fpmarkets

1.

TRADING STRATEGY SERIES

LEARN HOW TO SPOT OPPORTUNITIES IN VOLATILE MARKETS

FP Markets Pty Ltd ABN 16 112 600 281, Australian Financial Services Licence Number 286354.

Overview

This is one of a series of mini e-books from FP Markets designed to provide you with trading strategies and a guide to some of the technical and charting tools used by the best traders to maximise their returns and minimise trading errors. For any strategy you implement, the aim is to make sure the potential reward is greater than the total risk, and that wins on good trades more than cover the smaller losses on losing trades. To be a successful trader you will require discipline, planning and careful reflection to refine your skills.

Money and Risk Management: Trade Planning

Before we proceed to explore strategies we need to consider Money and Risk Management. You need only a few simple risk management tools to ensure that you have the best chance of making more than you lose, overall, when trading in the financial markets. For simplicity we will use stock prices in examples, but these rules apply to any trade you make, whether it's in shares, indices, commodities or currencies.

Most traders don't risk more than 1 per cent.

If you risk 5% of your initial capital on each of ten trades in a row, and lose money on each, half your capital is gone. Now you have to double your money to get back to square one. The percentage gain required to recoup your losses increases at a much more rapid rate than the loss of capital. So 5% is far too much to risk on one trade, as most traders don't risk more than 1%. The risk we are talking about is the maximum you will lose on the trade if it goes in the wrong direction and triggers your stop-loss order. The first step is to decide on where the stop-loss should be.

Loss of Capital	% Gain Required
10%	11.1%
20%	25%
30%	42.85%
40%	66.66%
50%	100%
60%	150%
70%	233%
80%	400%
90%	900%
100%	Broke

SET YOUR STOP-LOSS USING TECHNICAL TOOLS

Never enter a trade without first deciding at what point you will exit if the trade goes against you. For a long position, one way of doing this is to look back in the past and find a point where the price has met support – a level where new buying checks further decline, causing the price to bounce back up. Place the stop-loss just below this level. For a short position, look for a resistance level near your entry price. This is the price where, in the past, new selling has prevented further rises and the price has repeatedly moved down again after reaching this level. Place your stop-loss just above the resistance level.

Alternatively, check the typical daily price range – the amount the price has been moving, on average, in a day – and set the stop loss at, say twice this amount. For a long position in a stock with a daily range of 10 cents a share, place the stop 20 cents below the entry point. Use an Average True Range (ATR) calculation to refine this strategy (type 'average true range' into your internet search engine for more details). Different multiples of ATR may work better in different markets.

CALCULATE YOUR MAXIMUM POSITION SIZE BASED ON YOUR STOP-LOSS

If your risk capital is $10,000 and your stop-loss is set at 20 cents a share away from the entry price, your maximum position size is the 1% of capital you will risk divided by 20 cents. You do not wish to lose more than $100 on the trade, so the position size will be $100/$0.20 or 500 shares. Remember to adjust the position size if you need to move the stop-loss (for example, if the daily range increases dramatically).

- Don't risk more than 1% of your capital on any one trade.
- Never enter a trade without first deciding at what point you'll exit if it goes against you.
- Calculate your maximum position size based on your stop-loss.

Trend Following – Strategy #1

Trend following, one of the most important concepts in technical analysis, makes use of the tendency of many markets to move in one direction for a considerable time. It doesn't matter whether the trend is up or down provided it lasts long enough for your position to earn significant rewards. It's one of the easiest technical tools to use, and it works particularly well in commodity and currency markets.

> *It's one of the easiest technical tools to use and it works particularly well in commodity and currency markets.*

- Rio Tinto was in an uptrend from October 2009 to January 2010.
- A trend line is drawn from the low point at the start of the trend to the highest low point at the end.
- The time to buy is indicated by the price touching the uptrend line for the third time in late August.

WHAT DOES A TREND LOOK LIKE?

As a price moves up, it keeps making new recent high prices, and often falls back to a lower point that is still higher than previous lows. This succession of higher highs and higher lows defines an upward trend. To illustrate, Rio Tinto was in an uptrend from October 2009 to January 2010. A trend line is one drawn from the low point at the start of the trend to the highest low point at the end. The uptrend, drawn underneath, connects at least three of the low points, each one higher than the last, in a straight line. If the price moves significantly below the trend line, the current upward trend is probably over, although a longer-term upward trend may still be in place.

ENTERING AN UPTREND

Entering an uptrend once it is in place involves buying on any pullback on the price. In the Rio Tinto example, the time to buy is indicated by the price touching the uptrend line for the third time in late August, a sign that the uptrend is in place. It may also be possible to identify a potential up trend before it starts using moving averages. For example, an upward moving price that crosses the 50-day moving average line is signalling the likelihood of a continuing upward trend.

EXITING A TREND

You should not exit until the market tells you the trend is over. For an uptrend, as the price rises, you keep moving your stop-loss point higher so that you exit on any reversal of a known size, usually based on average true range (ATR). With such a trailing stop, the exit is automatic. Earlier, more profitable exits might be spotted using such indicators as head-and-shoulders tops and double tops. Similarly, if you are short, let the market tell you when the downtrend is over. Move your trailing stop down closer to, but still above, the current price by an amount based on ATR.

In the following example, the graph illustrates a downtrend line in Macquarie Group stock in February to July 2011. The downtrend line is drawn on the upside, connecting at least three successively lower high points in a straight line.

Just remember before trading, make sure you understand the strategy and ensure that it fits your trading plan.

ENTERING A DOWNTREND

Don’t be afraid to use a downtrend to profit from falling prices. If the trend is in place, sell on any bounce up close to the downtrend line. A price that has been steadily moving up and suddenly moves down through the uptrend line signals a possible downtrend in the making, as does a move downward through a long-term moving average of 50 or 100 days.

CHANNELS

Prices that have been steadily but only slowly rising, drifting lower, or moving sideways, may form a channel in which the highs can be connected on the high side and the lows form a parallel – or almost parallel – straight line on the low side. A price that moves strongly, breaking through the channel line on either side, is likely to keep moving in that direction. In other words, a rise in price up through the channel line is a buy signal, while a break on the other side suggests a short sale.

Back test your plan using actual market data in the share, commodity or currency you are trading to make sure it works, and ensure you follow sound risk management principles.

Short Selling – Trading Tools

Short selling turns everything upside down. Falling prices are now a benefit; rising prices are undesirable. Instead of paying interest, you actually receive a small amount for as long as you hold the position. Stop losses are placed above the entry price, not below. Little wonder that many traders, so psychologically accustomed to buying before they sell, start to experience a spinning head when thinking about short selling.

Markets do often move faster on the downside. But this comes with a warning about volatility. Fast-moving markets are extremely sensitive to changes in market sentiment – the emotional tenor of the market as shown by their reactions – usually overreactions – to changes in any fundamentals or the outlook for the future.

That means big swings in both directions are often experienced when markets are moving down quickly. Risk management through stop-loss orders is even more vital at such times than when markets are steadily rising. While an asset has a lower limit on its price – it can't fall below zero – it has potentially unlimited upward movement, with correspondingly greater risk if there is no stop-loss in place on a short sale.

- Markets often move faster on the downside.
- When markets are moving down quickly big swings in both directions are often experienced.
- Selling short is a strategy to hedge against a downturn in the price of an asset.

Short selling turns everything upside down. Falling prices are now a benefit; rising prices are undesirable.

BOTH HANDS FREE

People sell short – that is, sell or agree to sell shares or commodities they do not own at the time – for two reasons. One is to hedge against a downturn in the price of the asset – shares or commodity (in currencies, every purchase of one currency is a short sale of another). A copper miner may sell copper derivatives, for example, as a precaution against a falling copper price, or a fund manager may sell shares if he is concerned about falling share prices.

CFD traders are in the market to make profits from changing prices. From the point of view of making gains, the ability to sell short can potentially double the number of potential winning trades in your overall strategy. Neglecting to consider the advantages of short selling is a bit like having one hand tied behind you.

IDENTIFYING SHORT SELLING OPPORTUNITIES

Traders use much the same tools when identifying a price that is likely to fall as they do when scanning for potential winners. Price and volume action as displayed on the charts is the key. With the help of trend lines, support and resistance areas, moving averages, reversal patterns and candlestick patterns, they identify a downtrend, or a sign that the current period of upward or sideways movement has ended and that a reversal is likely.

RISK AND REWARD ANALYSIS

How much am I risking on this trade? How much profit will I make if I win? Together, the answers to those questions define your risk-reward ratio. If you risk $100 and your analysis suggests that your profit target – the price you think the market will probably move to – will give you a gain of $300, your ratio of reward to risk is 3:1. This is the minimum ratio for a share or commodity trade, although in foreign exchange it can be as low as 2:1. You should calculate a risk-reward ratio for every trade you enter, whether long or short.

Note that you don't necessarily close the position as soon as it reaches the profit target unless the market is indicating a reversal. If you sell short and the market is still moving down when it reaches the target, consider reducing the position size, taking some profits but allowing most of the position to ride the ongoing downtrend.

Just as for a long trade, place your stop-loss using chart signals such as average true range or support and resistance.

MACQUARIE GROUP, FEBRUARY 2011

On 18 February 2011 Macquarie Group's price on the ASX fell significantly below the 50-day moving average after making a triple top formation. Chart analysis suggests a probable fall to around $34 from the recent peak of $42. Average true range analysis suggests a stop-loss of around 50 cents above the entry price for a short trade.

At an entry price of $39 and target of $34, the risk-reward ratio is 10:1 ($5 gain for each 50c risked), which is well above the minimum. Using a stop-loss of $38.50 and with risk capital of $50,000, the position size is 1% of risk capital ($500) divided by 50c, or 1000 shares. We sell 1000 CFDs over Macquarie Group at $39.00. If the market rises, we lose 50p a share, or $500, when the position's stop-loss order is triggered.

RESULT

On 29 April the price moves back above the moving average and we take this as a signal to buy back Macquarie Group at $35.88 for a profit of $3.12 per share, or $3120 before costs. Commission of $75 is offset by interest of approximately $72.

- At an entry point of $39 and a target of $34, the risk-reward ratio is 10:1.
- If the market rises, we lose 50c a share when the stop-loss order set is triggered.
- On 29th April 2011 the shares are bought back at $35.88 for a profit of $3.12 per share or $3120 in total.

Summary

In summary this series will deliver trading strategies and frame these with helpful information that will help you improve as a trader.

For traders that do understand how CFDs work and learn to minimise the associated risks, there can be substantial benefiits. Through the utilisation of leverage and the convenience of online trading, short-term traders now have greater opportunities than at any time in the past.

WANT MORE INFORMATION ON CFDS?

FP Markets offer access to a wide range of complimentary trading tools and resources.

Visit www.fpmarkets.com.au for more information. Our DMA CFDs delivers REAL Transparency, Reliability and Trading Value.

FREE DMA CFD TRIAL

Get REAL CFD experience with our FREE 14 day CFD Platform trial.

Visit www.fpmarkets.com.au or call 1300 376 233 for more information.

Should you have any questions or enquiries, please don't hesitate to contact FP Markets.

Level 5, Exchange House 10 Bridge Street
Sydney NSW 2000

T:- 1300 376 233

F:- +61 2 8252 6899

fpmarkets.com

AFSL 286354 ABN. 16 112 600 281