only basic analytical skills need methods that don't require sophisticated and complex analysis. Beginners should also avoid short-term day trading that requires more technical analysis skills and faster decision making. Those with strong analytical skills may want to move as quickly as possible to designing and refining their own algorithm-based trading systems.

Lifestyle: This includes considerations like time and energy available. If you don't have the time or energy to monitor positions in real time, you need a trading style that doesn't require constant trade monitoring, or a short-term trading style in a market that's liquid when you're available to watch it.

Temperament: This includes aspects of your personality like:

1. Mental discipline and emotional control: Different traders feel different degrees of stress when risking their money.

A. Some have the discipline and lack of ego to do the following when money is at risk:

i Resist the temptation to take a quick, small profit when they know the trade has room to run until it hits resistance.

ii Admit they're wrong and cut their losses when their preplanned stop loss order is hit.

These traders at least have the key psychological foundations to succeed in short-term intraday trading that demands real-time decision making. Skills are another issue.

B. Others are more emotional and struggle to stick to their plans, such as:

i They take profits too early out of fear they'll lose them, even though they know there is still room before price hits resistance.

ii They let losses run too far because it hurts them to admit they were wrong, and they don't exit until they've incurred losses too large for their egos or accounts to survive.

These more emotional traders need trading styles that allow them to plan and enter entries and exits in advance so they don't have to make real-time decisions.

Risk tolerance: If you don't handle risk well, you'll need more conservative, lower-risk ways to trade. Lower (or zero) leverage, smaller positions, and longer time frames are a few ways to keep trader stress at acceptable levels.

How you make decisions: If you're a deliberate, analytical type who likes to look at lots of information, consult with others, mull things over, and research, then you need to make sure you have enough time to do so. That kind of trader will want slower, longer time frame-based trades. Having the time you need is important in the early stages while you're learning. If you don't like a lot of analysis and prefer quicker decisions based on limited data, you may be more comfortable with faster, shorter time frames and simple sets of indicators and trading rules.

Patience versus a need for action: More patient traders can sit with trades for weeks or months. Action junkies need shorter time frames; otherwise they risk entering bad trades out of sheer boredom.

Need for wins versus profits: There are trading systems that have lots of small losses and just a few huge gainers that make the whole system profitable. However, many traders get depressed if 70 percent or more of their trades are losers. They quit altogether or become so desperate for winners that they exit winning trades too soon and they miss much of the profits that would have made up for their losers. Other traders don't care about winning percentages as long as monthly or quarterly profits are satisfactory.

The key point of this is: If something about a trading style causes you too much pain, be it too many hours, too much stress, risk, boredom, complexity, discipline needed, or whatever, then you won't last.

Finding Your Trading Approach Lowers Your Risk

Finding the right trading style may not sound like it's related to risk management, but it is. Without the right trading style and methods, your risk of stress, frustration, and of quitting forex is much higher even if you're prospering.

Accept That It Takes Time to Find Your Way

Those getting started won't know what trading styles, analytical tool sets, currency pairs, or time frames work best for them. That's okay, since finding out is a big part of the learning process. That's why we spend months using practice accounts before we start risking our money. Successful traders will even return to practice accounts when trying new methods.

Getting to know yourself as a trader isn't a phase in your development that you can skip or cut short. All the advice in the world won't help if you're trading in ways that don't fit you. You probably won't be earning steady profits until you find what kind of trading feels comfortable. Steady profits over time will be the confirmation that you've found your niche.

Tips to Finding Yourself Faster

To expedite that process of finding your niche, here are some tips:

- Avoid day trading currencies (or anything else) until you've built up the requisite successful experience on demo accounts for about six months of part-time trading. After that, start with real money but with small positions, because practice accounts can't prepare you for the stress of having cash at risk. Know that few find they have the needed skills, concentration powers, and information resources to succeed at day trading currencies.
- If the time you can dedicate to forex trading is limited, seek out styles of trading that require only periodic monitoring at your convenience. For example, employees in an office should be careful about attempting any kind of trading that would require monitoring during work hours. You risk being distracted and underperforming in both capacities.
- Those who are risk-averse or have limited risk capital would need to avoid any combination of high leverage and large position sizes relative to their account size. As we'll discuss next, losses per trade must be kept around 1 to

3 percent of your available trading capital.

- Traders should never trade with money they can't afford to lose. The stress will likely prevent you from letting winners run or cutting losses short. You must learn to view trading capital as special funds set aside for trading that you can afford to lose with relative calm because you don't view losing trades as losses, but rather as your tuition for learning how to trade.

Lesson 2: Basics of the Trader's Mindset—Minimizing and Accepting Risk

Here are two tips on how the professionals deal with risk:

1. Their top priority is to minimize losses: Amateurs think first about how much they can make. Professionals focus first on how much they could lose. They accept calculated risk as part of the business but focus more on minimizing losses than maximizing gains. Study Appendix E to see how losses hurt you more than profits help you.

2. They stick to their plans and accept losses as the cost of experience: Once professionals have taken all the precautions they can and have a solid trade plan in progress, they stick with it and don't let risk of loss shake them out of that plan unless circumstances or assumptions on which they based their plan change and justify a change in their trading plan.

- They create plans that allow profitable trades to run until they hit resistance, and that include preset stop loss orders that will cut losses short. They avoid temptations to deviate from their plans and do the opposite. Once they enter a trade based on a solid plan, they don't deviate from it to take a quick profit during a normal pullback. They don't cancel stop loss orders that are about to be hit, they accept taking a small affordable loss rather than risk a larger one. They do this because they accept mistakes as a normal part of the business and admit to them. They don't need to be consistently right, just profitable. As long as their plan was solid and they stuck to it, they take satisfaction in their discipline, and if the loss bothers them, they review the trade and discern what they might have done wrong or how their read of the market may have been wrong.
- They view their trading accounts not as savings but as risk capital, funds set aside to take calculated risks, which over time should be profitable if they've done their jobs well.

- They view losses not only as part of the business, but also as the tuition for their ongoing training, as the cost of experience.
- To make sure they get the full education that they've “paid for” with losses, they keep a trade journal and analyze what went wrong to locate the problem or mistake so it's less likely to be repeated. We'll cover planning and trade journals later in the chapter.

Lesson 3: Dealing with Losing and Winning Streaks

Losing and winning streaks offer their own challenges.

Losing Streaks

Losing streaks sap confidence and capital. Professionals know that when they hit a losing streak, it's time to do one or more of three actions:

1. Cut position sizes and/or leverage used: Until they figure out what's wrong and break the streak, they reduce the amount risked per trade.

2. Take fewer trades, limiting themselves to only the most compelling situations with the lowest potential losses and highest potential yields (more on that later).

3. Take a break from trading: This is especially true if they're under stress from their personal life or have gone too long without some genuine rest (as opposed to a week or more traveling with children or touring for 12 hours a day to see a month's worth of sights in 10 days).

Winning Streaks

Winning streaks are great for our accounts, but they can also be too good for our egos. We can become overconfident and sloppy because we don't need our plans or trading rules now that we're on a hot streak. That bad idea can become dangerous if rewarded with a few more winners, which encourages further recklessness that puts the odds against you and eventually ends in losses.

When I close out a big winning trade I usually take the rest of the day off from trading, and I've known many others who would do the same when they start to feel invincible. They believed they were saving money by waiting until they calmed down because they felt they were too likely to get sloppy and make bad trades that violated their rules.

Conclusion

Conclusion

We could go deeper in trader psychology, but we won't. You've seen enough to be aware of its importance and how it influences the kind of trading you do and how well you manage your risk and capital. Many sources of free information on the psychological aspects of trading are available, as well as professional trader coaches and other vendors of materials on the topic.

Now let's get into the specifics of RAMM.

WHY TRADE LONGER TIME FRAMES

Here's the most important step in reducing risk.

Seek Safer Trading Styles

The first step to lowering risk is to choose a low-risk trading style. Professional football and ice hockey players wear more protective padding than professional golfers or tennis players and have referees to prevent dangerous behavior. Yet the golf and tennis players suffer far fewer serious injuries due to the far safer nature of their sports.

The same goes for trading. The best path to low risk is low-risk trading styles. One key component of lower-risk trading is longer time frames. Though day traders avoid risks from holding positions overnight, most people will find that trading from daily, weekly, or monthly charts is a more profitable, lower-risk approach. This section details why.

Beginning traders, or experienced traders who are still unprofitable, should avoid trying intraday time frames, those in which you open and close positions within a matter of minutes to the close of one to two trading days. Instead, stick to trading price moves that occur over a number of days, weeks, or months. That means using four-hour, daily, weekly, or monthly charts until you are consistently profitable on a monthly basis for about six months on a practice or demo account, then a similar period using small positions with real money. If, after that time, you still want to day trade currencies, then use practice accounts and go through the same process. Yes, I understand you can, in theory, make money faster on shorter time frames and this style is exciting. If your goal is to have the fun of gambling with money you don't mind losing, rather than earn a steady income, then by all means, pour yourself a drink, put on some music, and have fun.

Beware, however, that most short-term traders in any market, not just forex, fail. Your odds of success are much higher with trading off of longer-term time frame charts.

As with Driving, Speed Kills

Trading off short time frames moves at a faster pace. In addition to the added difficulties of short-term trading discussed below, this faster pace brings additional challenges that are too much for most traders. These include the need for fast decisions with money at risk. That might not be a problem for proven, experienced traders, but it's a potentially fatal problem for those lacking a track record with a simple manual or more complex automated trading systems. Because:

- There is often no time to create well-designed trading plans. Failing to plan means planning to fail.
- Having no time for advanced order placement risks emotion-driven decisions. Short-term price moves can be so unpredictable and quick that it's often not possible to enter entry and exit orders in advance. That means making real-time entry and exit decisions when your money is at risk. That leaves the door wide open for emotions to creep in and cause you to
  - Cut profits short even when there is plenty of room before the next resistance point.
  - Let losses run beyond what you can afford in the often vain hope that the trade will turn around.
- You must constantly monitor your positions and make decisions while money is at risk rather than making them in advance under calmer circumstances with orders placed in advance. That added stress can be dangerous because:
  - Few have the sufficiently strong concentrations skills.
  - There is risk of bad decisions from decision fatigue (the tendency to make poorer decisions after a long day of making decisions or other mentally taxing work as the mind tires). Professional traders know not to trade when they're tired, stressed, or otherwise suffering from impaired mental focus.

    It's not uncommon for day traders to make 10–20 or more trades per day when markets are volatile. That can and does lead to decision fatigue. It causes those who make many mentally demanding decisions to make bad decisions toward the end of a workday.

For example, a study of Israeli judges showed that the deciding factor in which prisoners got parole was not whether the prisoner was Jewish or Arab. Instead, the deciding factor was how long the judge had been on duty that day.[4] Prisoners on trial early in the morning received parole about 70 percent of the time, but those who appeared late in the day were paroled less than 10 percent of the time. Decision fatigue is a known problem for day traders.[5]

    - Traders using longer time frame charts are less likely to encounter this problem. The more reliable trends, chart patterns, and support and resistance (s/r) levels on longer-term charts take more time to develop, so decisions about whether to take a trade are much less frequent. Usually, those trading off of daily or longer time frame charts can reach a tentative conclusion, and then sleep on it before reaching a final decision and executing the trade.

- There is less time to evaluate the available evidence or check with more experienced trades or analysts. This is a particularly serious problem for:
    - Newer traders.
    - Traders who have yet to find a trading style with which they are both comfortable and successful.
    - Those prone to making slower decisions and/or to examining lots of evidence before making financial decisions.

A More Level Playing Field

Remember what we said in Chapter 1 about not trying to compete with the big boys who have every advantage? Day trading currencies is the worst form of that. The traders running the forex departments of large financial institutions have decisive advantages that are most prominent with short-term intraday trading than with longer duration trades. They usually have:

- More experience because it's their full-time job (and the newer hires have access to their veteran supervisors).
- Better training and access to analysis, at times from top in-house gurus or private advisory services charging prices only institutions or the wealthy can afford.
- More natural ability. Competition for these lucrative institutional trading jobs is naturally fierce. Those who survive it tend to be the fittest.
- Access to the best information resources and equipment available. Assume

they will know everything before you do. That puts you at a huge disadvantage when you're holding positions over a matter of hours or a few days. However, over weeks or months more of the important information becomes widely known. For example, a big institutional trader might have ways of knowing about a major central bank announcement a few hours in advance. However, over the coming weeks that bank's policy bias will be clearer to all.

- Access to enough capital to move prices over a given number of minutes or hours to their advantage and start false breakouts or other fake price moves that can fool the herd into buying or selling at the wrong time. (More on that later and what to do about it over longer durations.)
- Even if you could afford to buy most of that, here's what no amount of money can buy (short of buying a majority share in one of these firms):
  - Direct or indirect access to their firms' order books, allowing them to know what price levels their own customers chose for their buy and sell orders.
  - Various inside contacts at other institutions with whom this information can be shared and traded for future tips. It's like playing cards with someone who can see your hand when you can't see theirs.
  - Pure insider information. This information is the only rational explanation for why markets seem so consistently good at anticipating certain major news events. For example, in the days before Greece agreed to terms allowing its second bailout in the spring of 2011, the Euro and other risk assets strengthened. Weeks later, just before Standard & Poor's (S&P) downgraded America's credit rating from AAA to AA+, markets were selling off. A coincidence? The SEC suspected otherwise. Days after the announcement, the SEC began investigating the firm on suspicion that news of the downgrade was leaked ahead of time. Insider trading scandals have become a regular occurrence. Given their record in recent years, it's safe to assume that regulators catch only a portion of the most egregious offenders.

    However, over a period of days or weeks, insider information tends to leak out, or if it doesn't, it still may show up on the charts as unexplained steady buying or selling pressure. That too can alert you to an opportunity. The longer your time frame the better your chances of seeing this, because those accumulating large positions try to be discreet and build them gradually. So the longer your time frame—multiple days, weeks, or longer—the more you can neutralize the natural advantages of the big players, especially if you're selective about the trades you take.

More and Better Information Means Better Trade Decisions

Intraday price movements are harder to predict. You don't have much information on which to base a good decision. Some of the following is repeated from above to make sure you get it clear.

First, random price movements or "market noise" is more influential over the course of a given number of hours, during which time trades can be made or broken based on the movements of 10 to 20 pips.

In addition to the attempted manipulations noted earlier, there are the more innocent short-term money flows from large players conducting their normal business. For example if a Chinese company buys an Australian firm, that payment or installment on that purchase could influence short-term AUD prices. These price movements are difficult to predict even for experienced institutional traders with every advantage available.

Those lower on the food chain, particularly the least experienced and skilled at the bottom of it, lack the training, experience, and information resources needed to identify and interpret the resulting short-term price movements, which can include a lot of sheer random movements.

The widely available technical indicators are less useful, and the publicly available longer-term fundamentals and trends of the underlying economies of a currency pair are irrelevant over the course of a given number of hours.

Trends Are More Reliable in Longer Time Frames

Currencies often perform as if we're really trading shares in entire national (or regional in the case of the EUR) economies. The economic fundamentals of a country (GDP, employment rates, consumer spending, etc.) change much more slowly for countries than for publicly traded companies. That stability in economic fundamentals creates equally stable trends (or flat trading ranges) in forex pairs that can persist over weeks, months, or years. So why not trade with longer holding periods that exploit these longer, stronger, more reliable trends?

Let's look at some examples.

Note how stable the long-term trends have been for the USDCHF, USDJPY, and AUDUSD from June 1999 to December 2011 (see Figure 5.1).

FIGURE 5.1 Top to Bottom: USD versus CHF, JPY, AUD from June 1999 to December 2011. Note the steady, persistent trend in these pairs.

Source: MetaQuotes Software Corp.

From January 2000 to mid-August 2011, the CAD gained over 32 percent against the U.S. dollar (USD) (see Figure 5.2).

FIGURE 5.2 USDCAD January Monthly Chart, December 1999 to August 18, 2011

Source: MetaQuotes Software Corp.

Long-term forex trends can persist for even longer than those shown in Figure 5.2.

From 1970 to 2011, the Swiss Franc gained 75% versus the USD. Imagine how well you'd have done with the right Swiss stocks and/or bonds since you'd have asset and currency appreciation in your favor.[6] We'll go deeper into that topic in Chapter 12.

In both cases, the monthly charts show that, with few exceptions, the trends were smooth and stable over the periods in question.

This tendency toward stable long-term trends is a huge advantage for forex traders with the intelligence, patience, and capital needed to play them because so much of successful trading is based on betting in the direction of the longer-term trend.

So why not take advantage of these safer, more easily predictable multiweekly, monthly, and yearly trends and trade them instead of their riskier, less predictable short-term counterparts? The pips are worth as much for easy trades as for hard ones.

One word of caution: Long-term positions mean there's more time for wider price swings, so if you're using leverage you need to be sure you have enough cash in reserve to afford the wider distances between your entry point and your stop loss orders. For example, a given pair might typically move only 50 pips over a given day but move hundreds of pips in the course of a month. You need enough cash in your account relative to your position size and leverage used to be able to absorb those temporary drawndowns as the longer-term trend makes its normal countermoves within its longer-term trend. If you don't want the risks associated with leveraged trading for a given position size, you can cut your position size, or use instruments like forex, exchange-traded funds (ETFs), and exchange-traded notes (ETNs), which we'll cover in Chapter 10.

These easily seen long-term national economic fundamentals create these persistent, reliable long-term trends. The ability to play such reliable trends is a great advantage of long-term trading over short-term trading, which lacks trends of comparable trend reliability.

Ideal Trends For Long-Term Investors

Should you continue to play the trends in Figure 5.2? Unless they've reversed by the time you read this, why not? These are decade-long trends that are assumed valid until proven otherwise. The only questions are when to enter, what stop loss settings make sense, and whether you are able to afford to ride out the likely price swings along the way for a given position size and leverage. For long-term investors, or those with limited analytical and RAMM skills, these are some of the lowest risk trends you can find. As we'll see in Chapters 10 through 12, you don't even have to play them by directly buying or selling the currency pairs themselves. There are multiple ways to ride these trends which long-term investors may find more suitable.

Other Technical Indicators Are Better in Longer Time Frames

As noted at the start of Chapter 4, the easily available TA indicators found on most popular charting platforms used by retail traders all work better on longer time frame charts because they're older, more established, and provide more meaningful s/r and better signals when they're breached or when they diverge from normal price behavior, regardless of whether they are:

- Forms of s/r that we've covered previously or those in later chapters: chart patterns, Fibonacci retracements (Fibs), price levels, and so forth.
- Momentum indicators: assorted oscillators, moving average (MA) crosses, Double Bollinger Bands (DBBs), and so on.
- Cycle or timing tools: Fibonacci, Gann, Elliot Wave or other price cycle

indicators.

Publicly Available Fundamental Data and Analysis Matters in Longer Time Frames

Over the course of weeks and months, the fundamentals of the underlying economies of a currency pair have time to affect its trend and price. For example, trends in interest rates, national debt levels, employment, consumer spending, and more may not matter over the course of a few hours or days (except as news items before and after the most recent figures are announced), but they become increasingly meaningful over weeks and months. Though the big players will still be better at fundamental analysis (FA), their advantage is less pronounced. With some experience, small traders and investors get a good grasp of the longer-term fundamentals of the major currencies. There's a lot of good information online for free or low cost, and there are only eight major currencies. Seriously, you don't need to pay thousands a year for a subscription to Nuriel Roubini or Charles Nenner to have had a firm grasp of how the EU or U.S. debt troubles are likely to influence their respective currencies. An hour a day on some top free websites like those listed in Appendix A will get you free access to some superb analysts and articles on forex and related macro and fundamental topics. When you're playing multiweekly or monthly trends, it usually wouldn't matter much if you read them a few days after their subscribers.

Lower Trading Costs

The potential trading range over a few minutes or hours is usually going to be a mere fraction of that which is possible over a period of many days or weeks. Let's say each transaction to open and close a position costs you on average 2 pips, so each trade costs about 4 pips. If you're striving for the 10–30 pips profit per trade of a typical day trader, transaction costs consume up to 40 percent of your profits. That kind of expense implies a trader needs a high percentage of winning trades to be profitable.

In contrast, those in positions that take multiple weeks to develop commonly earn 150 pips or more on winning trades because the trend or trading range has more time to cover a greater range of pips. That means transaction costs consume a much smaller percentage of profits and allow traders to be profitable with a much lower percentage of winning trades.

Start Out with Longer Duration Trades

In sum, trading longer-term positions from longer time frame charts increases your odds of success for six reasons:

1. A more level playing field: Longer duration positions allow you to compete by neutralizing much of the big institutions' advantages, which are more pronounced in the short term.

2. More and better information: The better the information, the greater the time to digest that information, with more reliable trends and technical indicators and less decision fatigue risk, combine to foster better decisions and a higher percentage of winning trades.

3. More time, less stress: You have more time to analyze and reconsider before placing a trade, with the ability to place trades in advance without greed and fear weighing on you as you decide in real time what to do, less pressure to decide, and lower chance of decision fatigue.

4. Work smarter, not harder: Longer time frames demand less active trade monitoring and less work. In addition to being better rested and less stressed, you can choose to put that extra time into finding the lowest risk trades, furthering your trading education, market research, and related reading. Or (dare I say it) you could do other things for a more balanced, rewarding life.

5. Lower transaction costs: The larger trading ranges over longer time frames mean that transaction costs consume a much smaller percentage of your revenues and allow you to be profitable with a much lower percentage of winning trades.

6. We believe these benefits far outweigh the potential excitement (or stress) and potential faster profits (which few achieve without considerable experience and skill) of the day traders.

To trade longer time frames, it helps if your broker provides the tools you need, particularly quality longer-term analysis.

Content Quality: The Sign of a Quality Broker

While we're encouraging trades on longer time frames, which depend on good long-term focused analysis, here's a related bit of critical advice for selecting a forex broker. Even though you have a number of criteria to consider, here's one you can use as a first screening to filter out the obviously lower quality operations.

The Best Forex Brokers Provide Quality Guidance to Trade Longer-Term Positions

The more quality content they provide that makes it easier for you to trade longer time frames (as well as shorter durations), the more they're oriented toward serious traders rather than casual gamblers and the better a chance of success they're giving you.

There are four signs to look for.

1. Price data going back at least 10 years, preferably more

An important sign of the quality of your charting tools is how far back you view the price action on a given asset or currency pair. There will likely be times when you will want a big picture view of the price action of the past decade or more. If your broker can give you only a few years or shorter for the assets or currency pairs you trade, that signals a bad trading platform. It suggests the broker is focused on encouraging the short-term trading to be avoided by all but the more experienced and successful traders or that the broker is focused on fleecing casual gamblers who are trading more for fun than profit. This is a warning to trade elsewhere.

2. Free access to quality longer-term as well as short-term analysis

A broker who's serious about helping you profit will provide quality technical and fundamental analysis for periods extending beyond hours or days. If a broker provides only news updates you could find on any financial or forex news site, poor quality analysis, or analysis covering only the next few days at most, then move on. The broker is either unwilling or unable to invest in the resources you need for success playing the safer, more reliable longer-term trends.

The best will provide specific trade advice, including suggested entry and exit points. Some decent brokers don't do this out of liability concerns though there are ways to avoid that, and few traders would publicly admit to being stupid enough to believe that a given analyst was guaranteeing a winning trade (especially when nearly all analysis web pages contain legal disclaimers).

3. Free quality trader training

Similarly, a broker that's on your side will make a serious effort to educate you with free or low-cost extensive training materials. We don't mean a superficial 30-page beginner's guide that barely covers basic s/r, plus a few brief, superficial webinars. We mean a full set of courseware on all aspects of trading.

4. Quality content means your broker is stable and on your side

Quality shows a genuine effort to help you succeed and says a lot about the broker's financial stability. Good analysts and full-featured websites represent a serious investment that suggests both financial stability and the intention to build a lasting business based on a large base of successful traders. The forex industry is young and has many small brokers started by those who come from the online gambling industry. Many of them retain that mentality, and continue to view traders as lambs to be slaughtered rather than long-term clients who will provide a lasting corps of repeat customers, who therefore should be nurtured. Cheap or nonexistent content suggests the broker isn't focused on helping you succeed. Instead, it's assuming high client turnover (read: you lose all your money) and is focused on bringing in the next group of suckers before the current group is wiped out.

In general, if a broker is not helping you survive and succeed in the long run, not teaching you to trade or is limiting your ability to take longer-term positions, then move along. Remember this advice when you explore binary options, an alternative way of trading forex that we'll look at in detail later.

For now, just note that most binary options brokers offer expirations of a day or less. Don't waste your time with them as these are just glorified gambling sites. View them as you would any other casino, as adversaries, not trusted brokers. You'll want to stick to the ones that offer weekly and monthly durations. At the time of this writing, only anyoption.com offered both of these though we hope more brokers do so by the time you read this.

THE ESSENCE OF GOOD RAMM

To be motivated to practice good RAMM, you first need the right mindset, discussed previously. RAMM is all about the following, which we cover in detail in this chapter:

- Trading with safer styles and methods, as discussed previously.
- Making sure your gains from winning trades are larger than your losses from losing trades, as discussed later in the chapter on risk-to-reward ratios

(rrrs).

- Increasing the odds of favorable rrrs. We'll consider only the trades that offer entry near strong support, with a reasonable stop loss that's much closer to our entry point than the next likely resistance area, which would serve as our likely exit point. Again, see the upcoming section on rrrs for details.
- Preventing a fatal loss from one or a series of losing trades from which you're unlikely to recover without adding funds. In essence, that means keeping your maximum loss per trade to a maximum of 1 percent to 3 percent of your trading capital.

THE THREE PILLARS OF RAMM

As in Chapter 2, the size of this maximum allowable loss per trade depends on three conditions:

1. Account size: Determines the cash value of the 1 to 3 percent maximum loss you can afford. Thus, it determines how far you can set your stop loss orders from your entry point. The larger the account, the wider the stops you can afford, and the more choices of trades you have available to take. For a given account size, that maximum loss you can safely afford is a function of the following two factors.

2. Leverage or margin used: Fixes the percent loss you incur for each 1 percent price move against you per lot traded. The greater the leverage (or the lower the margin), the greater the percent loss for each 1 percent price move against you, and the smaller the percent price move against you that you can afford without exceeding that 1 to 3 percent. The higher the leverage, the higher the risk and profit potential per trade. Some brokers allow you to adjust the leverage you use, some don't.

3. Position size: Determines cash value of each pip or 1 percent loss. For a given leverage setting, the larger the lot size used (more on that later), the more every pip move against you costs. The larger the lot size, the higher the risk and profit potential.

Let's look at these in greater detail. All focus is on insuring that your stop loss setting doesn't risk more than 1 to 3 percent of your capital and that gains per winning trade are much larger than losses per losing trade.

ACCOUNT SIZE AND AFFORDABLE LOSS PER TRADE

One of the core money management rules of professional traders is not to risk more than 1 to 3 percent of their capital on any one trade.

They understand the mathematics of losses, and how a given percent loss requires an even larger percent gain to recoup that loss. See Appendix E for illustration. This 1 to 3 percent refers to the amount risked by your stop loss, not position size. In other words, account size determines how far you can set your stop loss from your entry point without risking more than 1 to 3 percent of your account.

For example, those with a $10,000 account would not set their stop losses so far from their entry point that they risk more than $100–$300 per trade. Those with $100,000 accounts could accept $1,000–$3,000 loss per trade and so could set their stop loss orders further from their entry point.

The reason for keeping loss/trade to within these 1 to 3 percent limits is that you can then afford a string of 5 to 15 losses and still have about 85 percent of your capital left.

SETTING STOP LOSSES: BASIC TECHNIQUE AND PSYCHOLOGY

For a given position size and leverage, you limit your maximum loss per trade through your stop loss settings. The following rules on stop loss setting assume you're entering near strong support, because if you aren't, you shouldn't even consider entering the trade. If the trade moves against you, that nearby support is quickly breached and you have a signal to exit before a small loss becomes a large one.

Where to Set Stop Losses: Two Criteria

When setting your stop loss order, you're always striking a balance between two conflicting criteria:

1. The stop loss price is close enough to your entry point so if it's hit, the loss doesn't exceed 1 to 3 percent of your account value, as noted previously.

2. It's far enough away from your entry point and the likely support level so it doesn't get hit by normal random price movements and close your position before price has had time to move in your favor. Rather, it's triggered only by price moves that are big enough to suggest that you were wrong and overestimated the strength of a given support zone, and now a loss is more likely than you thought. It's time to close the position before a small affordable loss becomes a large one. There are different ways to determine normal or average price movement to expect during a given period. Some manually determine average or typical candle length over a given period. Some will use a certain percentage of the range as determined by the Average True Range (ATR) indicator (more on this soon). Price volatility varies with market conditions and time frame as must the distance from entry point to stop loss.

Viewed from another perspective, setting stop losses means striking a balance between:

- Less frequent but larger losses from wider (or looser) stop loss settings: The farther your stop loss from your entry point, the larger the losses on losing trades relative to your gains from winning trades. However, you have less chance of having your stop loss hit before price starts to move in your favor (being “stopped out”). The main advantage of this approach is a higher percentage of winning trades (which you may need for encouragement), at least when you're right about the ultimate price direction. The main disadvantage is that you risk too many large losses and lower profits compared to the following approach to setting stop losses.
- More frequent but smaller losses from tighter (or narrower) stop loss settings: The closer your stop losses to your entry point, the smaller the losses on losing trades relative to your gains from winning trades. However, you'll have more losses from being “stopped out” on trades that would have ultimately worked, because your stop loss will be hit more often, before price has had time to move in your favor.

More Capital Allows Wider Stop Losses and a Wider Choice of Low-Risk Trade Opportunities

A larger account means:

- You can afford to set stop loss settings that are wide enough to avoid getting prematurely “stopped out,” yet still only risk 1 to 3 percent of your capital, because you have more capital to risk. That means there are more trades available to take that have entry points that are both close enough to strong support and only risk 1 to 3 percent of your capital.

- You can afford the wider stop losses needed to ride the more stable longer-term trends via longer-term positions. As noted previously, forex markets produce many stable long-term trends. However, the longer you hold a position, the larger the normal price swings and the farther the stop loss must be from your entry point. For example, a pair may have average daily price swings of 50 points, but weekly or monthly average price swings could be many times larger. A bigger account allows you to set those stop losses far enough from your entry point (near strong support, of course) to ride the wider short-term fluctuations within the more predictable long-term trends. In sum, a larger account allows you a wider choice of trades in any time frame, and also offers more chances to ride the most stable, predictable, and safer trends that are the basis of lower risk trading.

Not surprisingly, studies suggest certain minimum account sizes increase your chances of being profitable.[7]

Balancing Risk versus the Need to Win

While a larger account allows for wider stop losses, you need to accept the added risk that comes with them. Wider stop losses can increase your percentage of winning trades, but risks lower profits because losing trades cost more.

The right balance between winning percentage and loss sizes varies for each trader.

Some need a higher percentage of winning trades that comes from wider stop losses in order to avoid getting too discouraged, even if it comes at a cost of higher losses and lower overall profits.

Others are less emotional. As long as they achieve realistic profits at the end of the week, month, or quarter, they can accept taking more (but smaller) losses as long as the gains from the winners outweigh those losses enough to keep profits healthy. Few, however, are cool enough to accept very high losing percentages, such as 70 percent of their trades, no matter how profitable the trading style.

So, as you experiment with trading styles, be sensitive to what you need most to keep going. For some traders, particularly when starting out, the priority will be a higher winning percentage to build confidence. Others will need lower losses per trade and can accept the tradeoff of more “stopped out” trades and less frequent wins as part of the learning process.

When in doubt, err on the side of tighter stops and smaller but more frequent losses. Deal with the discouragement that may come from those by:

- Reminding yourself that it takes time to be successful, especially given the profit potential and competition it attracts. You need to learn and practice a lot to know enough and know what kind of trading suits you (e.g., your risk tolerance, time available, patience).
- Taking a break from trading to review your losing trades in your trading journal and identifying and correcting your mistakes.
- Taking a break from trading, period. I'm amazed at how much clarity can come after a good night's sleep or a few days off from a given dilemma.

Do not underestimate the importance of managing your mood and attitude, and of finding trading styles that give you enough of a winning percentage to keep going even if they are perhaps less profitable.

So how far (in pips) from strong support do you want to set your stop loss? First, it must be close enough to your entry point so that if hit your loss is less than 3%. Second, want it beyond the range of random price movements. So we need a way to define the range of “normal random price movements.” There are many ways to do this; here are a few simple ones.

Method 1: Recent Range

The simplest, perhaps most intuitive way to set stop loss orders is to look at recent highs and lows for the period in question. In other words, the stop loss should be at least as far away from support as suggested by the recent price volatility, which of course varies dramatically depending on the circumstances and time frame. See our trade examples in Chapter 7.

Method 2: Average True Range (ATR)

Rather than using your own judgment, some statistical measures of price volatility are available. One of the most popular is the Average True Range (ATR) indicator, which measures the average movement for a given currency pair (or stock, commodity, etc.) for a given time period. Typically, the default setting is 14 periods, that is, 14 days on a daily chart, 14 hours on an hourly chart, and so forth, but over time you may want to experiment with that setting.

Knowing the ATR for a given period, traders can chose to place stops a given percentage of that range away from the entry point. For example, traders with great confidence in the direction of the trend who want to avoid having their stop loss hit would place their stop loss 80 to 100 percent of the ATR beyond their entry point near strong support. They'll accept the larger loss if that stop is hit because they believe the likelihood of that happening is low. Those with less confidence and more risk aversion who want smaller losses (even if there are more of them because the stop gets hit) might place their stop closer, perhaps 50 percent or less of the ATR away from the entry point.

Once you know the average volatility for a given period via the ATR, you have a better idea of how far away your fixed or trailing stop loss order needs to be to avoid getting hit by random price movements.

Later in this chapter and in Chapter 7, we'll see examples of how to use ATR.

So How Much Capital Is Enough?

By the time you've graduated from practice accounts, you should have a an initial idea about what kinds of trading you like to do, and your trading journal (more on that later) should provide a record of the amount you need to allow for realistically wide stop loss settings per trade and still be able to absorb a string of 5 to 15 losses. That amount will vary with trading styles and methods. For example, positions held for weeks or months need wider stop loss settings to absorb wider price swings than positions held for a few days.

We offer 5 to 15 losses only as a rough guide. We're not suggesting you rack up 10 straight losses before stopping. After you see five losing trades out of the past six to seven, you should consider stopping to identify the problem by studying your trade journal (discussed later on in this chapter). You may well repeat this process a few times before you've fixed the problem, suffering periodic losing streaks of about 15 losses as part of your tuition for your trading education.

Again, you should have about six profitable months of trading with practice accounts (and very small positions with real money) before doing any serious trading with live money. Thus you should have some experience with the process of fixing losing streaks before you “go live” with larger position sizes. Furthermore, you'll have extensive records of your past trading to guide you. Again, we'll cover trade plans and journals later.

If the account size you need and can afford is unclear, and it may well be, don't worry. You're allowed to make mistakes with your account size in the early stages. Start with an amount that meets the following criteria:

- You can afford to lose it as an investment in your education.
- Based on your limited experience with the size of your positions, leverage, and stop losses, you can absorb a string of 5 to 15 losses and still have about 85 percent of your capital left.

Practically speaking, most people will have limited control over what they can afford to lose. Instead, most people will adapt their trading style, position size, and leverage to their account size. So, let's move on to those aspects of RAMM.

LEVERAGE AND MARGIN

We covered this second pillar of RAMM earlier in Chapter 2 and provide additional details in Appendix D. However, no discussion of RAMM would be complete without a reminder that the higher your leverage, the higher your risk. Until you're an accomplished trader, or at least good at RAMM, you want to keep it as low as your broker will allow and add more as your success warrants. Many brokers have fixed leverage levels, so you have to adjust your account size or position size.

POSITION SIZING

Of the three pillars of RAMM, position size is usually the easiest one to adjust, at times the only one.

As you may recall from Chapter 2, you typically have three choices of lot sizes you can trade.

1. Standard Accounts: 100,000 units of the base currency (the one on the left).
2. Mini Accounts: 10,000 units of base currency.
3. Micro or super mini accounts: 1,000 units of base currency.

Just to give you an idea of what that means, if:

- The account is denominated in Euros.
- The Euro is the base currency (the one on the right), which is common with the major currency pairs.

Then the cost per pip is €10.00 for a standard lot, €1.00 for a mini lot, and €0.10 for a micro lot. See Appendix B for details.

In practice, you may not have much control over your account size because that's largely fixed by how much you're able to afford. Many brokers don't offer much choice on leverage used. So, lot size is the one thing everyone can use to keep risk down.

When you first graduate from practice to real accounts, no matter how successful you were with demo accounts, stick to trading one or a few lots of the smallest lot size offered. The one big weakness of practice accounts is that they can't simulate the pressure of having money at risk, so many traders struggle to attain the same success they had with demo accounts when they start trading real money.

Expect your performance to suffer when you transition to trading and risking real money. That's normal.

So when you start trading with real money, use small positions that keep your losses to around 1% or less of your total account. You can increase your position size after you see a number of months of profitable trading. Because you'll be working with small lots, evaluate your performance based on percentage rather than nominal gains. Don't view this period as a delay. View it like you would a paid internship. You accept less money for the sake of gaining better experience. After you see that you've maintained or improved on your performance with practice accounts, then you can consider moving up to larger position sizes. If you hit a losing streak, strongly consider cutting down your position sizes until your performance recovers.

AVOID HAVING TOO MANY OPEN POSITIONS

Closely related to position sizing is the common mistake of overtrading with too many full-sized (versus partial) open positions. This can be distracting, and it defeats the purpose of keeping position sizes small by increasing the percentage of your account at risk at any one time. How many open positions are too many? This is a judgment call and depends on your skill level and time frame. Trades that occur over days or weeks require less active monitoring than those that complete in a matter of minutes or hours.

ENTRIES NEAR STRONG SUPPORT, EXITS NEAR STRONG RESISTANCE

Regardless of whether you enter or exit all at once or in stages, a key part of good risk management is to base your entries and exits on the location of strong s/r.

Entries

If you're playing trading ranges (bounces off lower and upper channel lines that form resistance or support), only enter the near strong support of one channel line and at least plan to take some profits near the likely strong resistance around the opposite channel line unless you're using a trailing stop.

If you're a momentum trader who enters trades on breakouts past resistance levels, enter only after a strong resistance level is decisively broken (based on personal judgement that will improve with experience), and plan to take at least partial profits near the next strong resistance level.

Exits: Use Trailing Stops to Protect and Maximize Gains

Though your initial plan should be to exit near likely resistance, remember that you have the option of using a trailing stop.

Instead of fixed stop losses, use trailing stop loss orders whenever possible because they give you the best of both worlds, the protection of a regular stop loss without the limitations of a fixed exit point. Until price retraces and hits the trailing limit, you ride the move as high as it goes. Once your trailing stop is above your entry point, the only question is how much you'll profit. As part of our drive to maintain a high rrr, we try to get even better than 1:3 rrrs when we can. Using trailing stops allows us to get those extra gains. These big winners help compensate for losing trades and for winners in which you were forced to exit with minimal gains to avoid a loss.

It isn't always practical to use a trailing stop when you begin a trade. In these cases, you simply change the switch from a fixed to a trailing stop loss once the trade has moved a certain number of pips in your favor, at minimum so that your loss would be less than your initial fixed stop loss.

ENTRIES AND EXITS: SINGLE VERSUS MULTIPLE

Because s/r levels occur over areas or zones rather than precise points, selecting entry, exit, and stop loss points can be stressful because you're never sure if you're right. To lower the risk and stress level, many find it helpful to enter and exit positions in stages.

For example, if your planned position is two mini account lots, you could take profits on one lot at a more conservative price, and leave the other lot to continue with a trailing stop loss (defined in Chapter 2).

If your trailing stop loss is set to trigger at no worse a position than your first exit point, you at least lock in a smaller profit as a worst-case scenario. This first exit should bring profits on that first lot that are at least equal to the loss risked by your trailing stop, thus allowing a 1:1 rrr on that lot. Set your trailing stop so at worst it triggers at your initial exit and you lock in at least a modest profit and a 1:1 rrr on the trade. If price continues to run higher, the second lot gives you added returns though not as much as if you'd let both lots run with a trailing stop once the first exit. Safety usually comes at a cost of lower returns.

Taking partial profits not only eases stress levels, it also helps build your confidence while you are learning and finding a trading method and style that works for you.

Unlike stock brokers, forex brokers' fees are based on spreads (number of pips between bid and ask). That means they make money on your trading volume (the amount of currency you trade) rather than your trading frequency, so you pay no extra for partial exits and entries. How often you use these will depend greatly on your confidence in a given exit or entry point. When you're very confident about a trade, you're more likely to keep the full position open until you hit your planned exit point.

RISK-REWARD RATIOS (RRRS)

Favorable rrrs are another key part of good RAMM. We seek 1:3 risk-reward ratios (aka 3:1 reward-risk ratios, same thing) or better, though we will certainly consider trades with 1:2 rrrs, as shown next. In other words, we seek trades where the entry point (which is near strong support of course) is ideally at least three times farther away from the profit-taking point (near resistance) than it is from the stop loss. That way your winning trades bring gains triple the size of your losses. That allows you to be profitable with an achievable winning trade percentage of just over 25 percent.

By all means, try strategies that seek lower rrrs and higher winning ratios, and these may be a better fit for those needing frequent wins. At times, market conditions will almost force us to accept lower rrrs. However, be cautious with such approaches until you've made those strategies work in practice accounts and then with small positions. Start out by trading less frequently and only when your loss is smaller than your likely gain if you're right.

Example: How 1:3 RRRs Make Winners Out of Losers

Here's an illustration of the math:

Assumptions

You have $20,000 in trading capital. You will follow good RAMM practice and not risk more than 1 to 3 percent of that on any given trade, in this case, $200.

You place 10 trades with a stop loss that risks no more than $200 on average, 1 percent of capital risked per trade on average, $1,000 total capital risked. So, you could lose 10 straight trades and still have $19,000 or 95 percent of your capital.

Trade selection criteria

You enter trades only when the distance in pips from your planned entry to stop loss (see setting stop losses) does not risk more than $200 on average.

You will only take trades that offer a minimum of 1:3 rrr. In other words, if our stop loss is hit, we lose $200. If our sell limit is hit, we earn at least about $600.

1:3 rrr: Profitable with over 25 percent winning trades

If 50 percent winning trades:	Percent gain from $1,000 risked
5 × –$200 = ($1,000)	
5 × $600 = $3,000	
$2,000	200 percent
If 40 percent winning trades:	
6 × –200 = ($1,200)	
4 × $600 = $2,400	
$1,200	120 percent
If 35 percent winning trades:	
6.5 × –200 = ($1,300)	
3.5 × $600 = $2,100	
$800	80 percent
If 30 percent winning trades:	
7 × –200 = ($1,400)	
3 × $600 = $1,800	
$400	40 percent
If 27.5 percent winning trades:	
7.25 × –200 = ($1,450)	
2.75 × $600 = $1,650	
$200	20 percent

As long as you're right more than 27.5 percent of the time, you'll be profitable. The only question is whether your ego can handle that many losses. That's a function of your sensitivity and ego. If you're humble and mature enough to focus on your profits, you'll be fine. Hey, a baseball player with .275 batting average is a good hitter.

If 25 percent winning trades:	
7.5 × 200 = ($1,500)	
2.5 × $600 = $1,500	
$0	0 percent
If 20 percent winning trades:	
8 × 200 = ($1,600)	
2 × $600 = $1,200	
($400)	–40 percent

This ideal of 1:3 rrr can often be found when markets or at least an individual currency pair are at the start of a trend reversal or at either extremes of a wide trading range.

However, the rest of the time, such opportunities may be much harder to find. Usually they are still available, and you need to spend more time searching for these optimal situations rather than trading. That's fine; better to trade less often to take only the lowest risk and highest yielders that don't require any special skill level or information sources. That's how we trade like a great beginner and make money without the advantages of the big institutions.

Example: How 1:2 Risk-Reward Ratios Make Winners Out of Losers

If you can't find compelling opportunities offering 1:3 rrr (that can happen in certain markets) and you feel confident about the trade, then a 1:2 rrr will be acceptable and may often be a more realistic criterion under the circumstances. If your winning trades bring gains double the size of your losses, you can still be profitable with an achievable winning trade percentage of under 35 percent.

A 1:2 rrr allows you to find more trade opportunities because resistance need only be twice as far from the entry point as the stop loss rather than three times as far. There are legitimate reasons to take trades that offer only a 1:2 rrrr. For example:

- Sometimes that's as much as the market is offering and you spot a setup with high odds of success, so you accept a lower rrr rather than miss a likely profit.
- Sometimes you're too late in spotting what would have been a 1:3 rrr with a very strong trend that still has room to run, so you accept a later, less optimal entry with a lower rrr because you're particularly confident that the trade will be profitable.
- If you're still using a practice demo account and want the experience of the trade.

Alternatively, you can choose to stand aside until you find a 1:3 rrr trade, which is especially wise if you've reason to be especially risk averse. For example:

You've recently graduated to trading real money and want your first few months to show a net profit. Your trading capital is limited and you need the gains from your winners to far exceed your losses from losing trades.

Here's the math:

Assumptions

The same assumptions and trade criteria apply, except the rrr changes to 1:2.

Trade selection criteria

You enter trades only when the distance in pips from your planned entry to stop loss (see setting stop losses) does not risk more than $200.

You will only take trades that offer a minimum of 1:2 rrr. In other words, if our stop loss is hit we lose $200, if our sell limit is hit we earn $400.

1:2 rrr: Profitable with a bit less than 35 percent winning trades

If 50 percent winning trades:	% Gain from $1,000 risked
5 × –$200 = ($1,000)	
5 × $400 = $2,000	
$1,000	100 percent
If 40 percent winning trades:	
6 × –200 = ($1,200)	
4 × $400 = $1,600	
$400	40 percent
If 35 percent winning trades:	
6.5 × –200 = ($1,300)	
3.5 × $400 = $1,400	
$100	10 percent
If 30 percent winning trades:	
7 × –200 = ($1,400)	
3 × $400 = $1,200	
($200)	–20 percent

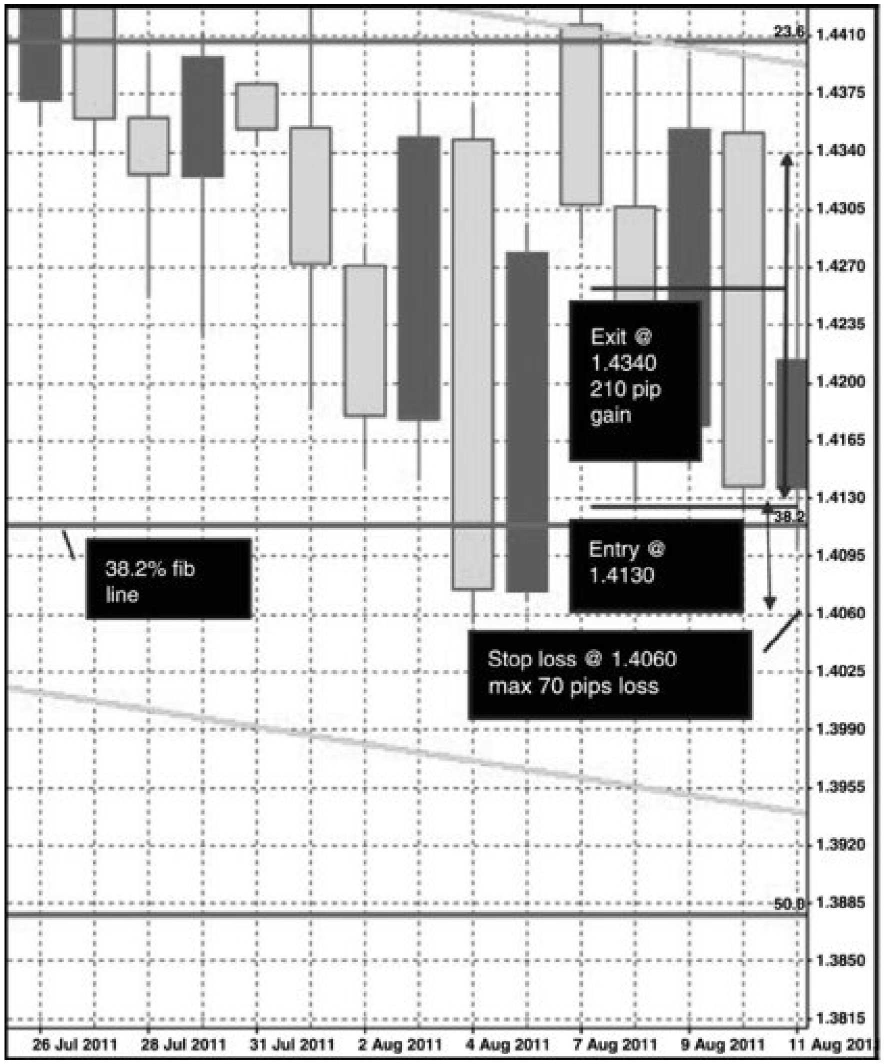
What started out as a planned 1:3 rrr often becomes a 1:2 or less if you're using a trailing stop loss order that gets triggered if the trade starts to move against you. That's fine. Though it makes sense to aim for a 1:3 rrr level, markets aren't always that cooperative, and we'll take what's available. More on the value of using trailing stops later.

Applying 1:3 RRR: An Example

Here's an illustrated example (see Figure 5.3).

FIGURE 5.3 URUSD Daily Chart, July 28 to August 11, 2011

Source: MetaQuotes Software Corp.



On August 11, 2011, we see an opportunity to enter near strong support of the 38.2 percent Fib at 1.4110. These Fib lines were drawn for the longer-term uptrend from January 9 to May 1, 2011, not shown here.

We can set a reasonable stop loss order at the recent low of August 4 and 5 around 1.4060 for a maximum loss of 70 pips. Strong resistance is formed by a combination of the upper descending channel line drawn from May 1, 2011, and the 23.6 percent Fib line converging around 1.4410, but we'd prefer a more conservative profit target below the closing price of August 9 around 1.4340. Do we have a 1:3 rrr? Here's the math:

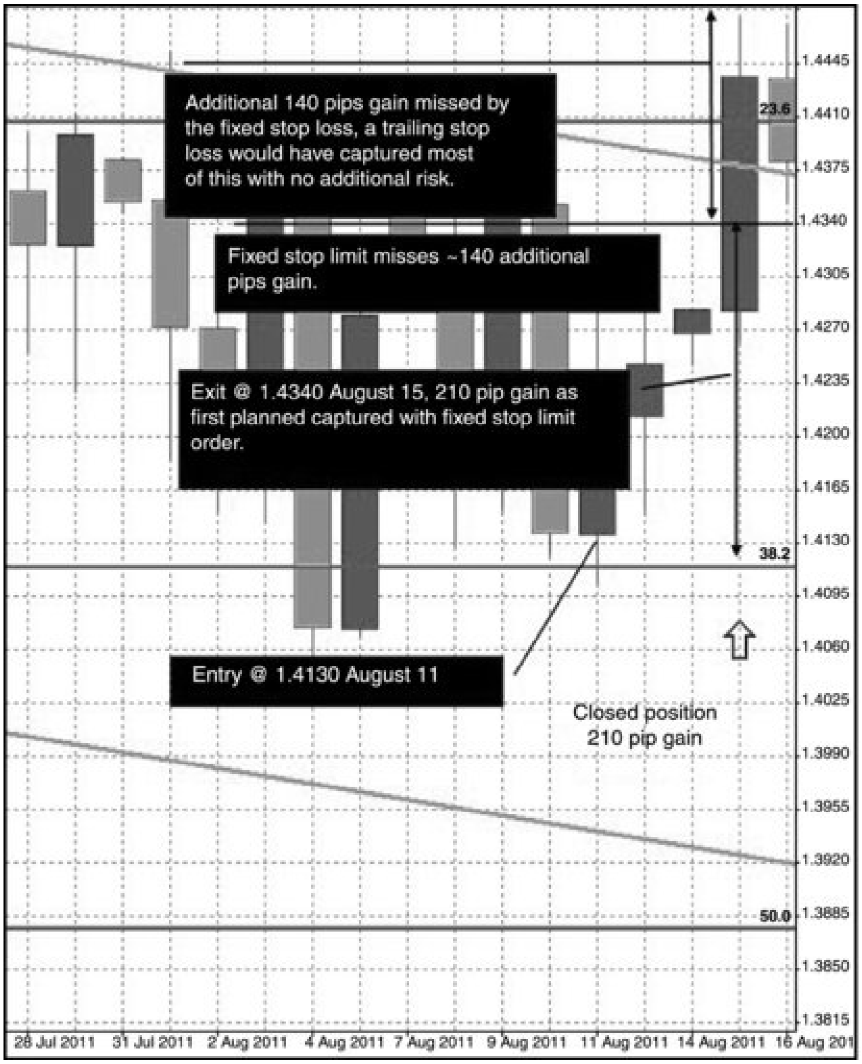
Enter August 11, 2011 at	1.4130
Stop loss order set at August 4 low of	1.4060
Maximum loss 70 pips	0.0070
Profit-taking exit via sell stop order	1.4340

August 11 entry via buy limit order	1.4130
Planned gain 210 pips three times planned loss	0.0210

So, we have our 1:3 rrr. Figure 5.4 shows how it worked out on August 15.

FIGURE 5.4 EURUSD Daily Chart, July 28 to August 16, 2011

Source: MetaQuotes Software Corp.



If we had stayed with a fixed sell limit order at 1.4340, we would have made out 210 pips. Sounds great, and it would be. However, most of us would be kicking ourselves for missing so much of the move, which peaked below 1.4480 for another 140 pips gain. An exit around there would have given you a roughly 1:5 rrr.

But there's no way you'd have known and been able to play that, right? Actually, there is. *All you had to do was use a trailing stop* instead and ride the move higher while locking in most of the profits. Others who are more conservative might have taken partial profits and let the rest run with a trailing stop. This brings us to our next point.

Acceptable RRR Can Vary with Market Conditions

Consider market conditions when deciding whether to use a more aggressive 1:2 rrr. In a strongly trending market (up or down), more justification exists for loosening your standards and accepting a lower rrr if the trade is in the direction of the strong trend and you risk missing the trade altogether.

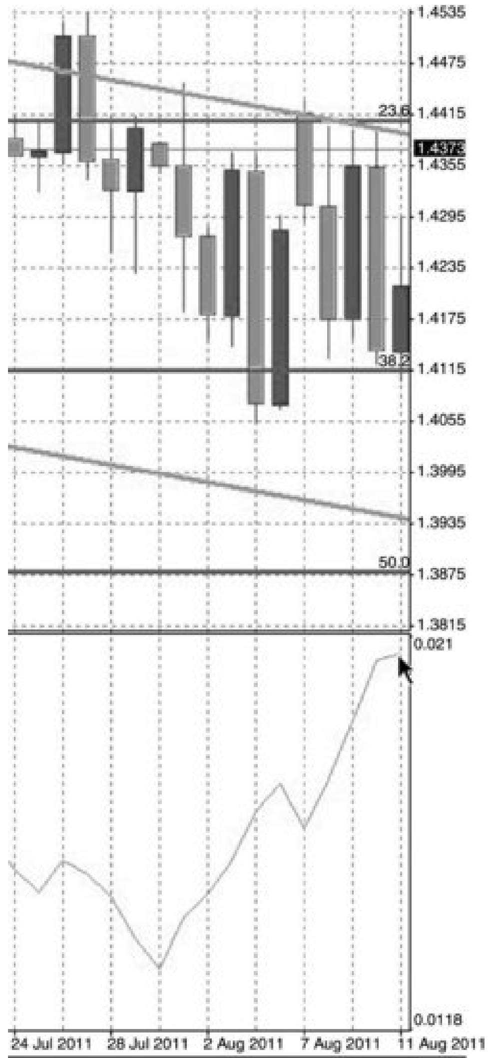
More on Stop Loss Orders: An Example of Using ATR to Gauge Volatility and Place a Fixed or Trailing Stop Loss Order

We refer to the above example.

In Figure 5.5, we show the same EURUSD daily chart showing the daily candle for the entry date of the trade on August 11, but this time we include an ATR, which shows that over the past 14 days or daily candles, the average price range was about 210 pips. Those interested in how ATR is calculated can look it up online.

FIGURE 5.5 EURUSD Daily Chart, July 24 to August 11, 2011

Source: MetaQuotes Software Corp.



In this example, we based our stop losses on the other factors mentioned previously. However, if we wanted to lower the chances of getting stopped out of the trade in exchange for the risk of more loss if the trade turned against us, we could have set the stop loss at a distance 50 percent or more of the ATR, 105 pips, beneath the entry point, or some different percentage of ATR.

The point here is that there are different ways to determine how far away you set your stop loss. In the previous example, we used the recent lows as a guide though we could have used ATR instead. Much depends on factors like your risk appetite, market conditions, and confidence in the trade. For example, if you've caught a pullback to strong support in an overall strong uptrend, you might have more confidence that this uptrend will resume and allow a wider stop loss to avoid getting stopped out by random price movements. When you're less confident, you might keep stops tighter.

IF YOU FAIL TO PLAN, YOU PLAN TO FAIL

Planning each and every trade is another aspect of RAMM that separates the professionals from the amateurs. The benefits more than justify the work. Writing out a plan:

- Insures that you go through the full planning process, particularly if you prepare a trading plan form (like that shown in Table 5.1) that reminds you of each step in the planning process.
- Forces you to articulate the pros and cons of the trade, helping you decide if you should take it or not. You go into the trade clear on why it should work, what could go wrong, and what you're risking.
- Leaves you a written record of your thinking and results from which to learn from what you've done right and wrong, and spot repeated mistakes or chronic weaknesses that need to be addressed.
- Makes it easier to keep track of your profits and losses.

Let's look at these benefits in more depth.

Table 5.1 Sample Trade Plan Form For Trade Illustrated in Figure 5.3

0	1	2	3	4	5	6	7	8	9	10	11	12
Trade	**Date and Time**	**Pair**	**Long/ Short**	**Chart Time Frame and Estimated Duration**	**Entry (E) Stop Loss (SL) Take Profit Point (TPP)**	**Amount and % of A/C at Risk from Stop Loss Mini A/C~ $1.00/PIP**	**RRR**	**Lot Size Margin Leverage**	**Comments Rationale for Entry See Page**	**Gain or Loss**	**Comments Post Mortem See Page**	**Screenshot Entry and Exit See Page**
124	110811	EURUSD	Long	Multi-Day or Week	E: 1.4130	$70/$20,000						
					SL: 1.4060 TPP: 1.4340	0.003	1:3	$10K $100 100:1	Page XXX	$210	Page YYY	Page ZZZ

Note: At bottom of column 5 E = Entry Point, SL = Stop Loss Point, TPP = Take Profit Point.

To insure that you actually use the ideas taught in this book and learn from both your winning and losing trades, you need to write a plan for every trade that includes such basics as the following.

What's Your Rationale for Taking This Trade?

First, consider the basics that determine whether you've got a favorable risk-reward ratio of at least 1:2, preferably 1:3.

S/R

How strong are the s/r points where you plan your entries and exits?

RRR

Based on the strong s/r points near your planned entry and exit and the needed distance from your entry to your stop loss (to avoid it being triggered by random price movements), does it appear to offer an adequate rrr of at least 1:2 or better, 1:3?

To determine that rrr, in addition to your likely entry and exit, you need to know the distance from your entry point to your stop loss. So, think through where you'll place your initial stop loss and why.

Entry and Exits: Stop Loss

Where are you placing your initial stop loss and why? How do you know it's far enough from your entry point so it won't get hit by random price moves? Recent highs and lows? Or an estimate of average volatility per candle? How large a move would you define that? Based on what? ATR or a visual inspection of recent volatility? Is the planned exit two to three times further from your entry point than your stop loss to allow for a safe stop loss yet still have a 1:3 rrr?

Trend Strength

Assuming your rrr is acceptable, is the trend or trading range likely to continue? How strong is the trend if there is one? What's your evidence for that trend strength? Do the underlying fundamentals look like they'll continue to fuel the continuation in the trend that you need to reach your planned exit near strong resistance?

Other Fundamental and Technical Evidence Pros and Cons

Cons

What fundamentals are fueling the move?

What technical or fundamental evidence suggests the trade won't work?

Why do you believe the balance of evidence favors the trade?

What new fundamental or technical evidence might cause you to exit or add to your position?

Scenarios or Decision Trees

If the trade moves in your favor, when would you switch from your original stop loss to a trailing stop to lock in gains or minimize losses?

If trading multiple lots, at what point would you take partial profits? Would you let the whole position ride? Are there possible news events or other fundamental factors, which if announced, would cause you to alter your plan? Are there any planned news announcements (central bank rate statements, U.S. monthly jobs reports, a meeting expected to resolve a major geopolitical crisis, etc.) that could change your opinion of the trade and cause you to exit or to add to your position?

The mere act of writing it forces you to examine whether the analysis and RAMM of each trade is sound. The collected trading plans become your trading journal, one of the most important learning tools you'll have.

You'll need two kinds of plans:

1. A plan for each individual trade. The collection of these forms your trading journal.

2. An overall trade business plan that covers your goals, trading methods, performance monitoring, feedback methods, *etc.*

No. 1: Plan Every Trade and Record It in a Journal

You know how they say that those who don't learn from the past are destined to repeat it? So, learn from your trading mistakes and correct moves. Keep records of your trade plans, review the trade afterward, and note why it did or didn't work and what that tells you about what you need to do to avoid the same mistake or ensure that you repeat the successful trade.

All the theory you'll learn about TA and fundamental analysis, trader psychology, and RAMM is worthless unless you can implement it. A written trading plan for each trade, stored in a trading diary, is one of the most effective means of doing that because it:

- Serves as a checklist to see that you've taken all of the analytical and RAMM steps needed.
- Forces you to think through the trade rationale (the balance of fundamental and technical pros and cons) and RAMM, so you can develop a step-by-step method for deciding whether a trade provides the right combination of low risk and high potential yield.
- Provides a record of your methods for later review so you learn from what you did right and wrong. Combined with each written trade plan and post-trade analysis you record, it forms a trading diary or journal. You'll want to review these trades periodically. This kind of review is especially valuable when (not if) you hit a losing streak and are figuring out what you're doing wrong. You can examine the common denominators of your winning and losing trades. Include screenshots of the relevant charts at the times of entry and exit. They provide a complete visual picture of the technical evidence, and they take less time to create than a written description. I often print these and scribble notes all over them as I notice things I didn't catch the first time. If you don't have screen capture software, you can get it free online.[8]
- Provides a personal database to identify mistakes, strengths, weaknesses, shows what kinds of trades and trading styles work or don't work for you, and highlights which produce less stress, more fun, and are better suited for your personality.
- Becomes a tool for knowing what kind of trader or investor you are. There many different ways to trade or invest. One of the prime keys to success is to find the methods and styles that fit you rather than adapting to a given way of trading.
- When using a prepared trade plan form as shown in Table 5.1, this can serve as a checklist to insure you consider and record each aspect of the planning process.
- The basic form can include cross-references to more detailed notes than possible on this form. I've always been a big fan of including screenshots of the charts, so I have a picture of the scenario before and after and can scribble notes right on the chart.

Table 5.1 is an example of how the trade example from the previous Risk-Reward Ratios section would be recorded in your trading journal.

Explanation of Columns

Columns 0 and 1 are for reference. Most of the others are self-explanatory, just there to remind you to consider essential elements of RAMM.

Columns 9, 11, and 12 are meant to reference separate pages where there would be enough room to include your thoughts and where most of your thinking will be recorded and reviewed later for what you did wrong or correctly.

Column 9 is Comments Rationale for Entry. There isn't room in this column for your comments, so you'd put in a reference number of some page in a separate journal where you could include the full rationale for the trade like the answers to the sample previous questions.

For example, you could enter these comments:

- Why you believe there is enough room for a 1:3 rrr.
- Whether this trade is going with a longer-term trend, and if not, why you believe the counter move is worth trading.

Sample Trade Rationale as Recorded in Journal

Here's what I recorded, referring to the scenario shown in Figure 5.6.

Column 9: COMMENTS, RATIONALE FOR ENTRY

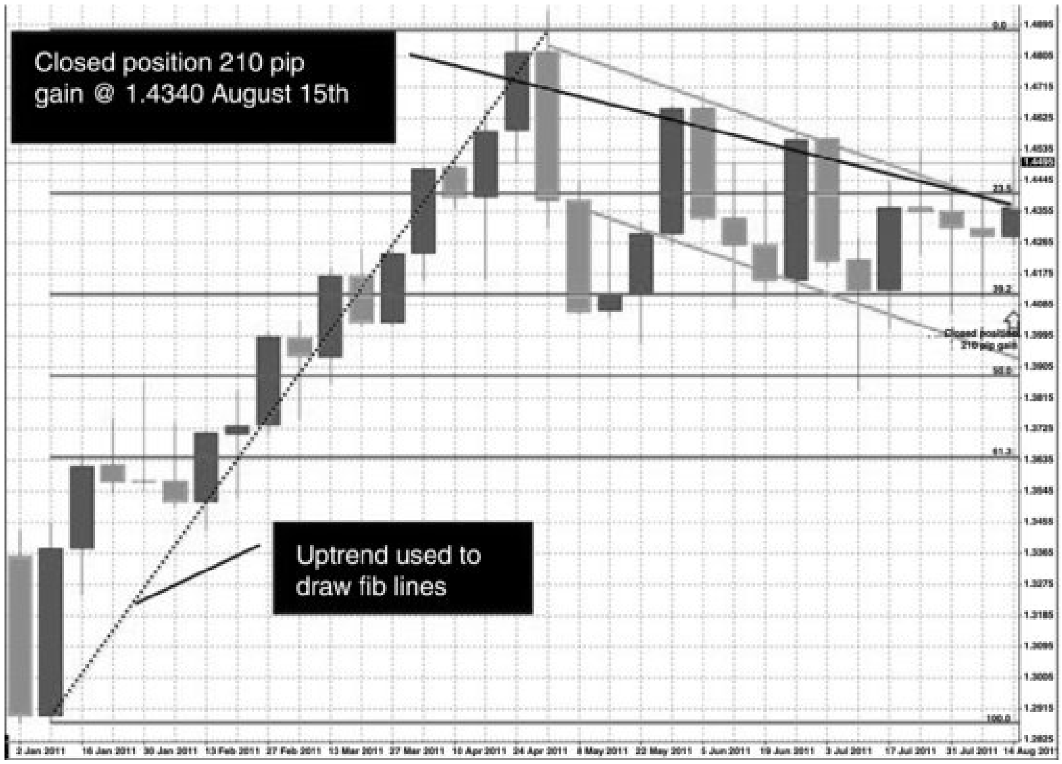
- I'm going long the EURUSD, trading with the daily trend (my chosen time frame, I usually trade based on daily charts) but I'm going against the longer-term trend on the weekly or monthly charts. I wouldn't normally do this but am making an exception here because I have a chance to enter at 1.4130, above what I believe is a strong support level comprised of the 38.2 percent Fib level at 1.4110, and a price support level of 1.4060 that was tested and held twice (on August 4 and 5) within the prior seven trading sessions. Placing an initial stop loss there, my maximum loss is 70 pips. As shown, this allows a likely rrr of between 1:2 and 1:3.
- There is no significant resistance until at least the 1.4340 level, the closing price on August 8 (175 pips from my entry point, a better than 1:2 rrr).
- After that, the next significant resistance is at minimum around 1.4340, based on the opening and closing prices of August 9 and 10. That allows for a 210 pip gain for a 1:3 rrr.
- Neither of these resistance levels are especially strong, so if there are any positive EURUSD developments, they could easily be reached and

exceeded.

- There is potential for even greater rrr. No strong resistance at all until the area around 1.4410 where two kinds of strong resistance converge: the 23.6 percent Fib level and the descending upper channel line dating back to the first week of May.
- There are reasons not to take this trade.
- Long-term fundamentals are mostly "risk off," that is, not supportive of this trade. Given that the planned duration is 1 to 2 weeks only, long-term fundamentals are less important than the short-term technical picture noted previously. U.S. credit rating downgrade and ongoing EU crisis. However, short-term fundamentals have had little direct impact on this pair, given that the fundamentals of the underlying economies of the EUR and USD stink, so predicting multiday moves for the pair based on these has been a waste of time. We don't make trade decisions based on these. Besides, we suspect the Chinese are buying the EUR on dips.
- Overall technical picture for risk assets like stocks and the EURUSD as represented by the Standard & Poor's 500 Index (S&P 500) daily and weekly charts for this period is bearish and not supportive of long EURUSD positions (this pair tends to rise and fall with this index). The index is in a downtrend on daily and weekly charts during this period.

FIGURE 5.6 EURUSD Weekly Chart, January 2, 2011, to August 14, 2011

Source: MetaQuotes Software Corp.



Again, however, the short-term technical picture takes priority. We'll see if this works.

Column 11: COMMENTS, POST MORTEM

- Trade worked, support held, weaker resistance gave way, no clear fundamental driver though a number of possible ones. Just speculation. Switched to trailing stop and achieved better than 1:3 rrr, which I hope will compensate for those trades in which my trailing stop takes me out before achieving at least 1:2 rrr.

Column 12: SCREENSHOT ENTRY and EXIT

- Includes a reference to a page in the trade journal with the screenshot shown in Figure 5.7 of the chart for a visual record which at times, when reviewed later, yields clues about why things did or didn't work out or hints that I didn't pick up originally.

FIGURE 5.7 EURUSD Weekly Chart, January 2, 2011, to August 14, 2011

Source: MetaQuotes Software Corp.

It can include handwritten or other additional comments, observations, or questions for future investigation. For example, look at this same chart later with some momentum indicators like DBBs, MA crossovers, or others, to see if there were additional clues I didn't see at the time.

No. 2: Your Overall Business Plan

This is the other, bigger picture plan you'll need to make though it comes later than the trading journal shown previously, which you should be keeping from your first practice account trades.

This comes later, after you've had enough study and practice trading on demo accounts to have an idea about how to answer some of the following. If at that point you decide you want to pursue trading as a serious money-making venture, you need to make a business plan.

Much of this business plan will be similar in most ways to any business plan, for example:

- Qualifications/skills your staff (you) possess to justify success, and if others are needed, how to attain them. Some skills you'll still need to learn yourself, others can be bought via paid information services. Some can be attained from your circle of trader contacts either in person or via online forums or email contact. If you want exposure to different kinds of trading, you may allocate time and funds to invest with a proven pro through one of the social networks mentioned in Chapter 11.

- Time allocated, day or week.
- Trading capital.
- Equipment or training costs.
- Training period.
- Profit goals.
- Your market niche: trading style, and so on.
- Assorted goals: profitability, education.
- Feedback methods and periodic review of whether these goals are met and what you'll do if they are or aren't met.

Again, you'll need a number of months' background before you can answer some of these. That's okay; you can always adapt your plan as you learn more.

As with any business, management must review monthly or quarterly performance to measure progress and identify what's going well and what needs fixing. You are management.

WHAT CONDITIONS DO YOU NEED FOR SUCCESS?

We conclude this chapter with a review and another look at the commonly neglected questions that you need to ask yourself to understand what kind of trading style and conditions you need to succeed. If you don't clarify these questions, you may find yourself doing everything else right yet somehow dissatisfied even if you're successful.

Are you an extrovert? Do you prefer to learn by doing rather than by reading? Do you want to hear what others are doing and thinking? You may progress better by hanging out in online trade forums or virtual (or actual) trading rooms. Being shut in a quiet room doing research online or from other sources may leave you drained and bored.

Are you more of an introvert, scholar, or natural systems builder? Do you find most chat rooms or forums filled with more noise than signal, so you've no patience for sorting through mounds of mindless half-baked ideas to find a few pearls of serious, well-thought-out ideas? You'll progress better by researching the best books, online sources, or courses to take.

If you need a lot of action and don't mind risk, you'll gravitate to shorter-term day trading styles. Though we don't urge these for beginners, some succeed with this kind of trading, especially if they've enough RAMM skills and the discipline needed to implement them and survive the learning period. If you're averse to risk and more patient, you'll gravitate to longer-term trading methods.

If you're not the introspective type and don't have a clear idea, then you need to invest some time to find out because you'll get a better idea of what trading or investing suits you. Being aware of the questions we've raised at the beginning of this chapter on trader psychology will help. Knowing the question is halfway to the answer. Experimenting with different trading methods via a demo account will go a long way to helping you.

For those with the time and money, you can find online trader coaches who might provide the answers in less time.

SAFETY IN NUMBERS: BUILD A TEAM

You'll reduce your mistakes and increase your rate of progress if you've both mentors and colleagues with whom you can evaluate trading or investing ideas. This powerful combination is standard operating practice in most kinds of professional education (in law and business schools these roles are filled by professors and study groups).

As we'll discuss in Chapter 11, it's easier than ever to find them without even needing to leave your home via the advent of online trader forums and social trading networks.

As with any fruitful marriage or partnership, you want your teammates to share similar goals. That is, short-term high-risk traders should seek out their own kind, as should longer-term more risk-averse traders, and long-term investors seeking to diversify their assets by currency exposure as well as by asset and sector type.

Ideally, your like-minded mentors and colleagues should offer talents and perspectives that differ from yours, so that your collective wisdom is greater than the sum of your individual members. For example, technicians seek out fundamentalists—those focused on Europe pair up with those more familiar with U.S. or Asian markets, *etc.* Alternatively, scholars can focus on reading a wide range of analysis and charts, and seek out less academic types with trader and other financial industry contacts. Those who are more verbally inclined and read a lot of fundamental analysis would benefit from contact with more quantitative types who want to build algorithms.

Notes

1. Mary Buffett and David Clark, "The Tao of Warren Buffett" (New York: Simon & Schuster, 2006).
2. *Forbes*, "Forbes' 400 Richest Americans" (September 2011), www.forbes.com.
3. Alex Howe, "The 15 Best Things Paul Tudor Jones Has Ever Said About Trading," *Business Insider* (September 2011), www.businessinsider.com/the-tk-best-things-paul-tudor-jones-has-ever-said-2011-8#at-the-end-of-the-day-the-most-important-thing-is-how-good-are-you-at-risk-control-15#ixzz1l9omVe7j.
4. John Tierney, "Do You Suffer From Decision Fatigue?" *New York Times* (August 2011), http://mobile.nytimes.com/article?a=829776&f=37.
5. Boris Schlossberg, "Three Men Doing Time in Israel Prison Are Up for Parole" (August 2011), www.fxstreet.com/education/trading-strategies/forex-trading-strategy/2011/08/19/
6. Joe Weisenthal, "If You Had Bought Swiss Franc in 1970…" *Business Insider* (August 2011), www.businessinsider.com/if-you-had-bought-swiss-franc-in-1970-2011-8.
7. Jeremy Wagner and Timothy Shea, "How Much Capital Should I Trade Forex With?" (December 2011), www.dailyfx.com/forex/education/trading_tips/daily_trading_lesson/2011/12/2
8. Just enter the search term "screen capture" into your preferred search engine for the latest free versions of such popular software packages as ScreenHunter, Snagit, and so forth.

CHAPTER 7
Pulling It All Together with Trade Examples

Congratulations; at this stage you've already seen the basics.

Now it's time to pull together some of what we've covered thus far and apply it in real-life trades.

In this chapter we'll:

- Review the steps to identifying and executing low-risk, high potential yield trades.
- Introduce some of the common types or styles of trades.
- Apply these ideas in a few real-life trades from my personal trading journal.

IDENTIFYING AND EXECUTING LOW-RISK, HIGH POTENTIAL YIELD TRADES

You should be trading from daily, weekly, or monthly charts for all the reasons we mentioned earlier in Chapter 3, particularly because indicators and trends are more reliable and stable in these time frames. That means your likely holding period will be days, weeks, or months.

Begin Your Search On Longer Time Frame Charts, Then Zoom In

Here's the basic idea behind how we locate simple, low-risk, high potential trades. Start your search for low-risk trades by scanning charts with time frames that are 4 to 5 times longer than the time frame from which you intend to trade. The first goal is to find low-risk entry points by identifying the long established, and therefore most reliable, s/r areas, because they're where the risk of opening a position is lowest. Here's why.

If price breaches long-term strong support, that's a clear signal that price is moving decisively against you. By entering close to strong support, you can also set your stop loss order relatively close to that support, using the methods discussed in Chapter 5, so that you escape with only a small, affordable loss, ideally one that is ever less than your maximum allowed loss of 1 to 3 percent of your account.

Like a bird of prey, you begin your hunt where you can view of lots of territory. The longer time frame chart allows you to view key s/r points over months or years. Then, if you see something interesting (a pair approaching one of those levels) you swoop in for a closer look on the shorter, time frame chart from which you actually trade, in order to make your final trading decisions. That's where you'll see if you've got a situation that combines a low-risk entry near strong support, with a likely resistance area far enough away from your entry point so that you've a good chance of earning three times as much as what you'll lose if your stop loss is hit, for a 3:1 reward/risk ratio.

This process will be clearer in the following examples.

Consider the Fundamental Context

Note that the longer you think the trade will need to play out, the more important it is that the trade fits with your fundamental analysis for your planned holding period. This is less important if you think the trade will last less than a week or so, unless you're trading based on a specific news item that's due out during that time. However, trades that may take weeks or months are typically based at least in part on some theory you have about how certain fundamentals are likely to play out.

For example, you go long the AUDJPY because you believe markets will be optimistic over the coming weeks or months (favoring risk over safety currencies), or you believe Australia's economic data will be much better than Japan's. You'll see examples of this kind of thinking in the following trade examples. Now let's look at the concepts just covered in greater detail.

Initial Screening on Longer Time Frame Charts

The purpose of your first screening is to find a currency pair that meets the following four criterias:

1. Risk Management Criterion #1: The currency pair is approaching a strong support area that provides a low-risk entry point. For example, by definition, strong s/r levels on a weekly chart will be even stronger on a daily chart, because they're more established than the s/r levels you see on daily charts. You then set your stop loss just far enough beyond this area so that it doesn't get hit by random price movements, but rather only when price has turned far enough against you that you know you were probably wrong about the trade and it's best to escape with a small loss. Thus the stronger the s/r area where you enter, the lower your risk of a losing trade (barring any unforeseen change in fundamentals and sentiment). Once you know your likely entry and stop loss points, you can check if the trade may meet your second criteria

2. Risk Management Criterion #2: Find the nearest major resistance area, because that's where you'd expect to exit and take profits. If the distance from entry (at support) to exit (at resistance) is 2 to 3 times farther than the distance from entry to stop loss, then you may have a 2:1 to 3:1 reward/risk ratio (rrr). We'll know for sure only when we do the second screening.

3. Risk Management Criteria #3-Stop Loss Placement: The stop loss should be far enough away from your entry point so that it does not get hit by normal random price movements, but only by larger moves against you that suggest price may be making a sustained move against you.

4. Money Management Criterion #1: The stop loss should be close enough to your entry point so that you don't lose more than 1-3 percent of your account on the trade.

These are the first criteria for low-risk, high-reward trades. Remember that definitions of support and resistance are the opposite for short and long positions, as discussed in Chapter 3.

Again, we scan for situations that look like they might fulfill the preceding criteria on charts with a time frame approximately four to five times longer than the time frame on which we trade. *For the examples that follow, we trade off daily charts, so we scan weekly charts in the first screening.*

This first screening doesn't take long because we generally prefer to trade only the most liquid pairs. There are only about eight really liquid pairs, and maybe about 20 liquid enough for most of your trading.[1]

In short, we're scanning the weekly charts of these pairs for an entry near strong support, with any likely resistance far enough away so that there's a chance of getting a 1:3 or 1:2 risk-to-reward ratio (rrr).

As we'll see, *the deciding factor in whether you take the trade is if the second* *screening on the daily charts shows you can get a combination of stop loss, entry, and exit points that allows the desired rrr yet does not cost you more than 1 to 3 percent of your account if the stop loss is hit.*

For the purpose of illustration, assume just one entry and exit, and mostly avoid consideration of variations like trailing stop losses and partial or staged entries and exits.

When we talk about strong support or resistance, that means we want to see at least one well-tested kind of support, ideally as many kinds as we can get, all converging on a narrow price range. Just to remind you, these include:

- Prices that have clearly been support or resistance in the past; often these are some kind of round number, because traders tend to think in round numbers.
- Trend lines and/or their variations like channels, moving averages, and Bollinger Bands.
- Fibonacci retracements.
- Chart patterns, besides being useful in their own right, also provide additional evidence of s/r points. For example, if a head-and-shoulders pattern is about to complete its second shoulder or if price is about to hit the neckline of that pattern, that price level takes on added significance as a possible s/r point.

Again, there are many more indicators you could use, and we haven't even covered momentum indicators yet. But these give us enough for some trading examples from my trading journal.

Second Screening

Once you've found some situations that meet these criteria on the weekly charts, the next step is to see if the same criteria for low-risk, high potential reward trades are present in your chosen time frame, in this case, daily charts.

Why bother with the first screening? As noted previously, the longer time frame chart shows you stronger s/r levels. We're hoping to find an entry point on the daily charts that is near the stronger s/r areas found on the longer time frame, in this case the weekly charts. If we find that a pair nears its weekly s/r, we'll know it's worth doing a second screening on the daily chart.

Again, the deciding factor in whether you take the trade will be if the daily chart (or whatever timeframe from which you trade) shows the combination of stop loss, entry, and exit points that allow the desired rrr, yet will not cost you more than 1 to 3 percent of your account if the stop loss is hit. To reiterate:

- The stop loss is far enough past strong support so that it would get hit only by strong price moves that signal your trade idea was mistaken, and close enough so you're out with a small but affordable loss that doesn't exceed 1 to 3 percent of your trading capital, so you can afford lots of mistakes, recover your losses, and be profitable
- It's two to three times closer to your entry point than is your profit-taking point, so you have a 1:3 or at worst 1:2 rrr.

Regarding stop loss placement, remember that there are different methods. These include:

- The Intuitive Approach: Study the chart for the relevant period and define the price range for the normal up and down oscillation of price. You want your stop loss to be no closer to your entry point than that distance, ideally a bit more than that, while still not causing a loss greater than your 1–3 percent limit. This is a very simple approach and hence the one we choose to use in the example that follows. This method involves a heavy dose of personal judgment.
- The Somewhat More Objective Approach: Set distance from entry point to stop loss based on fixed percentages (also a judgment call) of the Average True Range (ATR), as mentioned in Chapter 5, or other formula or statistically based methods to ensure you don't get shaken out of your trade due to normal price fluctuations.

Regarding rrr, if the trade is in the direction of a very strong trend, it's safer to be more aggressive, so we're more likely to accept a 1:2 rrr.

In the end, you're always trying to strike a balance between the size of the loss if hit versus the risk of being stopped out. In other words, the farther away your stop loss is from your entry point, the bigger the loss if hit but the lower the chance of being hit by random price fluctuations rather than a real move against you.

If the second screening shows that you can get the desired rrr without risking more than 1 to 3 percent of your capital, you take the trade near strong support. The precise entry level you choose is a judgment call. You're trying to strike a balance between entering at the best price and not being so greedy that price never hits your order and you miss the trade altogether.

Third Screening to Monitor Trade Progress

This screening occurs on a chart time frame four to five times shorter than your trading time frame. For example, if you're trading on daily charts, then use two- to four-hour candles. This one usually doesn't determine whether you take the trade. Instead, it's mostly just to identify short-term s/r points that are likely to be temporary, so you're not surprised if the trend halts or reverses around these zones. Rather than getting worried, you expect a progressing trade to temporarily halt or even reverse. These areas can also serve as points where you augment or reduce your position if you're using staged entries and exits.

At times, this screening may alter your strategy. For example, if price repeatedly struggles to break through the resistance you see on the four hour chart, that might indicate that the longer-term trend may be failing, especially if important new information just came out. Similarly, if there's too much quality short-term resistance too close to your entry, you might elect to enter in stages, saving most of your planned position until price clears that resistance area. Alternatively, if there are better opportunities or if breaking news casts doubts on your conclusions from the second screening, you might change your mind about the trade and just get out.

For the sake of brevity and simplicity, the following trade examples omit the third screening.

TYPES OF TRADES

While any good trader should be using most of the techniques we cover, within these guidelines there are different types or styles of trading for any given time frame. Here's a brief listing of the most popular styles. The idea is just to acquaint you with these terms. There are whole books written about each of these trading styles, so use this listing as both an introduction to the vocabulary of trading styles and as a starting point for further research into the styles that interest you. Just take these as general labels, because trades often combine elements of more than one style. The most popular types of trades include:

- Position trading—taking a longer-term position to ride a trend: Trading a longer-term trend (multiple days, weeks, or months) typically involves entering on some kind of pullback to strong support, waiting to see if that support holds, and then going long soon after longer-term trend bounces back up from support and resumes (and vice versa for short positions). This style is associated with longer-term trends (so pay attention to the relevant long-term fundamentals).

- Trend trading: This type is essentially the same as position trading but is associated with shorter-term trends, and is thus mostly based on technical analysis of trend strength. Again, the goal is usually to enter after some kind of support, and to ride the trend as it resumes. Also, when shorting in order to ride a downtrend, a pullback means a brief move up to a near-term high that serves as support.
- Swing trading: This type involves entering just after a trend reverses briefly, then resumes. You enter just as price is pushing or “swinging” past its former resistance, which indicates that the trend has found new strength. Your technical analysis will need to focus not only on s/r points but also on:
  - Momentum indicators (Chapter 8) that either telegraph a possible coming trend reversal or confirm it.
  - Timing or wave indicators like Elliott Wave, Fibonacci, or Gann style analysis (Chapter 9).
- Range trading: This is when you identify a pair that is locked in a sideways (or nearly so) trading range or channel and you attempt to go long at the lows and short at the highs. As mentioned earlier, when doing this with strongly trending channels. This kind of trading works when you have both flat or weak trends, and wide channels.
- Momentum trading: This involves locating pairs showing signs of accelerating trends via momentum indicators covered in the next chapter.

Like swing traders, momentum traders are less focused on entering on a bounce off support. Instead, they want to enter just after price as broken through key resistance, which suggests a new stage in the trend.

In sum, position, trend, range, and swing traders seek to buy low and sell high. Momentum traders seek to buy high on breakouts past resistance because these suggest price is making its next run higher.

Again, with all of these styles, the longer you think you'll be holding the position, the more you need to consider longer-term fundamentals because they'll have more time to influence the pair.

TRADE EXAMPLE 1: A SWING TRADE

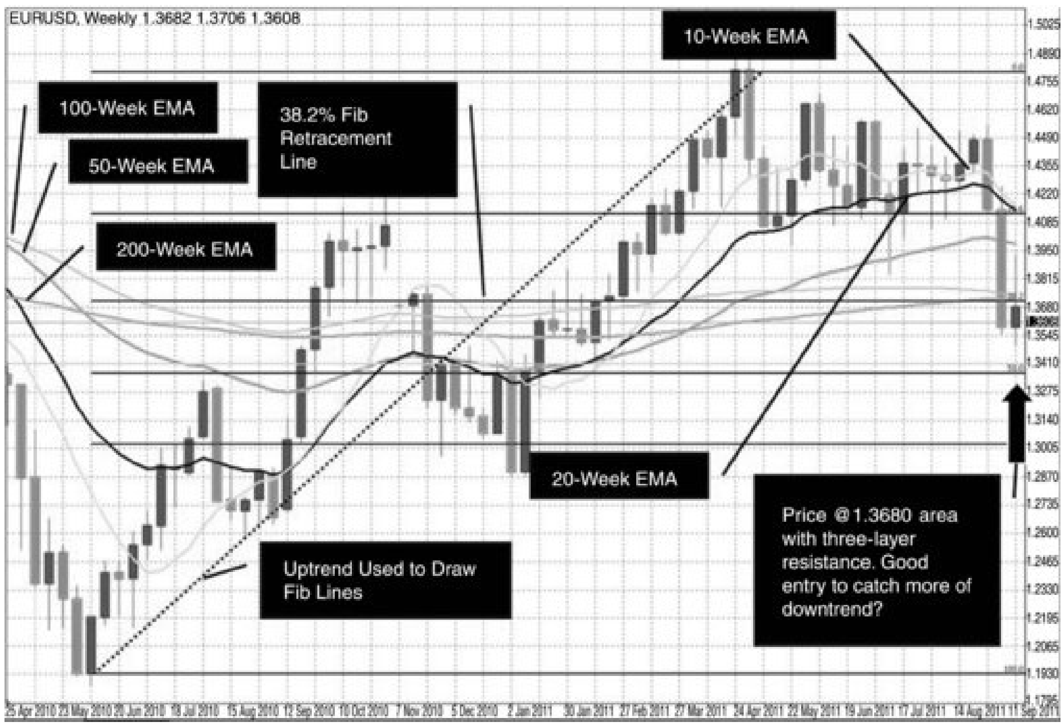
Here's a simple example that pulls together much of the previous discussion. I label it a swing trade, though as I'll discuss in the conclusion it's really a hybrid combination of a position or trend trade with an attempt to play a brief reversal that gives the trade its “swing” element. One of the reasons I chose it is to illustrate how the trade types are just general labels, as the distinctions between them are often blurred.

Initial Screening

On Sunday, September 18, 2011, while scanning weekly charts, I find the following intriguing situation for the EURUSD shown in Figure 7.1.

FIGURE 7.1 EURUSD Weekly Chart, May 16 to September 11, 2011

Source: MetaQuotes Software Corp.



What Initially Attracts Me

The pair has been in a strong downtrend for the past three weeks but bounced in the prior week, putting it back near strong support for a short trade if the downtrend resumes. Specifically, we note that the pair's most recent weekly close is 1.3680 and it has recently broken a major support at 1.3700, a level that included the:

- 100 week exponential moving average (EMA)
- 200 week EMA
- 38.2 percent Fibonacci retracement level of the uptrend from the week of June 6, 2010, to the week of May 1, 2011

We also note that the shorter duration (and more sensitive to recent price momentum) 10-, 20-, and 50-week EMAs have begun turning lower, a sign of downward momentum that further supports the case for shorting the pair. We'll discuss more on using moving average crossovers to discern momentum changes in Chapter 8.

Fundamental Analysis Context—Weekly Chart

During the prior week, the pair had bounced higher, back close to this support level. As I noted in my weekly review at the time, I believed the move was based on false hopes that the EU situation would improve soon and that the EURUSD would rise.[2] The prior week's bounce seemed like a possible new chance to enter a short EURUSD position right back near strong support around the 1.3700 area (remember that support for a short position is the likely high for the period in question).

So I suspect we may have a "short the rally" situation—that is, a rally unlikely to last that may allow promising entry points for new short EURUSD positions near strong support.

Technical Analysis (TA)—Weekly Chart

First, there are the technical factors that initially attracted me to this trade, on the weekly chart, like the strong three-week-old downtrend that is still very much intact after the prior week's small bounce back up to near the 38.2 percent Fib retracement line. So we may have a safe entry point around there.

Then, we also may have a temptingly distant exit point. According to the indicators displayed, there's no significant resistance to a further downside until the 1.3400 to 1.3275 area, where there may be resistance from both:

- The 1.3400 price level itself (note how often it served as an s/r point in the past).
- The 50 percent Fibonacci retracement nearby at 1.3366.

With the current price around 1.3680, that leaves almost 300 pips of room for profit according to this first look, assuming an exit around 1.3400. The question is: can I find a low-risk, high potential yield entry point? That is, an entry point with a reasonable stop loss that allows both:

- Enough room so that I don't get stopped out by random movements but rather only if the pair is really moving higher and my thinking was wrong.
- A loss that is a third or less the size of my gain according to what I see as

likely strong resistance.

Second Screening

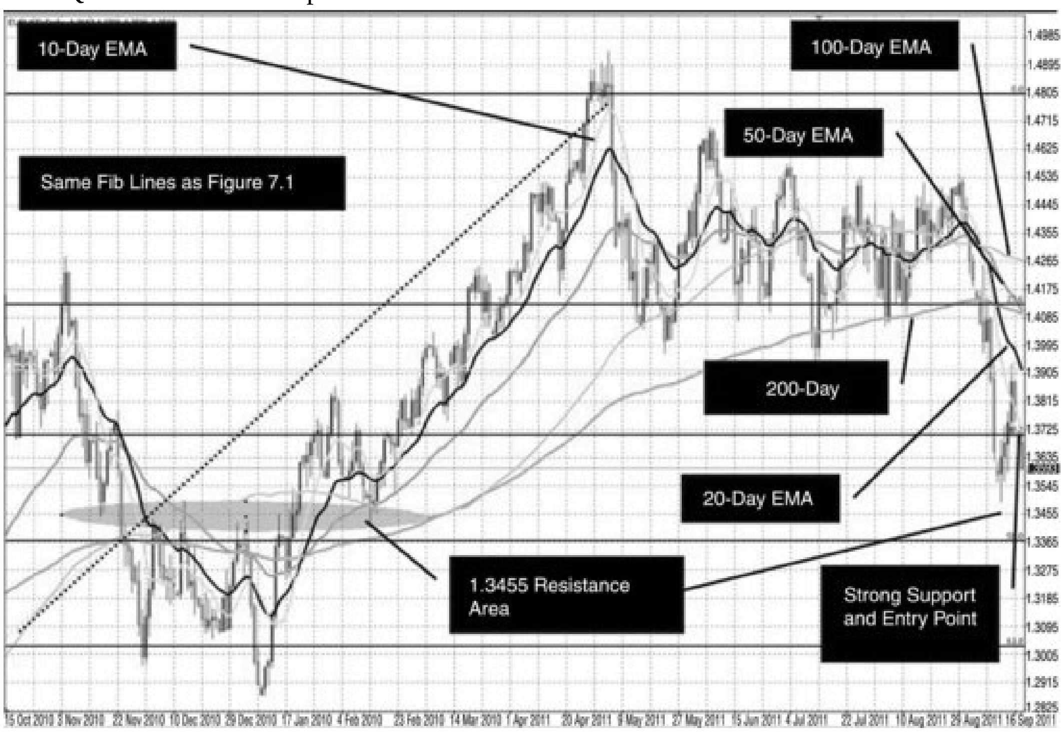
To find out, let's zoom in to look at this possible entry point on a daily time frame, because we appear to have a good entry point at a near term high for a short EURUSD trade in this time frame.

TA and RAMM Considerations—Daily Chart

We now need to see where resistance might be on the daily chart shown in Figure 7.2. First we look for s/r points over a longer period.

FIGURE 7.2 EURUSD Daily Chart, October 15, 2010, to September 16, 2011

Source: MetaQuotes Software Corp.



No real resistance until about 1.3455, which was an s/r point from November 2010 to February 2011 (highlighted with the ellipsis). The Fibonacci retracements are the same as in the weekly chart (Figure 7.1). Note the strong downward momentum indicated by the shorter-term moving averages crossing below the longer-term moving averages.

I zoom in further for a closer look on the daily chart shown in Figure 7.3 to the period of August 10 to September 16, 2011, in order to get a sense of where my stop loss should be.

FIGURE 7.3 EURUSD Daily Chart, August 11 to September 16, 2011

Source: MetaQuotes Software Corp.

We see that the nearest meaningful high (support) is in the 1.3915 to 1.3865 area highlighted by the ellipsis.

RRR Evaluation

In sum, the daily chart for the EURUSD indicates the potential gain and potential loss on the trade.

Potential Gain: Likely Profit-Taking Point

There's no likely resistance until around 1.3455 per the chart, though it's possible the 38.2 percent Fib level at about 1.3700 could stop us, so I'd consider switching from a fixed to a trailing stop loss order just before that level.

It's now Friday, September 16, 2011.

Planned entry point:	1.3815
Planned exit point:	1.3455
Potential gain:	0.0360 or 360 pips

Potential Loss: Stop Loss Placement and RRR

I'll keep it simple and just refer to recent highs as a guide for setting a stop loss, and see if that's small enough compared to the likely gain from the pair falling to the 1.3455 area.

The recent highs are around the 1.3915 to 1.3865 area.

If I use those as a guide for placing my stop loss at 1.3915 (the high of the prior week), then if this stop loss is hit my loss is:

Planned entry point:	1.3815
Planned stop loss:	1.3915
Potential loss:	0.0100 or 100 pips
Risk-reward ratio	100/360 = 1:3.6, exceeding our 1:3 criterion

Assume that 100 pip loss represents less than 3 percent of my total trading account equity, so I'm within my money management guidelines.

I'd plan on switching to a 50 pip trailing stop loss order at around 1.3720. I choose 50 pips because it represents a good chunk of the recent daily volatility, while still allowing me to break even (or do slightly better) after expenses.

Fundamental Analysis Context

I know there is a meeting of European finance ministers Friday and Saturday discussing the latest Greek bailout package. Greece has failed miserably to meet its deficit reduction targets, so there's a good chance of the meeting producing either its usual disappointing lack of results (bearish for the pair) or even a chance they'll get tough with Greece and demand further budget cutbacks, which would put the Greek bailout in even greater doubt, which would likely send the EURUSD down.

In sum, it appears that we have a low-risk, high potential reward trade on the daily chart from the perspectives of:

- Money management

- Risk management
- Technical analysis
- Fundamental context

If the price moves in our favor, we might do better than the 360 pips by switching to a trailing stop once we gain ∼150 to 200 pips (so that we get at least a 1:1.5 to 1:2 rrr as a worst-case scenario) and the EURUSD moves below our anticipated 360 pip drop. I'd have to consider conditions at the time to determine how wide the trailing stop should be.

Conclusion: We Take the Trade

We take this trade with the stated entry and stop loss points, and probably move up our stop loss and change it from a fixed to a trailing stop once price moves in our favor, as noted. However, we're going to take only a relatively small position, half of what I'd like to do. Why?

Note again that this is *not* really a classic swing trade, which would wait until we clear the recent low around 1.3570, and thus truly swing past this most recent resistance. I'm being more aggressive and getting in earlier for two reasons:

1. The fundamental considerations suggest the odds favor more downside. That was decisive.

2. The entry point is near strong support for entering an existing trend (making this a mix of position and swing trade).

So I want to take a more aggressive position. There are many who would say I'm being too aggressive and should wait. However, my stop loss and position sizes are not large, and the rrr is excellent, so I make a judgment call and enter with half of what I would like to put in, and may add to the short when the EURUSD closes below 1.3565.

Here's one last word about the importance of trying to understand the fundamental context in which the trade occurs. Throughout the EU sovereign debt and banking crisis, trading the EURUSD was hazardous. There was constant risk that the crisis could become another Lehman Brothers event that could crash global markets and spark another recession or worse. Thus the real drivers of this crisis were political decisions that are inherently difficult to predict. Just when a default would seem imminent, a last-minute rescue deal, or a mere rumor of one, could send the pair higher. The opposite kind of news could send the pair crashing lower.

Trade Postmortem: What Happened

As shown in Figure 7.4, the trade worked as planned.

FIGURE 7.4 EURUSD Weekly Chart, June 6 to October 30, 2011

Source: MetaQuotes Software Corp.

Specifically:

- Anticipated support (or resistance for our short position) held due to hopes that there would be a decisive solution to the EU debt crisis in the coming weeks.
- As the long down candle for the week of October 30 shows, these hopes proved incorrect. Our bearish view of the EU situation continued to be correct after a brief rally as the EURUSD pair put in another lower high, setting up another move lower in the continued downtrend of the EURUSD.

So this trade had a happy ending. However, there's a reason we want those nice high risk-to-reward ratios when we can get them. We want to make enough on the winners so that we can be wrong more often than we're right, or to provide extra cash reserves so that we can afford to be patient when we're having trouble finding low-risk, high potential yield trades.

TRADE EXAMPLE 2: A BREAKOUT TRADE

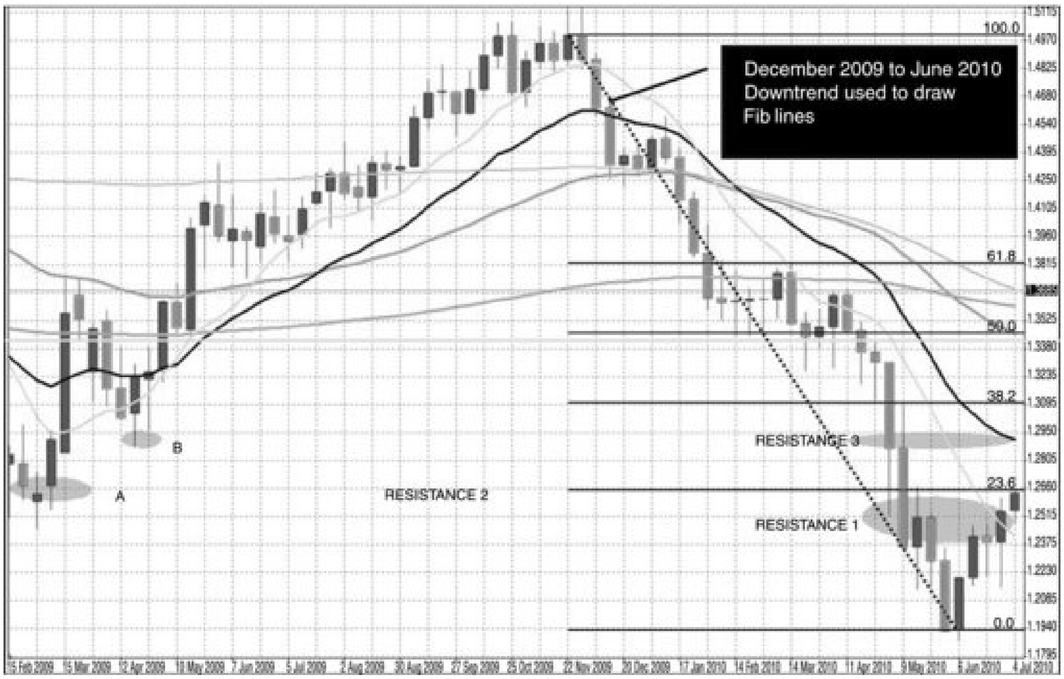
Here's another simple trade example, this time a breakout type of trade.

First Screening

On Sunday, July 11, 2010, while scanning weekly charts, I find the situation for the EURUSD shown in Figure 7.5.

FIGURE 7.5 EURUSD Weekly Chart, February 15, 2009, to July 4, 2010

Source: MetaQuotes Software Corp.



What Initially Attracts Me

If the EURUSD can make a decisive break above the 1.2700 area labeled Resistance 2, this would then become a strong support and possible low-risk entry point ~1.2700, which we'll then examine more closely on the daily chart in the second screening.

The EURUSD has already broken through two resistance levels at 1.2375 (bottom of ellipsis labeled Resistance 1) and at 1.2515 (middle of ellipsis labeled Resistance 1). Now it may be ready to break through the next area at around 1.2660 to 1.2700 (labeled Resistance 2), which would be a bullish sign of strength for the current uptrend because:

- This price level was a significant s/r point in the past, from the weekly candles of February 15 to March 15 (ellipsis A), and also for the weekly candles of May 2, 16, and 23.
- It has the 23.6 percent Fibonacci retracement level for the downtrend that ran from the weekly candle of November 29 to that of June 6.

- The prior week's high was around 1.2720.

If the pair can make a decisive break above the prior week's high of about 1.2720 (the upper extreme of the July 4 candlewick), that breakout could signal the next move higher, so I might want to enter a long EURUSD position around that price.

Fundamental Analysis Context—Weekly Chart

Though long-term prospects for the EUR may be very cloudy, we have the ingredients for some kind of further rally:

- The EURUSD is in a five-week uptrend after hitting multiyear lows around 1.2000 on fears that Greece would default. Given that the newly passed €750 billion rescue package is currently believed to be able to cover Greece for the coming year and also the next most likely default threats, Portugal and Ireland, these default threats have passed for now, and no other peripheral economy poses an immediate default threat. None of the long-term problems at the root of the EU sovereign debt and banking crisis have been addressed, but they've likely been deferred long enough for a tradable multiweek rally, as suggested by the current five-week rally. I may not personally believe the EUR has a bright future, but that's irrelevant. The uptrend is telling me that the other traders believe it at least has a tradable rally. If the pair breaks above the area labeled Resistance 2, that will be further confirmation of that belief and an indication that the uptrend has room to run.
- The pair is coming off multiyear lows, and so could well retrace a chunk of the December 2009 to June 2010 downtrend shown in Figure 7.5.
- An upcoming stress test of EU banks will likely paint a rosy picture, and while everyone knows in advance that the results will show that all is in order, this little PR exercise may still provide an excuse for a further rally. I suspect the market wants that excuse, given that the primary fundamental driver of the recent downtrend (threat of Greek default) has passed and the EURUSD pair is coming off multiyear lows and so may be ripe for a further rally.

Technical Analysis (TA)—Weekly Chart

As noted above and shown in Figure 7.5 the pair has broken past recent resistance at 1.2500 (Resistance 1) and now faces resistance around 1.2660

(Resistance 2), which has served as a strong weekly s/r point from mid-February to mid-March in 2009 and for much of May in 2010, and from the 23.6 percent Fib retracement of the downtrend.

As noted earlier, if it can break past the prior week's high around 1.2720 (which would be an entry point), there is no significant resistance until about 1.2900 (Resistance 3), which is the next likely strong resistance because:

- 1.2900 was the s/r price level in April 2009 (ellipsis B).
- 1.2900 was a recent s/r price level in early to mid-May 2010 (Resistance 3).
- The 20-week exponential moving average (the descending line that touches the right side of the Resistance 3 area ellipsis) also converges on this area.

From 1.2720 to 1.2900 we have about 280 pips, depending on our exact entry and exit points. Again, we assume only one entry and exit to simplify our presentation. That implies that for this trade to work we'll need to see if a stop loss can be placed no farther than a third to a half of that distance from the entry point so that we get a 1:3 or 1:2 risk-reward ratio.

Second Screening

The two questions we now seek to answer are:

1. Can we find a stop loss that meets our risk and money management criteria given our planned entry around 1.2700?

- Risk Management: Not likely to be hit by random price movements but rather only if the breakout is truly failing, yet less than 90 pips from the entry point (about a third of the potential gain for a 1:3 rrr) or at least no more than 140 pips from the entry point (for a 1:2 rrr) from our preferred entry at a price that suggests a decisive breakout. The 90 pip limit means a stop loss no lower than 1.2630, and the 140 pip limit means a stop loss no lower than 1.2560.
- Money Management: Doesn't risk more that 1 to 3 percent of our capital.

2. Is there any support or resistance we need to consider for planning entries or exits that we didn't see on the weekly chart?

For the answers to these questions we zoom in on the daily chart for the prior weeks (see Figure 7.6).

FIGURE 7.6 EURUSD Daily Chart, April 16 to July 9, 2010 (Ends Week Beginning Sunday, July 4, 2010)

Source: MetaQuotes Software Corp.

FIGURE 7.7 EURUSD Daily Chart, July 9 to October 1, 2010

Source: MetaQuotes Software Corp.

TA and RAMM Considerations—Daily Chart

For an entry around 1.2700, the TA and RAMM picture is not great. Here's why. While there is some minor resistance around 1.2735 (Resistance 1), there is stronger resistance around 1.2800 (Resistance 2) from both the price level itself and the 100 day EMA.

RRR Evaluation

To see if this trade offers the rrr we want, we first consider stop loss placement.

Stop Loss Placement

There isn't firm support until around 1.2435, where four kinds of support converge (at the bottom of ellipsis B):

- The 1.2435 price area itself (ellipsis A)
- The 10-day EMA
- The 50-day EMA
- The 20-day EMA

So if we enter at 1.2700, we could get stopped by resistance at around 1.2800 for only a 100 pip gain, and a trustworthy stop loss around 1.2435 would, if hit, inflict a 265 pip loss. That's a 2.65:1 rrr, the opposite of what we want. No, thanks.

Before we give up, here's another idea. What about if we entered at a breakout above Resistance 1 and Resistance 2 at around 1.2830, with an eye to ride the EURUSD higher until the next significant resistance area between the 38.2 percent Fibonacci retracement (the same one as on the weekly chart) and the 200-day EMA at ∼1.3145?

Potential Gain: Likely Profit-Taking Point

Planned entry point:	1.2830
Planned exit point:	1.3145
Potential gain:	0.0315 or 315 pips

Potential Loss: Stop Loss Placement and RRR

We still don't have any trustworthy support until around 1.2435, given that the 23.6 percent Fib retracement did not provide strong s/r back in May 2010 on the daily chart.

Planned entry point:	1.2830
Planned stop loss:	1.2435
Potential loss:	0.0395 or 395 pips
Risk-reward ratio	395/315 = 1.25:1

Again, more risk than reward, not tempting. Given that the likely loss is higher than the likely gain, we needn't even bother considering whether this trade risks less than three percent of our account.

Fundamental Analysis Context

There is nothing to add from the fundamentals mentioned earlier.

Conclusion: Know When to Walk Away

We pass on this one. Yes, I know you're thinking, Cliff, WTF? This is supposed to be a full real-life trade example. Baby, there is *nothing* more real-life about trading than investing time and effort to study a trade, and then concluding it's not worthwhile.

Is this as exciting a conclusion as opening a new trade? No. So what? If you want action while sitting at your computer, play video games.

Was this analysis wasted time? Hardly. As you'll learn if you start taking questionable trades out of a need for some action, some of your most profitable trading decisions will be to reject trades that don't meet your standards, thus avoiding a loss.

Hey, a penny saved is a penny earned.

Trade Postmortem: Was I Right?

The next question is: did I just blow an opportunity? Have I just become the trading version of Peter Best, the original Beatles drummer, the one whom Ringo Starr replaced just before they made it big? Or much worse, have I become the trading version of Ronald Wayne? He's the little-known third founder of Apple Computer (along with Jobs and Wozniak) who sold his 10 percent stake for $2,300. As of this writing it would be worth about $22 billion, and would have made him among the world's top 20 richest people.[3]

Ah, the road not taken.

Fortunately, we have no regrets this time.

Our maximum affordable stop loss was 140 pips. From our 1.2700 entry that would have been 1.25600.

As we can see in Figure 7.7, my stop loss would have been hit a few days later on July 13, when the low was about 1.2520. So in the short term, I was definitely right.

However, even if I had missed an opportunity, that would have been okay, because the rrr was terrible. With a 1.25:1 rrr, I'd have to be right on over 60 percent of my trades just to break even. That's too much risk; the odds are against me. Those odds would catch up to me eventually, as surely as they get most amateur gamblers in casinos.

The Second-Guessing Game

However, if I wanted to second-guess myself about this trade, I could look at what happened after that July 13 exit.

If I had taken on extra risk with a wider stop loss (and thus a lower rrr), stayed in the trade, and put on a trailing stop of, say, 20 to 50 pips (depending on a variety of variables) once it moved about 50 to 100 pips in my favor to lock in some profit, I could have probably gotten out during the July 21 pullback (candle A) somewhere around 1.2865 (50 pips from the high of 1.2915, assuming a trailing stop of 50 pips) for a gain of 165 pips from our 1.2700 entry at about an rrr of about 1:1, maybe worse. That's poor risk management because it means I have to be right on most of my trades to be profitable, which isn't a great assumption for most traders.

If I had somehow stayed in the trade, either with a wider fixed or trailing stop, I might have ridden it higher to somewhere around the early August highs of 1.3200 (candle B on the chart, a gain of 500 pips from our 1.2700 entry). Again, however, this would have required a very wide fixed initial stop loss or a nearly 200 pip trailing stop loss in order to have stayed in during the July 21 pullback (candle A). That's a lot of risk considering our initial goal was only 200 pips, and again gives us about a 1:1 risk-reward ratio, which means we need to be right most of the time to be profitable and that we're exposed to much larger losses. As illustrated in Appendix E, big losses hurt us more than big gains help us.

This case of taking on extra risk for potentially winning trades brings us to another very key lesson in how to have a professional trader's mindset.

MORE KEY TRADER PSYCHOLOGY: DISTINGUISHING BETWEEN GOOD TRADES AND WINNING TRADES

A winning trade is not a good trade if you took on too much risk, because that habit is likely to kill you in the end.

A good trade is not necessarily a winning trade. If you had a good plan, stayed with it, incurred a small but affordable loss, and then learned something from the trade, you just had a successful trade. You're keeping the odds on your side, so, like a casino, you should be profitable in the long run as long as you refine your methods and systems and keep risk low.

Would higher-risk alternatives have been better trades in retrospect?

No! *Any profits from higher-risk trades would have been more a matter of luck than skill.* Like a casino, we take calculated risks, but only trade when the odds are in our favor.

Eventually the odds will catch up with traders with poor (or nonexistent) RAMM and who regularly trade with risk-to-reward ratios around 1:1 or worse, and they'll join the 80 percent or more of forex traders who fail.

I'm not saying anything original here, and pardon me for repeating myself, but it's really worth repeating.

If you followed your plan and it included proper RAMM, *that* is a good trade even if you missed out on profits or even took a small but acceptable loss. You'll live to fight another day, unlike the reckless and undisciplined traders. Once you find a system (and style) that works, you'll be able to execute it and be consistently profitable.

Pat yourself on the back, pour yourself a good glass of something, study the trade and strategy for possible mistakes or faults, and move on. These things happen, a lot. That's why we love trades with risk-to-reward ratios of 1:3 or better. Our conservative assumption is that most of our trades won't work out. As long as we're profitable at the end of the month, that's fine.

Markets are hard to predict, and that is what you're trying to do. So part of having realistic expectations is to accept that you'll have a lot of losing trades, even a majority of losing trades.

As mentioned in Chapter 5, if you need a certain percentage of wins to keep from getting discouraged, consider taking partial profits early on trades that are moving in your favor. Your rrr may fall to below 1:2 overall, but you'll be happier and able to continue trading. You'll also be able to build confidence that may allow you to accept more losing trades in exchange for higher profits as you mature as a trader.

Notes

1. Because we generally prefer to trade only the most liquid pairs, there are only 8 to 9 really liquid pairs, the EURUSD, USDJPY, GBPUSD, AUDUSD, USDCAD, USDCHF, EURJPY, and EURGBP, NZDUSD. Throw in some of the more popular EUR, JPY, and GBP crosses (like the EURCAD, EURCHF, AUDJPY), and you're up to ∼12. Then maybe add the SEK, NOK, HDK, and SGD combined with some of the others for some added exposure to hard money (low debt/GDP economy) currencies, and you have around 12 to 20 pairs at most for almost all of your trading.

2. Cliff Wachtel, "Lessons From Last Week's Market Movers: Faith, Hope and Charity to the Rescue" (September 2011), http://seekingalpha.com/article/294253-lessons-from-last-week-s-market-movers-faith-hope-and-charity-to-the-rescue.

3. John C. Abell, "Apple Co-Founder Ron Wayne's Long, Strange—and Sad—Trip," *Wired* (June 2010), www.wired.com/epicenter/2010/06/apple-co-founder-ron-waynes-long-strange-and-sad-trip/.

CHAPTER 11
Newer, Smarter Methods

For those seeking simpler ways to tap the potentially faster profits from short-to medium-term (ranging from minutes to weeks) trading of forex, with more controlled risk, we introduce two new and very useful instruments:

- Forex social trading.
- Forex binary options.

Both have come out only over the past few years, and are the fastest-growing sectors of the forex industry for good reason. They meet an important need of traders to tap forex trading in ways that are easier and less time-consuming, and for many traders they offer a better chance of profiting.

FOLLOW THE LEADERS: FOREX SOCIAL NETWORKS AND TRADING

Between 2007 and 2009, the first social networks and social trading sites showed promise for stock investors,[1] so it was natural that the idea of tapping crowd sentiment via social networks, and copying the moves of top traders via social trading, would quickly be applied to the rapidly growing forex trading scene.

The first social trading networks appeared in late 2010 and are on their way to becoming ideal solutions for many investors seeking forex exposure and diversification but who lack the time or expertise to trade successfully on their own.

The trading networks evolved from an only slightly older and equally valuable new tool, forex social networks.

What Are Forex Social Networks?

As retail forex trading gained popularity over the past decade, forex social networks arose to fill a massive information vacuum. Compared to other financial markets like stocks, retail forex is still in its infancy and is still largely unknown to mainstream investors. It's neglected by the mainstream media, and whatever coverage it gets tends to be superficial and often misinformed, as noted earlier in Chapters 1 and 2. Retail forex trading was born online; it was only natural that this information vacuum would be filled by online sources. These were filled by a combination of:

- Dedicated forex content sites: DailyFX.com, ForexFactory.com, Forexpros.com, DailyForex.com, and others.
- Content sections of forex broker sites: Some provided good analysis, some little more than news summaries. Unlike the content sites, however, they avoided specific trading advice given brokers' legal and liability concerns.

A huge part of any professional's on-the-job training is the input from mentors and co-workers. Because most forex traders typically work alone at home, online forex social networks have filled much of that workplace role as a source of practical advice and news. Whether they're seeking new opportunities or trading the same pairs and time frames, traders can easily share information and critique or validate each other's trade ideas or methods.

The first to attempt to fill these voids were Forex forums found on some of the content sites like BabyPips.com, ForexFactory.com, ForexP eaceArmy.com, Forexpros.com, and DailyFX.com. They offered a venue for exchange of information and advice among traders but lacked the more personal, user-profile-oriented interface of a true social network like Facebook. There are also sites such as ZuluTrade and Tradency that solely offer automated strategies, which could be seen as a kind of social trading, but these still lack the complete social interaction of the forums. Then, over the past three years, came the first true forex social networks that better filled these needs. The most prominent are such websites as Currensee, eToro's OpenBook, FxStat, and Myfxbook.

While the definition of a social network is not clear-cut, for the purposes of this discussion we'll loosely define it as a website that puts greater emphasis on user profiles and trading credentials than a typical trader forum does.

In their original forms as of 2009, these nascent forex social networks offered lots of advice and interaction, but they still lacked a way to distinguish the real experts from the mere posers who were better at getting attention than at trading. The sites lacked a means of accountability, an easy way for users to identify who was worth following and who was just good at getting attention.

What Is Social Trading?

Then in late 2010, Currensee and eToro took social networks to the next level.

They went from being marketplaces of actionable ideas to those of actual traders. They began offering social trading, a service that allows your account to automatically mimic the trades of one or more chosen expert traders. To help you identify the top traders most suitable for your needs, these services include trader rankings complete with detailed data on their styles, performance, maximum drawdown, and other risk data, experience, and so on.

Most major brokers are either linking up with existing social trading services or building their own. Why? Because social trading fills an important unmet need, a shortcut to trading success without needing to trade yourself, but with better transparency and lower entry costs than with traditional managed accounts.

As we'll see later, you're more likely to actually make money by letting an expert do it for you. For those interested in becoming star traders themselves, they can raise their chances of making money sooner by using a portion of their accounts to trade via experts until they reach a similar level of performance. For those who just want some exposure to forex trading without as much work, here's the solution.

How It Works: The Highest Form of Flattery

Basically, you select one or more of your favorite experts based on the data available on them, and set up an account that mimics their every trade, either automatically or only after your approval (depending on the broker).

Experts are compensated based on performance measures that vary from site to site, such as profitability and number of followers.

We'll focus on the two big players, Currensee and eToro.

EToro is a forex broker, and requires having an eToro account in order to follow its experts.

Currensee is not a broker; it's a pure social network and social trading site. You set up an account, or part of an account, with a third-party broker and link that account to Currensee. You then select the trader(s) that your account will mimic.

When that star trader makes a trade, your linked account simultaneously makes the same trade automatically, or notifies you and awaits your approval. This use of hired expertise makes social trading similar to managed accounts, with the advantages of lower entry costs, greater accountability, more transparency, and far greater ease of switching between experts. You always know how your chosen traders are performing in real time by a variety of measures and how they compare to others. If you see that a chosen trader is underperforming, you can switch over to another.

Risks of Social Trading

In theory, having a proven pro trade for you should vastly improve your odds of making money. There are still risks, though. Because pros focus on risks before profits, let's consider risks first.

Trade Replication Risk

Will your results accurately reflect those of your chosen experts? That is, do these accounts accurately mimic the trades of the expert trader you're following? Because currency prices can change so quickly, followers' trades might be executed at slightly different prices than those of the trader they're following. For trading styles that seek to eke out very small gains from minute-to-minute moves, that difference could turn a profitable trade into a loser for the followers.

Different sites deal with this trade replication risk differently. For example, Currensee.com doesn't accept this style of trading when selecting its trade leaders.[2] Even by eliminating this style of trading from the mix, CEO Dave Lemont admits there can still be minor differences in the price received by the Trade Leader and that subsequently received by the followers at both the open and close of the position. He notes:

> *All of this is transparent for you in the portfolio performance page in the platform. A negative number in parentheses* [*see the Open Price and Close Price columns in Figure 11.1*] *indicates a better price for the Trade Leader and a positive number in parentheses indicates a better price for the investor. In addition, all of these prices and their correlation to the Trade Leader can be exported to Excel for further analysis.*[3]

FIGURE 11.1 Portfolio Performance

Portfolio Performance CUTBTA **Account Balance: 8,327.63 USD**

Export Excel

Open Time	Close Time	Type	Ticker	Lots	Currency	Open Price	Close Price	Gain/Loss	Comments
03/08/2011 01:12:53 PM	03/08/2011 03:43:10 PM	Close Long	ANBZN.A	0.02	USD/JPY	82.637 (-1.1)	82.646 (-0.3)	0.22 USD	Followed
03/07/2011 02:01:03 PM	03/08/2011 09:53:09 PM	Close Long	WIHFG.A	0.01	EUR/USD	1.39613 (+0.7)	1.38652 (+3.2)	-9.60 USD	Followed
03/07/2011 02:00:56 PM	03/08/2011 09:53:07 PM	Close Long	WIHFG.A	0.01	EUR/USD	1.39613 (+1.7)	1.38660 (+3.0)	-9.52 USD	Followed
03/08/2011 01:01:22 AM	03/08/2011 09:11:24 AM	Close Long	WIHFG.A	0.01	EUR/USD	1.39613 (+1.3)	1.38825 (-1.5)	-10.02 USD	Followed
03/04/2011 09:13:35 AM	03/08/2011 09:08:44 AM	Close Short	ROICU.A	0.01	AUD/USD	1.01009 (-0.7)	1.00672 (-0.3)	-3.10 USD	Followed
03/04/2011 09:03:25 AM	03/08/2011 09:07:27 AM	Close Short	ROICU.A	0.01	AUD/USD	1.00945 (-1.2)	1.00735 (-0.7)	1.83 USD	Followed
03/08/2011 03:30:07 AM	03/08/2011 08:45:03 AM	Close Short	LIWWK.B	0.02	EUR/USD	1.39332 (-1.2)	1.38936	7.92 USD	Followed
03/08/2011 03:45:06 AM	03/08/2011 07:30:09 AM	Close Short	LIWWK.B	0.02	EUR/USD	1.39256 (+0.1)	1.39035 (+0.2)	4.42 USD	Followed
03/02/2011 05:45:34 AM	03/08/2011 02:45:51 AM	Close Long	DOCGM.A	0.07	EUR/USD	1.38350 (-1.5)	1.39461 (-0.2)	77.95 USD	Followed
03/02/2011 09:01:16 AM	03/08/2011 01:01:20 AM	Close Short	WIHFG.A	0.01	EUR/USD	1.40028 (-1.2)	1.39828 (+1.2)	1.97 USD	Followed
03/07/2011 06:16:04 PM	03/07/2011 07:03:30 PM	Close Long	ANBZN.A	0.02	EUR/GBP	0.86214 (-0.8)	0.86238 (-0.8)	0.78 USD	Followed

EToro.com does allow you to follow Guru traders using this approach and attempts to minimize any differences in execution time and thus price. With eToro's social trading, the accounts of both the experts and followers are all in-house under one integrated trading platform. That tighter integration may better minimize any time lag between the actions of the experts and the accounts that are linked to them.

Selection Process and Quality of Experts Vary

As with managed accounts, your success depends on your ability to pick winning traders and know when to switch to others. That gets easier if you have all the information you need to make that choice, a range of choices from a qualified pool of applicants, and an ability to move to different experts quickly and easily without needing to close and open different accounts. Both Currensee and eToro fill these requirements, though in distinctly different ways.

To get an initial feel for the quality of the selection of experts, it pays to be familiar with:

The rigorousness of the selection process

EToro allows traders to become Guru traders, who can then recruit followers, if they:

- Have a documented “positive trading history” in the three months prior to admission.
- Continue to meet certain performance, trade frequency, and recruiting targets.

At last count, eToro has about 400 Guru traders with around 200 having at least 10 followers, between 50 and 100 of whom are full-time professional traders.[4]

Currensee takes a much more selective approach. It accepts only about 2 percent out of thousands who apply. There are typically between 10 to 20 selected Trade Leaders available at any one time that have both survived that screening process and met ongoing performance goals needed to remain in this very exclusive club. At the time of this writing, 11 of the 14 Trade Leaders were full-time professionals or trading firms rather than solo traders.[5] Currensee is clearly the more selective of the two. As we discuss later, that's no guarantee that you will succeed, though it should improve your odds.

If Currensee's more limited selection of traders doesn't suit your needs, you'll have a wider selection at eToro, though you'll have many more to sort through and most won't sport the same level of credentials.

Note that because both Currensee's and eToro's programs began in late 2010, the track records of most experts in the programs are measured in months rather than years. While Currensee may have checked farther back, keep in mind that you're dealing with shorter, hence less reliable, performance records than you'd normally see with other asset classes. That should improve over time as these services mature.

How well the expert compensation system aligns trader interests with yours

Logically, we want to see compensation systems that:

- Connect the experts' earnings directly to those of their followers.
- Pay very well for good performance in order to attract better expert traders. You get what you pay for, so if the network can provide a handsome income for top traders, it should in theory attract them.

Both eToro and Currensee attempt to do this, but in different ways.

ETOro pays its Guru traders $10 per follower per month up to a maximum of $10,000 per month while they have live accounts that can be copied, its theory apparently being that top performers will attract more followers. Assuming the system quickly makes that performance well known throughout the network, then that would connect performance and reward. If not, then this method is rewarding a mix of the trader's marketing skills as well as performance. The advantage of this approach is that it encourages top traders to respond to questions or comments and serve a mentor role. That could be a real plus for educating traders, as long as top traders aren't put off by this extra demand on their time.

Currensee pays 15 percent of the amount by which the expert trader actually increases a follower's account measured from its highest value (high-water mark). So if the account loses money in a given month, the experts don't start getting paid again from that follower until they recoup those losses. They then get 15 percent of any additional gains beyond the prior high water mark. There are no limits on how much a Trade Leader can earn.

This method appears to more directly connect reward with performance, and in theory allows for a higher income than from eToro. Currensee does not reward or encourage Trade Leaders to be mentors. Indeed the Currensee website explicitly states that users should not expect to have contact with Trade Leaders. This makes sense given that Currensee seeks only a very small, elite group of mostly professional traders who may well be unwilling or unable to commit the time needed to assume the correspondence and mentoring roles of eToro Gurus.

Your costs to participate

EToro is a forex broker and earns its money from your trading volume, without charging anything to follow another trader.

Currensee is not a brokerage but rather a pure forex social network and trading business. It charges an annual service fee of 2 percent charged monthly, based on the average capital in your account, plus a 20 percent performance fee paid to your Trade Leaders on whatever profits they generated for you.[6] For example, if you had an average monthly balance of $10,000 and earned $1,500 for 15 percent annual profits:

EOY balance:	$11,500 (assuming the 2% fee is collected only at EOY for sake of illustration)
Annual service fee:	200
Performance fee:	300
Total EOY:	$11,000
Net annual yield:	11%

To participate in Currensee's social trading program, you need a minimum $3,000, though a Currensee spokesperson told me the average account is around $25,000, increasingly from satisfied customers starting with small accounts and subsequently adding funds in the hope of averaging up, like one would do with any other winning investment in a firm uptrend.

EToro's initial deposit for the social trading is a much easier to digest $100, and you're not permitted to have more than 20 percent of your account balance at risk from one trade or one guru trader.

Note that with either site, you're ultimately using the same leverage as the trader you follow for a given trade. Given that most traders use significant leverage (anywhere from 20:1 to 400:1), you'd need the appropriate cash reserves in your account, and very good risk and money management (RAMM) skills, to have any realistic chance of surviving normal price fluctuations and account drawndowns expected if following the more leveraged traders, as we covered in Chapter 5 on RAMM.

Regulation

The sites are essentially unregulated, so there are some gaps in oversight. As this industry matures, we expect that situation to get better as firms seek to improve their standing as legitimate alternative investment vehicles and so work with relevant regulatory agencies like the National Futures Association (NFA), in the case of U.S.-based firms, on their risk disclosures and marketing materials.

Success at Social Trading Still Ultimately Depends on Your Own Skill and Judgment

Though social trading is a huge shortcut to success, it's far from an idiot-proof solution. There's skill involved in knowing how to select expert traders, how long to stick with them, and how to deal with one's own psychological, risk, and money management issues. You are still responsible for these. These issues are critical, yet they are difficult to master and often neglected in the mistaken focus on finding the magical mix of trade setups or analytical tools.

In other words, you still need enough of a background in analysis, trader psychology, risk, and money management to be able to:

- Select the experts that best fit your own risk tolerance, account size, style preferences, and current market conditions, and know how long to stay with them even when normal drawdowns tempt you to switch prematurely to another expert.
- Be responsible for your own RAMM.

In sum, there are plenty of decisions left in your hands once you've selected your expert(s). For example:

- As a senior manager of one social trading venue told me, most profitable traders tend to use the riskiest strategies. When selecting which expert(s) to follow, you can't just rely on the sites' rankings or one profitability metric. You need to consider whether you can psychologically and financially accept large drawdowns that might not ever be recovered. The experts are human, and thus liable to have cold streaks and at some point lose their touch altogether, as with managed accounts.
- You need to assess which traders might be best for current market conditions. Like top hedge fund managers, star expert traders tend to have their winning and losing streaks, and tend to do better in certain kinds of

markets. At minimum, you need to be able to have some idea about whether the coming weeks or months are likely to favor risk or safety assets, and to trend strongly or stay within a range. Then you need to assess whether a given expert's track record was formed under similar market conditions to those you anticipate, or you have some reason to believe that the trader will succeed under the likely coming market conditions. As every site warns, past performance is no guarantee of future returns. You should be able to clearly articulate why your chosen expert(s) should continue to perform in current and near-term market conditions.

- You are still fully responsible for your own money management. The available performance metrics can tell you about the likely risk and maximum drawdown of given experts; however, these traders are making decisions based on their own account balances and risk tolerance, not yours. That is, you must still be sure you have enough funds in your account to cover those possible drawdowns. This is especially true for those following multiple experts, because their accounts must be able to absorb their combined losses at any one time or risk facing margin calls. As we noted earlier, you *must* be clear that you have enough cash in your account to be able to survive the possible drawdowns of your chosen experts given what you know about their leverage and maximum drawdown data. *If you have any doubt, back off until you are clear that you have the cash.* Otherwise it's very possible you will hit a margin call and lose your money just as your expert starts to turn around and get profitable.

Huge red flag and flashing lights warning**:** Before linking with any expert, you should first be very clear on how much leverage they use, what is their expected and maximum drawdown, and therefore how much cash you need to keep in your account to avoid a margin call and survive a likely worst-case scenario losing streak that most traders hit at one time or another. If in doubt, ask:

- The customer service reps: My experiences with them at both eToro and Currensee have been good.
- Fellow traders in the social network: This is exactly what they are there to do—provide advice.

As easy as social trading appears, don't even think about trying it until you know you have the needed cash to ride out possible drawdowns and losing streaks of your chosen expert. Otherwise you are *so* not ready for this.

To eToro's great credit, it has recognized that too many new traders make far too many mistakes with RAMM (not having read this book yet), *and has actually done something to help these poor innocents*. It has taken a number of steps to promote more responsible, less reckless trading. These include:

- Adjustable leverage and default leverage settings to reduce the risk of excessive leverage. *Note:* Unless regulations of the user's country of residence are lower, eToro's default leverage is 100:1. That's still quite high.
- Real-time "Guardian Angel" guidance system: an automated trading guide to help traders avoid some of the worst mistakes that can kill accounts and self-esteem. While the system is mentioned on the homepage, there's no easy-to-find link to more information on this. Instead, just do an online search (eToro and Guardian Angel) for full details.
- Maximum 20 percent of available balance with any given trader. That is a good diversification for most, who may not be both very well capitalized and very capable of identifying the right trader at the right time.
- Maximum 20 percent of available balance on any one trade. That may still be high (depending on account size and available balance), but does allow for an exceptional situation when a trader is willing to take on more risk than usual. In the end, users must be responsible for their own RAMM, and eToro wants to keep its rules simple.
- Users can not only copy others' trades but also automatically allocate the same proportion of their account to that trade as the expert trader's allocation, allowing users to not only copy trades of Gurus but also at least some of their risk management.
- The ability to practice social trading even on demo accounts. Currensee allows social trading only with real accounts.
- Exceptionally detailed screening tools to allow users to set criteria for selecting whom to copy or follow. That makes it far easier to find safer, lower-risk traders that suit your needs among the thousands of possibilities in the social network. Ease of use raises the chances that users will make the effort to do careful screening and selection. Users can even choose only one instrument of a given trader to copy. For example, if that trader is really an expert only in the AUDJPY or gold, you can choose to copy only trades in these instruments.

We hope more forex brokers will invest in providing these kinds of safety features, as well as in quality analysis, training, and other tools to help you survive and prosper, and so prove that they want to make money with you rather than from you.

So while using expert traders should improve your results (see the following page for details), until you attain a similar level of expertise, you still need a background in forex, analysis, and RAMM in order to best exploit social trading, even with the aforementioned safety features.

Rewards of Social Trading

Now that the risks are clear, let's look at the advantages of the social trading approach.

Higher Chances of Success

Not surprisingly, leaving the trading to those better qualified should produce better results than if you did your own trading, at least until you become an expert trader yourself.

According to a report by the Aite Group, a Boston consulting firm that specializes in the financial services industry, up to 50 percent of social traders are profitable in a given quarter versus only about a third (at best) of do-it-yourself retail traders, according to data from the major retail forex brokers.[7]

EToro reports even better results, claiming that between 80 and 90 percent of all copied trades are profitable, and that investors who copy are showing “significantly higher gains than manual (self) traders.”[8] As noted earlier, only about 20 percent to 30 percent of forex traders are profitable according to broker reports gathered by the U.S. government.

While it's not so surprising that copying experts should produce better results for most people, early results suggest that a decent picker of top traders could beat markets in general, regardless of whether conditions are bullish or bearish. As shown in Figure 11.1, Currensee's Trade Leaders have been doing just that.

As the social trading sites become more adept at making it easier to identify and track top performers, this performance advantage is likely to grow, regardless of how many followers are attracted. As noted in Chapter 1, the forex market dwarfs that of the major stock indexes, so it is very hard for anyone except for a few central banks to generate enough volume to move markets for more than a matter of days.

Time Saved

While it still takes skill to succeed with social trading, you save an enormous amount of time and effort compared to the time and effort invested to become and remain a top trader.

Even if you do expect to become a star trader, you still need to consider whether your results are likely to justify the extra time and effort invested.

We suspect that the advantages of better results and time saved will cause many to decide to study forex with a goal of becoming adept selectors of trading talent rather than traders themselves. Just like there are funds comprised of shares in other funds, and investors who focus on mutual funds and exchange-traded funds (ETFs), there will be forex investors who prefer to build portfolios of traders as part or all of their forex activities.

Better Way to Play the Lower Correlation with Other Markets

As we covered in Chapters 1 and 2, the very nature of currency trading allows traders and investors to profit in down as well as up markets. There's always a trend to be played in some pair or time frame, and the almost interchangeable nature of retail forex and commodity trading means that skilled forex traders can as easily exploit developments via certain commodities, making it easier still to find worthwhile opportunities when other retail markets are more challenging.

In other words, forex's low correlation to other markets means you're not forced into the same crowded and often overpriced assets like investors in other markets are.

In good times, cash pours into the most popular risk assets, bidding them up so that they quickly become expensive, and you risk paying too much and missing the gains. In bad times, the same thing happens with the popular safe haven assets. It's every asset manager's dream to find an asset class that can do well in any market conditions.

Given the nature and size of forex markets, *skillful* (yes, there's the catch) forex trading is a uniquely effective solution for those seeking assets with little correlation to other markets. The problem for most people, even otherwise sophisticated investors or fund managers, is that they aren't skilled forex traders. Social trading provides the shortcut to the benefits of professional forex trading without the requisite investment to build that skill.

With social trading, it's much easier for average traders to exploit that low correlation by automatically mirroring the trading of those who do it best. Again, there's a skill to identifying these experts, but that's still easier and less time-consuming than doing it all yourself. Study this book well and you've got most of the background you need to pick the right experts to follow.

For a more complete discussion of how uncorrelated expert trader returns can be to other markets, see Appendix G.

Transparency: You Know Your Experts' Track Records and Current Performance

You have the records of the other experts against which to compare the results of your own. This is critical, because even the most exclusive private account and hedge fund managers at some point go cold. You need a way to monitor them. Social trading provides past and current performance information that is at least as good as and usually better than traditional managed accounts, and come with the added bonus of community for consultations about your chosen experts and their competitors.

The Growth of Social Trading

Given these advantages, the appeal of better returns for less effort at a reasonable (or no additional) cost, and the added benefit of having an entire community to consult about how and whom to choose, social trading has been growing dramatically since it began in late 2010. For example, as of the end of 2011, Currensee reports the following for its Trade Leader program:[9]

- There has been $6 billion trading volume since the program began, and a 50 percent increase since April 14, 2011.
- There is $12 million in assets under management since launch.
- More than 400 individual investors are actively participating.
- Average investor account size is over $25,000.
- An average of 3,500 trades are executed daily.
- Investors from more than 50 countries are using the service in English, Chinese, French, Italian, and Spanish.
- Nearly 50 percent of the growth in assets during the prior 60 days has come from investors achieving success in the program and depositing additional capital.

As a purely social trading site, Currensee's growth figures are all attributable to the growth of social trading.

EToro reports that now 50 percent of all trades in its network are copied trades, up from 0 percent when the program began in late 2010.[10] Because eToro offers both self-directed and social trading, its figures suggest the potential future growth of copied trades versus traditional self-directed trades that we could see throughout the retail forex industry.

How eToro and Currensee Compare

EToro allows you to try their social trading platform with demo accounts. Currensee accepts only real money accounts. There is a reason for this difference.

EToro runs its own forex brokerage, which provides both a revenue stream independent of social trading and a preexisting infrastructure for demo accounts. If you see social trading as a key part of your forex activities, then strongly consider starting your social trading career with an eToro demo account. The chance to social trade on a demo account alone is enough to justify opening a demo account with eToro. Of course if your research shows other brokers to be more suitable, there's nothing stopping you from having demo accounts at different brokers as well, but you'll be able to practice social trading only on the eToro account.

Currensee, in contrast, is not a forex broker. As a pure social network and trading business, Currensee depends on its broker referral and social trading service fees, which come only with real accounts. Its lack of a social trading demo account is a distinct disadvantage for newer traders because, as we noted earlier, although social trading is easier than doing it yourself, it still demands skill, and demo accounts help build skill.

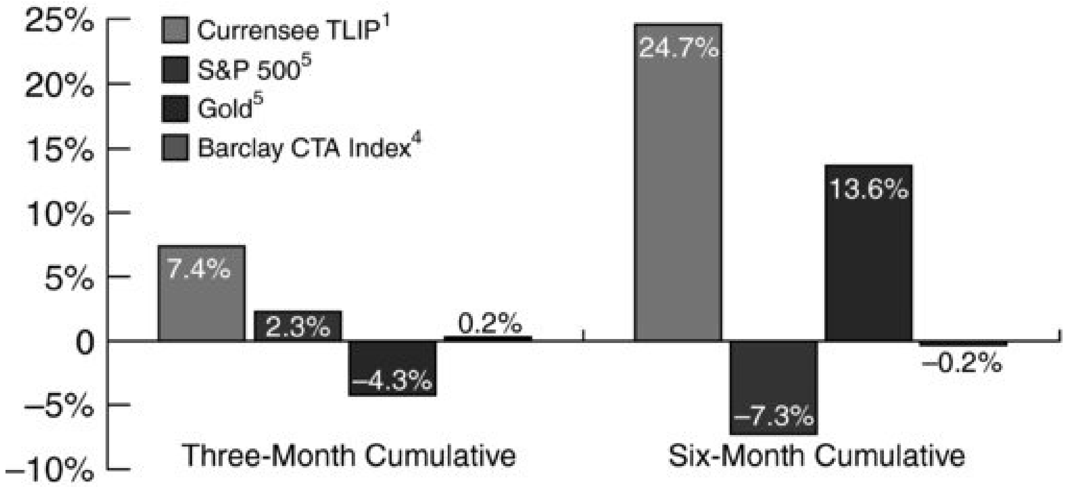
However, precisely because it's not a broker, Currensee allows you the flexibility to choose the broker that best fits you and still engage in social trading. Once you're past the entry-level stage, that flexibility becomes a huge advantage because different brokers do different things better, be it uniquely valuable members-only content, better prices, a wider range of assets to trade, a particular trading platform or language support, or something else. Also, eToro is available only to residents of certain countries (see: www.etoro.com/trade/etoro-and-brokers.aspx for details), so depending on where you live, Currensee may be your best social trading option because you're more likely to find a broker registered where you're a resident.[11]

As noted earlier, Currensee invests much more in selecting its expert traders, so your chances of picking a winner with less time and effort are better. While eToro claims between 50 and 100 full-time professionals among its roughly 400 trade Gurus, Currensee's team of experts is intended to be a small, elite all-star team, so any trader(s) you pick should be highly qualified.

Not surprisingly, these trader studs pump out some impressive documented returns compared to other asset classes. See Figure 11.2, which compares their average cumulative monthly performance versus some other popular asset classes over three-and six-month periods ending October 31, 2011.

FIGURE 11.2 Currensee.com versus Other Asset Classes

Note: TLIP stands for Trade Leaders Investment Program.



Admittedly this isn't a long time period, though it's an auspicious start. Not only has Currensee's dream team beaten the other asset classes, but it has shown very low correlation to other markets. That's another huge advantage, because it means you have a better chance of profiting regardless of market conditions. This is such a big deal that I've dedicated all of Appendix G to explaining it.

So in sum, how do the two social trading leaders compare? If you're new to forex or have very limited capital, and if you reside where eToro is available, it may well be a better one-stop solution. It is a brokerage that's as equipped as any to deal with beginners, so you need only deal with it. While other brokers like FXCM offer more extensive education for their members (via its superlative content site, DailyFX.com), eToro has some potent advantages for those who are newer or have yet to find themselves as traders, including:

- Numerous features noted earlier to help reduce (though not eliminate) RAMM mistakes. Until you're solid in these skills, this feature matters—a lot.
- Ability to practice social trading via demo accounts—also very, very significant for less experienced forex traders or investors.
- A stronger emphasis on trader education. In particular, it claims to have the largest social network, which may, in theory, make it easier to find more of the advice and mentoring a beginner would need. Moreover, you have a

chance to be in contact with those you follow.

- Guru trader compensation more heavily tied to number of followers than is Currensee's trader compensation. While that may not be the most precise alignment of compensation and performance as measured by profits, it should better reward those Gurus who do more marketing via mentoring. Currensee's traders operate more like traditional fund managers, and are generally not available for consultation.
- Much larger selection of traders to copy. Not only are there hundreds of certified Gurus, with 50 to 100 full-time professionals among them, but also you can choose to copy any one of the many thousands in the social network. That could be a distinct advantage for those seeking an unusual trader profile to copy. Yes, that could require a much greater time investment than if operating with Currensee. However, eToro has extensive screening tools to speed that process of sifting through thousands of potential experts to copy.
- Much lower minimum deposit, only $100, versus about $3,000 for Currensee. Again, however, I'd warn that $100 seems far too little to have a realistic chance of surviving any kind of temporary setback, though it's certainly possible for those with good RAMM skills to begin with less than $3,000. However, even $3,000 is dangerously small when dealing with any kind of moderate to high leverage or high-risk trader who experiences significant drawdowns in the normal course of business.
- For those who are already successful traders and seek to build at least a part-time career in trading, but lack the trading style or track record for Currensee's elite club, eToro is the place to build a track record and reputation among the many successful part-time traders and full-time professionals there.
- If you've the skill, time, and energy to sort through the hundreds of Guru traders to find the top performers for your particular trading style and risk preferences, you could build a portfolio of star traders producing stellar results at a significant discount to what you'd pay with Currensee, possibly with greater diversification due to the greater choice available. With eToro's screening tools, that shouldn't be any harder than using stock-screening software to screen stocks.

In sum, eToro may be the better bet for traders with less capital, less RAMM skill, and/or those who are willing to dedicate the time to exploit the educational benefits of the larger social network and access to input from trade experts. It's also definitely the place for those seeking to build a following of traders. While only registered Guru traders get paid for having active copiers, anyone can be copied and build a following and reputation as a good trader. Also, eToro will offer a much wider range, albeit less selective, group of traders to follow. So if Currensee doesn't have a trader that fits your needs, eToro's wider selection might.

On the other hand, Currensee is likely to be a better choice for:

- Those who can afford the higher minimum required investment (typically between $2,000 and $4,000) or, better still, $20,000 or more to allow for diversifying into a number of traders.
- Finding a top trader, or for building a portfolio of traders faster and with less effort, due to the smaller size and more selective composition of its Trade Leader team. Heck, for somewhere between $30,000 and $60,000 you can have a small diversified portfolio comprised of each Trade Leader.
- Flexibility of broker choices, an important point if you're particularly attached to a given broker and want all your trading done through that account. As good as eToro may be, it can't be all things to all people. That said, even if eToro allows social trading via other brokerage accounts, the mere fact that Currensee is not a potentially competing broker may simplify its ability to connect with additional brokers.
- Those who already have enough RAMM skills so that the assistance eToro provides in this critical area for beginners is not decisive. Currensee's selection process considers risk management, that's built into its system, although some of the Trade Leaders still experience significant drawdowns and volatility, so RAMM is more in your own hands.
- Those with less time or interest in actively monitoring their trading experts or alternative experts, given the higher bar set for its Trade Leaders and much more limited selection of them.
- Those with less interest in using the site for trader education via exploiting a larger social network or being able to contact those whom you follow. We suspect wealthier, busier private investors, as well as institutional investors and money managers, will be more comfortable at Currensee.

GREAT TOOL, BUT REQUIRES SKILL TO USE

For most aspiring traders, using proven traders should work better, at least until you're on their level. The available data shown earlier suggests you have a much better chance of profiting, and with less effort, too.

If optimal returns are your top priority, it's hard to argue against having at least some of your forex-dedicated funds allocated to copying experts, even if you're an aspiring star trader yourself. If you're not set on becoming a successful trader, then your time is probably better spent learning enough about forex to evaluate market conditions and traders, focusing on becoming adept at choosing the best traders, building a portfolio of them, and leaving the actual trading to them.

Yes, you'd probably be a better selector of talent if you're active in the social network, doing some trading and constantly growing your own skills. However, as with everything else, there's a time (and probably money) price to pay. It's your call if the price is worth it.

That said, even if you're totally sold on the efficiency of social trading, keep in mind that, as with any other professional services business, while you needn't be a great practitioner to succeed, you do need to be a good judge of the talent you hire. Also, as we noted earlier, you need to be competent at:

- Knowing yourself and what styles and risks you can comfortably handle: That is, are you okay with seeing your account fall dramatically if you're using a trader with a volatile high-risk strategy?
- Risk and money management: You need to thoroughly understand, given the leverage and risk data provided for a given expert, how much you could lose at a given time, and you must be sure to have enough cash on hand to survive that drawdown until the longer-term profitability statistics kick in.
- Assessing whether a trader's style fits current market conditions: Different traders succeed under different circumstances, so you want to have some idea of why your chosen trader should succeed in the future. Consulting your colleagues in the social network may help, and so would diversifying your holdings among multiple traders.

In other words, with social trading, as with managed accounts or automated systems, while you don't need to be a great trader yourself, you still need enough of the core four skills mentioned in Chapter 2 to select which delegated or outsourced trading solution to follow, and how long to stay with a given trader or system.

No matter how good the experts may be, you still have plenty of chances to screw up. So continue to educate yourself so that you can better exploit social trading through better selection of the right traders and solid RAMM practices.

In sum, social trading is a potentially extraordinary tool and shortcut, but still requires skill, or trustworthy, competent advice, to use it properly. By all means consider it, but don't view it as a substitute for building your own knowledge and skills, at least to the point where you can manage your talent choices and RAMM.

An Auspicious Start

Given that social trading only began in late 2010, it has shown great promise for reasons mentioned earlier. However, given that it is still so new, be aware that its track record is very limited.

When you start trading, strongly consider allocating at least a portion of your capital to following one or more experts, compare your results to theirs over a period of months, and draw your own conclusions.

Do Your Homework Before You Decide Which to Use

In addition to the obvious wisdom of not relying solely on my information, both sites are constantly upgrading their services, so it's possible that each may offer new features or copy features from the other over time. Given how useful social trading services could be, it could be well worth your while trying both, and even continuing to use both, depending on your needs. Also, by the time you read this, new players may have emerged that may also be worth a look.

Social Studies: Further Reading on Social Networks and Trading

Forex isn't the only market where you can tap experts via social trading. For more on social trading, read the seminal work on the topic, *TradeStream Your Way to Profits* by Zack Miller (John Wiley & Sons, 2010). For the latest in social trading across different markets, and other new ways to apply technology to investing, see his superb website, www.tradestreaming.com.

Consider Market Conditions in Choosing Strategy and Risk Tolerance

Just as you'll find that your preferred trading or investing style works best in certain conditions, the same holds true for anyone, or anything, to which you delegate your trading decisions, be it a computerized or human trader. They will work better in some markets than in others. *That's why we strive to get a sense of the longer-term trend, the one that's four to five times longer than the time frame in which you trade, and then make sure our chosen strategy, system, or trader is in harmony with that trend.* That's easier said than done, and why you'll seek out reliable sources of good analysis to use for guidance.

How much risk you accept for a given trading strategy, be it manual, automated, or professionally managed, depends on two factors.

1. Your own personal risk tolerance in general: That's a personal decision, no matter what the time frame, be it five minutes or five years.

2. How well that chosen strategy fits the anticipated conditions: In other words, if the trend is strong, you may accept more risk with strategies that work well with very clear trends. The longer you hold positions, the more trustworthy the trends and indicators are and hence the more important it is to move in harmony with them.

If you believe you're at the early or middle stages of a long-term bull market in risk assets, you should be biased to more aggressively bullish strategies, whether you implement them manually, via auto-trading systems, or via professional managers. If you believed the opposite, you'd be looking for solutions that are likely to do best in bearish conditions.

For the sake of illustration, let's say your time horizon is very long term, say five to 10 years or more.

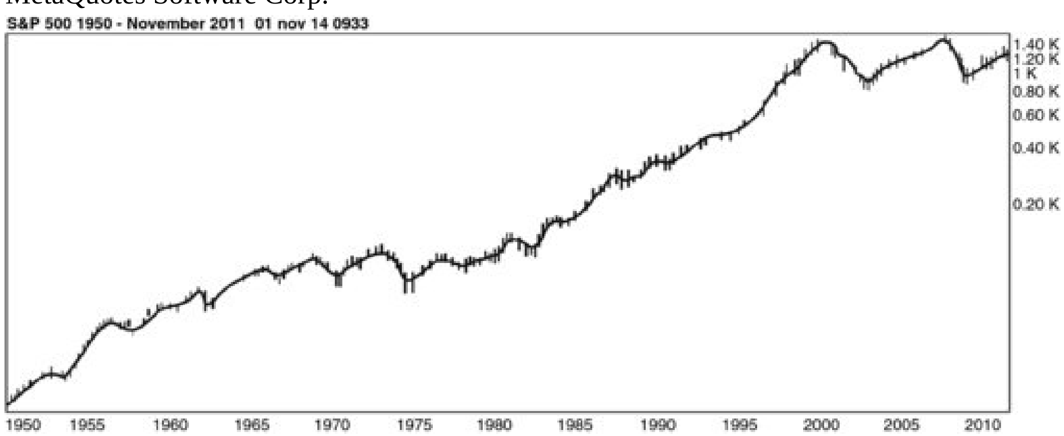
How would you know if you're in a long-term bull or bear market? Study one or more of the risk appetite barometers we introduced in Chapter 6; this is what they're for. For example, look at some long-term charts of 10 years or more of some major market stock indexes like the S&P 500. (See Figures 11.3 and 11.4.)

FIGURE 11.3 S&P 500 Monthly Chart, December 1999 to September 2011

Source: MetaQuotes Software Corp.

FIGURE 11.4 S&P 500, 1950 to November 2011

Source: MetaQuotes Software Corp.



Some key points to note:

- We have a bearish double top as discussed in Chapter 4 in the section on Western chart patterns. A valid double top pattern needs to be preceded by a long uptrend.
  Figure 11.4 of the S&P 500 dating back to 1950 shows that we do indeed have a prior uptrend and also shows the 60-plus-year perspective to demonstrate how significant this double top is, the first decade-long topping pattern since the 1970s.
- In Figure 11.3 note the double top formed in 2000 and 2007 (A and B) with

the lower high (C) in May 2011 that confirmed the double top.

- Additional confirmation of the longer-term bear market in risk assets that began in the summer of 2007 includes a close below the 200-month exponential moving average (EMA) as well as all shorter-term EMAs in September 2011.

Our conclusion is that as of September 2011, for our long-term portfolio, we should seek strategies that will benefit from a bear market. In other words, it should involve shorting risk assets and being long safe haven assets.

So when selecting an auto-trading system, professional manager, or social network trade expert to manage a long-term portfolio (or a trade strategy), you'd want one with a track record that suggests success when risk assets are in a long-term downtrend.

In theory, the same thinking could be applied to even short-term time frames, though as we've noted repeatedly, shorter-term trends are less stable, and those that occur over a matter of hours or days are even less so. Short-term trading works only for those good at RAMM and technical analysis. Until you're proven with short-term trading, stick to proven systems or traders for that.

How low could the S&P 500 (and by implication other risk assets) fall given the Head and Shoulders reversal pattern? As we learned in Chapter 4, the general rule of thumb is that the potential pullback is double the distance from the tops to the neckline. The tops were at about 1,500 and the neckline was at about 800—a 700-point or 46 percent drop! Another 700-point drop would bring the S&P 500 to 100, a 93 percent drop!

Obviously you wouldn't base your long-term portfolio strategy on this one indicator, though. Also, you'd refer to fundamental analysis for confirmation or refutation of that bearish analysis. There is significant fundamental evidence that as of this writing, markets are in a multiyear downtrend. See some of the most important financial books in recent years on the topic:

This Time Is Different: Eight Centuries of Financial Folly, by Carmen M. Reinhart and Kenneth S. Rogoff (Princeton University Press, 2009).

Endgame: The End of the Debt Supercycle and How It Changes Everything, by John Mauldin and Jonathan Tepper (John Wiley & Sons, 2011).

Planet Ponzi: How Politicians and Bankers Stole Your Future, by Mitch Feierstein (Bantam Press, 2012).

Both suggest the fundamental outlook for the coming years could be very bleak. Both are also considered to be among the most important books in recent years on financial markets, and very worthwhile for framing your longer-term perspective.

BINARY OPTIONS: TRADING MADE EASIER

The other big innovation in forex trading that has shown dramatic growth in recent years is the binary option (BO; aka digital or fixed-return options). Like forex social trading and social networks, it's so new that there's little objective information out about it. So for the second time in one chapter, and for the first time in any forex book, I'll introduce a new approach to forex that, when done intelligently, can provide exceptional gains without exceptional risk.

The following is a summary of my full study, *Binary Options: Pros and Cons*, which is available on the website, thesensibleguidetoforex.com. It is one of the more valuable parts of this book, because the information is both very worthwhile and currently unavailable elsewhere. Binary options are an incredibly useful tool. While their popularity has grown enormously since they became available to retail traders just a few years ago (they were formerly reserved for the big boys), they remain an underutilized tool, particularly for traders seeking a simplified way to ride a multiday or multiweek trend with very controlled (though not insignificant) risk.

Make 70 percent in under an hour! Limited risk! Just forecast the trend and rake in the dough! No experience necessary!

Try to research binary options, and that's the typical way they're presented. The material is more focused on attracting reckless speculators than on reaching and teaching prudent, serious traders and investors how and when to use binary options.

Like most rational adults, I gave up believing in get-rich-quick schemes shortly after I abandoned belief in Santa Claus and that Mom was still a virgin. Too bad (not for Mom) but reality beckons.

The popularity of binary options for forex and other assets has literally exploded since 2010[12] because their combination of simplicity, high profit potential, and controlled risk makes them an ideal introductory trading vehicle.

Unfortunately, that same simplicity has attracted gamblers and thus gambler-oriented websites, hence the unfortunate casino feel of many brokers as they aim their marketing at the ignorant and reckless, undermining the credibility of binary options among the more serious traders and investors.

However, it would be a big mistake to ignore binary options. Like a junkyard, it isn't the most posh venue, but there's very serious money to be made without exceptional talent or effort if you're willing to put in the requisite work.

As compelling an option as social trading is, most of us should aspire to do at least some part-time trading in order to improve our skills and market awareness; and if you're going to trade, you will want to use binary options at least some of the time, perhaps regularly. There are just too many situations in which they can't be beat for quickly exploiting a trend, exceptional potential returns, low entry cost, and clearly predefined maximum loss.

Ignore the suspicious-sounding claims of many binary options brokers and the gambling mentality that pervades some of their websites. When used intelligently, mostly *via binary options with weekly or monthly expirations*, binary options in fact can be an extremely useful complement or substitute to traditional spot market instruments. Their simplicity, availability at very small and low-cost position sizes, and more controlled risk make them at times an ideal vehicle for:

- Beginning traders or anyone else seeking a simpler way to trade that allows for faster decision making.
- Those with limited capital.
- More advanced and well-funded serious traders seeking a way to jump on a short-term trend quickly (because binary options require less trade planning) with strictly controlled downside risk.

When first learning about binary options, I couldn't find any decent objective review of their advantages and disadvantages that made clear when and for whom they are appropriate. The following is the product of my own research and analysis to answer that need. I believe you'll find it very helpful and objective despite my affiliation with the industry.

Full disclosure: As of this writing I provide analysis for one broker, Anyoption.com, the only broker I'd consider using (were I not a related party and thus prohibited) because as of the time of this writing:

- It is the only broker I know that provides weekly and monthly expirations. That is a critical advantage for the trader. These are time frames in which individual traders with some analytical skills have a very realistic chance of being profitable, if they're selective about which trades they enter and follow the principles we've discussed.

    - The support, resistance, and other indicators are old enough to be meaningful. There's enough time for the publicly available fundamental data (interest rate trends, growth rates, jobs and spending trends, etc.) to have some predictable impact on the trend, and binary options are all about being right about the direction of that trend.
    - Whereas options that expire within an hour or a day are usually suitable only for the reckless gamblers or skilled day traders. As we've noted earlier, intraday (never mind intrahour) price movements are mostly based on unpredictable short-term money flows from big players. Admittedly, these short-term options can be useful for news traders.
- It offers one of the widest selections of instruments found among binary options brokers.
- It offers a wider range of ways to trade binary options than most other brokers.
- Anyoption.com has its faults, but they aren't disadvantages relative to other brokers because these same faults are shared by the entire binary brokerage industry (like limited charting tools, inability to place limit orders for entries and exits, etc).
- It typically ranks at or near the top of every binary options broker survey I've seen, so I'm not the only one it has impressed.

Most binary option brokers offer only very short-term daily or hourly expirations—too short a period for most traders to make any reliable forecast about the trend.

The industry is growing very rapidly, and new brokers and offerings appear regularly, so by all means do your own online research to find the most updated information on which brokers are offering what features.

To cover binary options properly requires almost 50 pages, because binary options are so new to most people and I can't be sure you'll find other trustworthy materials elsewhere on whether binary options are right for you. Thus more coverage is needed.

In order to avoid interfering with the continuity of the book, this full review is in the appendix on binary options found on the website. The following is a brief summary of the key points you should know to give you an overview of what's covered.

Background

The five most common types of binary options are the asset-or-nothing, cash-or-nothing, no-touch, one-touch, and double-no-touch/double-one-touch. The most popular of these is the cash-or-nothing binary option, which is typically what's referenced when describing binary options and what is most commonly offered by most brokers. The other varieties are not always available, with most brokers at best offering a few but not all of them and not for all instruments. *Unless stated otherwise, we'll be covering the cash-or-nothing type.*

How They Work

With regular plain-vanilla options:

- When you buy an option, you're buying a right, but not an obligation, to buy or sell the underlying asset (a stock, commodity, currency pair, etc.) at a certain price called the *strike price*, at any time until the *expiration date*, after which time the option contract expires and is worthless.
- If you think the price will go higher than the strike price, you buy a *call option*, which is the right to buy at the lower strike price. You buy calls when you think the trend will rise over the given expiration period.
- If you think the price will go lower than the strike price, you buy a *put option*, which is the right to sell at the higher strike price. You buy puts when you believe the trend will fall during the expiration period.
- You can place orders in advance to buy or sell an option as you would in forex or other kinds of spot market trading.
- If you were right, your profit is roughly proportional to how far the price of the underlying asset moved in your favor (*in the money*) at the time you sell the option. For example, if you bought a call on the GBPUSD and the pair was up 3 percent when you sold, you made about 3 percent. If you bought a put, you lose the full amount, but no more, of what you paid for the option. The opposite would apply if the pair fell by 3 percent at the time you sold the option: the put would be worth about 3 percent more and the call would be worthless if price remained below the strike price when the option expired. Your profit varies with how far price moves in your favor. If there's enough time left before the expiration date, you may still be able to sell a losing option position (*out of the money*) to cut your loss, because your buyer thinks that price could still turn around.

Yes, this is an oversimplification for the sake of illustration. In many cases option prices do not move in the same proportion as the price of the underlying asset.

The main differences with binary options include these four points:

1. Fixed holding period: Generally, binary options can't be sold before expiration, so there is no chance of taking profits or cutting losses before the expiration date.

2. Fixed payout: If the option expires in the money, it generally yields about 70 percent profit regardless of how little the underlying asset moved in your favor. Some brokers credit you 5 percent to 15 percent of the option's cost if it expires out of the money.

3. Shorter expiration periods: Binary option expiration periods range from about one hour (sometimes less) to one month at most. Plain-vanilla options can be held for much longer periods.

4. No advance order placement: Generally you can't place entry limit orders. If you want to be long via a call or to be short via a put at a certain price, you have to wait to place your order until that price is hit.

Pros and Cons

There is much more on these and others in the Appendix (Binary Options: Pros and Cons) on the book's companion website (thesensibleguidetoforex.com), but here are the key points in brief.

Pros

- High potential profit: The fixed payouts are high, especially considering:
  - The short expiration times: You can earn about 70 percent[1] in as little as an hour or at most up to a month. While it's not realistic to expect most traders to be consistently profitable on very short time frames like one hour or one day, the odds are much better when trading binary options with weekly and monthly expiration dates.
  - Strictly defined maximum loss: You can't lose more than the cost of the option. With standard trading, even stop loss orders are no guarantee against unplanned higher losses if the market suddenly gaps past your stop loss price.
  - This makes binary options a particularly lucrative way to play small percentage moves without the added RAMM planning needed with leveraged instruments.
- Greater simplicity can boost earnings: This fixed holding period and payout vastly simplify trading. That can boost profits because:
  - There are just fewer mistakes to make: Once you've bought a call (to be long the currency pair) or put (to open a short position) at a price and position size you deem acceptable, no further planning or monitoring is needed. You need only be correct about the overall price direction over the life of the binary option. That's it. For example, as long as the pair has appreciated, even just slightly, by the time the option expires, the call binary option earns about 70 percent. If it fell, even just incrementally, by the expiration time, the put option also earns about 70 percent. Usually,[2] risk management is limited to choosing your entry points, and money management is limited to choosing position sizes that don't risk over one to three percent of your account. Beyond these, there's no chance to make fatal RAMM mistakes regarding planned profit taking and stop loss points, *etc.* Reward-risk ratios, exit points, *etc.* are generally fixed or irrelevant. See the full “Binary Options Pros and Cons” material on the companion website for illustrations of how binary options' greater simplicity can boost your profitability.
  - You can make decisions faster: This simplicity also raises the odds of being profitable because it cuts down the decision-making time when you need to move fast, as is often the case for those trading shorter-term positions or breaking news.

- Low entry cost: Depending on the broker, options can cost as little as $10, maybe less.

Cons

- Negative risk-reward ratio: Winning trades typically yield 70 percent over your investment, while losing trades typically cost you 85 percent, sometimes more, depending on the broker. That means you have to be right over 55 percent of the time just to break even.
  On the other hand, it's much easier to be right most of the time with binary options because the only thing that you must be right about is the overall trend during the life of the option, as noted above.
  Throughout this book we've encouraged you to use strategies that allow you to be wrong most of the time and still make money, and for standard forex trading that makes sense given the greater complexity and thus more chances for mistakes. The far greater simplicity of the binary option trading decision, fully detailed in the appendix on the website, balances this disadvantage and for many traders will outweigh it as they hit a higher percentage of winning trades. Still, those who are skilled at RAMM will usually be able to attain better practical risk-reward ratios with standard (spot market) forex trading, though they still risk greater than anticipated losses when price gaps beyond their stop losses.
- No advanced order placement: This means you have to be ready and waiting to go if you want a specific entry point. At minimum that's inconvenient, and for those who are not always watching the markets (who is?), it can mean missed opportunities.
- Less selection: Most binary option brokers don't offer as wide a range of assets to trade as most of the better forex brokers, though all offer the most popular ones, so this is a problem only for some.
- Binary options brokers provide fewer services. For example, charting packages, as well as content offerings (both training and trade guidance) tend to be minimal or non-existent. Any serious binary option trader will need to find their own charting software and data feed in order to do any real technical analysis.

Again, see the Appendix on the website for the full story.

Notes

1. Zach Miller, *Tradestream Your Way To Profits* (Hoboken, NJ: John Wiley & Sons, 2010).
2. Sarah Morgan, "New Tool for Currency Traders: Mimicry," *SmartMoney* (August 2011), www.smartmoney.com/invest/currencies/new-tool-for-currency-traders-mimicry-1312324538631/ .
3. Dave Lemont, "Will I Have the Same Profitability as the Trade Leaders I Follow?" © Currensee Inc., www.currensee.com/newsletter/issue4-article1.
4. Interview with Jonathan Assia, Insight Corporate Governance Germany, November 2011, pp. 10–11, and Tom Groenfeldt, "Better Foreign Exchange Investing Through Social Networking," *Forbes* (July 2011), www.forbes.com/sites/tomgroenfeldt/2011/07/26/better-foreign-exchange-investing-through-social-networking/.
5. "Currensee Provides Emerging Money Managers with New Route to Alternative Investments," *Wealth Adviser* (April 2011), www.wealthadviser.co/2011/04/04/111575/currensee-provides-emerging-money-managers-new-route-alternative-investments.
6. "Compensation," © Currensee Inc., www.currensee.com/tradeleaders/compensation.
7. Sarah Morgan, "New Tool for Currency Traders: Mimicry," *SmartMoney* (August 2011), www.smartmoney.com/invest/currencies/new-tool-for-currency-traders-mimicry-1312324538631/ ; Michael Greenberg, "U.S. Forex Brokers Account Profitability Comparison" (October 2010), http://forexmagnates.com/us-forex-brokers-account-profitability-comparison.
8. Alon Levitan, Etoro Head of Strategic Marketing, email message to author, December 26, 2011.
9. "Currensee Alternative Investment Program Surpasses $6 Billion in Trading Volume" © Currensee Inc. (June 2011), www.currensee.com/about-us/news-events/currensee-alternative-investment-program-surpasses-6B-trading-volume.
10. Alon Levitan, Etoro Head of Strategic Marketing, email message to author, December 26, 2011.
11. eToro, Regulation and license (accessed, August 2011), www.etoro.com/trade/etoro-and-brokers.aspx.
12. Forex Magnates Retail Forex Market Quarterly Report for Q1 2011,

http://forexmagnates.com/wp-content/uploads/2011/04/Forex_Magnates_Q1_2011_preview.pdf.

CHAPTER 13
Now What? Next Steps

Here's what we've covered and what you should do next.

WHERE YOU'VE BEEN

Chapters 1 through 9 give you the very basics, which you'd find in some form in most forex books, but with the advantage of greater:

- Clarity and detail.
- Detail and emphasis on keeping your losses and stress lower, via obsessive RAMM, and focus on longer-term holding periods needed to exploit the more reliable longer-term trends and ranges.
- Detail and emphasis on discovering which kinds of trading styles fit you best.

While these were of more direct use to traders, long-term passive investors should be very familiar with this material as well because it will help them make better decisions and lower their risk by getting better entry points, and by knowing when a planned long-term investment is best abandoned as a mistake, at least for the time being.

Chapters 10 through 12 are for the more passive long-term investors, showing how you can still benefit from forex markets even if regular online leveraged spot market trading isn't for you. For many of you, it won't be appropriate, and that's fine. You can still profit handsomely from forex markets using the alternatives presented. No one talks about these (maybe because they're relatively new), but they should, because everyone needs some forex exposure for reasons cited in the introduction, Chapters 1, 2, and 12. It can lower your currency risk, which can be substantial when you're overexposed to currencies of mismanaged economies, and can increase your returns.

WHERE YOU'RE GOING

Following are some suggestions for how to proceed now that you've finished the book.

For Traders or Those Seeking Exposure to Forex Trading

- Select one or more brokers to start using their practice accounts. You may find after just a few weeks that you start getting friendly calls from their representative checking on your progress and encouraging you to start trading with real money. Politely but firmly tell them you want to first use the practice account for a "number of months" until you become consistently profitable on a weekly or monthly basis. Usually they'll give you all the time you want. If they don't, then they're not even making a pretense of looking out for your interests, so move on. See Appendix F, tips on selecting a broker.
- Once you have your practice account, start creating a basic trading system, which again is just some rules for how you select trades, when you enter and exit, what RAMM rules you'll use, *etc.* You'll draw primarily on what we covered in Chapters 2 though 8 (especially 5 through 7). Your simple systems should include the technical and fundamental indicators you're going to try, your likely time frame, what percentage of your account you'll risk with any given trade, the risk-reward ratio you seek, and so on, as illustrated in Chapters 5–7. Don't drive yourself crazy making elaborate plans at this stage. The first ones will be glorified guesses. You will change your systems repeatedly as you experiment with them by simple manual back testing, and gain experience and insight into what sets of rules work best with which currency pairs. The first goal is to just get used to always trading with some kind of system (set of rules) in mind, and then building trading plans based on the RAMM, time frames, indicators, and so forth of your system. You'll know you're on the right path if you have a written set of rules and can justify every entry and exit based on those rules, and have each trade fully recorded in a trade journal that you periodically review. I assign bonus points to those who include screen shots of the charts on which they based their decisions in their journals, and so on. Successful trading will come eventually because you, unlike most others, have a way to identify and learn from your mistakes. Conversely, you'll know you're on the path to failure if you start trading based on hunches that "just feel right," or tips, or anything other than a set of rules that you followed. If they don't work, analyze what the problem is and change your system. Using a trade journal is invaluable because it forces you to articulate your rules and reasons for what you're doing, including why you may chose to depart from

them in a given situation.

- When choosing your technical indicators, remember what we taught in Chapter 9, apply the “gang of four” principle to select three to seven indicators that give you the different kinds of information you need. You want to know about the s/r points, trend direction and momentum (or strength), and have some indication of where the move is likely to halt or make a normal retracement. Then start manually back testing these indicators for a given currency pair (or other asset) and time frame (daily, weekly, monthly, etc.) as discussed in Chapter 9. The goal is to find a set of rules, using these indicators, that tells you when to enter and exit a position. With time and experimentation you'll find some. The goal isn't to come up with a foolproof system. You just want to get used to the thought process and find some rules that increase your odds. Again, your plans and systems may not be great at first; that's normal. They should become successful in time as you learn from your mistakes and find what kinds of trading styles suit you. If time permits, do an online search for the various trader forums or social networks and visit them (as well as the ones we've mentioned) and ask for guidance.
- In general, when attempting to refine your system, change only one aspect of it at a time, be it an indicator, time frame, whatever, rather than making multiple changes. That way you'll know how each change affects your performance.
- After trying assorted combinations of rules for a number of months, you should find a set of rules that appears promising. The system needn't be amazing. If it keeps your losses low, appears to produce net profits over a few months, and fits your personal needs (skill level, time to monitor, risk level, etc.) then you've got a starting point. Start applying this system consistently over a period of months on your practice account. Get comfortable with using it: how to apply the indicators, change time frames, draw trend lines, enter stop and limit orders, keep track of funds in your account, use tools like pip value calculators (so you know how much cash is at risk from your entry and stop loss points), and so on.
- Start looking for the kind of low-risk, high-potential yield trades we discussed. That is, those that allow you to enter near strong support, with likely resistance much farther away from your entry than your stop loss, so that you have planned 1:2 risk-to-reward ratios or better.
- At the same time that you're getting comfortable with the mechanics of

applying your plan, you should be getting used to using a trading journal as covered in Chapter 5, both to plan trades and to review them afterward, noting what went right, what didn't, and any ideas you have about why and how to improve. You'll find that you'll improve format and organization of your journal to include the information you need and make the review and learning process easier.

- From the preceding steps you should have some idea of how much time you can dedicate per day or week to both practice trading and continuing education. You'll also be getting a better idea of the trading styles and time frames that work best for you.
- Seek out sources of analysis and further education for your daily and/or weekly reading. Consider those mentioned earlier and those suggested in Appendix A on free trader resources. While you're there, explore the available trader forums, and don't be shy about asking for guidance on the various aspects of how to proceed, like recommended reading, trading methods, and so on.
- Strongly consider joining at least one social network as another source of advice and guidance.
- Those simply looking for some forex exposure to hedge currency risk and who aren't interested in trading should stick to the ideas covered in Chapters 0 through 12.
- Finally, visit www.thesensibleguidetoforex.com periodically. In addition to bonus material, we're planning to have a growing archive of training material, as well as conservative trading ideas.

For Those Seeking Currency Diversification for Longer-Term Investment Portfolio

- Study long-term forex trends as mentioned in Chapter 2 and make a list of the currencies and currency pairs with the strongest long-term trends. As of this writing, I'd be seeking exposure to the CAD, AUD, CHF, NOK, SEK, and SGD. The CNY is likely to make the list when China produces trustworthy data, but currently I view the AUD as a safer way to play China, for a variety of reasons. Those without USD exposure should have at least some, possibly a lot if your long term outlook for the EU, Japan, and UK is very bearish, or you believe China is due for a major slowdown. As reckless and inept as the US deficit management has been, leaders of the aforementioned nations appear determined to be as bad or worse. Moreover, most of the USD's fundamental troubles can be corrected by a change in political will to do so. It does not suffer from an ungovernable currency union like the EU, or a terminally aging population like Japan. As bad as the USD may look, it may yet prove to be one of the relatively stronger currencies by default. Moreover, if things get really ugly, the US is still arguably the least vulnerable of any nation to economic or military coercion. Should the Euro-zone ultimately contract to include only the nations with a hard money tradition, the EUR could then be attractive.

- Decide what percentage of your portfolio of stocks, bonds, or other assets you want denominated or exposed to these currencies. Then research them as you would for any domestic asset. You may need to locate new research sources and identify salient differences in tax and transactional details, but otherwise the research and criteria you seek are similar.
- Research which currency pairs or other assets to be long or short:
  - Using sources recommended previously and others you find, research which specific stocks, bonds, or other assets in those specific currencies you want to own, and acquire them, using your technical and fundamental analysis (or that of those analysts you follow) to time your entries. As of this writing, as noted earlier, stocks and many other risk assets remain in a long-term downtrend. If that remains the case, whatever you buy should be with money you can afford to let sit, and should have a relatively high and sustainable dividend so that you're relatively well paid while you wait until the next multiyear bull market looks like it's coming.
  - Similarly, one could consider a mirror image of this strategy, picking the weakest currencies and shorting weaker assets denominated in or exposed to these currencies. This is a bit more complicated, especially if global exchanges continue to ban short selling whenever it becomes most likely to be profitable. There are ways around these rules, but they're beyond the scope of this book. There are also short exchange-traded funds (ETFs) for all kinds of currencies and stock sectors, though beware of the rebalancing issues that tend to make these poor vehicles for long-term holds. See the bonus material for Chapter 10 on the website for details on the hazards of ETFs that short specific asset classes or currencies.

I could go on and on, but I won't. Beyond these or other general comments, what would be the right advice for you would depend on what kind of trading or investing you want to do. If you don't know, experiment. If you do, seek out online gathering spots of like-minded individuals (found in trading/investing forums and social networks). The whole topic of conservative forex trading and currency diversified investing is vast and changing, and so all additional thoughts, insights, and teachings will be on www.thesensibleguidetoforex.com.

May the time you've spent reading this book prove to be among your most fruitful investments. For further updates and ideas, you're likely to find my current thoughts on one or more of the following websites.

TheSensibleGuidetoForex.com, the book's companion website, I hope will become a gathering point for the community of traders and investors to which this book is dedicated: those interested in smarter, safer ways to use forex for both lower currency risk and higher portfolio returns.

In addition, you can always just search my name online to see the websites where I often post, like SeekingAlpha.com or ForexFactory.com. I've received a variety of kind invitations from some excellent forex and financial sites, so there could well be others. If you need to reach me, try either the Contact Us tab at thesensibleguidetoforex.com, or, you can leave a message for me via the Send Message button on my profile page at seekingalpha.com (http://seekingalpha.com/author/cliff-wachtel). Like everyone else, I'm also on LinkedIn and other major online hangouts, though I don't always check them regularly.

Good luck!

APPENDIX A
Recommended Free Online Resources

Many of the following websites were mentioned earlier, but here's a one-stop guide to my favorites for forex traders and investors at all levels. Not only will these websites prove useful from the start, you're also unlikely to ever outgrow them. They'll lead you to further resources as well. I'll just hit the highlights: The “About” pages on these sites will provide a more complete picture.

FOREX SITES

Here are my favorite pure forex resources.

Thesensibleguidetoforex.com

If you like the book, you'll love the website. Your online home for continuing education, as well as trade and investment ideas for those seeking a range of ways to diversify currency exposure either via active trading or currency diversified income investing. Includes a variety of bonus materials to supplement the book.

BabyPips.com

BabyPips.com focuses on beginning traders, providing a wide array of lessons and tools needed to develop the fundamental skills of forex trading and analysis. Don't be put off by the site's more light-hearted, informal take on forex. This is a great site for those seeking an unintimidating, clear, well-organized, and illustrated introduction to forex.

Its most outstanding feature is its School of Pipsology, an organized multitopic intro to the forex course. A stand-out feature of the school is that readers can mark the lessons “completed” to track their progress. New traders looking to build a solid foundation should read through the lessons in order. More seasoned traders can jump ahead to later lessons as needed for reference or to refresh their skills in more advanced topics.

On top of educational content, readers can find news, analyses, and trade ideas in the site's blog. BabyPips.com also provides features like a forex forum, a “Forexpedia,” forex-specific calculators, and an economic calendar.

DailyForex.com

While there are many sites that offer forex broker reviews, they are for the most part submitted by volunteer contributors of unknown reliability and objectivity. In contrast, DailyForex.com provides reviews that incorporate the results of its own in-house testing and research of each broker's trading platforms, customer service feedback, trading conditions, and so on. In other words, DailyForex puts its reputation at stake with each review, which should provide much better quality control and reliability.

The site is funded by broker advertising, but this presents no more of a conflict of interest issue than there would be, for example, with accounting firms that get paid by the clients they audit, and for the same reason. DailyForex.com's need to preserve its reputation for reliable reviews is worth more to it than any one broker's patronage. Practically speaking, the site's visitors appear to get consistently reliable reporting (I'm familiar with some of the organizations covered and those reviews were objective and fair) although they will view ads in the process.

Still, don't be shy about seeking second opinions on trader forums regarding a given broker's pros and cons. Each review also includes screenshots and explanations of each broker's site to give viewers a quick feel for what's offered.

There are also reviews of forex binary options brokers, as well as of some forex training courses, and automated trading programs. Credible reviews of these are hard to find, so these really add to the site. Also, there are a variety of news, analysis, and educational offerings, trader tools, and forums.

DailyFX.com

This is one of the most widely-viewed forex content websites, and justifiably so. It's a one-stop shop for news, analysis, analyst picks, extensive educational materials, trader tools, and forums. It's as good a dedicated forex content site as any, beautifully designed, and easy to navigate. My personal favorite features include:

- One of, if not the most extensive offerings of consistently quality analysis from full-time in-house staff. John Kicklighter and Joel Kruger are among my regular reads for daily and weekly analysis.

- Real-time news feeds of tweets from its staff of obviously sharp analysts. It's the best of its kind that I've seen, and the analysts are not above wry comedic observations about the markets and responses to each other's tweets, an added bonus.
- A growing archive of quality training materials. What sets apart DailyFX.com from most other brokers is its serious investment in useful quality content, both analysis and training. It reflects an all too rare business plan based on profiting from long-term relationships with successful traders, rather than just marketing to new suckers and getting them to trade and lose money before they're ready. Which kind of management team do you think is likely to look out for your interests?

Forex.com

Kathleen Brooks' weekly analysis is excellent and one of my weekly reads. As one who does these myself, I know how hard it is to deliver consistent quality, but she does it.

The site's research team does a solid job covering the market 24×5, and provides intraday, daily and weekly research and analysis, including:

- Daily session updates at the end of each major trading session.
- Weekly research including a newsletter that analyzes events that just occurred, with predictions for the upcoming week and a weekly strategy, providing actionable trade ideas.
- Research notes released just before major economic reports, plus an economic calendar.
- Periodic commentary on topics ranging from emerging markets to commodities.
- 24×5 twitter coverage (http://twitter.com/FOREXcom)

Trader education is provided under the “Learn” tab on the website. FOREX.com offers a variety of resources including a limited library of video tutorials, training modules, articles and other text-based content, as well as a schedule of regularly held webinars.

ForexCrunch.com

Forex Crunch has news, analysis, and educational materials along with some good links to other forex sites and articles. Check out the popular posts section.

ForexFactory.com

Along with DailyFX.com, this is one of, if not the most widely viewed forex sites, so you're likely to wind up here at some point—possibly as a regular viewer, if you become a serious trader. ForexFactory.com offers news and opinion via an editor-vetted selection of daily articles, forums, and a variety of trader tools, including one of the best forex economic calendars. Full disclosure: I'm a contributor as well as daily reader.

ForexMagnates.com

Forex Magnates is the leading site for forex brokerage industry news, such as what's happening with individual brokers, hot new products, and so on, and consequently is particularly useful as you narrow your broker selection. To aid in that process, the site has an active forum on broker selection and other topics of interest, as well as a searchable archive. For the larger brokers, it sometimes publishes useful data on the percentage of their clients who are profitable.

Forexpros.com

Another one of the more popular forex content portals, it offers a range of news, analysis, trader tools, and educational materials.

FXstreet.com

This content portal is another of the best content sites in both quantity and quality, from both regular and guest contributors, many of whom are first rate. This is another one of my regular research sources. My favorite features of FXstreet.com include:

- One of the few content sites to publish high-quality macroeconomic and forex-related research from leading international banks, a brilliant idea that I wish more content providers would copy. I try to read this every weekend.
- Exceptional educational materials that go beyond the basics.

Bkassetmanagement.com

Another of the very best content sites, lead by Kathy Lien and Boris

Schlossberg, arguably the best one-two combination of analysts anywhere—certainly among the most widely read. The site has excellent daily and longer-term analysis and is another of my daily reads.

OTHER FAVORITE FINANCIAL SITES

BusinessInsider.com

This is a popular hybrid financial site that combines:

- A focus on financial market and business topics with a wide range of other popular verticals (topic categories organized on the homepage's horizontal navigation bar).
- Both in-house reporting and an aggregation of externally produced blogs.
- The result is a combination of financial analysis and news mixed with a variety of tech and tabloid topics ranging from cars, sports, and celebrities to other topic verticals.
- Especially useful, the site features a daily preview before the U.S. markets open ("10 Things You Need To Know Before The Opening Bell") and an even more useful review of the day's top stories and events after the U.S. close (no set title). These are useful time-saving tools for staying up to date with minimal effort, and the bullet-pointed items are often hyperlinked to their sources for further details.

Full disclosure: I'm an occasional contributor.

Investopedia.com

As the name implies, this site is a virtual encyclopedia of financial markets and investing. It's one of, if not the best general financial education websites. Whenever you're researching an unfamiliar topic on markets, this is a great place to start. For those seeking a structured free intro to a forex course that's got a more academic feel than that of BabyPips.com, this is the place to go. The archive of forex training articles is as good, or better than any I've seen in both quantity and quality.

SeekingAlpha.com

Seeking Alpha aggregates about 250 financial and investing articles per day, mostly from 400-plus amateur and professional investors worldwide who serve as regular contributors, augmented by thousands of irregulars. In other words, the articles and comments are by and for fellow investors and traders. To help you find the articles you want, you can subscribe to e-mailed lists of daily offerings on a variety of specific topics. The articles are archived by topic and author, so you can find “that thing I read about three months ago” fairly easily. In its Investing for Income section, it has extensive daily articles on US and international dividend paying stocks, to help those seeking to build a currency diversified income stream, with quality ranging from mediocre to excellent.

While its emphasis is on U.S. equities and related topics, SeekingAl pha.com (SA) also includes some quality forex and commodity articles, but those aren't necessarily what will keep you coming back. Here's my take on the five most useful features for forex trading or investing:

1. Extensive daily selection of archived, searchable articles on:

- The macroeconomic forces affecting all markets, including daily pre–U.S. market-opening review of top stories.
- The SA *Market Currents* blog (see number two following).
- Income investing (including articles on global dividend stocks). The articles on global stocks tend to focus on the prospects of the company and its dividends without considering the long-term strength of the currency to which it's tied. So that's still up to you. However, once you know what percent of your income you want tied to CAD, AUD, CNY, or other currencies, then SA is a good place to go looking for ideas.
- ETFs, including currency and commodity ETFs.

2. *Market Currents* blog: Imagine you hired someone to keep a diary of the top news and commentary for global and forex markets, making entries every five minutes, which become hyperlinks to the sources for those seeking further details. Now imagine you hired a whole team to do this for general market news and the more popular market sectors or asset types. That's the *Market Currents* blog. It's your personal market diary, hyperlinked to sources and searchable by date. For anyone trying to keep track of the most important news and comments of the day, or what happened concerning any major asset class on any given day, there is nothing else like it. In 10 minutes you can read the entries for a given day and get caught up fast. It's as good as any 10-minute market overview available for any given day. It's among my daily reads.

3. An especially active and useful stream of comments. This is one of the few sites where I actually read the comments because they're often as useful as the article itself—a tribute to the quality of the often savvy readership. Full disclosure: I'm a contributor.

4. Investors can set up portfolios and get alerts sent by e-mail whenever something comes up on that stock or ETF, making this feature very useful for keeping up on currencies represented by an ETF.

5. "Wall Street Breakfast: Must Know News," a daily premarket review. There's also a small paragraph summarizing the U.S. stock market activity that serves as a useful shorter complement to BusinessIn sider.com's more comprehensive wrap of the major events.

Wall Street Sector Selector (wallstreetsectorselector.com)

A leading ETF portal, this a good place for those seeking information on forex ETFs and related news and analysis.

INDIVIDUAL ANALYSTS

In addition to the sites already mentioned, the following are names I tend to read regularly. All offer free content; some offer paid subscriptions as well. You can just search their names online for more information. In no particular order, these are the writers or blogs that get my attention. For the most part, they cover the overall macro picture and, at times, include specific investment advice. The list is far from comprehensive. Unless otherwise noted, they cover general markets, though many have particular specialties.

Fundamental Analysis

John Mauldin, Cullen Roche, Mike "Mish" Shedlock, Ed Harrison, Reggie Middleton, ZeroHedge.com (all writers use pseudonyms), Patrick Chovanec (China specialist), Michael Pettis (China specialist), Ambrose Evans Pritchard, Martin Wolf, Marc Chandler (forex), Bruce Krasting, Cullen Roche and Ralph Shell (forex).

Technical Analysis

While there are many worthwhile technical analysts and signal providers, one of the best that you've probably never heard of is Charles Nenner. Unlike anyone else I've seen, this former Goldman Sachs analyst provides a unique application of sophisticated cycle analysis to forex and related markets that can be particularly useful for the longer-term and intermarket-focused trading styles we've covered. While most of his material is subscription only, he regularly appears in interviews, many of which are archived on his website, CharlesNenner.com, or searchable online. He offers free trials, so you can sample his work for yourself at no risk.

APPENDIX B
How to Calculate Pip Values and Examples

DEFINITION

A *pip* is the smallest unit of price movement for any currency pair. For pairs with the JPY as the counter currency, it's 0.01 Yen. For all other pairs, it's 0.0001 of the counter or quote currency.

For example:

- For the EURUSD and most other pairs, movement from 1.4000 to 1.4001 is one pip.
- For the USDJPY, a movement from 80.00 to 80.01 is one pip.

Its cash value is always in terms of the quote currency (the one on the right), which you then convert to whatever currency your account is denominated in, using the currency pair price, which is the actual exchange rate.

CALCULATION

Happily, you needn't go through the following, because there are plenty of free pip calculators you can find online, and the better brokers will provide pip calculators, or their dealing platforms will show pip values in whatever currency your account is denominated.

Still, just so you know, here's the calculation.

The basic formula for calculating a pip value (in the quote or counter currency —the one on the right):

- Pip value per lot equals 1 pip (0.0001 for most currency pairs, or 0.01 if the JPY is the counter currency)
- Divided by the exchange rate or current price of the pair
- Times lot size (in base currency)

Or,

(1 pip/exchange rate or price of the pair)

× lot size [in base currency—the one on the left]

= pip value in the quote currency [the one on the right]

You'll then need to convert the result into the currency in which your account is denominated if that is different from the base currency. (This will all become clear in the following examples.)

Note that a standard lot size is 100,000 units of the *base* currency (the one on the left). Most online retail brokers offer mini accounts in lot sizes of 10,000 units, and micro accounts in lot sizes of 1,000 units.

EXAMPLE: EURUSD

Assuming a standard 100,000 lot size, and EURUSD price of 1.4000, account denominated in USD:

$(0.0001/1.4000) \times 100{,}000 = \$7.14/\text{pip for a standard lot}$

$(\$0.74/\text{pip for a mini lot, } \$0.074/\text{pip for a micro lot})$

If you are trading 3 lots, each pip would be worth 3 times that amount.

If your account is denominated in USD, you'd be finished.

If it is in EUR or JPY, then you'd need to convert the $7.14 into that currency.

For example, if the account is denominated in EUR, then:

$\$7.14 \times 1.4000 \text{ dollars per Euro} = €10.00/\text{pip/standard lot,}$

$€1.00/\text{pip/mini lot, } €0.1000 \text{ per micro lot}$

HANDY RULE OF TENS

When the account is denominated in the base currency, pip values are in units of 10 (except when the JPY is the counter or quote currency).

This illustrates how, when the account is denominated in the base currency, the pip value is:

Standard (100,000 lots base currency): 10 units of the currency in which your account is denominated.

Mini (10,000 lots base currency): 1 unit of the currency in which your account is denominated.

Micro (1,000 lots base currency): 0.10 units of the currency in which your account is denominated.

For instance:

In the earlier EURUSD example, if the account is denominated in Euros, then each pip would be worth €10 for a standard lot size, €1 for a mini lot, and €0.1 for a micro lot.

With any currency pair in which the USD is the base currency (with the majors, that only happens with the USDJPY and USDCAD), the pip value of the USDCAD in a USD-denominated account would be $10 per standard lot, $1.00 for a mini lot, and $0.1000 for a micro lot.

This rule is handy for those who trade the major pairs with EUR or GBP denominated accounts, because these are usually the base currencies. The EUR takes precedence over all others as the base currency, followed by the GBP. Thus the EURGBP is the only major pair with the GBP as the quote or counter currency.

EXAMPLE USDCAD

Assuming a standard 100,000 lot size, and USDCAD price of 1.01935, denominated in USD:

$$(0.0001/1.01935) * 100{,}000 = 10.1935 \text{ CAD/pip}$$

Divide that value by the 1.01935, and you get $10/pip for a standard lot size, $1 for a mini, and $0.10 for a micro account.

EXAMPLE USDJPY: RULE OF TENS DOESN'T APPLY WITH THE JPY

The exception to this rule occurs when the JPY is the quote currency (all the time with the majors) because pips are in increments of 0.01 not 0.0001.

Assuming a standard 100,000 lot size, and USDJPY price of 80, account denominated in USD:

$$0.01/80 \times 100{,}000 = \text{¥}12.50/\text{standard lot}, \text{¥}1.25/\text{pip}/\text{mini lot}, \text{¥}0.125/\text{pip per micro lot}$$

Converting that to USD: ¥12.5/80 = $0.15625/pip for a standard lot, $0.01562/pip for a micro lot, and so on.

Pip calculation is a bit more complex for cross currencies. For the sake of brevity I'll leave that for your own online search.[1]

Note

1. Here's one source to get you started: www.forexfactory.com/showthread.php?t=8568.

APPENDIX C

Forex Trading Time Zones, Liquidity, and Why These Matter

The trading week runs 5.5 days per week, 24 hours a day. It begins in Asia Sunday afternoon Eastern Standard Time (EST), or Sunday evening Greenwich Mean Time (GMT), and progresses each day until the close of trading in the United States as follows.

- New Zealand trading is open from 2:00 p.m. to 11 p.m. EST starting Sunday.
- Sydney is open from 5:00 p.m. to 2:00 a.m. EST.
- Tokyo is open from 7:00 p.m. to 4:00 a.m. EST.
- Hong Kong and Singapore are open from 9 p.m. EST to 6 a.m. EST.
- Frankfurt, Germany, the primary European market, is open from 2:00 a.m. to 11:00 a.m. EST.
- London is open from 3:00 a.m. to 12:00 noon EST. London is the world's largest forex trading center.
- New York opens at 8:00 a.m. to 5:00 p.m. EST. NYC is the second-largest forex center. Not surprisingly, then, the greatest liquidity occurs when both London and New York are operating.

Table C.1 shows this graphically.

TABLE C.1 The Trading Day per EST

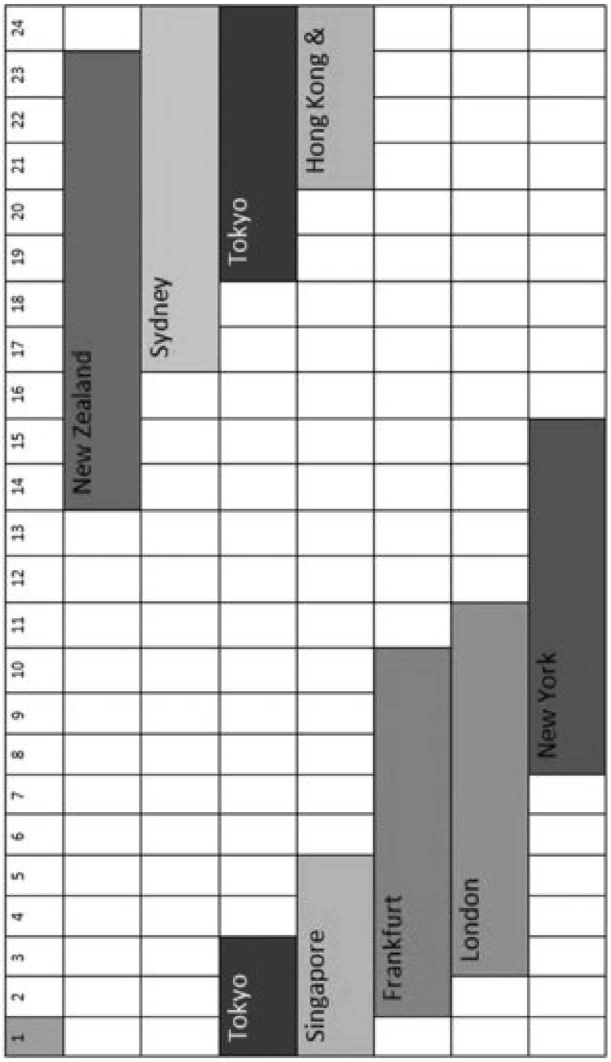
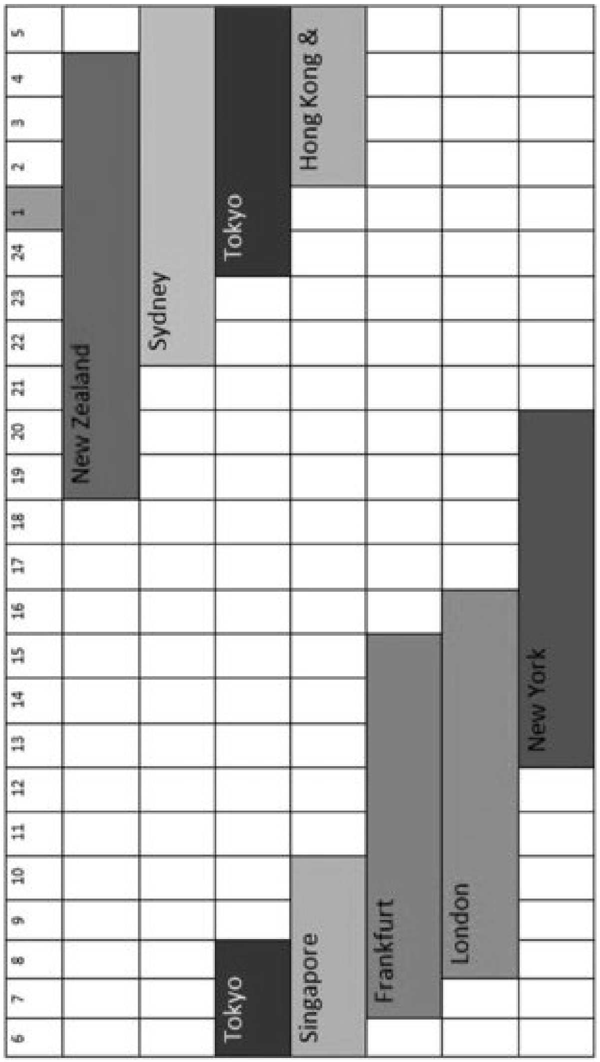


TABLE C.2 Trading Day per GMT(To adjust to GMT, add 5 hours to EST. That is, Tokyo would begin at 12:00 midnight, London at 8:00 a.m.,New York at 12:00 noon, etc.)



THREE MAJOR TRADING SESSIONS AND WHY THEY MATTER

There are three major sessions each day: Asian, London/European, and U.S. The timing of these is important because the best times to trade are when two of the sessions overlap. When they do, the increased liquidity means you get the fairest prices due to the abundance of those willing to take the other side of your trade. These are:

The second most liquid time: 1 to 3 a.m. EST combines the top Asian and European sessions. The most liquid time is 8 to 11 a.m. EST, which combines the most liquid European markets with those of the United States.

Asian: Relatively quiet, lower liquidity, though the JPY may trade heavily if a major financial event has just happened and Asian markets are reacting to it. It is centered near Tokyo.

European/London: Has the highest trading volume; most active currencies are the USD, EUR, and GBP. Heavily centered around London, *the* traditional center of forex markets.

U.S.: The second-heaviest volume; most active currencies are the USD, EUR, JPY, GBP, and AUD. Centered around New York, although includes other U.S. trading centers like Boston, Philadelphia, and (mostly) Chicago.

The most liquid, and thus best hours for trading are when London and the U.S. sessions overlap. You usually get the most participants, and hence strongest price moves and fairest trade execution.

However, don't make the mistake of thinking that each currency trades heaviest in its local time zones. Instead, they trade most heavily in the most liquid markets, during the London and New York sessions.

MARKETS TEND TO FOLLOW EACH OTHER

In all financial markets, not just forex, one session tends to take its cues from the one before it. For example:

If the U.S. markets are bullish or showing risk appetite, Asia will open the same way and continue to do so until whatever news or sentiment that drive the U.S. markets is priced in.

If Asia closes strongly bullish or bearish, expect Europe, centered on London, to open the same way.

If Europe is still rocking higher when the U.S. session opens, expect the United States to open higher, favoring risk assets and risk currencies.

Similarly, if one session reverses the prior session's moves, chances are good that the next session will open in that same direction.

WHAT STOPS THE FOLLOW-THROUGH?

Obviously markets don't continue in one direction for long stretches on a daily basis. What breaks the cycle of follow-through from one session to the next? The two most common forces that change market direction are:

1. News or How It's Interpreted

Major news events or reports are what tend to drive these changes. For example, the United States could close very bullishly, but if during the Asian session some significant bearish news comes, like evidence of China, the biggest Asian economy, slowing down, that could cause Asia to reverse lower.

New interpretations of news events can have the same effect. For example, there are occasions when a major event occurs late Friday in the U.S. session (like U.S. monthly jobs reports) and markets don't have enough time to digest them before the weekend. In such cases, final judgment isn't rendered until the Asian session begins the following week.

2. Technical Resistance: The News Is Already Priced In

Trend exhaustion from technical resistance can also break the cycle of follow-through from one session to the next. In other words, at some point a rally or pullback hits enough technical resistance to halt the current trend unless there is new news to fuel a continuation of the move. Otherwise, all news is already “priced in,” and price either remains locked in a range or reverses as participants take profits or open short positions.

The Prior Session Is Most Influential

Asia tends to lag the New York trading session because Asia is closed when U.S. news comes out, so major U.S. news provides hints about how Asia will open. The European session reacts to early U.S. news but misses later news, and its open is influenced by what happened in Asia. For example, if great news comes from the United States, but then there's bad news in Asia, Europe's opening will reflect how traders are responding to the combination of news from both sessions.

Likewise, the U.S. opening tends to take into account the news of both Asia and Europe.

In sum, short-term moves are heavily influenced by the region that most recently finished its trading day, news, and whether that news justifies moves up to or past the next technical levels. As mentioned earlier, short-term money flows from big players (either from big speculators or simply commercial traders funding normal multinational business operations) can also start short-term price moves.

Beware Holiday Catch-Up Sessions

If Tokyo, London, or New York are closed for a holiday and the other two were open, then you'd expect a catch-up session when markets reopen for that region. For example, if the United States shows strongly improving monthly employment reports on a Friday (during the last session of the last trading day of the week), and closes sharply higher, expect Asia to open strongly to price in that news at the start of the following week.

APPENDIX D
More on Leverage and Margin

As the retail forex industry has developed and expanded since its beginnings in the mid-1990s, so too have regulatory controls, as governments seek to protect the unwary from unscrupulous or what they deem excessively risky leverage limits. Leverage limits vary with time and place.

For example, as of October 18, 2010, U.S. retail forex brokers are limited to 50:1 (2 percent margin) leverage for the most liquid currencies, the majors, and the more liquid crosses, and 20:1 for the exotics. While this may seem positively sedate compared to the 200:1 to 400:1 offered in many places outside the United States, compared to the 2:1 (∼50 percent) margin offered by most equities brokers, the greater risk and reward offered U.S. forex traders is still substantial, and still demands careful RAMM practices.

Note, however, there is a loophole that allows SEC/FINRA-regulated brokers (like Citi, Deutschebank, etc.) to keep offering higher leverage to retail forex trading regardless of these regulations, therefore becoming potentially more attractive to forex traders than CFTC forex brokers (like FXCM, IBFX, etc.).[1]

There is some confusion surrounding the classification of “majors.” In common Forex jargon, the majors are only the seven pairs mentioned in Chapter 2. However, as far as the new rules go, the majors are all pairs which include any two of the following currencies:

- U.S. Dollar (USD)
- British Pound (GBP)
- Swiss Franc (CHF)
- Canadian Dollar (CAD)
- Japanese Yen (JPY)
- Euro (EUR)
- Australian Dollar (AUD)
- New Zealand Dollar (NZD)
- Swedish Krona (SEK)
- Norwegian Krone (NOK)
- Danish Krone (DKK)

This means that a wide range of pairs which are normally considered crosses fall under the majors designation for the purposes of this rule and can be traded at 50:1 leverage (2 percent margin deposit). Trading any other currency pair will demand a margin of 5 percent or 20:1 leverage. The rest can be traded at 20:1 leverage (5 percent margin).

These rules are subject to change, because the new regulations charge the National Futures Association (NFA) with defining which currencies are ‘‘major currencies,” and require at least an annual review of these designations to potentially adjust them as necessary in light of changes in the volatility of currencies and other economic and market factors.

In Japan, maximum leverage was reduced to 1:25 in August 2011, after it had been reduced to 1:50 a year earlier, as per rules set by Japan's Financial Services Agency in 2009.[2] Other nations, like Israel, had already cut leverage to 1:25 a year earlier.

Notes

1. “New Forex Margin Rules Start Today” (October 2010), Fxmadness.com, http://fxmadness.com/2010/10/17/general/new-forex-margin-rules-start-today/.
2. Adil Siddiqui, “Japan Further Reduces Leverage” (August 2011), http://forexmagnates.com/japan-further-reduces-leverage/.

APPENDIX E

How the Mathematics of Loss Demands Keeping Losses Per Trade Low

As noted at the start of Chapter 5, losses hurt you more than gains help you. This is true from both a financial and psychological perspective.

First let's look at the financial side. Losses do disproportionately greater financial damage because in order to recover your losses you need to earn higher returns with a smaller capital base.

For example, let's say you started the year with $100,000 and lost 20 percent, or $20,000, over the course of the year. You now have $80,000 left. To recoup that $20,000 or 20 percent that you lost from your remaining $80,000, you have to make 25 percent on that $80,000. However, if you'd gained just 10 percent over the course of the first year, you would only need a 9 percent return over the coming year on that $110,000 to add another $10,000 to your account.

Which of the two possibilities is more likely? A 10 percent gainer earning 9 percent or a 20 percent loser gaining 25 percent?

Do you see how losses hurt you more than gains help you?

I recommend not risking more than 1 percent to 3 percent per trade. In other words, if you start with a $20,000 account, your stop loss should be close enough to your entry point so that if hit, your loss won't exceed $200 to $600. Assume you follow my advice and risk 2 percent on average.

Here is a more detailed illustration of the difference between risking that 2 percent of your capital and risking 10 percent.

Imagine two traders each starting with a $20,000 account. One risks 2 percent/trade, the other risks 10 percent. Both slide into a losing streak. Look what happens in Table E.1.

TABLE E.1 Difference in Drawdown When Trader Risks 2 Percent versus10 Percent on Each Trade

Trade #	Trader A: Loss with 2 percent Risk per Trade	Total Account	Trader B: Loss with 10 percent Risk per Trade	Total Account
1	$400	$20,000	$2,000	$20,000
2	$392	$19,600	$1,800	$18,000
3	$384	$19,208	$1,620	$16,200
4	$376	$18,824	$1,458	$14,580
5	$369	$18,447	$1,312	$13,122
6	$362	$18,078	$1,181	$11,810
7	$354	$17,717	$1,063	$10,629
8	$347	$17,363	$ 957	$ 9,566
9	$340	$17,015	$ 861	$ 8,609
10	$333	$16,675	$ 775	$ 7,748
11	$327	$16,341	$ 697	$ 6,974
12	$320	$16,015	$ 628	$ 6,276
13	$314	$15,694	$ 565	$ 5,649
14	$308	$15,380	$ 508	$ 5,084
15	$301	$15,073	$ 458	$ 4,575
16	$295	$14,771	$ 412	$ 4,118
17	$290	$14,476	$ 371	$ 3,706
18	$284	$14,186	$ 334	$ 3,335
19	$278	$13,903	$ 300	$ 3,002

After just seven trades, trader B has lost nearly half his capital, and needs to nearly double his money just to break even on the year. Trader A has almost 80 percent of his capital left. Trader A has a realistic chance of recovering if he's smart and takes a break, goes back to a demo account until he believes he's fixed the problem, and then returns to trading smaller positions, ideally with even smaller amounts risked.

Trader B is unlikely to recover without adding additional capital to his account. Remember from Chapter 5 that the more capital you have, the more trade opportunities you're able to take while still only risking 1 to 3 percent of your capital. Trader B can now only afford stop losses that are half the distance from the entry point as those of Trader A. Trader A has more opportunities to make money, because he can afford wider, more realistic stop losses that allow a greater margin of error. Trader B must be very right, very often. Given his past, that's not likely to happen.

In sum, allowing only small losses allows you to survive and recover from the inevitable drawdowns.

To make the point more vividly, Table E.2 shows the damage done from each 10 percent loss.

TABLE E.2 Losses Hurt More Than Gains Help: PercentGain Needed to Recover after Each 10 percent Loss

Trader B Loss of Capital	% Return on Capital Required to Reach Breakeven of $20,000
10%	11%
20%	25%
30%	43%
40%	67%
50%	100%
60%	150%
70%	233%
80%	400%
90%	900%

Get the point? Losses hurt you more than gains help you. Until you have a very strong track record, trade defensively. Focus more on surviving losses than scoring fast gains.

Losses also do disproportionate damage on a psychological level. Researchers have found that the pain of losing money is twice as strong as the joy of gaining the same amount of money.[1]

This pain leads to a psychological bias called Loss Aversion. It manifests itself in the variety of mistakes traders make to avoid admitting they were wrong. These include:

- Adding money to losing positions to lower their cost basis
- Staying in a trade after their stop loss has been hit
- Prematurely exiting trades before price hits likely resistance in order to "lock in" profits

We began Chapter 5 with quotes from two of the most accomplished market players of their era, one a trader, one a longer-term investor. After all their successes, they continued to focus on keeping losses low.

How can we be any less cautious?

Note

1. Tversky, A. & Kahneman, D., "Loss Aversion in Riskless Choice: A Reference Dependent Model" *The Quarterly Journal of Economics*, (1991), http://www.econ.brown.edu/fac/Kfir_Eliaz/LossAversionRisklessChoice.pdf.

APPENDIX F

Choosing a Forex Broker

As with evaluating any vendor, do your homework.

To maintain maximum objectivity, I will neither recommendbrokers nor specific reviews or websites that provide them.

To speed your search, however, I offer the following guidance.

SUGGESTED SEARCH TERMS TO FIND BROKER REVIEWS

Search for reviews using the obvious combinations of keywords like:

- "Forex brokers" AND (reviews OR comparisons)
- "Forex trading" AND "recommended brokers"
- "Online forex trading" AND "broker reviews"

If you're curious about a specific broker, try searching for specific reviews about them. For example,

- FXCM AND reviews
- GFT AND "compared to other brokers"

Criteria to Consider Once you've seen some reviews and have a list of possible brokers, consider how they compare on the following criteria.

A few must-mentions include:

1. Overall good reviews. While there are many forums you can find online, anyone can post anything to many of these, making them great spots for any loser seeking to vent frustration at a broker. Unhappy customers are more likely to post than satisfied ones. You may well do better sticking to websites like DailyForex.com that do their own independent reviews. When visiting these sites, look for evidence credibility. Does the site reveal weaknesses as well as strengths, or do the reviews sound like they were written by the broker's marketing writers? Also, take note if the same brokers that get top reviews are running advertisements or have links on the site to open an account, which create potential conflicts of interest. Check other sites and forums and try to pick up the overall level of satisfaction. ForexMagnates.com is a site dedicated to industry news and can also be a source of who's doing well and who's in trouble.

Look for what traders and reviewers say in regard to information about:

- Transaction costs: commissions (if any), spreads, rollover rates, quality of execution.
- Trading platforms: Many offer a choice, from simple platforms to more advanced and complex ones.
- Where are they located and who regulates them?
- Customer service and trading support.

2. Overall feel of the site: If the site lacks a professional look and feel, if it feels cheap, is hard to navigate, or behaves poorly, there's no reason to expect that your impression will improve with time. Does it look more like a gambling site (gaudy animation, loaded with promises of returns that seem too good to be true, etc.) than a serious investing site?

3. Check out the “About” page. The longer the company has been in business, and the more impressive the management team (their profiles are often available at LinkedIn.com), the more likely they have a reputation and investment to protect.

4. Clear Links to Quality Analysis and Training: *As detailed in Chapter* 5, *content quality is key, and an excellent way to tell who the quality brokers are.* Brokers that don't offer a variety of quality analysis and training that actually helps you find and execute trades (versus just having generic news items) either don't have the financial resources and stability to help you, or don't care enough to do so. *These sites are probably run by gambling-site types. Their business model is to offer minimal content, just for show, while investing heavily in marketing campaigns to provide a needed steady supply of new suckers, gambler sheep, to be fleeced and slaughtered within a matter of months. Remember, unless they're providing useful guidance that helps you survive and succeed, they're probably assuming you'll fail quickly. Move on.* Note: Often a broker will have a content site separate from the main site. As long as the content site is easy to access from the main site's homepage and offers quality content, that's fine. That content should ideally include:

- Analysis that guides you to successful long-and short-term trades.
- Big picture fundamental and technical analysis over long and short terms (daily, weekly, and, ideally, quarterly outlooks).
- Trader training: on the full gamut of topics covered in this book, aimed at a variety of levels. If the material is superficial, then it's more likely serving as a way to fool the gullible into thinking they're ready to succeed, when instead they're just ready to be exploited.

5. Range of assets offered to trade: The wider the variety, the greater your chances of finding a reliable trend in one or more of them.

APPENDIX G

Low Correlations to Other Markets via Social Trading Means There's Always a Bull Market Somewhere*

Global asset markets tend to move in the same direction. More precisely, in times of optimism most risk assets rise and safe haven assets fall. In times of pessimism, the opposite occurs. This phenomenon creates a problem for investors. In good times, the price of risk assets gets bid up as cash floods into risk assets, lowering returns and raising risks that you'll be paying too much and may be buying at the top. In bad times, the same thing occurs, only it's safe haven assets that quickly become expensive.

Through skilled forex trading, it's very possible to achieve market-beating returns that don't correlate closely with other markets. That means it's possible to make exceptional returns even when other risk or safe haven assets are too expensive.

However, the problem for most people is that they aren't skilled forex traders, nor do they have the large sums needed to invest with a top forex account manager, even if they are able to find one.

It is not a problem. Locating top traders is relatively easy via social trading networks. Skilled forex traders are able to achieve returns that are not correlated to other markets. That means, in essence, that they're able to create bull-market returns regardless of what's actually happening in most other markets.

For proof, Currensee.com has kindly consented to let me reprint the following article detailing how its Trade Leaders' results are not correlated to other markets.

TRADE LEADER NONCORRELATIONS TO THE MARKETS

A little while ago I did a basic correlation study. It looked at the markets as well as at the Trade Leaders over the June 2010 to September 2011 time frame. In this post I'll share with you the results.

MARKET CORRELATIONS

Let me first start with the correlations between some of the major market asset classes. They include stocks, fixed income, and gold, which together represent the biggest fraction of the asset allocation for most investors these days. Here's what those cross-market correlations were over that full period.

	USD Index	TLT	HQD	GLD
S&P 500	−0.367	−0.707	−0.338	0.121
USD Index		0.195	0.033	−0.406
TLT			0.658	−0.023
HQD				0.147

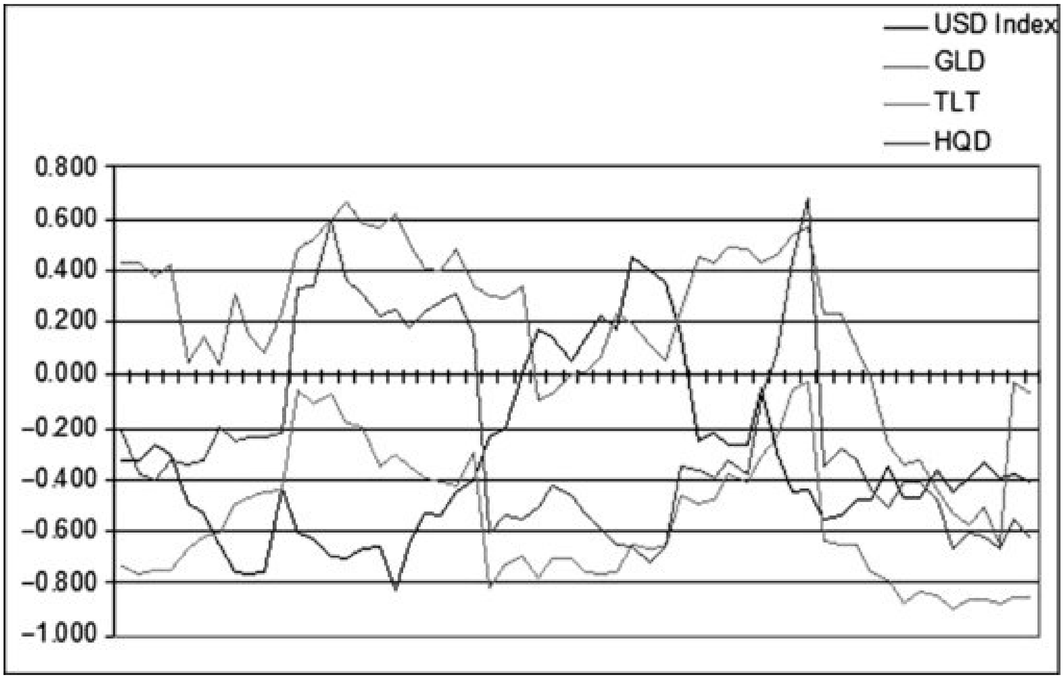
TLT is the leading long-term Treasury securities ETF and HQD is an ETF that focuses on high-grade corporate bonds. GLD is the gold-tracking ETF. I opted to use these ETFs to avoid any kind of issues that using cash bonds or futures might have caused in determining period-over-period returns. These correlations are based on weekly figures.

There probably won't be much surprise in the numbers. Stocks and the bond ETFs are negatively correlated, indicating that stocks and interest rates were generally moving in the same direction. Stocks and the dollar were also negatively correlated, but not hugely so (+1 means totally positively correlated, −1 means totally negatively correlated). The negative correlation between the dollar and GLD is also no surprise.

These aggregate figures mask the reality of the markets, though. Correlations are not static things as the chart in Figure G.1 shows.

FIGURE G.1 S&P 500 Correlations

Source: Currensee, Inc.



Here we have the rolling three-month correlation of the fixed-income ETFs, gold, and the USD Index against the S&P 500. Notice how they have moved up and down and all around. For example, the USD Index was mostly negatively correlated to stocks, but for a while there it went to positive. Likewise, gold was mostly positively correlated to stocks, but in the latter part of the covered time it went negative.

LOOKING AT THE TRADE LEADERS

Now let me turn the attention to the Trade Leaders. Here are the figures for how they correlated against the five markets shown in the studies previously mentioned.

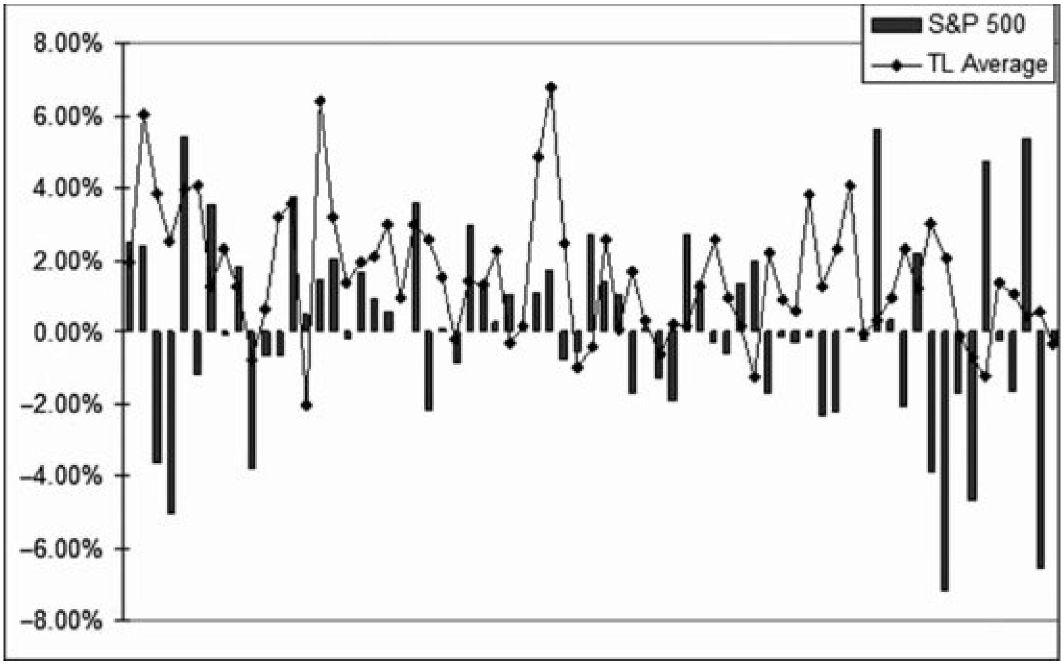
USD Index	S&P 500	GLD	TLT	HQD
−0.239	0.059	−0.065	−0.105	0.145

Notice how small these figures are. The Trade Leaders were modestly negatively correlated to the dollar, but otherwise their returns were essentially not correlated against the other markets. Again, we're talking about a comparison of weekly returns here. I used an equal weight average return for the Trade Leader which incorporated all those that were active during a given week.

To see what this looks like, Figure G.2 is a chart which shows a week-by-week comparison of the Trade Leaders and the S&P 500.

FIGURE G.2 Trade Leaders vs. S&P 500

Source: Currensee Inc.



The S&P 500 weekly returns are indicated by the bars while the line represents the Trade Leaders. It's pretty easy to see how unrelated the returns of the two are in this graph. The directions of the plots are frequently different and the amplitudes are almost never the same. That's basically the definition of uncorrelated.

DIVERSIFICATION OF APPROACH

What we're seeing with the Trade Leaders' correlations is the impact of diversification of trading approach. The index and ETF returns work on the basis of buy-and-hold while the Trade Leaders are employing much more active strategies. Those strategies are somewhat correlated to the direction of the dollar, which will be no real surprise given how much of a focus EUR/USD gets in forex trading, but even that isn't a close relationship. This tends to indicate that Trade Leader performance is mainly a function of skill, not market performance overall.

About the Author

C**liff Wachtel**, CPA, is the Chief Analyst of Anyoption.com, a leading binary options broker, and Director of Market Research, New Media, and Training for Caesartrade.com, a fast-growing forex and CFD broker.

He is also publisher of TheSensibleGuidetoForex.com, a website uniquely dedicated to providing safer, simpler ways for active traders and passive long-term income investors to exploit forex markets for lower currency risk and better returns. When the Great Financial Crisis began in 2007, Cliff was among the first financial writers to focus on stocks that provide steady, currency diversified high-yield income for insurance against losses from currency devaluation. He focuses on top income stocks for exposure to multiple quality currencies on safer, simpler, less demanding types of longer-term forex trades than commonly covered on other forex sites, on the macro view of global markets for formulating longer-term strategies, and on trader training. He also posts these via Globalmarkets.anyoption.com, Globalmarkets.com, TheSensibleGuidetoForex.com, and others. Most can also be found at leading financial websites like SeekingAlpha.com, businessinsider.com, on forex sites like ForexFactory.com, and occasionally in print media like *The Forex Journal*. Many of these are translated into numerous languages, including Spanish, French, Italian, Turkish, Arabic, Swedish, German, Japanese, Chinese, and Russian.

Prior to his current positions, he was Chief Analyst at avafx.com, and a 30-year financial market veteran as investor, trader, writer, and adviser to private clients and institutions.

He is married with five children and lives in Jerusalem, Israel, where he can follow Asian markets in the early morning, Europe through the workday, and the United States at night.