Currency Trading Vehicles

Windsor Advisory Services

Currency Trading Vehicles

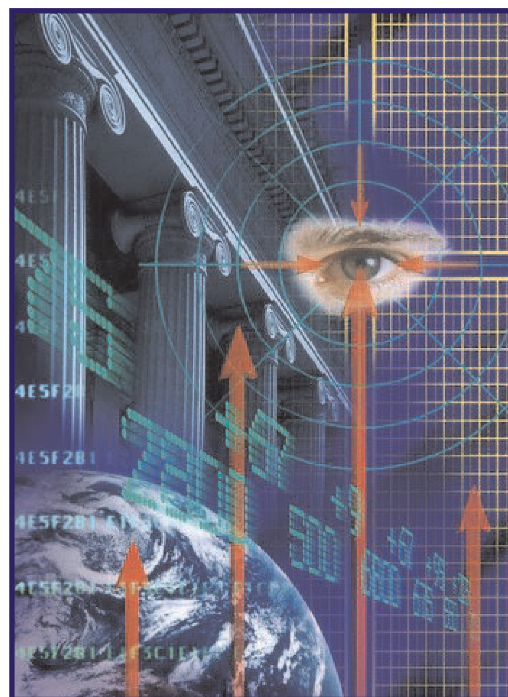
There are a variety of ways to trade currencies and this report will give an introduction to the main ones used by speculators.

Leverage The Key To Large Profit Potential

Currency trading can yield large profit potential due to the use of leverage, which is the ability to trade with a small deposit leveraging a larger investment; profits and losses are therefore magnified. A simple example will illustrate this: A trader deposits $10,000 to trade and is granted a leverage of 20:1. He buys $10,000 worth of his nominated currency. We then need to multiply by his leverage in this case 20:1, so 20 X $10,000 or $200,000. The currency trade moves by 5%, so the profit or loss on the deal is $10,000. Because the trader has only put down a deposit of $10,000 on his investment, he either makes a profit of 100% or he losses his entire deposit. It is the use of leverage that gives the trader the opportunity to make large capital gains. The amount of leverage granted to a customer will depend on the bank or broker and the creditworthiness of the customer, and it is common today for customers to, in many instances, get leverage of up to 100:1.

The Spot Market

This type of trading is the most popular in terms of volume with around 50% of deals conducted in this manner. A spot deal is simply a contract between two parties to a certain currency to a counter party who delivers another currency at a fixed exchange rate. The exchange rate is agreed within two days of the deal date. Spot does not mean that currency exchange occurs on the same day the trade is executed. Currency traders that require same day delivery are called cash transactions. The two-day spot delivery for currencies was developed long before the technological breakthroughs in information processing. This time period was necessary to check out all transaction details and correct any errors. In fact this time period is still important as human errors still occur. A trader can roll his position forward for as long as he wants and the liquidity and volatility of spot trading makes it highly popular with banks, institutions and an increasing number of private speculators.



The Forward Market

In the forward market there is no norm with regard to settlement dates, which can range anywhere between three days and three years. Any deal above the standard two-day spot rate falls into the category of forward trading. There are two types of deal:

A forward outright deal: Which is an individual trade, which matures past the spot delivery date. Since its value date differs from spot, intuitively, we have a rate that

will differ from the spot rate.

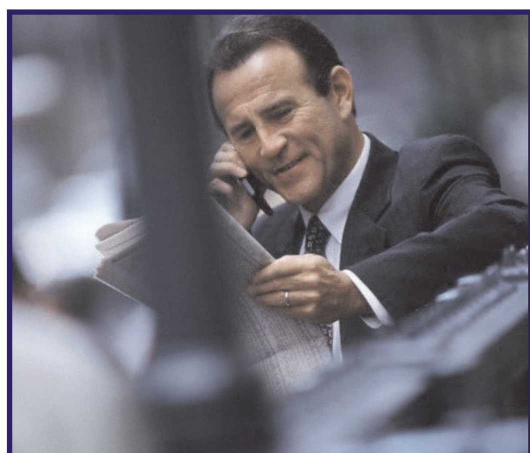
A swap deal: Is different in that it is not one deal it consists of two. All the other deals in currencies consist of single deals. In its original form, a swap deal is a combination of a spot deal and a forward outright deal. Generally, the private trader wants to liquidate his trade quickly to maximise profits and limit losses, so this tends not to be a market traded by private speculators.

The Futures Markets

The futures markets are specific types of forward outright deals. Since they are derived from the spot price, they are a derivative instrument. They are specific with regard to the expiration size and amounts. Whereas forward deals normally can mature past the spot delivery on any valid day agreed between the counter parties, currency forward contracts expire on specific dates, on the third Wednesday of March June September and December.

The currency futures markets have done a lot to promote currency trading to the smaller speculator. When first devised back in the 70s, they allowed small traders to participate when spot deals were only for the larger player. The fact that they were traded in as central regulated market place gave traders a degree of security and a transparent price they could deal off.

The Currency Option - The Ideal Speculative Trading Vehicle



The advantage of trading currencies is the leverage that is made available to speculators in all the methods of trading we have looked at. Leverage, of course, is a double-edged sword in that it increases the ability to make large profits but also increases the loss potential dramatically.

The mechanics of options trading are described in our Introduction To Options in this section. Before reading this and how options work, we just want to summarise why options are the perfect speculative vehicle in terms of flexibility and limiting risk.

Volatility & Staying Power

The big problem, from both a psychological and a monetary point of view, is the volatility of trading on margin. To trade on margin with smaller amounts of money needs strict money management, with the placement of stop losses, where the trade is liquidated on an adverse move against the speculator and this creates a problem. If stops are placed to close then the speculator will be continually stopped out, and then see the market turn around and go in the direction he originally predicted, but rather

than have a profit, he has been stopped out at a loss! Buying options gives the trader not only limited risk but staying power. The trade can move against him in the short term, but providing it trades "in the money" by the expiration of the contract he will make money. The speculator does not, therefore, have to worry about the short-term volatility that occurs, but the longer-term trend. This opportunity to gain unlimited profit potential, linked to limited risk, is a great advantage to speculators. Not only do they gain peace of mind on the risk side, but they have the staying power to ride out short term volatility and they still get unlimited profit potential. In addition, there are a large variety of strategies that can be utilised to take maximum advantage of the speculators view of a currencies direction.

RISK WARNING

Trading in volatile markets, which include foreign currencies and foreign currency derivatives, involves a high degree of risk. Profitability in the past is no guarantee of profitability in the future. The maximum possible loss in the purchase of foreign currency options is limited to the premium, mark-ups and any commissions and fees paid.