BIRD WATCHING in LION Country

Retail Forex Trading EXPLAINED

by Dirk du Toit (aka DrForex)

Bird watching in Lion Country – Retail Forex Trading Explained

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For my darlings, Charlotte, Danielle, Embeth

About Dirk Du Toit

Dirk du Toit hails from sunny South Africa, where he was born in 1963. He currently lives in the Jacaranda City – Pretoria, capital of SA. His two daughters Danielle and Embeth and his wife Charlotte, a professor in econometrics, put up with him as best they can.

After Dirk completed his MA degree at the University of Pretoria, he became a financial advisor in 1991. Since 1998 Dirk has earned his living in the global financial markets - an experience which he says is more nerve racking than rock climbing without a rope and more fun than a birthday when you're six.

Initially he focused on equities and bonds, traded on margin. But the lure of forex was too much and Dirk made the change from a successful bond trader to a successful forex trader.

While sitting around waiting for profits to materialize Dirk founded DayForex (www.dayforex.com) in 2001, in order to help others also to sit around and wait for profits to materialize. These days DayForex focuses also on sitting around and waiting for profits to materialize on investors managed forex accounts. As chief trader and mentor Dirk does all the sitting, only interrupting himself to take profits.

Now for all the worthy stuff: Dirk completed the International Capital Markets Qualification at the Securities Institute of London in 1999; he is an Associate of the Financial Planning Institute of South Africa and he is the Chairman of the Forex Investment Association which helps regulate the forex industry in South Africa.

When he has time between all the sitting around he speaks very well, especially in front of audiences, and tosses off articles on forex investment or write books. This is his second book (and if his wife has anything to do with it, his last). His first, *An Introduction to the Foreign Exchange Market* is a formal study guide for financial markets students in South Africa.

If you think sitting around, waiting for forex profits to materialze, is not a bad way to make money, then this book just may be for you.

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EPILOGUE

Preface

If you tell lies about a product you will be found out – either by the government, which will prosecute you, or by the consumer, who will punish you by not buying your product a second time.

- *David Ogilvy, advertiser*

The first person I met in the retail forex trading industry, the CEO of a prominent start-up forex trading company (IB) in South Africa was previously a star trader – in vending machines. The second person I met was the marketing director of a market maker. I expected to meet knowledgeable, successful and profitable traders. I met fast talking, successful, profitable salesmen. I knew I had entered lion country.

Shattered expectations. That is the result of all financial failures. And shattered expectations are part of the history of the relatively young retail forex trading industry. Thousands of traders expected to become star traders, leaders of a new generation of ‘market wizards’. Instead they became the victims of the ‘marketing wizards’ at the heart of this industry.

Someone once said advertising is the art of making whole lies out of half-truths. In the financial markets, the online forex trading industry is a very good example of this art. Half-truths about what can be achieved and how and in what time. Half-truths about the knowledge and experience of the avalanche of trainers, coaches and mentors pressed on the public through aggressive marketing campaigns. Half-truths about the value and appropriateness of certain types of analysis. Half-truths about the solution to the problems caused by our emotions. Half-truths about the risks involved.

But that is part of life, especially life in the financial markets where it is commonplace to find that the winners are the service providers and not the clients, so aptly illustrated in the book title *“Where are the customers’ yachts?”*

I believe the winners in the trading world are those who know how to distinguish the real truths from the half-truths. They dodge the spells cast by the marketing wizards. They see every composite part of this market in its proper perspective.

It took me a long time to decide what would be my approach in this book, what was the essence I was trying to distil. It became clear to me after mulling it over that what I wanted to convey was exactly this proper perspective. Developing a trading system is such a preoccupation with traders that it is very easy for us to get locked into a narrow-minded view about what we are busy with. This leads to a lack of perspective, openness and consequently a lack of growth, preventing us from accepting and incorporating new ideas and all the while improving our perspectives. You must have a trading system, and I suggest one in this book that has worked for me, but without the right perspective, no trading system will work. It’s easy to give a trading system, much harder to convey a perspective, but it’s in the hard stuff that the nuggets of gold are buried.

The book contains personal opinions and convictions gleaned both from my head and my heart. Here and there is a bit of polemic, but it is not an attempt to engage in a debate about who or what is wrong or right in the forex industry. I have been fortunate enough to be in the small group of winning traders and being philosophically minded as well as deeply contrarian, I have a pretty strong opinion on why this is so (including the fact that I have had my portion of good fortune). So I am going to tell it as it is, how I see it and how I have experienced it.

This book is only in a very limited sense a goal in itself. Conceptually the sequel is already in development. During the last six to eight months I started to look at the development of a more rigid application, or for lack of a better word, ‘automating’ the principles of my trading strategy and methodology.

The preliminary work in this regard is very encouraging and while I am acutely aware of the dangers of curve fitting and other limitations inherent in “optimising” systems based on historical data, I believe the experimentation we have already done confirms that what is described in this book as a 4 X 1 strategy and median trading is indeed a successful recipe. I hope it contributes to your success too.

I want to express my appreciation and thanks to my clients who read and commented on the first drafts of this book. The contribution and role of Lourens Ackermann, who became a client, a friend, a soul mate, and co-writer of this book cannot be expressed in only a sentence or two. You did much more than I anticipated and I value it very highly indeed. Thank you.

Dirk du Toit

September 2004

Part 1

How to build a bomb

"Outside of a dog a book is a man's best friend. Inside a dog it is too dark to read."

- Groucho Marx

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Introduction

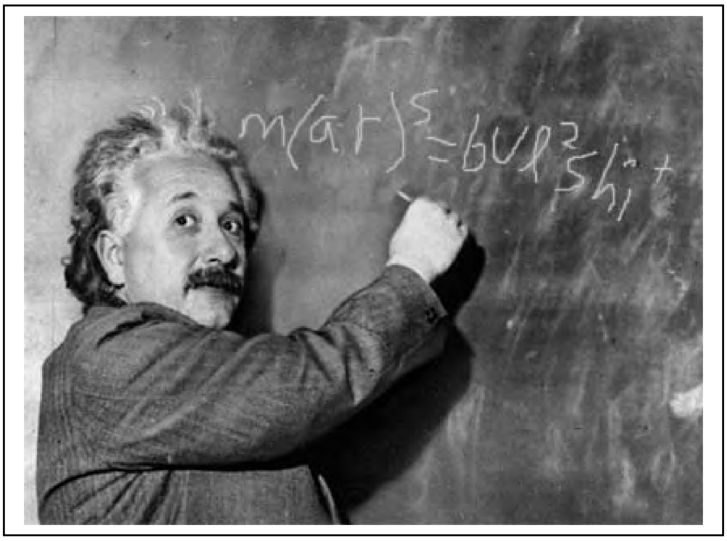
You've probably heard of $E=mc^2$. You may know that it is a famous formula thought out by Albert Einstein. You may also know that it has something to do with energy, mass, and the speed of light. And if you read up on these things then you will know that whereas the equation comes from the early part of the twentieth century it wasn't until later that scientists properly understood its applications for making a bomb. But that's about it. Even if you were really curious you probably are not going to fully understand its implications, what it is really about.

The point is, you may have the formula, but that doesn't mean you know how to build the bomb. So what? So a lot, and here's why.

I am going to give you my formula for how I make money in the currency markets. I take one currency, I trade it in one direction only, I regularly bank one percent of my capital and I do it with low gearing on multiple levels (my 4x1 strategy). There, you have the formula, now go make lots of money.

You can't. You need more.

That's what this book is about. Actually it is about more than that because along the way I am going to tell you that this book is in itself not enough to understand the formula. You will also need a mentor, a teacher, somebody who can explain all that chalk on the blackboard. But without this book as a start, a mentor is probably not going to mean much. Like with school you are going to have to do your own homework.



Chapter 1

Who is this book for?

This book is for those who read books in order to become traders or better traders. It's for those searching for the elusive "successful system". It's for those who are looking for a different approach. It's for those who want to hear what a practicing successful trader has to offer. It's for those of you asking: "I want you to tell me in a language I can understand how I can make money with currency trading".

I have read a considerable number of books on trading myself. Some are good, some are bad, some are indifferent. They come in many shapes and forms, with different styles and approaches. Some are chatty, others are serious and very technical. But none of this matters to me – whether I enjoyed the book or not - when it comes to dividing them into two piles on the floor, the useful pile and the not so useful pile. The useful pile makes a small lump on the floor. The not so useful pile reaches half-way to the roof and that includes books on currency trading.

Throughout, I will be practical; if an issue can be simply explained, I will do so. I will make use of analogies and examples to illustrate what may otherwise be difficult to grasp. If I can't tell you what something is, I will tell you what it is not. One way or another I will get the message across.

A SIMPLE PREMISE

You've heard of Shakespeare's *Macbeth*. It is a play about an ambitious man who wants to become king at all costs. Obviously it's about a lot more than that, but the point is that compelling stories have a central, simple premise. The trading books I like also have simple premises. *Reminiscences of a Stock Operator*[1] is a story about a trader who understood that he could make money if he could figure out what the prices were telling him. *Fooled by Randomness*[2] is the story of a trader who knew how little he actually knew. *Bird Watching in Lion Country* is the story of a trader who loved to put on other traders' hats and second-guess them. In the words of the British economist John Maynard Keynes, I like to "figure out what the average opinion of the average opinion is" and then profit from it.

WHY ISN'T EVERYONE MAKING MONEY?

The reason why many books are not useful is simple enough: useful trading books don't skirt the difficult issues which makes them hard to write since the tough concepts, the vitally important aspects of trading success, are often intangible. They are illusive. If they weren't everyone would be making money. But everyone isn't. I intend facing the tough issues head-on. Why do so many try and so few succeed? And what distinguishes them from the rest? A lot of books appear to give the answer but few actually do. None of the books I have read that specialise in currency trading, address this point. Yet the currency market is probably the leader in terms of creating losers, exactly because it is so hyped these days. Perhaps I should just qualify what I mean by 'the answer' for clearly, given the complexity of the markets, there cannot be such a thing as a simple answer. That would be glib and misleading. Trading is great fun, but it is not easy. This is a fact, if it weren't, you, your neighbour and a good chunk of the world's population would be scooping buckets full of cash out of the market after a cursory introduction.

Some books are loaded with technical jargon. That is inadequate. Others so assiduously avoid being technical that they are airy-fairy. The useful books make clear what the challenges are based on a sound understanding of the market and the forces driving it, and then they put forward rigorous but common sense approaches for successful trading (this common sense is a highly refined version of what you would normally understand by the term).

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[1] Edwin Lefèvre, 1994, John Wiley and Sons Inc.
[2] Nassim Taleb, 2001, Texere Publishing Ltd.

I don't want to frighten you with stories of failure, difficulty or hardship. I want to prepare you. If you know you are about to enter a battle zone, you'll pay more attention, if nothing else, to what I am saying.

I also want to avoid, and, at the same time, expose, the sort of slick and often dishonest marketing which promises great returns for little effort. The aggressively marketed 'surefire systems' you can execute blindly after a one-week course. They all read the same:

"My secret formula, which can be yours for only $69.99, is a high tech, fail-safe mixture of proprietary indicators and oscillators to generate reliable buy and sell signals. Just switch it on and watch the money roll in. Grow your profits day after day! If you order now you'll get, together with your trading CD, a completely free…"

The teasing problem remains. Why is there such a high failure rate amongst day traders, even though there are a plethora of well-meaning and well-trained, advisors with lots of experience teaching these people how to trade?

I believe one of the main reasons is a lack of understanding of the role that randomness plays in trading. That is evident in much of the literature concerning the financial markets where it is often simply glossed over. The radical changes caused by the availability of real-time information are also not properly discounted, especially in "new" markets such as the retail spot forex market.

KNOWING THE MARKET, NOT JUST DESCRIBING IT

The books I treasure, the few making up my small pile, go right to the heart of trading because as varied as they may be in style and content they have this one golden thread that runs through all of them. They grapple with the grassroots issues and are not afraid to tell it like it is. They do not bluff themselves, the first requirement in really understanding the market. That is what it is about: knowing the market. Unsuccessful traders often lose sight of this simple fact while new traders and beginners simply underestimate it in their urge to get to a point where they can "make money". They may know a "system" and how to apply it but none of this is much good if they don't understand the market they are dealing with. In Part 3 of this book, ***"And All That Jazz …"*** I try to address some of the aspects of what it means to really know this market. Books often simply describe the market. That is something different from knowing it. The peculiar characteristics of the currency market have a profound impact on anyone’s ability, from a small trader to a professional fund manager, to trade profitably.

THE “TRYERS”

I would like this book to be useful to a wide range of people trading in the currency market. I intend applying the general principles applicable to all markets with special consideration of the currency market. There will be those of you who have never traded (“tryers”), whose only experience of the currency markets is buying traveler’s cheques and who think that bulls and bears are wild animals. You may need a more thorough introduction to the foreign exchange market and I can recommend my ***An Introduction to The Foreign Exchange Market.*** It is available in e-book format from fxmodule@dayforex.com. (Part 3 “And All that Jazz...” of this book is an abbreviated version (adapted for practical trading purposes) of abovementioned e-book).

There will undoubtedly be some of you who have done a little reading on the subject or perhaps attended a short course on currencies and currency trading, and you may have played around on a demo account or even traded live but now want to make a serious go of it. You may even have been disillusioned with the course you took (and there have been some pretty shocking ones fuelling and feeding off the currency trading boom). That’s fine too. I am not (I hope I am not) prescriptive about my methods or dismissive of the methods of other traders because a mind that needs dogma for comfort will not make a success of trading or training others to trade. I place a lot of emphasis on what you yourself bring to trading and the importance of using your strengths, personal preferences and goals, and shaping them, along with what I give you, into your personalized trading system.

THE “CRIERS”

Then there are a lot of traders who have struggled, lost money, spent time and effort in trying to make head-way, and are feeling that they are simply not getting ‘it’, whatever ‘it’ is. (The “criers”). Don’t despair. I believe a lot of beginner traders are “left behind” by tutors even though these tutors have the proper experience, and are well versed in their own trading systems. The tutor just assumes the learner is comfortable with principles the tutor himself is comfortable with. There are a lot of wrong assumptions out there, assumptions about randomness being one. Assumptions have an enormous impact on short-term trading and influence your approach to trading in general. This, rather than the quality of assistance and advice, leads to the downfall of the new or struggling trader.

TIP SERVICES

The above is most obvious in the case of tip services, where well-meaning trainers / mentors offer their day-to-day trades and tips for sale (I am assuming bona fides because many tip services are scams). What they, the mentors, often do not take into account, is the open position sizes of their clients and the impact, percentage wise, of losses on accounts of different sizes. Often a great deal of freedom is given by tipsters regarding position size, stop loss placement and profit taking. This, even with good calls, can be disastrous. For example, I recently saw somebody conscientiously follow the instructions of a tip service using buy signals. This service, over a three-month period, had one negative month and some up and down in between, but it was generally more right than wrong. Yet, instead of being up on his equity this person lost two-thirds of his sizeable account. This highly acclaimed service ruined a trading career. Were they incompetent? No. Ill-intentioned? Certainly not. But the example serves to illustrate an important point.

There is only one road to success. Your own. You have to learn to put everything together yourself.

Nobody except a mentor you work very closely with on all the aspects of your trading business can make you a winner. Without a mentor you greatly reduce your chances of success.

There is a lot that you know already if you have done any trading and by making a few small adjustments, perhaps putting a little more emphasis on this rather than that, changing your time frame or shifting your focus, setting new, more realistic goals, or by learning a skill you didn't think important in trading, like patience, or some practical application of general business sense, you can turn a bad trading record into a profitable one.

THE MENTOR

I am also going to stress the importance of having **a mentor** and thereby immediately admit the limitations of books such as this. Books have their place and they are always an excellent reference work one can return to again and again but often they are not enough.

Very few people, if any, can finish reading a 'How to' book on trading, put it down, open an account, and start trading profitably. Everyone who trades learnt their trading from someone, not something. And everyone who learnt to trade successfully realised along the way, that mentors, like books, have their limitations. At some point you will have to let go and fly on your own. But mentors are important. Books are final, the printed word stands; mentors are people who can make suggestions, guide and teach because they get to know you. They are more flexible and can accommodate your individual strengths and weaknesses. At the same time there is a temptation to turn a mentor into a guru, or if things go wrong to say it was my mentor, not me. I have students who want me to think for them. The market will reward this attitude with loss. Trading mentors are better than arm-chair mentors. Actively trading mentors can help you by telling you what they are thinking **while** they are trading. That is very useful. They are in the firing line like you, not directing you from the safety of an arm-chair. But they can't apply their know-how on your behalf.

The *Aha!* experience

It's a mistaken belief that someone can teach you that 'something' that will make you a good trader. There is no 'something', no one thing, which makes you a success. Divesting students of this idea is probably one of the most important tasks of a mentor. From my role as a mentor I have realized the importance of allowing oneself to mature, taking your time. Most successful traders at some stage have a break-through, an ***Aha!*** experience. Often this is not new information, or a new approach, but the time was just right, they had matured and were ready to 'see' in a new way, to apprehend things clearly on a conceptual level, rather than a technical level. This book hopes to contribute to your journey towards your ***Aha!*** experience, by addressing both conceptual and practical aspects of currency trading. I will try to illustrate to you what the specific differences on a conceptual level are that distinguish the losers and the winners. Broadly speaking we all start with the same tools, the same information, the same attitude and the same basic ideas. ***The winners and losers are divided not two years down the road or even six months down the road, but from day one.*** If you are in the loser's group (paradigm) you have to make a giant leap to leave it if you want to join the winners group (paradigm).

Another very important role the mentor plays is that he is often in a position to offer objective advice. It is easy to lose your way in trading, get too close to what you are doing. Outside advice does not have to be earth shatteringly insightful in order to be useful. Often the mere fact that it is impartial makes the advice very valuable.

When successful traders recall their mentors it is often to talk about the quality of the person not the trader, their approach to life and not only their approach to trading. It's the mentor's general attitude rather than the tricks of the trade which makes a lasting impression. If after completing this book you want to engage a mentor you can contact me at drforex@dayforex.comT.

CAN I REALLY MAKE IT?

This book is meant to be more than just a primer. It goes into some detail as to what FX is and the nuts and bolts of how it is traded over the Internet, utilizing the power of technology and the services of online market makers.

You may wonder, given the size of some of the participants in the FX market - banks, central banks, mutual funds and corporations – whether it is possible for you to play in this game. ***The answer is "yes".*** Interestingly, the playing field is now leveler than ever before. You have access today to information that was previously the domain of the few. You have it instantaneously just like the other market participants. Furthermore the technology that many households and businesses already have, a PC and Internet connection, is all the equipment required. In addition, until very recently, only financial and investment institutions and very wealthy private individuals (families) could afford to trade forex because of the large minimum lot (transaction) sizes and margin or credit line requirements set by the banks. Today these lot sizes have shrunk to the point where it is feasible to start trading with relatively small – but not undercapitalized – margin accounts. And finally because of the size and liquidity of the FX market it is very difficult to manipulate, and the issue of insider trading, a problem in the stock markets, is non-existent.

But this is still lion country. The landscape is changing fast. During the last few years, the smaller brokers and market makers struggled to establish clearing relationships, professional dealing rooms and software that would appeal to finicky, small, choosy, retail traders, and that would work reliably. Today they have new problems, capacity constraints, too many small clients and too few big ones, clients causing serious congestions at specific junctures such as when major economic data releases take place. These aspects are beginning to influence market pricing and dealing procedures.

It's not just about the trading

The idea for this book sprang from my years as a trader and later a mentor to people with little or no trading experience. I was trading my system successfully but more often than not I couldn't seem to transfer the know-how to some of my students. No matter how hard I tried, some just didn't make the grade. They weren't necessarily wiped out financially, just confused, low on enthusiasm, perplexed by the unbearable lightness of it all.

After a while I realised that certain repetitive mistakes were being made, and repeated. Often those mistakes were not even directly related to trading, and that was why I was not picking them up.

Most beginners have absolutely no clue as to what "successful" means. While they also understand that trading is a serious occupation, a "business", they still lack a clear goal, a business plan, an implementation strategy and methodology. Most just rush in, hoping to find some system that will allow them to "spot successful trades".

COMMON MISTAKES

While lost in lion country from day one, chasing this elusive methodology to make them instant successes, they make probably the biggest mistake of them all. Instead of broadening their horizons, learning more about the market, looking at the bigger picture, longer timeframes, they narrow down their perspective, they specialise in an aspect of an aspect of the market and they look at too short time frames which only serve to increase the affects of randomness. The one thing they should make smaller, position size, they actually make bigger, oblivious of the real effects of gearing, what it can achieve and what it can't.

They dream about "consistency", surefire systems, exact entries, exits and stops, and "unemotional" mental states that cannot realistically be developed before you have your own track record of (relative) success. They do not take responsibility for the major task at hand, namely to develop through their own judgment (discretion) a personal trading system or strategy.

Chapter 2

A Trading System

My actual trading is based on what I call ***Real Time Analysis***. My approach is discretionary. ***I do not subscribe to the myth of non-discretionary trading.*** I do not believe that mechanical trading can deliver extraordinary results. Discretion comes in many forms. You use your discretion in selecting a learning source, in subscribing to this technical analysis indicator rather than that one, or in deciding on the value of simplistic indicators versus complex indicators. If you are an expert you can do all of these with much greater certainty that your choice is likely to be a good one. If you're a beginner you may very well set off on the wrong path.

REAL TIME

Why the emphasis on "real time"? It is absolutely crucial that one considers the changes that occurred between the pre-information age (computer and connectivity) and the furnace of the information age – trading in the global financial markets.

Except for the military no industry contributed more than the international financial markets to meeting the need for real time information delivered through different mediums. The fact that we have this technology must not be underestimated. If you don't understand this, the affect of real time events, and even the real affect of fictitious events on the currency markets, then you are once again bird watching in lion country. We will examine, in some detail, what real time analysis means, but for now you must know that my approach to currency trading is rooted in the here and now, the reality of what is happening around me. This may seem obvious but it is not, and it is the key to trading success in the currency markets.

A lot of people think they know how to listen and what to listen for. They make a few good *"calls"* and their confidence in the system they are developing is high. Then the market goes against them for some time and they feel let down, upset, on the wrong end. They haven't been listening. They've been eavesdropping. Being able to 'listen', to really listen to what the market, the here and now, the reality, is telling you, is a skill you must develop. ***The currency market is like a symphony orchestra.*** There are several instruments all contributing to the creation of a harmonious whole, in this case, the price. The price is precisely what it is, no more, no less, but its very impersonality belies the fact that a multitude of individual contributing factors have come together, and are constantly coming together, in an ongoing real time process of ever changing events. To understand how an entire orchestra produces its sound you need to know what role the individual instruments play, the violin, cello, kettledrums, the flute. The more proficient you get at 'listening' to the market, the better you will become at identifying discordant sounds and like the conductor asking the violinists to pick up the tempo or indicating to the kettle drums to be a touch more retiring, you will act depending on what you hear.

Unlike some trading systems, my system begins before any buy or sell buttons are pushed. ***It includes for example my goals, because these have a direct bearing on when I push the buy or sell buttons.*** Unsuccessful trading can result from factors that have nothing to do with the market. Trading is not simply about analysing price charts. It is also about realistic goals, proper business plans, the sober implementation of strategies and then developing and refining a methodology.

PRACTICAL ASPECTS

Let's take a very brief look at some of the practical aspects of my approach to trading. Remember, it's mine, you can use it, but adapt it, personalize it to fit you.

1. **Business plan** - My trading system starts with proper **goal setting and a well-defined business plan**. Understand that you have embarked on a business venture. Unrealistic expectations can be one of your biggest enemies. What is it that you want? Not what you think you want or think you ought to want. What is it that you really want? You will be surprised how, after a little examination, you may come up with goals that are different, even very different from what you thought. *I want to make money* is not a goal. A goal is *I want to make money because*….or *I want to make money in order to*….and that 'because' or that 'in order to' is critical to your trading success. It is about being realistic and honest with yourself.

   Whatever your goals are, make sure you keep your feet on the ground. Always ask yourself this simple question: Am I trying to achieve the impossible? You cannot make returns of 100% on capital per month. Yet there are service providers selling this absurdity to the public. You may be lucky and do it once using high gearing but I guarantee you this: you will not do it month after month. Unscrupulous service providers are after your money. ***Don't believe their promises or stories. "Open an account with just $500.00. It gives you buying power of $100,000!"*** This is a business - your business, don't confuse it with buying a lottery ticket while running errands.

   Your business plan is an organized process to work towards those goals. Both the setting of realistic long-term goals and the concept of a business plan should place you in a frame of mind that will increase your chances of making a success of your trading. The business plan should include certain "what if" scenarios, the usual "S-W-O-T" (strengths-weaknesses-opportunities-threats) analysis, market research and several other aspects peculiar to a trading business. Reading this book will contribute to your general market research and the development of a profitable business plan you can implement. It even gives some strategic guidelines and methodological pointers. It is not a 1-2-3-you're-a-millionaire-if-you-do-exactly-this-or-your-money-back-guaranteed-guide.

2. **4x1 strategy** - To implement my business plan, I have a **4x1 strategy**, one currency, one lot, one direction, one percent

One currency

Concentrate on one currency. Get to know it. Don't jump back and forth.

One lot

Low gearing. Small position size.

One direction

Trade in the direction of the "fundamental" trend. Be disciplined and patient.

One Percent (1%)

Understand profit – what it is and when to take money off the table

3. **Median trading** - The specific methodology I use to make the nitty-gritty trading decisions I call "median trading". Those of you who may have been around the block a few times, will immediately recognise that the parameters of this methodology are neither original nor new and are used by other successful traders. It remains an interesting, and perhaps instructive fact, that ***many successful traders use much the same basic principles.*** My 4x1 strategy is deployed within a comfort zone I get by 'snapping' a static picture of the market and fixing it in my 'median grid' based on the principle that price always reverts to a median. My median grid is divided into price levels. This is an important concept. Exactly because intra day pricing is virtually random ***I substitute fretting about entries and exits at specific prices with a system of identifying ever changing buying and selling price levels*** of 20 – 50 pips, depending on relevant factors such as account size, gearing and so on. This provides a comfort zone because there is a high probability that immediate future price action will occur within this demarcated zone. It provides flexibility and room-for-error (another very important concept in discretionary trading), in which both discretionary and non-discretionary technical trading produces good results. Price levels, rather than specific prices at specific moments in time are buying and selling zones. This also determines the time frame I use. ***I use a time frame that I feel is "manageable". This means I can relate cause and effect (information and resulting price action / price changes).*** When I can't I can't. I call it noise and ignore it, rather than find a reason just in order to say I have one. I

accept it. The market moved. That's it, let's get on with things. No one can tell you what is happening all the time.

I can also anticipate price changes based on known future events. I can gauge the size of the price move based on the impact of the event. I can also discern between noise (meaningless price changes), trend following / supporting / enhancing price changes or trend changing price changes.

4. **Relational analysis** - Unlike many other good, successful traders who rely solely on technical analysis, I make a lot of use of fundamental analysis (anything that is not technical or psychological). I believe in a holistic approach, the more relevant analysis you include in your trading decision-making the better the decision-making is going to be. ***Relational analysis is what brings it all together, the meaningful relating, one to the other, and all to one, of Price, Event, and Time (PET).*** You must learn to 'see' connections which are not obvious. This applies especially to major fundamental trends. What are the factors at play today that will cause us to look back in three months' time and with the perfect science of hindsight see the obvious trend. If you can see the trend developing with that type of foresight today you are 90% of the way there.

SIMPLIFICATION

There is a temptation, when faced with complexity, to reduce and simplify. That is sometimes necessary, even good, but how much simplification does this complex market allow before it punishes you, not for simplifying, but for being simple? That is the question all traders face everyday. There is no easy answer but finding an acceptable, workable answer will make you a winning trader. It will require you to grapple with this complexity and find your own way through the maze. If I am making it sound difficult then let me say that it really isn't. It's not a stroll, but most people will manage if they apply the basic rules. There are buyers and there are sellers. Sometimes the buyers are in charge and the market moves up. Other times it is the sellers and the market moves down. And sometimes the buyers and the sellers are slugging it out with neither gaining the ascendancy and the market moves side-ways. But within this seemingly simple 'battle' a lot is going on behind the scenes.

PRICE DEPENDS ON YOUR PERSPECTIVE

We must consider that prices may seem high for those with a short-term time frame but low for those with a medium or longer-term time frame. In other words, my buying level is someone else's selling level. It is absolutely irrelevant that someone else buys exactly what I sell (in most cases it's your broker taking the trade and sometimes sending it off into the 1.5 trillion USD daily pool), but it is extremely relevant that more might have been buying at the level I was selling at or vice versa. Time elapses, prices move, sometimes slowly and sometimes not so slowly. This constantly shifting mosaic of prices with its buyers and sellers, its subtle, and sometimes not so subtle moves, is like a multi-coloured tapestry of a face. Close up you can only see a motley jumble of colours. The further back you stand the easier it becomes to relate one aspect of the picture to another until the whole face emerges. Too far back and the face recedes in the distance. Backing up far enough, but not too far, is what I am going to try and teach you. Price, event, time; you must see them as a single entity and then you will understand the message the market is sending you. This relational analysis yields clues and answers questions that will make you money, and although there is no such thing as complete relational analysis (too many facts, too much complexity), practice will allow you to start to "feel" the market and make better trading decisions.

RISK MANAGEMENT

Lastly, but very importantly, the issue of **risk management**. How to take and protect your profits, how to manage your downside. Being able to manage your out-of-the-money positions and minimize your down-side is a crucial aspect of trading success. Sometimes it is easy to make profits but hard to keep them. Exactly the same problem that keeps traders from being successful in general is also applicable to risk management in particular. It has become fashionable to bandy about the concept of stop losses and where to place them. My risk management actually starts with my 4x1 strategy, and particularly **low gearing (small position size).** It is no good having a sophisticated risk management strategy and then blowing it out of the water with too high gearing.

"Cut your losses and run your profits" is an old trader's adage. I subscribe to it in principle but it is often misunderstood. The higher your gearing the seemingly more attractive the adage – you have to cut losses or you are dead. I don't like that approach. It is unsophisticated. Again the mysterious impact of randomness will confound and confuse many oblivious to its prevalent role in any trading system, especially its destructive role in mechanical, mathematically formulated entry-based systems. I have a different approach using, multi entry, low gearing strategies that **do not stop future profits by cutting existing temporary losses**. Positions need time to mature and you can't expect them always to be in the money minutes, hours or sometimes even days after you have entered a trade. Any trade should be able to spend some time on the wrong side of the tracks without you sniffing your nose at its potential profitability.

THE RIGHT VIEW

I am going to talk a lot about perspective in this book. The right perspective and the wrong perspective. In science, the larger your perspective, and the more relevant information you incorporate, the better (more accurate) your conclusion. If your worldview is small and narrow, you are likely to believe that the sun revolves around the earth. If you shift your focus out, the truth becomes apparent. Day (short-term) traders should be cautious however of taking too broad a view. It can be incapacitating. There is simply too much information to digest. Where to strike the balance is part of the skill you must acquire. An ostrich with its head in the sand is in as much danger as an ostrich caught in the headlights. This requires some practice and it is no good having one set view and thinking that is the right view. You need to be flexible, but not too flexible. You will get this balance right with time. Inflexible rules do have their place in trading, particularly in the much-neglected area of money management. And to some extent, every time you make a decision to enter a trade you have reduced a set of relational facts into a belief that this and not that is likely to happen. But you need to maintain an open, non-rigid approach to your own views and your perceptions of the market at any given time.

STRUCTURE OF THE REST OF THIS BOOK

Part 2 "Understanding the Edge" is about understanding that successful trading is about getting an edge. You are entering a world that does not deal in certainties but in probabilities. You need to understand what this means and what consequences it has for a trader. In this part we also introduce the different conceptual aspects that can cause you to either be a winner or a loser.

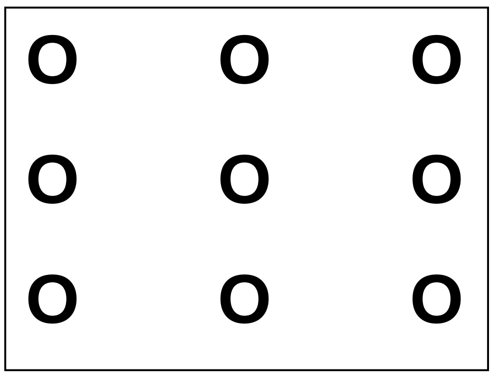
Part 3 "And all that Jazz .." is about the nuts and bolts of the foreign exchange market, what it is, how it functions and who its main players are. I examine the impact these functions, characteristics and players have on you as a retail trader.

Part 4 “Using the Edge” is about identifying the edges you have and looking at sensible ways of increasing these advantages. I then go into some detail explaining what I believe my edge(s) are and how I trade currencies by using these advantages I have accumulated.

My approach, rather than being a holy grail, provides generic edges. It is flexible which means it can be adapted. Take what you like, discard what you don’t (just make sure you know what you are doing first).

“OUTSIDE THE BOX”

Trading currencies will ask of you to consistently think ‘outside the box’, to think on your feet, to trust yourself in apparent adversity, to create room for error, to taste the bitter and the sweet, and to enjoy the unbearable lightness of it all. If you are reading this the chances are that you will, if you haven’t already traded, do some trading one day. If you’re going to trade then identify the challenges, face up to them, understand what it is that will be required of you. Don’t be a bird watcher in lion country.



Start thinking like a winning trader by considering this brainteaser. Link up these 9 dots, with no more than three straight lines without lifting your pen.

Part 2

Understanding the edge

"Chance favours the prepared mind"

- *Louis Pasteur*

Chapter 3 Paint the right picture

Types of traders
Bird watching in lion country
Winners and losers
Perspective
Highway of death
What winners see
Time frames
Soap opera
When the big lions roar
Deep connections
Discretion
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Chapter 4 The Edge

Understanding probability
Paradigm shift
Dealing with randomness
What do successful traders have in common?
Getting started
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Chapter 5 How not to trade

Undercapitalise your account
Underestimate leverage
Place too much importance on timing
Place undue faith in mathematical formula-based indicators
Be inflexible
Trade against the “fundamental” trends
Ignore common sense
Have unrealistic expectations
Trading is not a business, right?
Pass the buck
A bad attitude
Trading too scientifically

Chapter 6 Elements of a proper trading system

Is, not ought
We are the market
The bigger picture
It’s a game – a game of chess
Trading rules
Middle game
End game
Think ahead

Chapter 3

Paint the right picture

TYPES OF TRADERS

Broadly speaking there are three different types of traders. There is the trader who no matter what he does will never make money. He just isn't suited to trading. Temperamentally, emotionally, physically, he just can't do it. Some people can hit a golf ball and others can't. It is just so. You are asking him to be a round peg in a square hole. These traders make out a small percentage of the population. Then there is the trader who knows his stuff but for some reason he can't make money. He is the proficient but poor trader. He's got all the theory, all the knowledge but success eludes him. There is a gap between what he knows and the reality of the market. Into this gap falls all his money. These traders make out a large percentage of the population. They are not stupid, they just haven't closed the gap. Then there is the trader who makes money. He has closed the gap, the money can't escape as losses. It goes into his account. Like the first group these traders make out a small percentage of the population.

How do you close this gap?

BIRD WATCHING IN LION COUNTRY

Let’s start with a story. Imagine a man bird watching, strolling through the bush on a fine summer’s day, enjoying the sunshine. On his walk he sees an object sticking out of a bush. It’s about a meter in length and two inches in diameter. The man is curious and moves closer. What could it be? Still curious he moves even closer and picks it up. The object turns out to be a tail, and attached to the other end of the tail is the rest of the lion.

Many traders play with fire without knowing it. They are full of curiosity but their biggest problem is that they look without seeing. They are literal. What’s that sticking out of the bush, I think I’ll give it a yank and see what happens. This is a different way of saying that they do not really understand the market they are in and are forced to take chances. They cannot paint an accurate picture of the currency market. This is not easy for unlike many other markets the currency market has no headquarters, no CEO, no employees like a company that issues stocks. But that does not mean that it is not real. It is, you’ll know that once you’ve lost money in it.

WINNERS AND LOSERS

So the first thing you need to know is that you will be required to visualize and make concrete an intangible entity. This is difficult and challenging but you need to have a fixed picture while at the same time be capable of rapid adaptation. If you can fix an accurate picture of this market in your mind, then the probability of you being a winner has sky-rocketed and you are going to end up taking home the proficient but poor traders’ money. I am going to talk in this book of winners and losers and because these words have multiple connotations I am going to state up front what I mean by them. The winners are the ones who make money, the losers don’t. That is all, no more no less. This is not about character, integrity or honor. It’s about trading currencies for profit.

To get back to our story for a minute, the difference between the winners and the losers is that the winners take the time and the effort to walk around the bush. The losers just pick up the tail and hope for the best. Don’t pick something up if you don’t know what it is. That’s risky. Yet you will be amazed by how many people do just that. They are rewarded by an unpleasant mauling, and often it is fatal.

My aim, as a mentor to my students, is to *not* have them standing unprotected and all alone out in the bush holding on to a lion's tail. I want to equip them with tracking skills, I want to improve their senses, I want to give them a chance in a hostile environment. The markets are often referred to as a jungle. It's an apt analogy for there are many dangers lurking unseen. You need to be awake and attuned to all the clues that can save your life or make you money.

***Perspective*, the word, means a way of regarding situations, facts, and judging their relative importance.**

PERSPECTIVE

I want to just get back for a minute to this issue of what the currency market looks like, or if one wishes to express it in the negative, why a lot of traders don't see properly. It has to do with perspective. What the currency market looks like depends on the perspective you choose.

What perspective you choose is directly related to whether you will make money or not.

You need to choose a perspective that is right for you. This is partly a matter of temperament. You can choose a perspective which is ill-suited to your personality and your expectations. But it is also a question of maths – it has to do with randomness and probability. The smaller your time frame the greater the randomness of what you are observing. If you are looking at price changes every minute the degree of randomness is very high and your probability of anticipating the next correct price movement, or series of price movements, is very low. There are few market participants that consistently make money using a very short time frame. I suggest you do not try joining them before thoroughly exhausting all other options. This book is one of those options. Rather work with time frames that are larger and therefore more apt at consistently producing good results for a large number of traders. If you are looking at prices once a week or once a month you have reduced the degree of randomness significantly and increased the correctness of your predictive probability greatly. Clearly once a month or once a week is too long for a day trader so your challenge is to find the right perspective somewhere in-between the strictly intra day and longer-term extremes.

HIGHWAY OF DEATH

You've got to be very careful if you don't know where you are going, because you might not get there.

- Yogi Berra

In order to give you a better understanding of what I mean by perspective I would like to use an analogy. Think of the currency market, these constantly fluctuating prices and this never ending stream of information, as a highway.

The losers are easy to recognize. They are the guys standing on the shoulder of the highway looking at the cars right in front of them with binoculars. Except they don't know that it's a highway and that these hurtling objects are cars. That's because they've got tunnel vision. What do they see? It's something moving fast, but what exactly it is is hard to say. It is all a bit of a blur. What do they hear? A lot of noise. In currency trading parlance they are looking at a too short time frame, trying to pick the intra day direction of the market by looking at one, five, ten, or fifteen-minute price changes.

Now, say the cars slow down. The close-up watchers start to get excited. They can almost make out a shape. Just as they start to see an outline the cars speed up again. Faster, slower, faster slower, noise, noise, noise. They are starting to get edgy and make the fatal mistake of thinking the closer they get the better they'll see. All that happens is that the objects appear to move faster. So they move even closer adjusting the focus but the focus doesn't work precisely because they are too close. They keep moving forward, desperate for a glimpse. And then - Whump! Another hit-and-run on the currency highway of death.

This edging towards destruction is often accompanied by higher gearing (the closer you are to the market the more you can see, right?) and tighter stop losses. All that it does is hasten the inevitable end. If you are standing back it may seem obvious and easy to point out the mistakes. Close up, and it's very difficult. The loser has a too small picture. He has his face pressed to the glass but can see nothing of the world passing him by. He is the guy who picks up the lion's tail.

WHAT WINNERS SEE

Contrast that with the winners. There are only a few of them spread across the top of a hill set well back from the highway. Because the winners are further away from the highway, the cars appear to be traveling slower, at a comfortable speed. They have no trouble distinguishing one from the other. There is less noise. The winners can see the bottlenecks, and predict with greater accuracy whether this particular traffic jam is serious or not (ie, is this price going to speed up, slow down, reverse?). Everything is in focus. Because they have distance and perspective they are in a better position to make good trading decisions. The winners differ from the losers in that their perspective of the market is more suitable to their strategy and expectations.

This is not the only difference but it is an important one. This book is partly about perspective, what the right perspective is, and how to get it. Perspective, the word, means a way of regarding situations, facts and judging their relative importance. The right perspective means a proper or accurate point of view. There is no one ‘accurate point of view’ of the market. It does not lend itself to that sort of exactness. There are several valid or good, or good enough, perspectives of the currency market. Each one can lay the foundations for a successful trading career.

What is important is that you find your perspective, the one that is going to give you an edge.

I can’t say this one perspective is better than that one. But that is something entirely different from me being able to say, and say it with a great amount of certainty, that certain perspectives will make it very difficult to trade successfully. It has to do with time frame, a practical aspect of your larger perspective. Here is why.

TIME FRAMES

Consider the two time frames you have to work with when trading. There is the time frame for making money which you have set as a goal, your *personal time frame*, and the time frame of the market you have chosen to work with which I will call your *chosen time frame*. These two time frames, your personal and your chosen time frames, must be adequate or realistic standing alone, and together they must dovetail. Let’s examine briefly what this means.

Adequate or realistic in this context means that there must be some meaningful correlation, some sensible or reasonable connection between the goals you have set and the way you go about achieving them on the one hand, and the known behavior of the market you are trading on the other hand. What you want has to take into account what you are dealing with. If you are bird watching in lion country and a lion attacks you you can try to use your binoculars to defend yourself, but they are probably going to be inadequate. Be realistic about what you are doing, what you are dealing with, what the dangers are and how well you can 'defend' yourself against them.

Practically this means that prepared traders have considered a number of factors that unprepared traders haven't, such as a mature, realistic assessment of their current situation, i.e. are they working full-time or part-time, are they just experimenting a bit with trading or is it a serious occupation. How does trading in a 24 hour market fit in with their existing daily rhythm? This market has specific important junctions, road signs if you like, at weird and wonderful times. It may be 9 o'clock in the morning for the professional traders in London or New York moving the market, but what time is it for you? Midnight? Time to spend with the kids? Time to get on the tube? Time to catch a plane, have a meeting, write an exam? These aspects will have a huge impact on your overall performance.

Personal time frame

Your *personal time frame* is the time you have given yourself to make money in, for example, a month, a quarter or a calendar year. This period must in itself be reasonable. Because of the volatility of the market there will be times when you are out of the money on some or all of your positions. What happens if you have two losing months in a row? Are you a bad trader, have you been unsuccessful? Yes, if a month is your personal time frame. Maybe you feel like a failure, but is one two or even three months all that important in terms of a lifelong investment in currency trading? Or is this just something you are going to give a try, and abandon at the first sign of trouble? If, however, your time frame is a year, or longer (you are viewing your trading as a business and a long term venture) then two losing months is simply a bad start to the year. The answer to whether or not you have been successful depends on how realistic your personal time frame is.

Considering your goals, especially the criteria you are going to use to measure if you are on track, is a vital aspect of your business plan. This will fundamentally affect every aspect of your trading and the choices you are going to make, and sometimes will have to make, regarding your trading business. Define what you consider success in your new venture, and please, give yourself a chance by being realistic. Try to take into account that this market will go against you, you will have out-of-the-money periods, there will be periods where inactivity is your ally and this can be frustrating to the novice.

Chosen time frame

Your *chosen time frame* of the market is, simply put, a choice about what sort of price movement you consider significant over a given period. This time frame can't be too long or too short. If it is too long you are not going to allow yourself time to enter the market and benefit from its daily volatility. If it is too short you are merely playing with randomness. The shorter your time frame the greater the randomness of price movements. Most day traders err by picking time frames that are too short. If you are watching a five minute or ten minute graph, you are merely watching prices randomly tick up and down. Yet there are traders, not many, who make money doing this. But what they are in fact doing is not basing their entire trading strategy on five minute graphs. Instead they have a good grasp of the bigger picture and are using these short time frame graphs to time their entries. In this they are misguided and I can prove it to them. Five minute or ten minute or fifteen minute graphs tell you nothing except how random randomness is. These traders should do a back test looking at what the market did immediately after they entered it. Go test it yourself on a demo account if you don't believe me. Half the time the market will move up and half the time it will move down. You are witnessing flurries of movement scurrying up and down with no discernible trend or pattern. Random movement. So why bother? I say, pick a level, it can be anything from 20 to 40 pips and get in, trusting that your level, and not the next move, is what is important. You'll sweat less too. Give randomness its due.

That is why I can say that some time frames are wrong (read "not optimal"), and I can say this with a great amount of certainty. Add to this the fact that you are probably watching the prices fed to you by one market maker, your market maker, while at the same time there are literally hundreds of other market makers all quoting their own prices. Since the market is reasonably efficient these prices won't differ too much but that of course is a function of your time frame. The smaller your time frame the greater this distortion. Two or three pips difference in a day which averages a 100 pips movement is far less significant than two or three pips in a ten minute period averaging only, say, a seven pip move. On a risk management level this also amplifies the risk exponentially. It is simply not true that you can apply universal risk management principals of risk reward, stop loss and other parameters on all time frames. Informed readers should make a note here that I differ from conventional wisdom on this point. I don't only differ on a basic, mathematical, statistical and probability theory level from this but also on a behavioral psychological level and a common sense (the most important) level. A trader can lack a lot of things, patience, discipline, but a bit of common sense goes a long way.

Relate personal and chosen time frames

Your personal and chosen time frames must not only be sound in themselves but in sync with each other. For example, you can't have a personal time frame of banking a profit a day while your chosen time frame is a weekly graph. These issues will become clearer when we start to look at practical trading strategies. For now I want you just to take note of the role which perspective and time frame plays in currency trading.

If I make the statement that having a view on the market (which way it will go) on any given day is fooling yourself - you are largely at the mercy of randomness - how is it possible, you may legitimately ask, to have a daily online briefing with my students and clients in which we look at the market, form opinions and take trading decisions? It has to do with the underlying longer-term view I have. This opinion, though formed daily, is made up of a composite of factors and some of these factors are longer term in order to reduce the role randomness plays. If I had to call currencies on a discrete daily basis, that is, for that day only without recourse to the price relative to recent highs and lows, upcoming or past events, in other words all the relevant and available information I normally use, I would flip a coin.

Randomness and time frames

Think about it like this. A coin, like a five minute graph, has no memory. Just because it has come up heads eight times in a row, it doesn't start to 'adjust' itself in order to provide the required probability balance of a 50/50 ratio over a given number of flips. Five minute charts are the same. They are like coin flipping. To call whether the next 5 minute period will end up or down is exactly like flipping a coin. Go try it. Prove it to yourself. These 5 minute periods have no memory. So why watch them for signals? People do, but very few make money from it. Those that do, as I have pointed out above, are doing something else besides. They are doing the right things using the wrong methods. They probably have a good grasp of the fundamentals and the bigger picture, trade with discipline, have a sound money management strategy, and so on. This, not watching randomness, is making them money. They may have taken a five minute graph and zoomed it out so that they are looking at a day's action. That's fine. But that is something different.

No matter what your time frame, entering the market and being in-the-money five minutes later is luck. That is all. It is nice, sure, but needing that fix is dangerous. It can't be repeated with any certainty. Short time frames give you no information that can turn a random series of price events into a series with higher predictive certainty, a probability that this and not that will occour. If you are winning then you are on a lucky streak. It will end. If you are consistently making money you are probably, inadvertently trading in the direction of the long-term underlying trend. This is unlikely though, since people who use short time frames generally don't keep their positions open for long enough to benefit from the long term trend (assuming that they are trading in that direction).

SOAP OPERA

Think of your time frames as episodes of a soap opera. Now, if you only watch one episode in a year, you won't know where the story is going, or where it has come from, and whether the ending is likely to be happy or sad. If you watch every episode you will probably get too involved and lose your objectivity. You'll side with this character against that character, or hope that this or that event will or won't occur. This is dangerous in trading because ideally you want to evaluate what is going on without getting involved with what is going on. Currency trading is like watching a soap opera enough to know what is going on but not so much that you become emotionally involved. You have to work out what the minimum number of episodes is that you can watch without being in the dark and the maximum number of episodes you can watch without becoming part of the soap, losing your objectivity, and taking sides. Clearly there is not a perfect number. But we can say that watching all the episodes is too much and watching one is too little.

The Pennsylvania Dutchman

Add to this the problem of the 'intangibility factor' inherent in currencies versus stocks and the importance of not only watching the right amount of episodes of the 'soap opera' but also of being able to see the characters for what they are, what they represent and how they will affect the outcome of the storyline, and you begin to understand some of the challenges of currency trading. Let me illustrate what I mean by way of an example.

The story is recounted in one of my favourite trading books, *Reminiscences of a Stock Operator* where an investor known as the Pennsylvania Dutchman who owned shares in a company called Atchison had heard some disquieting reports about the company and its management[1]. The President of the company, instead of being prudent, was rumoured to be profligate. The Dutchman wanted some facts.

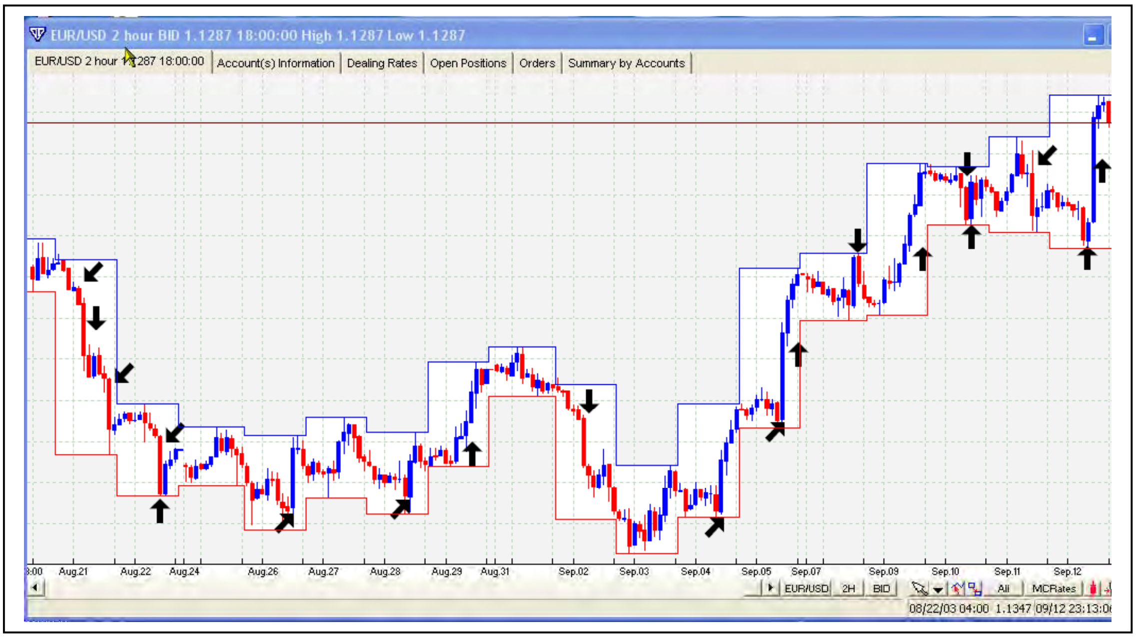
> *He hurried over to Boston to interview Mr. Reinhart [the President] and ask him a few questions. The questions consisted of repeating the accusations he had heard and then asking the president of the Atchison, Topeka & Santa Fe Railroad if they were true. Mr. Reinhart not only denied the allegations emphatically but said even more: He proceeded to prove by the figures that the allegators (sic) were malicious liars. The Pennsylvania Dutchman had asked for exact information and the president gave it to him, showing him what the company was doing and how it stood financially, to a cent. The Pennsylvania Dutchman thanked President Reinhart, returned to New York and promptly sold all his Atchison holdings. A week or so later he used his idle funds to buy a big lot of Delaware, Lackawanna & Western. Years afterward we were talking of lucky swaps and he cited, his own case. He explained what prompted him to make it. "You see," he said, "I noticed that President Reinhart when he wrote down figures, took sheets of letter paper from a pigeonhole in his mahogany roll-top desk. It was fine heavy linen paper with beautifully engraved letterheads in two colors. It was not only very expensive but worse--it was unnecessarily expensive. He would write a few figures on a sheet to show me exactly what the company was earning on certain divisions or to prove how they were cutting down expenses or operating costs, and then he would crumple up the sheet of expensive paper and throw it in the waste-basket. Pretty soon he would want to impress me with the economies they were introducing and he would reach for a fresh sheet of the beautiful notepaper with the engraved letterheads in two colors. A few figures--and bingo, into the waste-basket! More money wasted without a thought. It struck me that if the president was that kind of a man he would scarcely be likely to insist upon having or rewarding economical assistants. I therefore decided to believe the people who had told me the management was extravagant instead of accepting the president's version and I sold what Atchison stock I held."*

[1] Edwin Lefẻvre, *Reminiscences of a Stock Operator,* p. 208

The Dutchman had a worry. He laid his worry to rest by climbing into his car, driving over to the company HQ, talking with its top man and, having got a perspective on the situation, he made a decision. Clearly you can't get in your car and drive over to Forex HQ and have a chat with Mr Forex CEO. If I am stating the obvious then you will be surprised to know how many people have never properly absorbed the implications of this simple fact. What does one do to get a proper picture of the currency markets? The Dutchman simply had to walk into an office and ask a few questions and that contributed to his ability to become a successful trader. But what does our 'office' look like, where do we find our 'President'? How do we compensate for this absence of place and person in the currency market?

WHEN THE BIG LIONS ROAR

Everyone forms a picture in order to anticipate price moves, but how do you know how useful your picture is? Part of the answer lies in knowing what you can't know. Unrepresentative perspectives have in common the fact that their authors are seeing things that aren't there or that aren't relevant. Are there ways to get a good picture of this market? The answer is yes, and specifically the answer lies in, once again, not being too literal, walking around the bush before picking up dangerous objects, standing back from the highway to get a good perspective, and understanding the deep connections that are at play in the world of foreign exchange. In this market it is big money that moves prices up and down. Powerful entities, large institutions, central banks, these are all forces acting on the market, and, compared to you, they are very big and very strong. What you need to keep in mind is that this massive daily volume is made up of so many different role players, all of whom may have different motives, time frames, and different goals. Think about this. What happens when one player buys say, 300 million USD for a reason that has nothing to do with speculative currency trading? This type of transaction can happen at any time, without warning, day or night. There is a school of thought in technical analysis that the latest price contains all the relevant information. One 300 million USD purchase puts pay to any notion of meaningful relevant information in the sense it is used above, not to mention the usefulness, or rather lack thereof, of a 5 minute graph. That is why intra day currency price graphs look like this – the whole time:



You are looking at lion country.

DEEP CONNECTIONS

(P)rice + (E)vent + (T)ime = PET

In trading you need to make connections between disparate pieces of information: price, event and time (PET). From these connections you make deductions which proceed to trading decisions based on specific prices, or rather price levels. How you make these connections and deductions determine your success. For example, technical analysis and its indicators were developed primarily in order to trade stocks, futures and options on centralized exchanges. The difference between stocks and currencies is night and day. It's like comparing a hyrax (dassie) and an elephant; biologists have proven that the two were related many millions of years ago even though today one stands three meters tall and weighs five tons while the other is scarcely ankle height. I do use technical analysis, it is a valuable tool, but you have to understand what you are doing and why certain aspects of technical analysis and technical indicators are not suitable for short term currency trading. My students who struggle usually come from a background where indicators played a large role in their trading decision-making. I deal with indicators more fully in Part 4. I am skeptical of some as they are applied to currency trading. The story of the Pennsylvania Dutchmen illustrates the quality of 'tangibility' associated with the stock market and by contrast the 'intangibleness' of the currency market and this results in an even greater temptation to look for a sign, the certainty that some indicators seem to provide. Resist the temptation. It may be assumed that because of my skeptical views on aspects of technical analysis that I am a trader who relies heavily on the fundamentals to make short term trading decisions. I am not. Just as you can't make money trading this market relying only on the technicals you can't trade it only on the fundamentals.

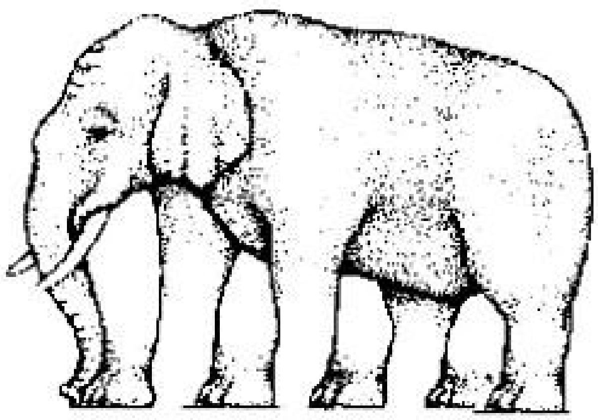
DISCRETION

I don't have a neat description of what I am, or how I should be classed, except to say that I have elevated discretion, my own discretion and the edge it gives me, to the point that if pressed I would call myself a discretionary technical trader. It's really not important what type of a trader I am. What is important is to know that your well exercised *informed* discretion and judgment is as good, if not better, than any indicator. I use technical analysis, but I employ it selectively. A lot of what trading is, is knowing what it is not. You will know something about what trading is *not* once you've finished this book. (I hope, more importantly, you will also know something about what it is.)

In currency trading you live in real time, or you don't live at all.

Also understand that what moves currency markets is different from what moves stocks. Do Microsoft's shares rise and fall on an insignificant throwaway comment by Bill Gates. Probably not. But let Alan Greenspan, chairman of the Fed sneeze, and currency markets catch a cold. When he appears on TV three weeks before a Fed rate announcement, currency traders start looking for signs. We're paranoid enough to start with but it gets ridiculous: is he walking differently? What is he trying to tell us by wearing the grey suit? Didn't he touch his left ear twice before dropping rates last year? What does he mean 'it's a nice day'? This may sound like silly exaggeration but it serves to illustrate the symptoms sometimes exhibited by currency traders as a direct result of the impact news has on currency prices. You have to be attuned and sometimes you run the risk of becoming 'over-attuned.'

In currency trading you live in real time, or you don't live at all. It's about here, now, or it's about nothing. Who is the quickest on the draw? It's not like the Wild West, it *is* the Wild West. It's the real thing, real time, real money. It's what I base my approach and my system on. It's why I call it **Real Time Analysis**. If you are going to grapple, grapple with reality. And just to complicate things further you need to know if you are not already aware of it that reality is not always what it seems.



How many legs does this elephant have?

Who would have thought a deep connection exists between mass and energy? It's perhaps not obvious, even counter-intuitive but there it is. Science in its most famous formula $E=mc^2$ has proven this relationship. You can understand all the different aspects of trading but without understanding their deep connections you are stumbling about in the dark. Deep connections help to formulate a picture you can rely on. It is so often the case; a novice trader diligently applies himself, a thorough study of technical analysis, fundamental analysis, and psychology is undertaken. He knows his stuff, no question. But still he can't make money. What's happening? What's happening is a short-circuit. The deep connection is not there. There may be many reasons why but they all come down to the same thing. The movement of currencies takes place in the real world in real time. A gap between your system and the real world is exactly where the money disappears into. Deep connections are what close this gap.

For example, there is a connection between leverage and speed. I learnt this when I made a mistake on a new platform I was trading on. Instead of being geared 3:1 one day I was geared 30:1 – I had bought $100,000 lots instead of $10,000 lots. Though I had made a mistake on the gearing, an amount, it manifested in speed, my equity moving up and down at an alarming rate. The markets weren't moving faster or slower. But everything in my world represented by my equity balance was.

DIFFERENT MOTIVES

You have to consider that some participants in the FX market will do exactly the same trade at roughly the same time (of day even) but with different, unconnected perspectives, goals and outcomes. For the small day trader this means that you must be conscious of the perspective of those "powerhouses" who really move the market when they start sending money, speculative or not, across countries' borders. At the risk of oversimplification one should always consider that there are at least three or four diverse groups of traders, who may trade in the same general direction (buy or sell a specific currency) at the same time or price but for completely different reasons. And just as "time" here refers to much more than a minute or two, price refers rather to a price level rather than one specific price. It must. Big money doesn't sit and watch five minute graphs in order to 'time' an entry. There you are, agonizing over two or three pips and the guy, the institution who is going to make a difference to the price when it gets in, buys for example, not because he is even looking at the price but because he must repatriate funds before the end of the week for, say, tax purposes. Can you see what I am getting at, how self-delusional you are being when two or three pips means something significant to you. Think about the investment horizons of these major players. They may differ significantly; years, months, weeks.

Take Warren Buffet for example. He recently took a view against the dollar. He thinks US assets are too expensive. His portfolio is cash heavy. But US cash (dollars) is losing its value and he believes this will continue for years. So he keeps some cash in other currencies to benefit from the fact that they may strengthen against the dollar. In order to do this he has to exchange United States dollars for euros or pounds or yen or whatever he fancies as a good play. During May 2004 he announced on his yearly shareholder's pow-wow at Omaha that he had shifted some $12 billion to other currencies, from 1 January 2004 onwards. This affects spot prices.

At the same time a large US bank's proprietary desk may want to benefit from some data showing that the Japanese stock exchange will probably rise during the next few months and then sell dollars to buy yen in order to invest in Japanese stocks. They may have a horizon of a few months.

A corporate treasurer may have an investment horizon of several weeks or months.

Short term speculators and position traders are swing traders with an investment horizon of weeks, or even days. The point is simply that these transactions, regardless of the motives or investment horizons of their actors, involve the buying and selling of foreign exchange. Sometimes the buying coincides, pushing the market in one direction. Other times buyers and sellers push and pull and we as day or short-term traders experience it as a flurry of activity with prices moving up and down. Those with longer investment horizons don't care about flurries.

So you can see how important it is for us with shorter 'investment' horizons to take note of what the big boys are doing. When the elephant comes to drink the other animals make way.

At this stage I am concerned only with conceptual arguments and will get down to the detail later.

I want to keep things simple. **So lets move on to what I think is the second big reason why so many traders fail. They don't understand the edge they have.**

Summary:

We have made our first attempt at answering the question why so many traders fail. We have seen that they struggle in creating a representative real time picture of the market and that trading success requires us to make deep connections in order to tease out the clues that give us a chance at making the right decisions. Your perspective is important, it requires balance; we definitely don’t want to be too close to the market or we end up a hit-and-run casualty. But we are day traders, we don’t want to have a perspective which is too big. We are thorough and risk averse. We don’t play with fire; if there is something lying about in the market jungle we don’t simply storm in and pick it up. By taking this approach we close the gap between the reality of what is out there and the reality of what is in here (my mind and the picture I have of the market).

Chapter 4

The Edge

I want to rather phrase this in the positive. Successful traders understand that they must get an edge and then maximize that advantage once they have it. I am not against the bird watchers per se. It's the bird watchers that are stupid, or naïve, or foolhardy that bothers me. It won't happen to me, they say. If you are go venture into dangerous territory, take some precautions, the right ones. So often I see traders taking precautions, but of the wrong type. A canvass chair and mosquito repellent will make your bird watching more comfortable, but they are not a lot of good when Simba starts to prowl. Reality bites. You must plan wisely, and for the event at hand. I make my students aware, early on, that they are engaged in a game of uncertainty. It is not wholly a game of chance either, but something in-between. And yet many students want a signed cheque, a system that will simply, and without too much effort or fuss, bank money. They are asking the market for an IOU. Unfortunately the market doesn't deal in them. If it does, let me know, I'll join the queue. But until then you need to accept that you will encounter a certain measure of random market behaviour. The trick is to find a way of managing the randomness while taking advantage of market conditions the outcome of which you can predict with a higher degree of probability. And we can best do this by identifying our edges, understanding them, and using them.

An edge is the conscious choice not to overcomplicate an already complex matter.

Huh? Say what?

UNDERSTANDING PROBABILITY

There are many advantages which traders simply ignore. They either don't know they are there or they know of their existence but don't think or understand that these are advantages which can give them an edge. In a sense trading successfully is nothing more than the conscious accumulation of advantages until the odds, probabilistically speaking, are weighted in your favour. Once one talks about probability, the issue of time is automatically introduced and this is a crucial insight which winners have. They understand that once they have swung the odds in their favour they must give them time to work. That is another reason why too short time frames are the wrong perspective for most traders.

Think about this for a moment. A common attitude found amongst winning traders is how little they worry about what the market is going to do next. That's right, they don't care. Why is that? Winning traders understand that *anything* can happen next. To think you know what will happen next is to fool yourself. But that is something entirely different from saying I have an idea, a view, on what the market will do in the longer run. If I couldn't say that with enough certainty to take positions confidently then trading would simply be gambling. There are people who believe this, that trading is a lottery, but I am not one of them. I believe that trading is more like gambling than most people would care to admit, but it is not gambling. Those traders who require certainty, or who say that they trade only when they are certain that this or that will happen do not understand what trading is about. You need to prepare yourself for any and every eventuality, but, smoothed out over a longer period of time, using all the advantages available to you, you will, based on the theory of probability make money. Much of what this book is is the identifying, describing and employing of these advantages. Whatever gives me an edge, I use.

PARADIGM SHIFT

I hope that by now you are starting to understand that trading is not simply about learning a few rules and then applying them. As you read this I want you to keep something in mind. Very few people go into trading with the right idea of what it is they are going to be doing, of what trading is all about. If you've got to the point where you understand that being part of the small group of winning traders is not a one-two-three job, you may still be under the mistaken belief that all you need to do is find out what they do and ape it. You will immediately find yourself back with the losers. In order to be a part of the elite you need to not only do what they do but learn to think as they think. That is hard. It requires change, often painful change. That is why so few people manage it.

On my website I use the concept of a paradigm shift. You must do something drastically different to leave the losers' paradigm and enter the winners' paradigm, if you are not there yet. A blind man can't lead another blind man. A deaf man can't tell another man what's playing on the radio. A trader in the losers' paradigm can't help those around him. Therefore I warn my students to stay out of chat rooms and other virtual gathering places where the losers keep each other company and turn losing into a social event.

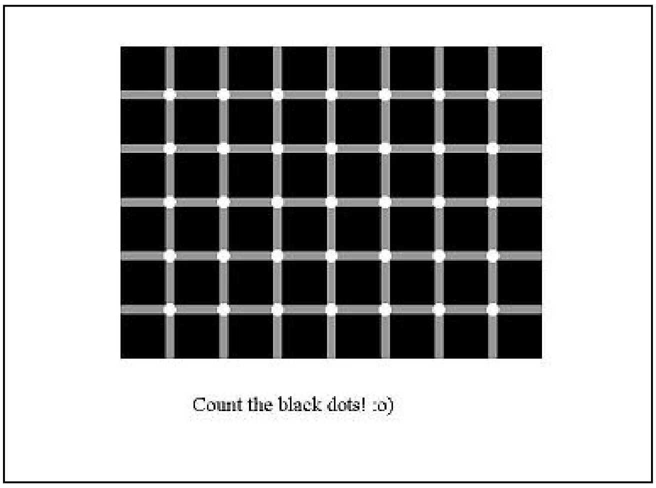
At the heart of my trading system is understanding what my edge is, and then intelligently using that edge. Casinos do that extremely effectively. They have only a small percentage advantage mathematically but they use this and other non-mathematical advantages to make large amounts of money. You need to understand this. You need to understand that a small advantage can be very instrumental in swinging the odds in your favour. The reverse is also true where small disadvantages can balloon and cost you money.

Casinos know that most punters do not sit down and start losing money from the word go. If you have any experience of gambling you will know that often you are up. But over the long run the casino wins because they manage to keep you there for more than one hand. They need a large enough sample of spins of the roulette wheel or enough black jack hands dealt in order to get their slight advantage working for them. That is central to my trading approach. Though there are times which require me to take swift action (either taking profits or managing down side) I know that I need time to let my positions mature.

Let me give you a simple example. Why do I stick to one directional buying? To trading with the fundamental (longer term) trend under almost all circumstances? Because the probability that a trade with that trend will end up in the money, even though it may be out of the money, is much higher than the probability that a trade against that trend and with the immediate, interim trend will be in the money. You may sometimes be wrong, but mostly you won't. Those are good odds.

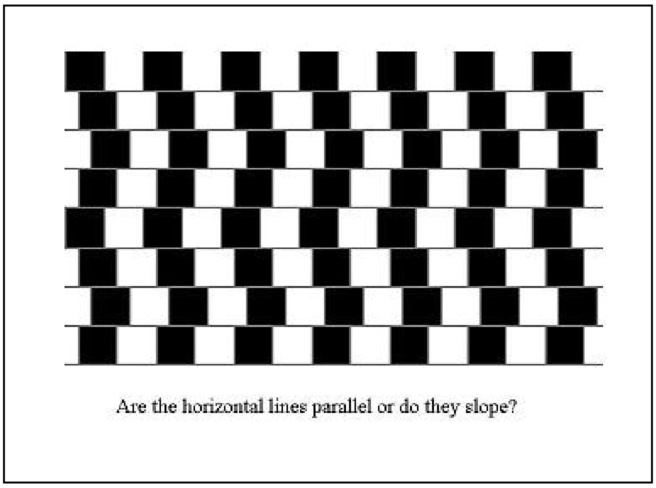
DEALING WITH RANDOMNESS

Our minds are not wired to deal with randomness.



Count the black dots.

We have a tendency to seek for and find patterns that are not there.



Are the horizontal lines parallel or do they shape?

We like order for order represents safety. That is one of the reasons trading requires discipline, self-control, insight and brutal honesty. You have to be prepared to deal with randomness without letting it affect you negatively. This is not a comfortable proposition but a necessary one for trading success. Many losing traders are obsessed with this issue. They crave certainty in a profession which has none.

They turn to tactics which seem to eliminate randomness and uncertainty, they like analysts who speak without doubt and indicators which provide mechanical buy or sell signals. This is understandable, but it is dangerous. In the markets there is little consistency or certainty. Even a trending market does not travel in a straight line. It zig-zags, up, a little down, before continuing further up. You need to be able to take the pain of uncertainty.

A fool takes all the credit for his success and blames bad luck for his failures. Unfortunately chance plays a role in life, just as it does in the markets.

I can define trading as a game of chance and be comfortable in that definition only if the odds are in my favour. That is not certainty, it is probability. The trader who requires more than probability is the trader who must know what is going to happen next. Because this is not possible the trader has entered himself into a game of blind man's bluff. Typically he calls a trade, certain that he is right. The trade happens to work and this strengthens his belief. He may have two or three such trades in succession. Then he calls one which goes against him. Note what he does now, how he thinks. He is making use of a mechanical approach that results in 'certainty'. Since the call was wrong something is amiss in the approach, whether it be the indicator or the trading system. So he tinkers with it, trying to identify the problem. I must just find that loose wire and the engine will run smoothly, he says to himself. He starts the practice of "curve fitting" where he convinces himself of a pattern and then finds the facts to fit it. The self-deception deepens but he is oblivious. He calls another trade and if this trade works he tells himself that it was all because of that loose wire. Sooner or later this faulty logic will be exposed. He will lose money with the additional problem of not knowing why. The trader who accepts uncertainty and understands the working of probability and the role of randomness in life, has no need for this false security. This comes when you believe in your edge.

Summary: So, apart from having the right picture, you need to understand that you are dealing here with a game involving probability. Once you have taken this to heart you will be better prepared to understand and learn about using what advantages you have to give you an edge. That edge, applied over a period of time, will make you money. This is what all winning traders have in common. And once having learnt it they repeat it. This cannot unfortunately ever be done mechanistically. Whereas some repetition is good one is dealing with a dynamic and complex entity made up of people and thus discretion will always have a place.

WHAT DO SUCCESSFUL TRADERS HAVE IN COMMON?

Many analysts have tried to identify what it is that successful traders have in common. This is not as easy as it sounds. Assuming it is possible, is it helpful? To what extent can these 'winning ways' be used by other people? Winning traders have winning trading systems characterized by a high degree of individuality, that is they have personalized or customised their system to suit their needs, including their own strengths and weaknesses. If no two people are alike then no two trading systems are alike. Yet, I still think it is useful to try and generate some general principles if only because it will give you some insight into a methodology of thinking. At this stage I am hoping that it will help you absorb, get the feel, for this type of thinking. Leaving aside a particular psychology or temperament I'm pretty sure that successful traders all understand the following.

1. Successful traders are adept at maximizing the advantages they have. This book goes into some detail on this topic because I think there are a lot of very simple steps you can take that immediately increase the chances of you being successful. A lot of these steps, interestingly, have nothing to do with actual trading. They are on a conceptual level and rooted in the planning phase of a trading business.
2. Successful traders are honest. What I mean by this is that they do not deceive themselves. It's another way of saying that they *acknowledge* reality or that they have a realistic picture of the market. This is important but surprisingly difficult for reality is usually the ugly stepsister. Tipping your hat to reality is how you close the gap between almost making money and actually making it. There is a large difference between what ought to be and what actually is. And reality is what it is, not what you would like it to be. Yet many traders hold on to losing positions while everything points to further downside and diminishing equity. They do this because they are hoping that the market will turn. They've played a psychological trick on themselves. They know what is happening but while it is happening they are hoping that it is not. This is a specific risk for short-term traders who, like myself, try to stick to long-term fundamental trends.
3. Trading is educated 'betting' not mathematical formulas. The essence of the market cannot be expressed in mathematical language, though aspects of it can. Many clever people know this but fail to heed the warning. Soon their mathematical formulas are 'expressive' of the entire market until the market shows its irrational side. That is why good traders work with probabilities. This

implies that they scrutinise their most basic assumptions about the market because these assumptions are what they build their trading system on. If these assumptions are wrong, they will fail. One of the reasons I trade confidently is because my basic assumptions are sound. I don't believe them to be right, and can't defend them as right. All I can say is that they stand up to rigorous testing, and the longer they stand up to testing in the demanding arena of live trading, the greater certainty I have that they are basically sound, a certainty which I temper with a healthy dose of skepticism.

4. Successful traders don't waste time arguing with the gods. The gods don't listen. You cannot trade with high gearing and survive. It's maths. You also can't trade with a too short time frame. You can't ignore the fundamentals. Spend your valuable time trying something that has at least a realistic possibility of working.
5. Successful traders develop a trading system that eliminates performance pressure, as far as that is ever possible. If the market is not going your way you don't want scenario's where you must suddenly make a lot of money in a short time, pull a rabbit out of a hat or do something that goes against the principles of your trading system. A good system, rather, is designed to benefit you optimally when the gods smile upon you. Your goals and the management of your goals are subject to this. You know when they are out-of-tune. You know when to pause, when to take a break and also when to step on the gas.

GETTING STARTED

"There are old traders around and bold traders around but there are no old, bold traders around"

– Bob Dinda

People trade for different reasons: money, freedom, status, self-employment are but some. I think there are probably deeper reasons to explain why trading holds an allure for so many people. In a sense we all trade, all the time. We trade our time for money, our skill for an income, our short term gratifications for longer term pleasures, we trade in our personal relationships. Trading forms the basis of much of what we do, and though we would probably not call it trading in the strict sense, we are weighing one course of action up against another, using our brains, experience and the best available information to make the right choice given a certain set of facts. The sort of trading this book is about is a highly refined version of crude bartering and the satisfaction it gives its participants may be the old simple pleasure of deal-making.

I find trading a fascinating endeavour. When things are tough they are tough, when the trades are going my way it all seems so easy that I wonder how it ever could have been different. I call this the 'unbearable lightness of trading'. The more experience you have the longer the periods of lightness. It's what professional athletes refer to as 'being in the zone', what was formerly difficult now appears effortless, trading seems to take care of itself and the profits accumulate. You must love what you do. In the context of currency trading this means you must be particularly interested in what's happening globally. Global politics, environmental issues, developments in technology, all should give you a kick. If you avoid news, or developments shaping the world, you are probably barking up the wrong tree trading this market. It takes work and dedication to get to this point. Deciding to become a currency trader is deciding to embark on a long journey full of challenges, adventures, ups and downs. It's as much a voyage of discovery as a fascinating way of making money. You will, sooner or later in your trading career, run the full gamut of emotions, and once you taste success you will wear the look all winning traders have: wry, wary, resourceful, and pretty damn happy.

HOW I STARTED

I don't know how other traders land up trading. It's not taught at school, aptitude courses don't recommend trading foreign exchange or futures as a possible career for young Joe, and every time I ask a fellow trader how he came to the business, it's a different story. But I want to tell you how I got into it, and thereby illustrate the point that trading is a process, both getting into it and sticking at it.

Except for a short period after I had graduated from university in 1986, I have always worked for myself. I started trading shares in the week that Russia defaulted on its debt in 1998, causing the Dow to crash and sending financial shock waves around the globe. Years earlier I had taken a correspondence course on technical analysis. I traded some stocks. One day I heard about trading treasuries (bonds, gilts, bunds) on margin. It sounded much more exciting than what I was doing. The next day I became a treasury trader. It **was** more exciting. Margin. Leverage. Making money whichever way the market moved. Everyday I would look in the newspapers at the previous day's closing prices. I kept tabs on upcoming economic issues and events. I applied very simple, basic, technical analysis, nothing fancy. I didn't spend too much time on it. This freed me up to track news and monitor how information affected price.

I learnt never to trade just before or after data releases. What I loved about it was that it changed my perspective. I found myself having to collate macro issues of global economics, oil prices, gold price, currency values rather than the micro economics of individual companies, a myriad of sectors of stocks and industries, which were in any case subject to global and macro market and economic conditions. Also, for every one stock there were a number of opinions as to where it was heading. What attracted me most about the global scene was the fact that it didn't matter what drove individual companies, they all took a back-seat to the health or otherwise of the Dow Jones Industrial Average (DJIA) which determines the Nikkei, the Footsie, the Dax, the JSE – everything. If you are not accustomed to, or attracted to macro events and global issues, you should probably stay a way from the currency market, for it requires some form of thinking on this level.

The Mentor

But most importantly, my treasury trading coincided with the discovery of a mentor. In Jack Schwager's book *Market Wizards*[2], Schwager interviews 17 of the best traders of all time. The one is more different from the other, each with his own approach, each with a different technique. But almost all of them have one thing in common: a mentor. They learnt their trading from someone who took time and mentored them. I realised something else about traders while reading Schwager's book. Most good traders start out making use of their discretion and judgment in a conscious fashion. As they develop, as they become more confident and trust themselves more and more, they start to take their decisions more unconsciously, that is, they employ a form of rule-bound trading developed from discretionary trading where experience and success have replaced conscious decision-making. They have achieved what most beginners crave, a system that 'mechanically' delivers results. They don't have to think so hard, worry so much. Trading decisions come naturally and easily.

Most aspirant traders misunderstand this crucial point.

Make it your own

It's the reason no shelf-bought software will work. It is the same reason why you will not have success trading by simply reading a book full of complicated mathematical formulas and some reliable money-management principles. This is where I want to

[2] Jack D Schwager, 1993, Market Wizards, Interviews with Top Traders. Harper Collins

start writing in bold, repeating myself, hammering the point home. It's why I hope this book will belong to your useful pile.

There is no magic in what I am telling you, but there is a lot of value. Beginners all look for the certainty of a system. They want to trust it, not themselves. They want to trust the mentor, but not themselves. They get told to be disciplined, unemotional, use my system says the great saint mentor, it works for me, just apply it. Well it won't work for you. Tattoo that on your forehead. You can take aspects of another's system, you can learn from the mentor's experience, receive ongoing advice, but you will have to craft your own system. Don't even think that you can get value from a 'mentor' who hasn't traded. They usually sell you by talking about the thousands of successful traders they made. The truth is more likely that they are shopping some cheap software system to the unwary and when you keep losing its because you don't understand the software. Use your head, think.

Those few traders who have progressed to a form of 'non-discretionary' trading, where trading seems effortless, and the decisions are seemingly made without your conscious involvement, those traders have arrived at this point through blood, sweat and tears. They have paid hard school fees.

Playboy

When I was still a little cautious trading treasuries on margin I had a mentor with whom I had discussions similar to the one above about the market. We did this on a day-to-day basis. It became the fabric of what I still reckon to be a more discretionary than non-discretionary system, but nevertheless it is much more non-discretionary today than it was in those days.

My mentor was a treasury trader. He learnt his trading in the pits before electronic trading became the norm and so he experienced the immediacy of the market, the real time battle between buyers and sellers that can often seem sanitized when seen on a computer screen. This experience rubbed off on me. He taught me the basics, and what I know today was built upon the simple strong foundations he provided.

He talked of 'Playboys', referring to those traders who used technical charts, and said using them was as useful for trading as looking at dirty pictures. I reserve judgment. His passing nod, the sum total of his application of technical analysis, was to say that if the market was high one should probably sell and if it was low one should probably buy. He taught me to leave a little for the other guy, 'leave a little sunshine' he would say, don't be greedy and try to pick tops and bottoms. He was a floor trader who traded the fundamentals and managed a large treasury portfolio. Smart young kids with high-tech equipment and ideas came and went. He is still there. Take your profits (money off the table), he'd say, that's what we are in the game for. That's why I tell my students, 'a profit a day keeps the bailiff away'. "Leave something for the others, we all have to eat" is another of his favorite reminders. Every morning I would chat with him, just five minutes, the most important five minutes of the day.

The Price

While I was trading treasuries I got a pager service that gave me up-to-date prices. I became interested in the hard truth these ticks represented. I recalled one of the smarter moves I made as a young man. While studying Greek 101, first semester, I realized that if I got this grammar down pat, if I put in the hard work now, the years of Greek that lay ahead would be a breeze. I did and they were.

I wanted to understand the basic structure of prices, their grammar, what it was they represented, their rhythms, their moods, I wanted to befriend them, to know what frightened them, to learn what they had to teach.

And what they had to teach was a lot. I learnt this by writing them down, every 15 minutes. I did this for four months. I also wrote down the gold price, the major foreign exchange rates, other treasuries' prices. Slowly I developed a feel for intra day and intra week volatility, what happens when gold goes up, how the treasury markets reacted to data releases, what happened when gold went down, and how, whenever I entered the market, it seemed to move against me! At this stage I had charts. **Daily charts.** This is very important. A lot is said about "too much information in the market". And then the self same person that warns the beginner not to get drowned in too much information immediately goes ahead and tells him to consider the information provided by daily, six hourly, four hourly, two hourly, one hourly, 30 minute, 15 minute, 10 minute, 5 minute periods. But that's not all. You can confuse yourself with charts alone, relating this to that price, highs and lows, price patterns, but people seem not to find this enough so they employ complicated indicators with lines and arrows and squiggles, and soon it's all a bit of a mess. A good price graph is like a great painting, simple, austere, precise, prepossessing. A Rembrandt, a Van Gogh, a Titian. When most beginners, backyard technical analysts, are finished with a price graph it is no longer a masterpiece.

Grappling with daily charts forces one to consider the most important information. The information that will be used by the major role players in the market, by Mr Buffet, Mr Soros, Mr Central Banker, Mr Deutsche Bank Chief Trader etc. Work with price relationships in the short term. There is a lot to be learnt from this chart, or rather from the underlying prices showing on the chart:

During this period I traded for a living, I paid my bills with my trading profits. I consider this important. Each person trades for different reasons. Being clear and honest about what those reasons are will make you more likely to succeed. It's about goal setting. What **only** trading for a living (I had no other sustainable income stream) taught me was that the market has no consideration for the fact that it's the end of the month and the telephone bill hasn't been paid. Or that it is summer holidays, the booking has been made, but the money is not there. This is pressure, and pressure affects your trading. When setting goals, developing your strategies and plans, your business plan, you must consider this aspect seriously. It has nothing to do with making trading decisions but it is a much-neglected aspect of trading psychology. I strongly believe in, and recommend to my students, a second non-trading related income.

Anyway, during the Argentinean currency crisis in 1999 I was looking for real time information about the Argentinean bond market and in the process I stumbled upon online currency trading. I liked what I saw. The market was liquid. And structural changes made it possible, for the first time ever, for little guys to trade. I registered for a demo account.

The big sell

Trading in the retail currency market was just taking off. Advertisements promising the world appeared everywhere. With great fanfare assurances of newfound wealth were made for those who were prepared to spend two weeks learning the trade. Agony followed ecstasy. One ad said “change your computer into an ATM”. A lot of people are still waiting for that to happen.

The liquidity in the treasury market had slowed, and I decided to focus on the currency market. I was convinced that experience in the treasury market was at least some sort of preparation for trading currencies. To this end I developed a business plan for trading and training / mentoring newcomers to the market.

I was convinced that most of the courses described above, especially the “two or three day courses” which, apart from being expensive (cost of course often exceeded recommended margin amount) were seriously flawed. The course presenters were going to make money, their student’s were not. The expectations that were created were simply ridiculous, the methods outrageous. Gearing of 30:1 or 40:1 was recommended (I think 2:1 or 3:1 is acceptable). Don’t worry about the course fees because you will recoup it in days, students were told. You will double your money in a month. Pay $200.00 per month for professional charting software. And if the student thought $200.00 was a bit steep he was quickly reminded how easily he can make $400.00 on Monday morning when most people are still asleep. People believed this and lost money. The whole business stank. And it was contrary to what my experience and common sense was telling me. If I, someone who had a pretty good track record as a treasury trader, was sure that I would tank if I acted on what was being taught, what chance did the novice have, people with not a day’s experience of trading?

Customising

I have a talent for trading, and I like to think, teaching. I wanted to change the business model that was being sold to the market. I knew currency trading presented a great opportunity, but not in this guise. This was suicide.

So I took what I knew, I took what had worked for me as a treasury trader, I remembered my mentor's advice, and I set to work reshaping it to fit the realities and demands posed by currency trading. I studied the prices and their movements and how they behaved relative to the Dow or each other, the influence of gold on currency prices, I studied the global drivers – what really moves the currency market. The change was not that big. On a short-term basis currency prices are to a large extent driven by exactly the same factors that drives the treasury markets, interest rate levels, expectation of interest rate changes, the same players and similar economic factors. Treasury markets, like currency markets, also dwarf stock markets. There are however not as many small traders in the bond market as there are in the currency market these days. I made notes of daily and weekly volatility, I studied the dynamics of the 24 hour market and tried to figure out who the big players were and how they operated. I started providing a training programme to teach others to do the same. This was not for selfless reasons. Though I like teaching, my business model included a group of core traders whom I had trained and who would eventually trade third party funds with me at DayForex Capital Management (www.dayforex.com). Trading is hard and can be exhausting. I don't want to be trading when I'm sixty-five. I want others to trade for me. The way I learnt was the way I wanted to teach. But I wanted to use the Internet.

Trading is not a spectator sport

Once, while I was still trading treasuries, I went over to my broker's place. I had always kept away, isolating myself, trying to do my own thinking. He saw me and afterwards he came up and asked me 'So, are you a better trader now?' He knew. You can't learn trading by looking over someone else's shoulder. They are just pushing buttons. You can learn from a mentor. You can have all the discussions with all the traders, visit all the chat rooms, you can back all the horses, but then you must realize that you have become a spectator. You don't have a business plan. I chose to back one horse, my mentor, perhaps I was lucky, but it worked for me.

I do my teaching and my trading on the Internet. I don't believe in crash courses. I believe in structured tuition, a process that takes place over a certain minimum length of time, different for each trader, until he reaches the breakthrough point, his Aha! experience.

You need a plan. You need a goal. You need to know that trading your own capital is hard. It is better, in the long run, to leverage your ability rather than your capital. That is what I am doing now, trading other people's money. But I also like teaching, it gives me satisfaction. I learn by teaching.

A mentor must care

A veritable cottage industry has sprung up in financial services, fueled by technology (the Internet) and globalisation (the international flow of capital). Most losers keep these industries in clover, subscribing to five different newsletters at a time, buying software that generates buy and sell signals, handing out money to whoever promises easy wealth. If a guide offers his services to take me safely through lion country I want to know that he has more than just book knowledge. Yet people listen to 'experts' telling them how to trade, 'experts' who have never traded, or commentators calling the market. When they're right they're right, when they're wrong they don't care. They have a monthly pay-cheque waiting. Get a mentor who cares. Someone who has been there.

If this book can impress one important fact on you it would be this: get a mentor who is an active trader, with a larger time frame (and, preferably, account) than you and prepared to share a thought a day. It should keep the bailiff away.

Chapter 5

How not to trade

Only two things are infinite, the universe and human stupidity, and I'm not sure about the former.

– Albert Einstein

I said I don't believe in crash courses but I think I should make one exception to that rule and give you a crash course on how not to trade. Absorb this and you have added another edge to your trading.

UNDERCAPITILISE YOUR ACCOUNT

It's the maths dummy. Mathematically, your chances of making a success are greatly reduced below a minimum initial starting capital. It becomes virtually impossible to mitigate the effects of leverage on a too small account. You cannot make a fortune from nothing. Anyone who tells you otherwise is lying, or has recently won the lottery.

There is also a psychological dimension to this. Under-capitalization may also cause the "computer-game" effect. You don't really care if you win or lose because it has virtually no impact on your financial situation or well-being. Know that when you increase the stakes to the point where losses and profits will change your financial situation, everything has changed. It is better to start with an account that will have an effect, win or lose, without betting the house of course. Don't bet the house please. Ever. It's not a good idea.

UNDERESTIMATE LEVERAGE

This is crucial. Leverage and an undercaptilised account are two sides of the same coin. Most beginners will at some point underestimate the potentially devastating damage leverage can wreak on their account. Understanding leverage and specifically its selective application, is key to currency trading success. I will discuss leverage in detail. For those who find the term "leverage" or "gearing" unclear, it basically refers to the "size" of the position you take or the value of the contracts you trade in relation to the margin you have. It is a very powerful tool, but losers use it to great effect to destroy their trading capital simply because they underestimate its destructive force.

PLACE TOO MUCH IMPORTANCE ON TIMING

How can one? You may be lucky and enter a trade and almost immediately the market moves in your direction. But that's all it is, luck. The currency market is so volatile that even a short study of its price movements over a day or week must convince an impartial observer that entering the market, except for having identified certain price levels as 'probably good entry points', is a more or less arbitrary act. It does not mean that your trade is in the hands of lady luck. Certainly not, since you have taken a view on the direction of the market based on the underlying trend. But it does mean that in the short term, hours, days, sometimes even weeks, you should not worry unduly if the market moves against you. We touched on this above, the role which randomness and probabilities play in trading.

I'm not saying that timing is unimportant. You want to enter trades at the right level. But a level may be 30 to 40 pips below where you thought it was, or more. Trading levels must also be seen in perspective. We referred to Warren Buffet earlier. Well, he may be buying at levels very distant from anyone with a much shorter time frame and smaller account. You just can't get $12 billion in the market at one price quote.

It's much easier to time your entries in tandem with these "deep connections" rather than low probability intra day mathematical formula-based signals oblivious of what is really going on. Close enough is good enough. Say this to yourself, over and over for this will not only make your trading easier, but it will create opportunities not open to the trader with a need to time his entries perfectly. This trader is looking for the magic signal. This morning he is right, this afternoon he is wrong, by bedtime he is confused.

I like to trade comfortably, without haste, watching my position mature, buying lower and selling higher. Patience: I know the market has never listened to me before and it's not going to start now.

PLACE UNDUE FAITH IN MATHEMATICAL FORMULA-BASED INDICATORS

Remember that indicators lag, all of them. That means they tell you what happened in the past. Let me repeat that: they are about **YESTERDAY**. The same Mr Buffet famously remarked "If history books were the key to riches, the Forbes 400 would consist of librarians." People who successfully use indicators understand their limitations. They understand that these indicators can do so much, and only so much. Consider also that in the equity markets the volume indicators are useful because they can tell you what sort of momentum is behind the move. There is no volume indicator in the spot currency market.

Beware of 'curve fitting', the temptation to see perfect patterns existing only on that specific historical data set you are looking at and then to shape your facts to fit these never-to-be-repeated patterns. It is one of the reasons why indicators are so difficult to use properly. They work well when back tested since one unconsciously 'fits the curve' as it were, but when predictive accuracy is required in real time their users often flounder.

BE INFLEXIBLE

Yes, have a system, but when the facts change adapt, employ that animal instinct to survive, use your discretion. Charles Darwin concluded that it was not the strongest or the fittest that survived, but the most adaptable.

TRADE AGAINST THE "FUNDAMENTAL" TRENDS

It is vital to understand what constitutes relevant information, and secondly, once you have the relevant information, it is just as vital to be able to interpret it properly. Don't trade against the fundamentals. Yet people do. For example, the market may be waiting for an immanent intervention by the Bank of Japan. This is not a certainty, but all the fundamentals point in this direction. Now it's not very smart to bet against the bank of Japan who has at its disposal billions of dollars which it can use to weaken its currency in order to help exports. And yet there are traders who believe so strongly in the technical virtuosity of their indicators with green lights flashing and telling them to buy yen that they will ignore a significant factor such as an immanent central bank intervention. I don't take positions against central banks. If you want to, make sure you have more money than they do.

IGNORE COMMON SENSE

I've said it before and I'll say it again. A beginner trader can lack everything but with good solid common sense he can go a long way. Some people would disagree and say you can't accomplish anything in trading without discipline. Discipline is important, but seeing that you are discretionary, you do use your judgment, please use your common sense. A lot of traders don't value their common sense. There is no magic to trading. It's common sense. Listen again – **IT'S COMMON SENSE.** Be skeptical, be critical. Good ideas are only good if they stand up to rigorous testing and scrutiny. Take nothing for granted, challenge and question. Remember, if something sounds like hocus-pocus, it probably is. If something sounds to good to be true, it probably is. Don't do something you don't understand. I speak from experience. Usually, when I didn't understand what I was doing, I lost money.

Common sense is my friend. If you are confused, take time out. Today, with so much information and bogus software and pundits in flashy suits and ties, it's easy to become confused. Losers do two things: they lose money and then they carry on losing money because they don't know why they lost the money in the first place. It's not possible in this game to win all the time. The idea is to win more than you lose. But there is a big difference on the one hand between making losing trades within a system where you have quantified the risk, you have anticipated and made provision in your trading strategy for an acceptable downside and you *know* where and why you have gone wrong, and on the other hand being part of the group of failed traders who day in and day out lose money and just can't put their finger on the flaw in their system.

HAVE UNREALISTIC EXPECTATIONS

There can be many flaws in a trading system but sometimes the damage is done before the first button is pressed. I think most traders that fail, do so before they have made their first trade. They've bought the hype, they've believed the ads, they think they can get something for nothing. You can't, no one can, trading requires dedication and sweat just like anything else. If you don't have realistic goals you won't make it and it won't be the market that gets you. It will be you. I don't let my students start without setting their goals first. Do you know yourself and what you want? Have you thought about risk and what your attitude towards losing money is? How will this affect your goals? Is your currency trading going to be a full-time profession or a hobby? What are the implications of this?

These are only some of the important questions you will have to answer in order to set proper goals. If you don't ask them of yourself, the market will. If you don't set your goals the market will set its goals for you, and the market can be cruel. Don't get yourself into a position where the market is the Grand Inquisitor and you can't come up with the answers. That is why trading is not exclusively about understanding the market. It is also a test of your discipline and self-knowledge. Some traders may not agree with this statement. Most probably would. In trading, YOU matter. Your personality, your strengths and weaknesses, your character. They don't matter to the market. The market doesn't care. They matter to you as an aspiring trader.

TRADING IS NOT A BUSINESS, RIGHT?

Wrong. It is a business which requires work, risk management, money management, a business plan (goal setting, and a trading strategy). If you have made a profit, hold on to it. Trading is like tax, it's not how much you make but how much you keep.

PASS THE BUCK

There are people, professional and experienced traders who successfully use software. They often have a hand in writing the programmes and essentially they are codifying their system. But it is *their* system. No piece of software off the shelf is going to generate reliable buy or sell signals. Yet people use them, rational, intelligent people. They don't work. Think for yourself, trust the software between your ears. Just think about it. If this software is as hot as it is claimed to be, why aren’t the vendors using it to make billions rather than flogging it to you for a hundred bucks and change?

A BAD ATTITUDE

Attitude is important. If you have a bad attitude you will make trading difficult for yourself. ‘Attitude’ is a general term, more general than ‘point of view’, less specific than ‘outlook’. It’s a manner, a way of thinking, a way of behaving. No one likes being wrong. That’s why there is tendency for us to blame others before we blame ourselves, to blame our tools, to blame the weather, to blame anything and anyone as long as it is not us. Or to be angry when the market doesn’t do what we want it to do. Or to be disappointed. These are unhealthy attitudes. The point is that you don’t need to be burdened by them. You don’t have to have them at all. Think of it this way. We solve problems by analysing them. That is, we break them down into manageable component parts. We examine these parts individually, then we put them back together. We find out how a watch works because we can open it up. But the market is not in that specific sense a ‘solvable’ problem. If it was we would all be millionaires. The market gives us glimpses, clues, before moving back into the shadows. I believe in cultivating an attitude that acknowledges this. Traders who have been around for a long time, people who have made a living from trading, often talk affectionately about the market as if it were an exasperating but loved spouse, something not knowable but always interesting and challenging.

TRADING TOO SCIENTIFICALLY

Trading is not an exact science. In fact it's not a science at all. It is more like an imprecise art form. It is essential to grasp this fact. And yet there is a refusal by many traders entering the market to do just that. They want the market to work according to their system and not the other way round. They try to wrestle the market into submission. The market fights back and hurts them and they start to fear it. Take away the pain, they ask. But their system is not structured to provide relief when times get tough. That’s when traders are at their most gullible, looking for a cure for the pain, an indicator, a simple system, that gives reliable signals. They don’t have to think, they want a signal. The signal doesn’t work, more pain follows, and the cycle repeats itself.

Summary:
Don’t try to parlay a pittance into a fortune and think you can do this with high gearing. You can’t, the odds are heavily stacked against you. Don’t try to time this market but rather pick price levels. Indicators have their place, but they have limitations too, particularly in the currency market. Be flexible, and never trade against the fundamentals. Your common sense is an edge, use it. Don’t ambush your trading career before it starts by having unrealistic expectations. Keep your feet on the ground, trading is a business, so tackle it as a business. Take responsibility, don’t pass the buck. And develop a good attitude. It will make trading easier and more fun. Also remember that the market is not a scientific problem that you can solve by analyzing it to death.

I’ve sketched for you a few scenarios that will lose you money. Avoid these pitfalls and you will be doing well. But let’s take a quick look at trading in a positive sense, how to trade, by briefly examining a few key elements of a good trading system.

Chapter 6

Elements of a proper trading system

"Markets are people, not places."

– Dr Julius Klein

I am offering you a system. Actually, I am offering you the basic building blocks upon which I constructed my trading system so that you can have a good foundation but eventually a house of your own, one you made.

Trading systems mean different things to different people. What I mean by a trading system is my total approach to the market including aspects of trading that have little to do with pushing buy or sell buttons. My goals are part of my trading system and so are my working hours. In fact my system is my business plan with everything a business plan implies. I've looked at what unsuccessful traders do and I avoid doing the same. People who struggle in trading have a tendency to think they are doing something unrelated to business. I prefer to think of trading as I would any other business.

IS, NOT OUGHT

Your system must accommodate the market as it is, not as you would like it to be. Obvious? You would be surprised. This is a subtle but crucial starting point but one which escapes most traders. That is, only a small percentage of all people who trade the currency markets see it as it. Which is a different way of saying only a small minority really understand what the market is. Desire, need, fear, greed, something makes ordinary intelligent people rationalise bad decisions and they continue to do so. The market requires you to be mature. There will always be a dissonance between what I would like, and what I can get, between what is and what ought to be, between how I see myself and how I really am, but the more honest I am the better for my trading.

WE ARE THE MARKET

The market is a priced representation of a segment of human life. People make markets and markets reflect their makers: unpredictable, greedy, volatile, complex. Once you can reduce the human being to a set of fixed parameters, predictable and fully knowable, the market may have had its day. But until then know this: markets are made up of people. Big, fat, thin, ugly, wild, conservative, crazy, dynamic, ordinary people and the market is the mean average of this mix. You need to keep this in mind when trading because there is a temptation to think of yourself as an insolated and independent actor, alone, pitting yourself against a great impersonal force out there. A trading system that helps you to interpret what the other guy is thinking, is very useful.

Because humans are involved, human psychology plays an important part in trading. This is one of the most difficult aspects of trading for the beginner to grasp, and most often neglected. Understanding the psychology of trading is an important weapon in the trader's armory. If you don't believe this, try the following. Open a demo account with an online currency dealer. Trade paper money for paper profit. Now do it with real money. Same game, same rules but same experience? No way.

What was once, thousands of years ago, a cross-road where tents were pitched and goats swapped for pigs, nuts for fruits, clothes for carpets, has today evolved into financial exchanges. But they essentially remain the same. People get together to buy and sell. Today they may conduct a transaction electronically, the buyer never sees the seller, nor the actual commodity he has purchased. Yet nothing has changed. An offer is made, and, once accepted, a binding contract comes into being.

Currency trading on the internet may be an advanced form of bartering but any prospective currency trader will do well to keep in mind that what drives trading is the people behind it and these people have changed very little over thousands of years. Essentially our base instincts are the same, fear, greed, loss, we react in much the same way to these feelings.

Remember also that nothing has an intrinsic value. We determine the price of a thing, be it the US dollar or a trinket in a flea market. Value, price, is affected by our perceptions of value, by information, by availability. The old crossroad's market place gossip takes place today on 24-hour global TV and looks impressively factual, sometimes downright scientific. Yet much of it is speculation couched in certainty, probability masquerading as a certain bet. But rumours fuel trends as much as facts do and you have to listen to them too.

The challenge is to understand this market, how it thinks, how it works, and perhaps most importantly, how it reacts to stimuli. In the currency game, this is crucial. What moves the markets and why? Knowing this gives you an edge.

THE BIGGER PICTURE

This is central to my approach and trading system and something I hammer into my students. Everyday somebody, usually an institution a million times larger than you, is going to do something and the market will respond. That means you will be affected. If you can learn to understand how the big players think you will be able to anticipate how they will act. This is seeing the bigger picture. Don't lose sight of it, ever. A mentor can help a beginner by reminding him of the bigger picture.

The big guys make a wave. You can choose, surf it or drown. Imagine yourself as say a welter-weight, in the ring with a heavy-weight. You are superbly fit, well trained, motivated and fast. Your opponent is big, slow, and out of shape. However, one punch and you are history, no matter how fit or fast you are. The heavy-weight flow of capital must be respected, and understood. You need to dodge it, or better, ride it. Quick in and quick out, punch, counter-punch, using your hand and foot speed, unconstrained by bulk and the rules that apply to larger objects. When you are trading you are in a scrap, fighting for your slice of the profits. The challenge is to score points while protecting yourself at all times. If I know one thing about currency trading it is this: if you don't understand how the big guys think you are dead. It is a skill one develops over time, and keeps developing. Commodities, foreign exchange, financial instruments, no matter how complex all adhere to certain immutable laws, the laws of the market place: supply and demand, as well as the human motives and reasons behind trading. We buy cheap and sell dear. If we do so we make money, if we don't we lose money. We don’t like risk, we don’t like losing money.

Summary:
The market doesn’t care about you. Stop hoping it will. It will not do what it ought to do in order to make you happy. Your trading system must acknowledge the realities of the market. Remember that the market is made up of people. Their emotions affect prices. Develop a ‘big guy’ mentality by trying to learn to think the way the big institutions think. There is a bigger picture out there. Keep that in mind. It’s the big guys who move the market, not you.

IT’S A GAME – A GAME OF CHESS

Currency trading is like chess, which has a beginning, middle and end game, strategy and tactics, as well as a fair dose of psychology.

In chess, you may be a brilliant tactician and strategist, you may have penetrating insights and a mastery of the nuances of chess psychology. But if you don’t know how to play openings you will lose the game. Openings are cold ‘book’, you study them and there are a number of moves (depending on the opening) that cannot be improved on. They have been played out over and over again and everyone agrees that this is the best move in this situation in the opening. Now if you know that you have an advantage over your opponent who doesn’t. You will go into the middle game either up on material or position, or both. And all you did was learn the moves from a book. Easy as that.

TRADING RULES

There are certain aspects to currency trading that are simple rules, the best in any given situation, like with chess. These rules apply and if not immutable, I don’t know anyone who disregarded them and is still trading. Your ‘opening gambit’ needs to know these rules. It doesn’t matter how smart you are as a trader, how well you understand the game, if you do not know the basic rules – the opening moves – you will lose. Low gearing is a rule you must learn, never trade against the fundamentals is a rule you must learn. Trading is about probabilities, not certainties, that is a rule you must know.

MIDDLE GAME

Let’s say you have passed the opening stages of the game. You are now in the middle game. There is no ‘book’ to fall back on because there are too many variables at play. You have to rely on tactics and strategy, attacking your opponents weak spots, making sure your own defence is secure, using each piece to maximum advantage, protecting your king, in other words doing everything necessary to swing the advantage your way. Multiple entries, with low gearing, trading one currency in one direction, applying real time analysis to the markets, using relational analysis to understand the interplay of price, event, time; all of this will give you an advantage so that when you enter the end game you are up on material or position. It's really where you earn your keep as a trader. Great chess players are not swots. They can't become successful by simply learning the openings. They must, but in itself it is not sufficient. The hard work is in the middle game (and the end game). That's why traders know that even if they have applied some pretty good common sense rules, they are not home dry yet. Just because you have used low gearing the market won't reward you with a profit. You have to have read it right using a strategy which consistently works. I use relational analysis because it operates in real time. I need that because this is a market which operates in real time. Assuming you've come this far, you need to close out the deal.

END GAME

The end game consists of finishing off your opponent. You've done the hard work, but the end-game can be tricky, so be on your guard. You can let a winning position slip from your grasp by being overhasty, or wait too long instead of pressing home your advantage. In trading the end game is where you take your profits, or if you are down it's where you see if you can play out a draw, frustrating your opponent with a skilful retreat.

THINK AHEAD

The point about trading is that like chess it is a battle. The great chess players are not flashy or opportunistic wood pushers looking for a sucker mate. They know that is for amateurs. Pros prepare, they respect their opponents, they know that hard work lies ahead. They take nothing for granted, and they don't hope for luck. They rely on their own skill and knowledge which they augment by reading and studying. If they lose they go back and pour over the game. Here I should have moved my knight thus, here I missed an opportunity, and they make sure not to repeat these mistakes. Amateur traders rush. Perhaps they've read just enough to be dangerous. They look for easy trades, the sure thing, the sucker punch. Successful traders are patient. They take their wins and their losses with equanimity. The king is the most important piece on the board and like chess players who protect their most valuable asset, traders do not give their money away. It’s often a choice of sacrificing a piece now, taking a loss in the short term, in order to be in a better position later on.

It’s the ability to think ahead that is so valuable for a chess player, and for a trader. This comes with experience but it requires constant practice. A good chess player is rarely taken by surprise. He has worked out the permutations, mulled them over many times, he knows what his opponent is going to do. The amateur trader is often surprised by the market. Hey, why isn’t it going in my direction? It’s not supposed to do that, is it? The winner doesn’t mind. He is the trader that knows anything can happen, at least in the short term. Why is he confident that in the longer term things will pan out for him? Because he has studied the book, his opening moves are sound, he is geared low, he used the odds he has, every little tactical or strategic advantage, and when it comes time to take his profit, he moves in for the kill. Check mate is not a gloating victory. It is the conclusion of a plan. Because he thinks several moves ahead, the market doesn’t hold terrors or surprises.

Eventually he has reduced trading to a chess-like game. He can’t win them all, but he can win enough to make good money.

Part 3

And all that Jazz …

"The secret of life is honesty and fair dealing. If you can fake that you've got it made."

- Groucho Marx - actor

Note: I want to cover some technical and practical aspects of currency trading before I discuss my system. Some of you may already be familiar with this, others may be reading it for the first time. Amongst other things I cover how to properly calculate leverage, a much misunderstood concept. It is important for you to have a sound understanding of this. In this section I also address a very important aspect of your possible success or failure. This concerns your whole view (perspective again) of the market, your service providers and your relationship with them. ***If you look at your broker from the right perspective you will see a marketing wizard (not a market wizard) who has set up shop to filter money out of the system.*** *Understand that you are paying for a service. Make sure you are not paying too much. If you miss the boat here you are going to struggle. If you don't understand how the structure of this market works on a very practical level you are going to join the 90 per cent losers – guaranteed. I am going to tell a few unpalatable truths as far as market makers and brokers are concerned. To paraphrase Howard Cosell, the famous sports commentator "I'm going to tell it like it is". What you make with this information is up to you, but you ignore it at your peril.*

Think of what you are about to read as the preparation necessary for the start of a new business. It's as though you have inherited the family farm. You have a vague recollection of having visited it in childhood but you really don't know much about animals or farming having grown up in the city. A rational person in this situation would make a thorough study of the farm and familiarise himself with all relevant aspects of farming. Once you've worked through Part 3 you may still not be properly equipped to trade (how to trade is dealt with in Part 4) but at least you won't try to shear the cows and milk the sheep.

For those interested in a more thorough introduction to the foreign exchange market I can recommend the source of the material herein abbreviated, my **An Introduction to The Foreign Exchange Market.** It is available in e-book format from fxmodule@dayforex.com.

This section also includes important practical "short term trading thoughts" on topics such as **Intervention; Interest Rate Factors; Overshooting Of Exchange Rates; economic data releases.**

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Chapter 7

Foreign Exchange Basics

A SHORT HISTORY

"I want the whole of Europe to have one currency."

\- *Napoleon Bonaparte*

Foreign exchange history can be traced back to ancient Greece and the Roman Empire where moneychangers were prominent in commercial centres. Their role was to weigh coins and also to ascertain the fineness of coins using simple assaying methods.

International commercial banking began when rich Italian merchants of the late 13th century established banking operations in several cities such as London.

The principle instruments they dealt in were paper debits or credits. These were issued in different currencies and then discounted based on what the individual merchant perceived to be the currencies' relative values at any given time.

At the heart of international capital flows during the period of colonization of the new world was a tendency by cash-rich European banks to incur high-risk loans to support the expansion drives of the colonizing countries.

Banking centres developed in England (London), France (Paris), Germany (Berlin) and also smaller centres in Italy, the Netherlands, Austria, Switzerland, and so on. From these centres European merchant banks moved capital in the form of bonds from the established European countries and economies to the developing regions in order to finance growth in the latter.

During the late 19th century (1850 – 1890) the first modern systematically traded forward foreign exchange markets came into being in Vienna and Berlin with forward trading in the Austrian currency, sterling and Russian rouble[1].

By 1870, according to the gold standard agreement, gold was the internationally recognised sole medium of exchange and all currencies' values were set in relation to gold. This is also known as a fixed exchange rate regime.

Under the gold standard a currency's value is defined in terms of a specific weight of gold. If more countries, trading with each other set a gold standard, their exchange rates relative to each other will be stable and there would be no foreign exchange risk. The UK set its gold standard at £100 equal to 22 ounces of gold. The US standard was set to $100 equal to 4.5 ounces of gold.

The gold exchange standard came to an end because one of its pillars, the US dollar, started to wobble as a result of the Vietnam war. Several measures were taken to "rescue" the system by devaluing the dollar from $35 to $38 per ounce (gold), revaluing other major currencies against the dollar and setting the guaranteed "deviation percentage" at 2.25 per cent. This was all in vain and the whole fixed rate system collapsed when the major currency countries from Europe, and Japan, simply abandoned it during 1973 and our current "floating exchange rate regime" was introduced.

A "floating exchange rate" simply means a currency is "free" to "float" to levels against other currencies as determined by market forces of supply and demand, with limited intervention by monetary authorities. Monetary policy will not primarily focus

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[1] Kettell, B. What drives currency markets? Financial Times, 2000, Prentice-Hall, p. 4.

on the value of the currency but will use other measures to influence the currency such as

- Stabilising domestic prices
- Stimulating economic growth
- Combating inflation

A number of factors, and particularly the floating rate system, has exponentially increased the amount of cross-border trade and investment transactions. The growth in traditional trade between countries has been comparatively much smaller than the extraordinary increase in turnover witnessed since the global introduction of floating exchange rates.

According to the Bank for International Settlements (BIS) the average daily turnover in "traditional" foreign exchange instruments, including spot[2], outright forwards[3] and foreign exchange swaps[4], has been officially estimated at $1,490 billion in 1998, compared with $590 billion in April 1989[5].

On January 1, 1999, the euro was introduced as the official currency of the 12 participating members of the European Union. For the first time the euro could be used for non-cash transactions, such as making electronic payments and other inter bank transactions. Balances were generally shown in both the old national currency as well as the corresponding euro value.

The euro currency was introduced on January 1, 2002 without any real problems as a "street" currency.

WHAT IS FOREIGN EXCHANGE?

"Foreign exchange" refers to money denominated in the currency of another nation or group of nations. Any person who exchanges money denominated in his own nation's currency for money denominated in another nation's currency acquires foreign exchange. The size of the transaction is irrelevant. A person changing a few pounds at Heathrow International airport or cashing a traveller's cheque at a shop in Venice is involved in a foreign exchange transaction just the same as a company who is changing millions of dollars in order to make an investment in another country.

[2] The spot market refers to the fact that a deal is done "on the spot" and settlement of obligations will take place in the shortest possible time, considering market conventions. In the FX this usually means two business days.

[3] (Forward outright) An outright purchase or sale of one currency in exchange for another currency for delivery on a fixed date in the future other than the **spot settlement date.**

[4] The simultaneous purchase and sale of identical amounts of currency for different value dates.

[5] Kettell, Brian, What drives currency markets? Financial Times, 2000, Prentice-Hall, p 18.

ROLE OF THE "EXCHANGE RATE"

The exchange rate is *a price* – it is the number of units of one currency that can be bought by a number of units of another currency, and vice versa. In the spot market, there is an exchange rate for every currency traded in that market.

A currency's market price is determined by supply and demand, by buyers and sellers, that is, the market participants, whether individual or institutional. A currency with an exchange rate that is fixed requires the support and intervention of its central bank to keep the currency at the fixed rate.

By contrast, a floating currency can fluctuate in value, determined by the market participants buying or selling the currency.

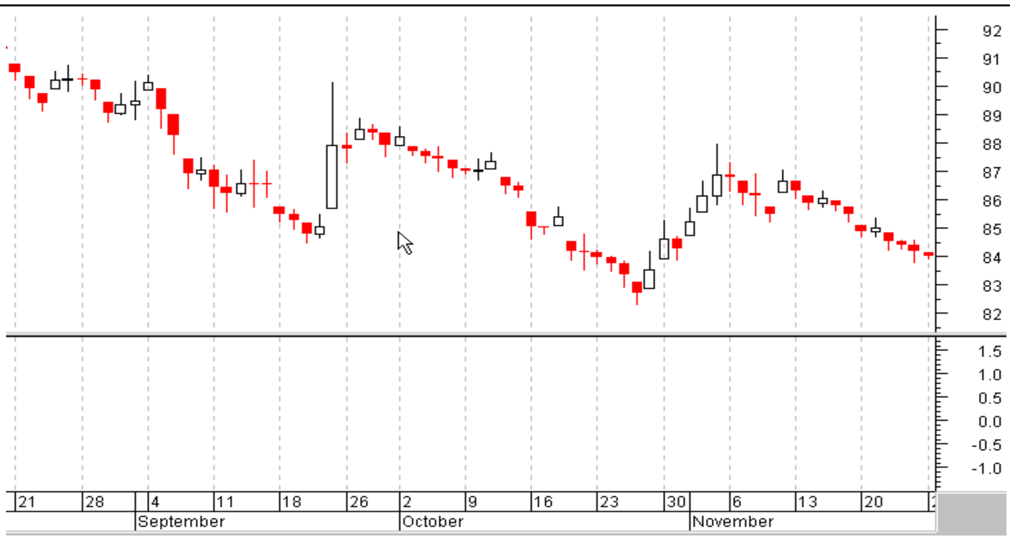
INTERVENTION

In many cases a central bank may want to alter exchange rates but without making government economic policy changes. In these cases the desired effect can be reached by changing the markets' perceptions about the value of the exchange rate or other economic variables.

In some cases a central bank uses covert intervention by either buying its own currency with foreign exchange reserves or in some instances buying foreign exchange reserves in order to weaken its own currency.

In the long-term a central bank cannot fight market forces indefinitely. Even central banks do not have unlimited reserves. Therefore, the timing of intervention, in order to achieve the maximum psychological impact, is very important.

Figure 3.1: ECB Intervention on 21 September 2000 to halt the slide in the EUR/USD value



EUR/USD - Graphics : Metastock

This example (Figure 3.1) clearly illustrates one of the limitations of intervention. The currency, after the initial boost provided by intervention, continued to weaken against the dollar. Repeated interventions in the following months were required in order to stabilise the euro against the dollar.

Soft intervention

Playing on market expectations, politicians or monetary officials may make statements in order to move a currency. The Japanese often make use of this type of currency management and role players in the market have learned to pay close attention to their rhetoric. In market terms this is known as "jawboning".

Example: Soft intervention: Japan, November 26th 2002

Japan's officialdom attempts to jawbone the yen lower after a sharp rise in the currency in Asian trading. Any further rise in the yen (USD/JPY fall) may be limited after Haruhiko Kuroda, Japan's vice finance minister of international affairs, said gains in the currency would worsen the country's efforts to reverse four years of deflation. The yen is up almost 2 percent against the dollar in the past month. However, BOJ (Bank of Japan) Governor Masaru Hayami, seemed to disagree, saying it was important to avoid the devaluation of the yen. Nonetheless, Minister of Finance Masajuro Shiokawa backed up Kuroda, saying a weak yen helps Japan's economic recovery. Source: Forex News

A very recent example was when the current President of the European Central bank made a remark on January 12th (2004) about "brutal moves" in the forex market. This halted and reversed the strengthening of the euro to such an extent that the euro almost retraced the complete move it made in the preceding three months from levels well below its previous all time highs of 1.1900 to 1.2900.

Short-Term Trading Thoughts On Intervention

My first introduction to intervention was the situation depicted in Figure 3.1 above, EURUSD, September 2000. You can see how exaggerated the candle of 21st September is compared with those around it. What happened?

The ECB (European Central Bank) had been denying that they were worried about the euro's weakness versus the USD. Then they 'crooked' by intervening in order to prop up the ailing euro. Now the market didn't like this one bit. The market generally doesn't like surprises but to have a central bank say one thing and do another is quite unacceptable. When the intervention came is was therefore a shock and the market reacted by 'punishing' the ECB. The professional market role players were furious and they sold euros because the fundamentals were wrong to buy euro. As mentioned before it took several months of repeated intervention before the ECB could stabilise the euro. On the day the intra day volatility was huge – 500 points. I saw it happen. The day's high and low were made in a 15 minute period! Scary stuff.

Intervention and opportunities

If you are a short-term trader with the right perspective, intervention presents opportunities. Intervention is rarely a one-off event. It is usually repeated over a period of weeks, even months, depending on the circumstances. Intervention is an abnormal occurrence, an 'interference' in a market generally left to itself to determine the price of currencies and consequently it happens infrequently. A central bank will therefore never intervene more than it has to. It is an action of last resort once all other avenues have been exhausted including interest rate adjustments and money supply manipulations. As a short-term trader you have two choices; either trade against the fundamental market forces and with the intervention, or wait for the affects of intervention to subside and then trade with the market forces backing them to reassert themselves. In the first case you would trade with the central bank; say BOJ was trying to weaken the yen by selling it, you would do the same. In the second case you would wait for what you believe to be the artificially induced weakness of the yen to wane, and then trade it long against the dollar. Because the US dollar is the dominant currency, any strong move by the dollar against one currency will have a muted but noticeable ripple affect on the other major currencies.

In recent times the BOJ (Bank of Japan) has been the king of intervention. Japan had to recover from a long-term economic slump. Because it has an export driven currency it's economy benefits from a weak yen which makes its exports more competitive. The US dollar has nose-dived since November 2001 and at the same time the yen has strengthened from its weak (good) level of 135 yen to the dollar.

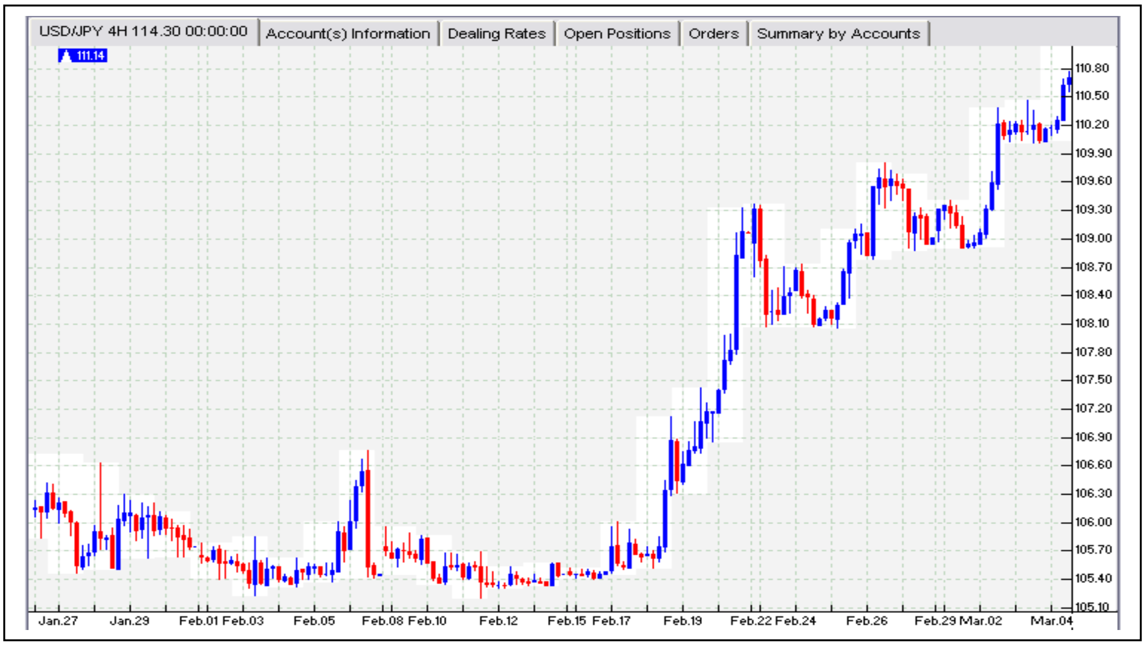
The BOJ often makes use of 'verbal intervention'. This is a method of preparing the market, warning them as it were that the BOJ is thinking of intervening and this can in itself weaken the yen. It's a bit of a cat and mouse game. What the BOJ does is to set a target level of the yen versus the US dollar, which they will resolutely defend. Obviously this target level is not announced, but the market quickly catches on, more or less, where it is and starts to get jittery once the level is approached. This makes it possible for speculators to have a ball. Some speculators place orders to trade with the intervention, i.e. selling yen and buying US dollar. This helps to keep the target level in place as these speculators' positions are mostly on the spot price side of the intervention. Other speculators will sell the dollar and buy the yen with the larger fundamental market forces. The latter group will eventually prevail because the intention of intervention is usually just to slow down the speed of a currency movement, not reverse it.

Central bankers, when they do decide to actively intervene in their country's currency mainly do this to slow down either a weakening or a strengthening of the currency.

Even large central banks can't indefinitely keep market forces at bay. The mere fact of intervention is therefore a very strong indicator of a trend that is expected to last for quite a measurable period of time. In my view such a one-way-play is the lowest risk trade and a short-term trader can benefit greatly from it. See also below the concept of overshooting. Currencies overshoot. That is, they always move too far (price change), too fast (time wise) from where they are 'supposed' to be. Central bankers, when they do decide to actively intervene in their country's currency mainly do this to slow down either a weakening or a strengthening of the currency. They can't do this indefinitely and they know it and so all they want is to oversee an orderly decline or strengthening, whatever the case may be. The main risk for the speculators who trade with the intervening central bank against the market forces is the risk of mis-timing the intervention. What happens if the central bank feels that they have done enough for the time being, and sit out? All the assumptions about what the line in the sand was fly out the window and a new overshoot takes place, but in the opposite direction. Graphically it looks like this:

After keeping the level of the yen above 115.00, 116.00 and 117.00 for a year against the US dollar the BOJ suddenly gave in and as money poured into Japan to exploit new growth opportunities in the stock market. The BOJ just stood back. In a matter of days the yen gained 1000 points against the US dollar.

The picture below gives a closer view of the mechanics of intervention. Over a two-week period, end of January to mid February 2004, the BOJ defended the 105.50 level. They did it by using state agencies to take all USD dollar offers at that specific level in a measured manner. That is, they did not, in a burst of activity, take all orders within sight up to say 100 or 200 points. They just made sure no significant high volume driven break of their target level took place. It looked like normal market action. The up-swing since Feb 17 coincided with general US dollar strength and it is quite possible that the BOJ joined in and helped it on a bit.



Nothing in the currency market is obvious, especially the seemingly obvious. Because the intervening central bank is actually busy with desperate measures they will take all sorts of other measures to make sure the market doesn't "beat" them. Intervention is therefore a tussle between the market and a temporary foe, the central bank. Expect tactics like double intervention (twice in one day) smaller intervention at regular times and then suddenly unexpected intervention through another central bank in a totally different time zone, and as explained above, the withholding of intervention when it is most expected.

Nothing in the currency market is obvious, especially the seemingly obvious.

The most practical trade for me is to stay out of the intervention zone, especially if the target zone seems to be well known and if it is in a currency that I do not at that stage follow as my major “ONE” currency. An intervening central bank is not there to give a free lottery ticket to speculators, they have a job to do and that job is not to make speculators rich.

FUNDAMENTAL FACTORS GOVERNING EXCHANGE RATES.

The first law of economics is that when the price goes up, consumption goes down. This is a divine law. You cannot change it.

-Sheihk Ahmed Yamani – Saudi oil minister

Countries with high relative real interest rates will see their currencies appreciate as foreign investors sell their ***home currencies*** and buy the currency of the country with the high real interest rate.

In recent years the flow of capital in the global markets due to trade in financial assets has reached a point where interest rates play a large role in determining where capital is parked. These flows of capital determine the exchange rate in the short-term. However, capital is a coward and will hit the road at the slightest sign of potential losses in its current location, or it may hit the road due to better prospects in another location. That is one of the reasons that exchange rates are volatile in response to new and unexpected news in the market, especially (news) relating to the interest rate environment.

PURCHASING POWER PARITY

There are three concepts of PPP that are employed by economists. On the most basic level, PPP states that identical goods should have exactly the same price irrespective the location of those goods.

The Law of One Price

The ‘law of one price’ states that identical goods should have the same price in all locations. For example, a Big Mac should cost the same in New York, London, Tokyo and Johannesburg after adjusting for the exchange rate. If widgets cost less in London than in Johannesburg, an enterprising individual will import widgets from London to Johannesburg and sell them in Johannesburg for cheaper than the domestic widgets. The demand for these cheaper imported widgets will increase, pushing up the price of the London widgets until the price is equal in Johannesburg and London.

However in practice the law of one price does not hold, due to the effects of tariffs, transportation costs and labour costs.

> Example:
>
> If a Big Mac cost $1.50 in New York and R12.50 in South Africa, then the exchange rate should be R/$ 8.33 (R12.50/$1.50)

Absolute Purchasing Power Parity

Instead of focusing on individual products, absolute PPP compares the price of a basket of similar goods between two countries.

Absolute PPP is derived as a measure of an equilibrium exchange rate:

> Definition:
>
> Absolute PPP = (Exchange Rate) x (Domestic Price/Foreign Price)

The PPP is intuitively appealing. For example, suppose prices in the foreign country rise by 10 per cent and remain constant in the US, each dollar still buys the same basket of foreign goods, but those goods are now 10 per cent more expensive – hence the dollar strengthens by 10 per cent.

Relative Purchasing Power Parity

While absolute PPP depends on the ratio of the *level* of prices in two countries, relative PPP depends on the ratio of the *growth rates* of the prices in the two countries. Hence, it is the rate of inflation that is critical here. Therefore, relative PPP requires that the exchange rate be only proportional to the ratio of the two price indices.

Empirical Observations regarding PPP

- PPP is a poor predictor of short-term exchange rate movements.
- PPP tends to hold over the long-term. However, evidence supporting the long-term effectiveness of PPP as a predictor of exchange fluctuations is weak.

Reasons why PPP does not tend to hold

- The measure of inflation varies across countries.
- Transaction costs, import taxes and export subsidies prevent ***arbitrage*** from taking place.
- Factors of production (i.e. labour and capital) are not completely mobile in the short-term.

For exchange rate forecasting PPP is not a good measure of what will happen to the exchange rate in the short run. What should be noticed from this is that price changes of goods play a role in exchange rate movements, but they are overshadowed by other factors in the short run. These are factors such as capital flows due to risk factors as well as supply and demand pressures of goods such as commodities (oil, gold, iron, platinum and other raw materials needed by industrialized countries) and financial assets such as stocks listed on a stock exchange, futures listed on a futures exchange, and government as well as corporate bonds.

INTEREST RATE FACTORS

The Fisher Effect

The nominal risk-free rate of interest in a country can be derived from the real interest rate and the rate of expected inflation.

Definition:
Nominal Rate = Real Rate + Expected Inflation

The nominal rate is the rate that you see quoted in the financial press on risk-free deposits. For example, the money market rate in the US is a nominal rate. As an investor however, you are really only concerned with the real interest rate. In other words: the return on your investment after adjusting for inflation.

The real interest rates will be equal across borders in an environment of capital integration. In an integrated global capital market, with no capital controls, funds flow relatively freely across borders – real interest rates are determined by the overall global supply and demand of funds.

Countries with high relative real rates will see their currencies appreciate as foreign investors sell their ***home currencies*** and buy the currency of the country with the high real rate.

There are however a couple of reasons why real ***interest rate differentials*** may still exist in the integrated market case:

- Tax rate differences between countries can force an after-tax real interest rate differential.
- Currency risk: Investors may want to avoid currency risk and invest primarily in domestic securities.

Again, interest rate differentials play a role in determining the exchange rate as capital flows in or out of a country. As more capital flows to the country, the currency will appreciate. However, the Fisher equation also only holds in the long run. Although the interest rate plays a definite role, other factors like risk, news and expectations may overshadow the day-to-day capital flows to and from a country.

Short-Term Trading Thoughts On Interest Rate Factors

Interest rates are very important in the life of a currency trader. They are probably the biggest driver behind medium term trends and understanding interest rates will give you a big advantage. It's no good waiting for the announcement of an interest rate hike or cut. That's too late. You need to be ahead of the curve. Interest rates are a short-term speculator's dream (or nightmare) and that is why you need to understand the prevailing moods, the subtle signs that precede a change in short-term interest rates.

Interest rates are very important in the life of a currency trader, as they are the biggest driver of medium term currency price trends.

Why is it so important? Large fund and portfolio managers are always looking for risk free investments. They want to park their client's money where it can earn the most interest for the least risk. If the US has a higher interest rate than Europe, that's where they will send their money, and vice versa. Keep in mind that when a country with a lower interest rate, relatively speaking, starts to hike rates, it may attract investors even though that country's rate is still nominally lower than where the big investors' money currently is. Smart money will try to get in early on the side of the currency which may be hiking rates in the future. This will cause demand for that currency and the strengthening of that currency over a number of weeks, even months.

Interest rates and the central bank

It is important to understand how this works in practice. These days we have a fractional bank system. It means banks only have to keep a fraction of the money they owe in reserve. But in general in first world countries these reserve levels are strictly enforced on a day-to-day basis. The central bank is the lender of last resort to other banks and banks can borrow money from the central bank. The rate at which the central bank lends money to banks on a day-to-day basis is the overnight rate, repo rate or Fed funds rate (in the case of the USA). If a bank pays, say, 2% interest to the central bank in order to have cash to on-lend it will charge more to the borrower in order to make a profit. Banks receive deposits from investors and also on-lend this money to borrowers. The overnight rate therefore determines all short-term interest rates in a country. If a discrepancy exists between the interest rate of say the US (as low as 1% and even becoming negative if adjusted for inflation (deterioration in value of money because of price rises)) and the UK, 4% and rising because of inflationary pressure building up in the retail and housing sector, lots and lots of money will flow to the British pound simply because of this interest rate differential. This will drive the pound up, and if you get in early you make money.

Interest rates on trades

A trade, where for example you hold GBP (long GBP) versus USD (short USD) will have positive interest carry into the next day if the UK has higher interest rates than the US (which it currently does). This is easy money and on large amounts, inflated further by gearing, it can amount to significant sums of money. The larger the interest rate differential the more profitable the carry trade, and while it fuels a capital appreciation in the currency, it is even better. And usually it does. I believe the main drivers of the carry trade are Asian and specifically Japanese investors. Real interest rates in Ozzie, Cable and even the Euro and USD were, for a very long time, higher than in Japan. The Japanese are also heavily invested in global markets as a result of the economic meltdown Japan had in the early 1990’s.

The risk for short-term traders riding these factors comes in when short-term interest rate expectations or the rates themselves change. Especially those of the US. The US dollar is known as the reserve currency of the world because of the dominant position of the US economy since World War II and also because most exchange rates started to float in the early 1970s. Any changes in short-term US interest rates therefore affect a vast pool of money; the value of dollars and interest received on dollar cash in the US and also billions of eurodollars, dollars kept in countries other than the USA.

Eurodollar is a term used for any currency kept offshore from the home country. It originates from the cold-war period when Russia withdrew dollars from US banks and deposited it in European banks – therefore eurodollars.

Short-term currency traders are therefore closely watching for signs for any possible indication that will give an early warning that the Fed may start tweaking interest rates for whatever reasons. During the reign of Alan Greenspan as the chairman of the Fed (the Fed consists of 13 federal or district reserve banks) he introduced a very active interest rate change policy – almost like using a faucet to either cool down the economy to halt inflation or lowering interest rates to revive economic activity. This approach has strong critics who say it causes all sorts of boom and bust cycles and asset bubbles in the US stock market and bond market, and, currently, inflated housing market values.

So keep in mind that interest rate differentials and perceived changes in interest rate differentials are probably the most visible and manageable trendsetters in the short and medium term for the currency market.

THE BALANCE OF PAYMENTS

Definition:

The Balance of Payments (BoP) is the systematic account of all transactions in a given period (usually a year) between a country and the rest of the world.

The BoP has different accounts that have different transactions in it. For exchange rate purposes the ***financial account*** and the ***current account*** are especially important.

The Current account

This is the account that holds all the transactions of imports and exports of goods and services for the country, its trade balance. For instance, when Japan exports (imports) electronic equipment, retailers in the US must buy yen on the forex market to pay for these products. There is thus an increase in the demand for yen, which will lead to an appreciation of the yen versus the dollar. So if it is announced that there is a surplus on the trade balance of Japan, it implies that Japan has exported more than they imported. This in turn means that demand for yen must have risen since the previous period. This increase in demand for yen should be reflected in an appreciation of the yen against its trading partner's currency.

Example: United States

The August FT-900 report on international trade revealed a trade deficit of $38.5 billion. Exports fell while imports gained, to increase the size of the deficit by $4.1 billion. This has been the result of years of importing more than exporting.

The Financial Account

This account holds the transaction for the flow of capital for portfolio and direct investment purposes to and from a country. When an investor (for example a large US investment bank) wants to buy Japanese government bonds for investment purposes, they have to do this in yen. An increase in the demand for yen will thus be experienced. When this transaction goes through, it will reflect on the financial account. The opposite also holds. When a huge investment bank decides to sell Japanese government bonds, it will increase the supply of yen in the market. Therefore, a surplus on the financial account of a country will reflect an increase in demand for a currency (implying an appreciation of the currency) while a deficit on the financial account will imply an increase in supply of the currency (implying a depreciation of the currency).

Example: From Dow Jones News Wires 25/11/2002

In a relatively light day of economic data, the foreign exchange market failed to show much interest in comments by William McDonough, president of the Federal Reserve Bank of New York, who said that "The world economy is best characterized as being badly balanced," and relies too much on continued spending by the US consumer.

He also said that "It is not in the long-run interest" of the US to be so dependent on heavy overseas investment flows, and it would be "one hell of a recession" if those flows were to be quickly withdrawn.

Short-Term Trading Thoughts On Balance Of Payments

Balance of payment issues affect currency values but only over the longer term. Theoretically large deficits are unsustainable and the weakening of a currency is necessary to assist in reducing the deficit. The US situation circa 2003, 2004 shows record deficits across the board and these deficits are rising despite the fact that the US dollar weakened substantially versus major currencies since the end of 2001.

Because it is such a fundamental driver, and not as direct as interest rates it is not useful in day-to-day decision making. The release of figures in this regard may however over a period of a few months start to indicate a change in trend. If, say, the US deficit starts to narrow then one of the fundamental drivers for a weaker dollar will start to disappear. If institutional investors and even central banks starts to act on longer-term expectations in this regard the short-term trader must consider the immediate short-term drivers may just be an illusion. But by keeping a good perspective – remember the example of the highway of death and those on the overlooking hills who could see the scene unfold – you will be able to make better decisions on the fundamental trend and consequently your short-term trades.

OVERSHOOTING EXCHANGE RATES

We know that purchasing parity does not hold well in the short term under flexible exchange rates. Exchange rates exhibit a lot more volatility than prices of goods and services do. In the short term, following some disturbance to the current equilibrium, prices will adjust slowly to the new equilibrium level, whereas exchange rates and interest rates will adjust quickly. This difference in the speed of adjustments to equilibrium allows for some interesting behaviour regarding exchange rates and prices.

At times it appears that the spot exchange rates move too far too fast following some economic disturbance or news. For example, country A has higher inflation than country B but country A's exchange rate still depreciates much more in the short term than it is "supposed" to. Anomalies like these can be explained in the context of an "overshooting" exchange rate model.

> Example:
>
> Say the ***money supply*** in country A increases. This implies more money in the pockets of the people. There is now an increase in demand for everything. Financial markets adjust instantly to this shock, whereas goods markets adjust slowly (because of labour contracts, production outlays, competition and so on). We further know that PPP does not hold in the short term, and that spot exchange rates are much more volatile than the forward rate. Also, for equilibrium in the money market, demand must equal supply. So if money supply increases, something must happen so that the money demand also increases.

Overshooting can be explained using the following three concepts.

- Firstly we know a person has a money demand function that is a function of interest rates and income. When income increases, money demand will increase, as people want to buy more. When interest rates increase, the money demand will decline as the opportunity cost of holding money increases.
- Secondly, the interest rate parity relation for countries A and B may be written as $i_a = i_b$ + (expected change in the exchange rate) or equivalent $i_a = i_b + (F - E)/E$ where E is the current spot rate for the exchange rate and F the forward rate for the exchange rate, $\boldsymbol{i_a}$ is the interest rate in country A and $\boldsymbol{i_b}$ is the interest rate in country B. This states that the interest rate in country A must be equal to the interest rate in country B plus the expected depreciation of the currency. If the interest rate in country A declines, and the interest rate in country B stays constant, then the exchange rate in country A must depreciate for the equation to hold. This will happen because of a capital outflow from country A to country B because money can earn greater returns in country B. Thus, if i_a decreases, given the foreign interest rate i_b, the forward ***premium*** must decrease.
- Thirdly, we may also think of the long-run value of the exchange rate to be consistent with PPP. PPP can be written as the ratio of prices in country A and B.
  $E_{LR} = P_a/P_b$

Given these three concepts, what happens with exchange rate overshooting?
When the money supply increases, people have more money in their pockets. This implies greater demand pressure on asset prices, goods prices and service prices as people try to spend this money. Since P_a is expected to rise over time, given P_b, E will also rise some time in the future according to the PPP equation. This higher expected future spot rate will be reflected in a higher forward rate now. But analysing the equation for interest rate parity that must hold, if F (the forward rate) rises while at the same time F – E must fall to maintain interest rate parity, the current spot exchange rate E will have to increase more than F. This implies that the spot rate now increases more than the forward rate. This is because prices for assets can change instantaneously, while prices for goods and services are slow to react. Then, once prices eventually start rising, real money balances fall, so that the domestic interest rate rises. Over time as the interest rate increases, the spot rate, E, will fall to maintain interest rate parity along its long term equilibrium path. Therefore, the initial rise in the spot rate, E, will be in excess of the long term exchange rate.

Summary:
Because of sticky prices for goods and services, and very flexible asset prices, the exchange rate will sometimes overshoot its long term equilibrium in the event of unanticipated news in order for the interest rate parity relationship to hold. However, when prices eventually start to adjust, the exchange rate will adjust as well, and move back to the long term equilibrium.

Short term Trading Thoughts About Overshooting Of Exchange Rates

The overshooting effect of exchange rates is extremely important for short-term traders. Exactly because we have a short term horizon, a short term trader with the correct perspective, strategy and methodology can make money in the final overshooting phase as well as in the pull-back following that phase and again when the fundamental trend reasserts itself.

The euro made a long-term comeback against the dollar from roughly the end of 2001. The first benchmark was to reach parity, one dollar = one euro. After that was achieved the next benchmark was to reach its original level, namely 1.1700 dollar = one euro. This was reached during the second US Iraq occupation of May 2003. On a fundamental level one could have expected it to pass that benchmark level (because of the inflated value of the US dollar versus a basket of all the currencies, especially the German mark, that made up the euro in its preliminary phase) sooner rather than later as US deficits increased and economic data, especially employment data was not good. After the euro reached highs of one euro = 1.1930 US dollar in May / June 2003, it pulled back to 1.0750 during the next two months and then the overshoot phase began, passing the 1.1900 highs during November and rallying to almost 1.3000 in a matter of weeks. Short-term and day traders who didn't have this perspective and shorted the euro (expecting it to weaken) at its highs on a daily basis were killed. But some made handsome gains. Here is an example of a DayForex Capital Management client's account, opened mid- November 2003, concluding in the highs of January 2004, a period of roughly two months. This account was traded using the principles described in this book, according to the strategy and methodologies explained in Part 4:

ACCOUNT STATEMENT			
Trader DFX -3332			
1	**11/12/2003 16:14:24**	**Deposit**	**$73,933.64**

Close Date/Time	Instrument	Open Rate	Close Rate	Gross PL
11/13/2003 04:59:05	GBPUSD	1.6785	1.6812	$230.97
11/13/2003 04:59:21	EURUSD	1.165	1.1687	$316.54
11/13/2003 09:24:41	EURUSD	1.1676	1.1705	$247.69
11/13/2003 09:24:52	GBPUSD	1.6831	1.6855	$204.99
11/14/2003 08:49:31	EURUSD	1.1719	1.1749	$255.34
11/14/2003 08:50:08	EURUSD	1.1713	1.1743	$255.38
11/14/2003 08:53:45	GBPUSD	1.6877	1.6847	($255.65)
11/16/2003 19:40:11	GBPUSD	1.6875	1.6928	$447.33
11/17/2003 03:25:15	EURUSD	1.1752	1.1808	$474.13
11/17/2003 06:04:52	EURUSD	1.179	1.1827	$625.58
11/17/2003 13:18:05	EURUSD	1.1805	1.1751	$919.07
11/18/2003 00:13:22	GBPUSD	1.6894	1.6934	$339.53
11/18/2003 01:51:15	GBPUSD	1.6895	1.693	$594.58
11/18/2003 08:51:26	EURUSD	1.174	1.1775	$594.33
11/18/2003 10:47:01	GBPUSD	1.6898	1.7005	$1,797.56
11/18/2003 10:47:06	GBPUSD	1.6908	1.7005	$1,629.57
11/18/2003 10:47:13	EURUSD	1.1778	1.19	$1,024.78
11/18/2003 10:47:17	EURUSD	1.1822	1.19	$1,310.37
11/18/2003 10:47:19	EURUSD	1.1795	1.19	$1,763.96
11/18/2003 13:37:18	GBPUSD	1.7001	1.7029	$468.89
11/18/2003 13:37:19	EURUSD	1.1901	1.194	$653.10
11/20/2003 06:46:14	GBPUSD	1.6991	1.7033	$528.43
11/20/2003 09:44:03	USDJPY	109.22	108.8	$485.32
11/20/2003 10:09:09	GBPUSD	1.7024	1.7045	$176.13
11/20/2003 10:09:11	GBPUSD	1.7023	1.7045	$369.03
11/21/2003 11:13:16	EURUSD	1.1862	1.1912	$839.28
11/26/2003 10:11:35	GBPUSD	1.6976	1.704	$538.13
11/26/2003 10:54:19	EURUSD	1.1839	1.1931	($1,542.72)
11/26/2003 10:59:31	GBPUSD	1.7047	1.7084	$465.33
11/26/2003 11:00:57	EURUSD	1.1874	1.1918	$369.10
11/28/2003 04:39:16	EURUSD	1.1918	1.1968	$417.64
11/28/2003 05:13:14	EURUSD	1.193	1.197	$501.13
11/28/2003 06:03:22	EURUSD	1.1913	1.197	$714.05
11/28/2003 06:09:59	EURUSD	1.1899	1.1967	$568.09

11/28/2003 06:10:09	EURUSD	1.1964	1.1966	$25.06
12/01/2003 07:35:25	GBPUSD	1.7207	1.7264	$948.34
12/01/2003 08:08:39	EURUSD	1.1977	1.2011	$566.01
12/02/2003 11:56:34	EURUSD	1.2026	1.208	$670.31
12/03/2003 02:11:58	GBPUSD	1.7251	1.7304	$657.57
12/03/2003 02:26:15	EURUSD	1.2061	1.2089	$347.34
12/03/2003 05:08:04	USDJPY	108.88	108.37	$583.35
12/03/2003 07:17:02	EURUSD	1.2075	1.211	$433.42
12/03/2003 08:44:58	EURUSD	1.2	1.2083	$1,373.49
12/03/2003 10:03:39	USDJPY	108.98	108.22	$580.51
12/04/2003 06:06:36	GBPUSD	1.7299	1.7219	($994.78)
12/04/2003 09:18:38	EURUSD	1.2083	1.2135	$642.72
12/05/2003 11:14:40	EURUSD	1.211	1.2146	$444.30
12/05/2003 11:14:45	EURUSD	1.2091	1.2146	$678.84
12/05/2003 11:22:05	GBPUSD	1.7224	1.727	$567.67
12/07/2003 22:45:33	GBPUSD	1.7272	1.7283	$135.72
12/07/2003 22:46:18	GBPUSD	1.7273	1.7283	$123.39
12/08/2003 06:49:31	EURUSD	1.2156	1.22	$540.72
12/08/2003 06:50:17	GBPUSD	1.7293	1.7342	$602.16
12/09/2003 05:46:23	GBPUSD	1.7348	1.7411	$1,541.35
12/09/2003 05:46:24	EURUSD	1.2209	1.2259	$1,223.29
12/10/2003 05:39:21	USDJPY	108.61	108.28	$748.53
12/12/2003 01:18:12	USDJPY	108.38	107.97	$559.51
12/12/2003 05:46:49	EURUSD	1.2184	1.2239	$808.69
12/12/2003 08:53:36	USDJPY	108.15	107.85	$409.84
12/12/2003 10:03:23	EURUSD	1.222	1.227	$1,222.29
12/12/2003 10:03:25	EURUSD	1.2223	1.227	$689.37
12/12/2003 10:03:27	EURUSD	1.2267	1.227	$44.00
12/12/2003 10:03:30	EURUSD	1.2242	1.227	$410.69
12/12/2003 12:22:34	EURUSD	1.2257	1.2286	$472.08
12/15/2003 11:03:42	EURUSD	1.2241	1.2287	$748.58
12/15/2003 11:07:14	GBPUSD	1.736	1.7459	($1,208.30)
12/15/2003 15:10:30	EURUSD	1.2157	1.2307	($1,219.12)
12/16/2003 00:04:01	EURUSD	1.2157	1.2337	($729.63)
12/16/2003 00:10:57	EURUSD	1.2276	1.2338	$1,004.62
12/16/2003 03:02:01	EURUSD	1.2291	1.2317	$422.08
12/16/2003 04:34:28	EURUSD	1.2298	1.2352	$874.14
12/16/2003 04:34:29	EURUSD	1.2335	1.2352	$275.19
12/16/2003 07:24:10	USDJPY	107.85	107.61	$271.29

12/16/2003 07:24:12	USDJPY	107.74	107.61	$195.93
12/16/2003 11:51:12	GBPUSD	1.7483	1.752	$450.12
12/16/2003 11:51:12	GBPUSD	1.7465	1.751	$729.93
12/16/2003 14:09:51	GBPUSD	1.7491	1.7552	$989.94
12/17/2003 08:48:09	EURUSD	1.2349	1.237	$254.61
12/17/2003 09:00:06	EURUSD	1.232	1.2373	$642.32
12/17/2003 09:00:07	GBPUSD	1.7531	1.7562	$500.93
01/05/2004 03:12:12	GBPUSD	1.77	1.7974	$4,327.91
01/05/2004 09:50:59	GBPUSD	1.7976	1.8032	$885.03
01/06/2004 03:20:00	EURUSD	1.2661	1.2711	$786.53
01/06/2004 03:20:02	EURUSD	1.2662	1.2711	$770.80
01/06/2004 06:23:45	USDJPY	106.31	106.19	$177.23
01/06/2004 09:07:04	EURUSD	1.2717	1.2785	$1,063.41
01/06/2004 09:07:19	GBPUSD	1.8218	1.8253	$547.30
01/08/2004 09:22:31	GBPUSD	1.8231	1.8287	$880.23
01/08/2004 14:07:53	EURUSD	1.27	1.275	$784.13
01/08/2004 14:07:55	EURUSD	1.2749	1.275	$15.68
01/09/2004 08:56:34	EURUSD	1.2764	1.2823	$920.65
01/09/2004 09:20:59	GBPUSD	1.832	1.8403	$1,294.75
01/12/2004 05:10:08	EURUSD	1.2825	1.2886	$946.62
01/12/2004 05:10:09	EURUSD	1.2821	1.2886	$1,008.69
01/20/2004 02:56:00	GBPUSD	1.7968	1.793	$305.07
01/20/2004 02:56:00	GBPUSD	1.7981	1.793	$409.44
01/20/2004 02:56:01	GBPUSD	1.8157	1.793	$3,645.12
01/20/2004 02:56:34	EURUSD	1.2385	1.2458	($586.20)
01/20/2004 02:56:36	EURUSD	1.2525	1.2458	$1,075.79
01/20/2004 02:56:37	EURUSD	1.238	1.2458	($626.36)
Total				$58,217.21

That's a return of 78.74% on the initial capital invested. Per trade gearing was between 1:1 and 3:1, averaging below 2:1.

Here I would like to pause and take some time to look at the significance of when you start a trading career in the light of the bull run described above. It also relates to the issue of what I call backyard back-testing.

I believe you should have a three to six month period as a 'start-up' phase in your career as a live trader. Should you have started trading in November 2003, all you had to do was hop on for the ride. A monkey could have made money. But traders who begin well run the risk of developing a skewed view of their trading ability. Don't read too much into your first few months of trading. Similarly you might have started trading as the market turned, and lost money. Don’t start to castigate yourself. You’re not a bad trader. Making or losing money in the early days of your trading career is often a matter of good or bad luck.

New traders have usually done a bit of back-testing and go into trading with this for support. Back-testing has its place but I am concerned with backyard back-testing which uses short time frames like five, ten or fifteen minute graphs. Now if the back tester happened to be testing during an overshoot period like the one described above his short-term price charts will be misleading, seemingly clearly giving signals to sell US dollar and buy just about everything else even on short time frames. This type of back-testing merely serves to confirm faulty judgment. It is very important for novices, especially in the retail online sector (where I assume many readers will be trading) of this dynamic market to understand the structural differences between the currency market and other markets and specifically how this may or may not impact on day-to-day trading.

Chapter 8

The Foreign Exchange Market

THE FOREIGN EXCHANGE "MARKET" IS NOT A FORMAL "EXCHANGE"

One should not confuse the usage of the term Forex "market" with an organised exchange such as the New York Stock Exchange or the London Stock Exchange or the Chicago Board of Exchange.

A traditional exchange is located at one physical location and the rules of the exchange are applicable to all stocks (or other financial instruments) listed on that particular exchange.

Members of the exchange, usually "stockbrokers" arrange all the buying and selling and report to the exchange. The exchange oversees the ***settlement*** of transactions, i.e. that the share certificates are delivered to the buyers and the money delivered to the sellers.

The foreign exchange "market" does not have a similarly organized exchange. Foreign exchange transactions are done "over-the-counter" between two parties and this movement of 1.5 trillion dollars per day is based on trust between participating parties.

However the most important consequence of the decentralized nature of the FX market is the fact that there is not ONE price at any specific time for any specific currency. Each transaction conducted between a participant in the market and another participant is over-the-counter and the price is highly negotiable.

There is not ONE global price at any moment for a specific currency.

Practically it means that two market makers (institutions quoting buying and selling prices simultaneously) on one street block in New York or London can quote, at the same time, different prices for the same currency and one market maker can quote two different prices at the same time for two different customers. This is perfectly acceptable since one customer may only deal in a $10,000 transaction and another may want to deal in a $10,000,000 transaction.

You also need to understand how market makers think and how they make their money. They want your money. You think it's just margin, but for them it is an income stream (remember money doesn't flow from the banks and the financial institutions outward towards you; it flows in exactly the opposite direction, from your pocket to their accounts.) Smart traders have worked out ways they can 'intercept' these money flows. Traders must understand that the entity they deal with, where they deposit their margin, sees their margin as a source of income - for them. Their purpose is not to be a safe custodian of your funds, but to make money from market making, the quoting of prices and the income earned from spreads. More about how this affects you later.

THE SIZE OF THE FOREIGN EXCHANGE MARKET

It has already been established that the foreign exchange market is huge in comparison to all other financial markets. The size of the market is relevant. I will talk more about this later but you need to be aware that its sheer size gives it certain specific characteristics which are important for you as a participant in this market.

The size of the market provides us traders with certain advantages:

- Continuous and full ***liquidity***.
- Around the clock trading
- Around the globe trading

- High efficiency
- Price stability

The global growth in FX trading

The growth in forex trading is the result of the globalisation of the financial markets, the formation of major trading blocks and the enormous growth in cross-border capital flows as well as innovation in the field of financial instruments– specifically derivative instruments.

"*Turnover is equivalent to more than $200.00 in foreign exchange market transactions, every business day of the year, for every man, woman and child on earth*."[6]

Table 3.2: **Growth in foreign exchange turnover**[7]

Year	Daily Turnover	Year	Daily Turnover
1977	$5 billion	1992	$ 1 trillion
1982	$ 40 billion	1998	$1.5 trillion
1987	$ 600 billion		

Source : Bank for International Settlements

"The breadth, depth and liquidity of the market is truly impressive. Individual trades of $200 million to $500 million are not uncommon. Quoted prices change as often as 20 times a minute. It has been estimated that the world's most active exchange rates can change up to 18,000 times during a single day. Large trades can be made, yet econometric studies indicate that prices tend to move in relatively small increments, a sign of a smoothly functioning and liquid market." [8]

Keep in mind that the figure of $1.5 trillion foreign exchange trading a day is made up of two-thirds internal reporting - dealers amongst themselves - and one-third external, transactions between reporting dealers and their customers. Only a small percentage of daily volume consists of non-speculative or non-hedged transactions. However, I mention the amounts involved in order to underline the size and liquidity of the foreign exchange market.

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[6] Cross, Sam, Y. The Foreign Exchange Market in the United States, Federal Reserve Bank, 1998, p. 15.
[7] Long, K. Electronic Currency Trading for Maximum Profit, 2001, Prima Publishing, p. 20.

[8] Cross, Sam, Y. The Foreign Exchange Market in the United States, Federal Reserve Bank, 1998, p. 15.

London is the centre of the Forex Market

A great number of financial institutions are located in London because of its dominance as the major trading centre in the world during the18th and 19th centuries. London also has other advantages such as its practical time zone location (it falls neatly between Asia and the USA) and its proximity to euro currency markets and their attendant financial institutions. This means that trading time in London catches both the end of the Asian trading day and the beginning of the American trading day.

The largest amount of foreign exchange trading takes place in London, UK even though the GBP is less widely traded than some other currencies. More dollars are actually traded in London than in New York. However, most of these trades are undertaken by non-UK owned companies situated in London, with US institutions owning the lion's share. New York and Tokyo are respectively the second and third largest forex centres.

THE FOREIGN EXCHANGE MARKET DAY

The foreign exchange market follows the sun around the earth. The forex "week" begins, according to the ACI Code of Conduct, at 05:00 Sydney time on Monday mornings.

The foreign exchange trading day almost never ceases except for short periods over weekends. At any given time, somebody, somewhere is buying and selling currencies. As one market closes, another market opens, business hours overlap, and the exchange continues as day becomes night and night becomes day.

The twenty-four-hour-a-day characteristic of the foreign exchange market has major implications for its participants with regards to physical delivery and settlement of transactions as wells as the dynamics of the market itself as regards short-term price behaviour. This is particularly relevant for the new breed of electronic intra-day traders such as us.

A typical trading day will start in New Zealand and Sydney, Australia, followed by Tokyo, Hong Kong and Singapore. These markets will be in full stride when trading begins in parts of the Middle East. As Tokyo begins to wind down, the European markets open for the day. The late European afternoon sees the start of business in New York, and as the US day reaches its end it is time for the Western Pacific countries to open their doors once again.

Table 3.3: **The 24-hour trading day**

CET Time	London Time	New York time	Action
Monday 01:00	Monday 00:00	Sunday 19:00	Trading starts in Tokyo
Monday 03:00	Monday 02:00	Sunday 21:00	Hong Kong, Singapore open
Monday 08:00	Monday 07:00	Monday 02:00	Trading starts in Europe
Monday 09:00	Monday 08:00	Monday 03:00	Tokyo closes
Monday 09:00	Monday 08:00	Monday 03:00	London opens
Monday 10:00	Monday 09:00	Monday 04:00	Hong Kong closes
Monday 14:00	Monday 13:00	Monday 08:00	New York opens
Monday 17:00	Monday 16:00	Monday 11:00	San Francisco opens
Monday 19:00	Monday 18:00	Monday 13:00	Europe, London closes
Monday 22:00	Monday 21:00	Monday 16:00	New York closes
Tuesday 01:00	Tuesday 00:00	Monday 19:00	San Francisco closes
Tuesday 01:00	Tuesday 00:00	Monday 19:00	Trading starts in Tokyo

***** Times refer to summer time periods

The implication for short-term speculators in the foreign exchange market is that they actually have three "trading days" in each 24-hour day. There is roughly a "day" each for the Asian time zone, European time zone and American time zone. Unlike other markets, currency traders do not have 16 hours to contemplate their next move or the advantages of herd-like behaviour at the opening of a market.

When I come to discussing my trading system and strategies, I will refer again to this 24-hour day because it has an important rhythm which traders must learn to adapt to. For now you just need to be aware of its general dynamics. The global nature of this market, its interconnectedness, means that events in different time zones can have universal impact. While institutions have the capacity to keep a 24 hour-watch, day traders cannot do so continuously and need to be aware of the possibility of sharp market movements during their off hours. Generally the markets tend to make their biggest moves during the European / London / New York overlap with New York usually more active in the morning than in the afternoon. There are no hard rules but market moves during these times tend to be more significant than moves that occur during traditionally more inactive periods, and traders respond accordingly. There are interesting day trading possibilities based on the structure of the FX market day – for example I have developed an "Asian follow-through" indicator. (See Part 4)

FOREIGN EXCHANGE CLASSIFICATIONS

The US Dollar (USD)

Since the discontinuation of the "Gold Standard" the new standard became the "dollar standard". The US dollar is the most widely traded currency. The US dollar (USD) has accounted for 40 – 45 per cent of all spot forex trading since the first comprehensive surveys were undertaken in 1989. Almost all major international deals and trade deals, like the trading of oil, gold and other commodities, is done in US dollars.

Major Currencies

Major currencies can be defined as currencies freely available in the spot and derivatives (forward) markets. The top five major currencies are very liquid, even in large volumes, in both the spot and forward markets. The top five majors are:

- US dollar
- Japanese yen
- Euro
- British pound
- Swiss Franc

Other majors:

- Canadian dollar
- Australian dollar

THE PARTICIPANTS IN THE FOREIGN EXCHANGE MARKET

Exporters and Importers

Traditionally the main purpose of the foreign exchange market was to support international trade and travel. Any firm that partakes in exports or imports makes use of the foreign exchange market. Goods and services are usually being paid for in the currency of the country the goods originate in. Trade transactions are usually done directly with the firm's bank or increasingly through Internet full-service brokers. Global corporations also fall into this group.

Example:
A small South African business has sold goods to a German firm to the value of €10,000. The German firm sends €10,000 via a ***SWIFT*** wire transfer to the small business' bank. The business' bank confirms the funds received and does the conversion from EUR to ZAR at the spot rate, say, EUR/ZAR 10.0050.

Example:
A printing company buys a new specialised electronic printing machine from a US-based manufacturer. Delivery will be in six months time. Payment of 15% is made at the time of the order and the balance is payable on delivery and installation. The price is $1,000,000. The spot rate is R9.20 to the dollar. An amount of R1,425,000 is paid over by the printing company's bank at the spot as deposit.

The printing company arranges with its bank a ***forward*** transaction on the balance. The price is agreed at the spot rate and adjusted for the risk of currency fluctuation as determined by the bank at say R9-50 to the dollar.

In six months time the bank will pay $850,000 to the American company. The transaction will be done at spot rate. For argument's sake, say at R10.00 to the dollar. The cost to the bank will be R8,500,000.

The client's account will be debited with the agreed forward rate of $850,000 X 9.50 = R8,075,000. The forward transaction has worked in favour of the importer and he has saved R425,000.

The bank may do several further transactions to offset or hedge its risk.

Investors

Foreign direct investments

Foreign direct investment refers to an entity or person that makes long-term investments in properties or companies, in a foreign country. In order to make this type of transaction or undertake this type of investment the investor has to acquire the currency of the foreign country. A currency exchange needs to take place.

Foreign portfolio investments

Foreign portfolio investment covers the investment in foreign financial assets such as bonds, equities or any other securities. In these cases the investor has to convert home currency into the foreign currency to make the investment and then convert the earnings from these investments back into the home currency. Also, when he repatriates the capital, he has to convert the foreign currency back into the home currency.

Speculators

Foreign exchange speculators buy and sell currencies with the goal to profit from anticipated changes in exchange rates. In the integrated global financial markets foreign exchange speculation is mostly combined with speculation in other financial instruments such as fixed income instruments (bonds, treasuries)[9]. Hence the direct correlation between the fundamental drivers of interest rate instruments and currencies.

The leading speculators are banks speculating with their own money (as opposed to their customers' money). This is usually done through the so-called ***proprietary trading*** desks. Other speculators include:

- Investment banks
- Investment funds
- Hedge funds
- Multinational corporations
- Other companies
- Individual high net-worth speculators
- Trading advisors / money managers
- Individual "retail" speculators who include "retail" money managers

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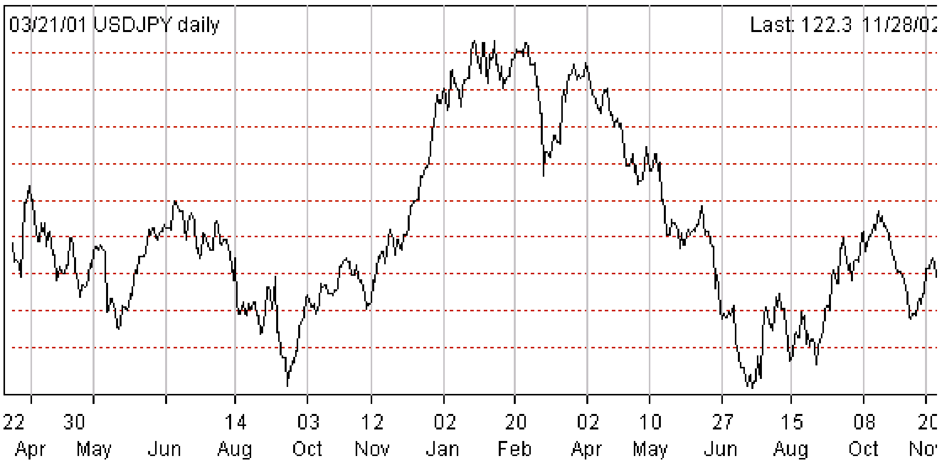
[9] Bonds or treasuries or gilts are one of the least understood financial instruments. Bonds are one of the ways a state (or company or municipality or province) can borrow funds. A bond is a piece of paper entitling the holder to a steady income (interest) usually every six months, and a repayment of capital loaned to the issuer of the bond at the end of the period, usually two – thirty years. This means the bondholder has the right to an income stream (regular payments) for a significant period of time, which is in itself a tradable instrument. The bond market is the secondary market where such bonds are traded between parties because of the supply and demand of these peculiarly priced income streams.

Central Banks (Governments)

For speculators it is crucial to recognise, understand and acknowledge the role of central banks in the foreign exchange markets. Central banks intervene from time to time to “adjust” the domestic currency values in relation to their other major trading partners’ currencies.

I stress to my students the importance of understanding the implication of this. If you are not awake, short-term currency rate changes of 10 to 15 per cent, (See Fig 6.1 below) highly exaggerated by leverage, may wipe you out.

Figure 3.4: **USD/JPY April 2001 – Nov 2002**



Source : Strategem

Auxiliary Services & Service Providers

“During a gold rush, the people that make the money are those selling picks and shovels.”

- *Unknown*

Market makers

All participants willing to quote simultaneous buy and sell prices in order to create liquidity are known as market makers. Market makers usually take the “other side” of the transaction and then hedge their position further in the market, by either matching it with another client or setting it off / clearing it with a bank or broker.

On the wholesale level these are the major banks, the so-called Interbank market.

Market makers buy and sell currencies on a continuous basis 24 hours a day, albeit from different locations. Market makers, "make a market" by quoting their own prices. They quote two-way prices, i.e. a "buy" price and a "sell" price. These are the prices they are prepared to deal on with a customer for as long as that price is valid. The price is valid until they make a new price. A market maker's BUY price is its customer's SELL price and the market maker's SELL price is its customers BUY price. His mark-up is therefore the difference between the BUY and SELL price or the "SPREAD" as it is called.

Any market maker can make the prices he wishes to, there are no restrictions, but common sense and parameters such as deal size as well as the knowledge of other most recent (up to the second) prices may play a role.

The gap ("spread") between the buy and sell prices quoted represents their profit after providing for costs.

On the retail level the mechanics and objectives are basically the same. Retail spreads may be wider to cover the costs of more role players in the transaction chain.

Most retail online traders will deal with market makers.

Brokers

These institutions act as intermediaries or agents rather than principals. They do not trade "against" their customers or do their own proprietary trading (although amongst online brokers you find some hybrids).

Their purpose would be to find good prices for their clients to trade at. Like insurance brokers, foreign exchange brokers act as a conduit putting the best ***bid*** and ***offer*** together to provide the most competitive quotation.

They also provide value added services such as research, and general opinions regarding the direction the market is moving in (trends) and news, helping clients to make short-term trading decisions.

They also contribute to liquidity by encouraging their clients (market making banks) to provide competitive prices.

Example: A typical broking scenario

The time is 07:15 in London and already the spot yen desk is fully staffed with brokers sitting in front of rows of open telephone connections to as many as 200 European banks. One of the brokers may be speaking simultaneously to similar desks in Tokyo, Singapore and Hong Kong. From these markets they combine the prices to form an own competitive price, being the best bid and offer making up the quotation. Similar companies in London would be doing the same, with their network.

Then in the banking dealing rooms the bids and offers of these different brokerages are heard and the dealer has an option as to which broker's transaction he wants to take or he may even put a bid or offer "inside" the broker's price.

Source : Taylor, F, Mastering Foreign Exchange and Currency Options, 1997, Prentice-Hall

Online brokerages offering electronic execution will, in the future, gain more and more market share.

Example: A simplified online brokerage transaction

- Indicative price of EUR/USD 1.1990 / 1.1995 is offered to the customer;
- Customer requests to buy EUR (1.1995);
- Broker searches to match with another client wanting to sell at 1.1990; or
- Broker searches for best deal (in terms of market) with several market makers;
- Broker relays trade to best price, and makes profit on spread differential

Price Vendors

Providers of up to the second prices play a very important role in the market although they are not active market participants. They contribute largely to the efficiency of the market by providing instantaneous prices sourced from hundreds, if not thousands of dealing rooms allowing dealers and traders to analyse and anticipate price changes more effectively.

As mentioned before any market maker can quote a price he sees fit to quote and that is the real price a client can deal on. Clients unhappy with prices cannot refer to some global price as *the* price. How do prices stay in contact? Price vendors. Price vendors gather prices, usually the most recent price from many dealing rooms, average the prices and then broadcast the most recent averaged price back to their subscribers, which in most instances include the dealing rooms originally providing these prices.

Real-rime charting services make use of such price information and most users of these services always keep in mind that these prices are only guidelines and representative of certain sections of the global FX market.

It is also useful to consider that there will always be a "global spread", which is never fixed and which will be wider during turbulent times: a terrorist attack or an interest rate announcement by the Federal Reserve.

The practical movement to fixed, very narrow spreads on retail level testifies to the efficiency of the market, but no retail trader should build a trading strategy on the concepts of orderly, consistent, non-fluctuating, rhythmic pricing. The opposite, in fact, is more characteristic of the foreign exchange market. Large spread changes occour, created by the volatile impact of news and events.

This is one of the reasons why the practice of scalping – taking many small profits very often – is an unsound business idea in retail currency trading.

PERSPECTIVES ON RETAIL FOREX MARKET MAKERS / BROKERS

To be a good broker you must be able to lie consistently

Terry Smith – renegade broker

Compared to online stock trading this is a very new business. It's also a very different business. Whereas your online stock broker matches your bid or offer with someone else's bid or offer, online retail forex brokers stand as counter-party to your trade. Common sense should warn you that this is therefore a different kettle of fish.

Why are the market makers/brokers in the business they are in? What makes them money? You need to know.

But to have a proper perspective regarding the online retail broker and how it will affect your business you have to consider this question. Why are the market makers/brokers in the business they are in? What makes them money? You must understand that the money in this market flows from you through its various stages, closer and closer to the so-called Interbank banks. This should be worrying. This means the system is geared to take your money. I want to explain to you what the danger signals are. In the rest of this book you will learn how to dodge these problems and how to keep your money and how to get some of the losers' money (the losers trading with your specific online broker). You'll be glad to hear that there are roughly 9 losers for every 1 winner- so there is plenty for you to make without worrying that your market maker will have to file for insolvency because of your trading prowess.

Go to www.google.com and search “online forex”. Literally hundreds of brokers are out there advertising their business, competing with each other for your money. Most of these seem to be genuine market makers, but in reality they are “white label” advertisers for the genuine market makers. You are working with a marketer, not a forex specialist, a marketing wizard not a market wizard.

I am trying to bring to your attention that this all impacts on your trading. Have a look at how these businesses sell themselves.

- Commission free trading
- Free software
- Trade with the click of a button – easy
- All kinds of fancy orders – entry / stop / limit
- Narrow spreads
- Leverage up to 400:1
- Low margins
- Mini accounts
- Free Training
- Risk management – stop losses (guaranteed)
- Segregated accounts

Here’s why you should be sceptical of all this marketing, why you shouldn’t listen to what they tell you, and why there are hidden costs that can make life difficult for you.

With what gearing / leverage do you trade? Write it down here _________or keep the figure in mind. We will come back to it.

- **Commission free trading:** Aha, cheap, not like stocks and futures, right? Wrong. There is a cost in the spread. Consequently the ‘free’ part should be seen for what it is.

- **Free software:** Trading is equated with clicking buttons. You even get the signals. Monkey see as monkey do. Click here click there, its like surfing the net, money is on the way. All very tempting.

- **Narrow spreads & quick orders:** Why does this matter? I am going to spend some time on it looking at the game from the market maker/broker's perspective. Just think about it for a moment. These guys make any price they like. At any given time they can run several systems and quote several prices to different customers. (I don't say they do it, but they can.) The point is the price you can trade on, say EURUSD 1.1900/03 or EURUSD 1.1900/04 can at that same moment be quoted 1.1898/900 or 1.1904/06 for another client wanting to make a 10 million dollar lot purchase. These brokers have a very short-term mindset. It's how they make their money. One or two pips are important to them. The more you trade the more they make on the spread. It's not in their interest to have a guy trading selectively, letting positions develop.

  The more you trade the more they make on the spread.

  Also if they can guess what you, their money making machines, will do and be on the right side (i.e. in the direction of the move) of the next 10 or 15 point move, they will make money.
  Now that is why they are in business, no problem with that. But YOU can't compete with them. You trade with them on a take-it-or leave it basis. You don't have the insight they have about where the other clients, including maybe you, have signalled (by placing, limit, entry and stop orders for them to see) your exact intention as to where you are prepared to buy and sell a currency, which they are going to sell to or buy from you.
  Why do they give you tick-by-tick and 1 minute and 2 minute and 3 minute and 5 minute and 10 minute and 15 minute data and tools to "analyse" this data. Because they know who is going to make the money. They are. Don't attempt the impossible.

- Leverage - 100:1, 200:1, 400:1 leverage: This is just crazy. They know you are going to lose, and the money is going to end up in their pockets. By the time you've finished reading about how 100:1 is risky and you need to understand this, 50:1 doesn't sound that bad, and 10:1 is positively conservative. Well it's not. It's still too high. Gearing of 5:1 is still too high. Don't fall for it. Any market maker who allows you to trade 100,000 lots with a $1,000 margin does not have your best interests at heart. But there is no law against parting a fool from his money.

- Low margins: More smoke and mirrors. For a long time I couldn't understand why US customers 'apparently' don't understand leverage. Then I realised it is because the margin required to take a position is used ambiguously by the online brokers.

  Margin required and leverage is not the same thing. "Low margins" = "low margin requirement" = "high gearing". You do not trade with 100:1 leverage or 1%. Your margin required is 1%. If you go for broke your broker will allow you to trade up to 100:1.

  Let me explain the problem with an example of half-percent margin. A prominent market maker offers "$1,000" lots and "$500" lots. You have $10,000 and you use 1% margin on the $1,000 lots. What's your leverage?

  Write it down here ________or hold the thought.   You make $300 dollars on a trade and decide this is too easy. You arrange to pay the $10.00 fee and trade on 200:1 leverage or "$500 lots."
  You have $10,300 and you now use 1% margin on the $500 lots. What's your leverage? Write it down here ________or hold the thought.
  The total is $1,000, still only 10% of your capital required for margin, what's the problem?
  The problem is that it is a false concept to express risk as a ratio of "margin required" to "capital on margin". It is an illusion that your risk was the same, yesterday and today.
  Yesterday you traded $100,000, i.e. you levered your money 10:1 (for each one dollar you have you trade as if you have ten). Today you traded $200,000, i.e. you levered your money 20:1 (for each one dollar you have you trade as if you have twenty. All it means is the time it takes for the guillotine to drop has been halved.
  You can be deceived by lots of $1,000 and risking "only 10% of your capital". You don't risk only 1/10th of your capital, you risk your capital 10 times.

- **Mini Accounts:** This is a very positive development in general, but it can be presented in a misleading manner. People just don't have 10 X $3,000 to gamble away with the high gearing, low margin, narrow spread, free training systems and keep coming back.

But with a mini account they can and will come back 10 times, if handled correctly, and the PR is made easier, because they can last 10 time times as long. And many more fools can attempt to do the impossible on a smaller scale, but that doesn't change the fact that it is still impossible.

> ***When a person with experience meets a person with money, pretty soon the person with the experience will have the money and the person with the money will have the experience –*** *Estee Lauder - perfumer*

Learn to trade profitably without leverage and then use leverage to enhance your profits. If you want me to teach you contact me at drforex@dayforex.com and we can arrange it.

If you don't have $10,000 to trade mini lots without leverage you will never know if you would have been able to actually become a winner. If you don't have $10,000, email me, drforex@dayforex.com and I will instruct you about where you can trade 1:1, in a well-regulated environment with a reputable company.

- **Free training (provided by your online broker):** You don't think for one moment these guys are going to effectively teach the clients whose money they take to actually take theirs?

- **Free training (provided by introducing brokers):** The training is free because they get revenue from your trading. Their revenue is directly related to the number of trades you do and the size of those trades. They will also encourage you to start trading in double quick time.

- **Risk management:** Currency trading is risky. Highly leveraged currency trading is even more risky. But the riskiest of all is beginner traders placing stop losses, 10, 15, 20, 30, 40 pips from their "perfectly timed" entry points. They are continuously stopped out and the money goes to the broker. Every time you are stopped out your broker makes money.

If these marketing wizards encourage you to do X and you want to be a winner, do Y. If they say "jump", sit. If they say "run", stand still.

I have no issue with online brokers. I work with several of them. I need them. I even like them. But I am not as a trader going to do what they want me to do. They want me to do many trades, gear them high, use stop losses close to my entries, try to pinpoint my entries to the pip (timing, timing, timing) with some backyard technical analysis system, run my profits (put my limits far, three, four times as far as my stop losses), cut my losses, use these miniscule time frames, signal my trades (entry orders, stop orders, limit orders). I am not going to do it.

Let me tell you what I do, and the account featured earlier in this chapter shows some of the results.

- I am not going to do lots of trades, only as much as I am comfortable with.
- I will not gear high, never ever will I gear any one trade higher than 3:1.
- I will not place a stop loss, I use mental stops and I will not have a mental stop close to the entry price ever (if I felt that was necessary, I will simply not do the trade. Tomorrow is another day.)
- I will not try to pinpoint my entry closer than, 20, 30, even 40 pips.
- I will not use some *hocus-pocus* guaranteed-to-make-you-rich technical analysis system.
- I will cut my profits, run my losses. You heard me, cut my profits and run my losses. Sounds crazy, anti all the conventional wisdom. I am going to tell you why it's not, and why it works.
- I will not even look at a timeframe shorter than 30 minutes which I only use because it gels nicely with my 30 – 40 pip price ranges.
- I will only under special circumstances place entry orders (but this is optional, if you don't trade full time, you should use orders more often).
- Oh yes, I will not study the trading methodology of a mini account trading competition monthly winner. These guys double their money in a month. That should tell you all you need to know right there. Their gearing is too high. Essentially the market maker/broker is inviting them to take a punt. It's like the casino giving you free chips to gamble with. Gee that's nice of them, but they know full well that the money will be coming straight back to them. Most people can't resist. So brokers offer cash prizes for the 'best trader' each month knowing that apart from the prize probably being traded and lost and coming straight back to them, many of the other traders competing are going to lose money too.

Chapter 9

Trading The Spot FX Market

PRICE QUOTATION

Currency prices are always quoted as a buying price and a selling price in one quotation. The dealer or market maker will quote simultaneously the price he is prepared to buy the currency at and the price he is prepared to sell the currency at. It is also called a “two-way” price.

For example a quote for EUR/USD 1.0779/1.0783, indicates the dealer is prepared to buy EUR at 1.0779 and sell EUR at 1.0783. The client, conversely, will buy at 1.0783 and sell at 1.0779.

The Base Currency

Every foreign exchange transaction involves two currencies, the ***base currency*** (or quoted, principal, underlying, or fixed currency) and ***terms currency*** (or variable, counter currency).

The international standard for currency code format is set by the bank-owned cooperative, ***SWIFT*** - the Society for Worldwide Interbank Financial Telecommunication.

Quoting conventions, established over years, lead to standard quoting formats followed by most market participants.

The base (principal) currency is always quoted first. That is, in a currency price quote the currency mentioned first is expressed in terms of the currency mentioned second. All deals are therefore sized in terms of the principal currency.

In other words, a currency quote indicates how many units of the second currency are worth one unit of the first currency. Amongst the major currencies, in pecking order (of quoting conventions), the principal currencies are:

- Euro (EUR)
- British pound (GBP)
- US dollar (USD)
- Swiss frank (CHF) / Japanese yen (JPY)

Example: Principal currency quotation formats

EUR/GBP	1 Euro equals, say 0.6400 pound sterling
EUR/USD	1 Euro equals, say 0.9950 US dollar
EURJPY	1 Euro equals, say 123.00 yen
EUR/CHF	1 Euro equals, say 1.4800 Swiss frank
GBP/USD	1 Pound sterling equals, say 1.5500 US dollar
GBP/JPY	1 Pound sterling equals, say 190.00 yen
USD/JPY	1 USD equals, say 122.50 yen
USD/CHF	1 USD equals, say 1.4860 Swiss frank

Figure 3.5: **Major currency quotations**

Rates | Advanced | 2003 04/07 10:46

Cur1	Cur2	BID	ASK	Time	High	Low	Ir
EUR	USD	1.0617	1.0620	10:46:29	1.0729	1.0561	
USD	JPY	120.46	120.49	10:46:02	120.87	119.96	
GBP	USD	1.5496	1.5500	10:46:50	1.5608	1.546	
USD	CHF	1.3994	1.3998	10:46:26	1.4079	1.3852	
EUR	CHF	1.4859	1.4864	10:45:50	1.4887	1.4857	
AUD	USD	0.5961	0.5966	10:45:22	0.6008	0.5927	
USD	CAD	1.4834	1.4839	10:46:42	1.494	1.4715	
EUR	GBP	0.6852	0.6857	10:46:50	0.6875	0.681	
EUR	JPY	127.91	127.95	10:46:45	128.81	127.45	
GBP	JPY	186.67	186.75	10:46:50	188.14	186.35	

Source: Visual Trading Systems.

“Bids” and “Offers”

“Traders ***always*** *think in terms of how much it costs to buy or sell the base currency. A market maker’s quotes are always presented from the market maker’s point of view, so the* ***bid*** *price is the amount of terms currency that the market maker will pay for a unit of the base currency; the* ***offer*** *price is the amount of terms currency the market maker will charge for a unit of the base currency.*

The higher price is the price the dealer sells the base currency at. This is also known as the “offer” (to buy at) or “asking” price (asked by the dealer). From the trader’s / customer’s perspective, this higher price is the price he can buy the base currency at.

The lower of the two prices is the dealer’s “bid”. The dealer is buying and therefore it is a “bid”. I.e. the “bid” price is the price the dealer is willing to pay for the base currency. From the trader’s / customer’s perspective, this lower price is the price he can sell the base currency at.”[10]

[10] Cross, Sam, Y. The Foreign Exchange Market in the United States, Federal Reserve Bank, 1998, p.33.

Example: Spot forex "bids" and "offers"

- Say the price quote is: GBP/USD 1.5495 / 99

If the customer sells 1 unit of GBP he will receive 1.5495 USD
If the customer buys 1 unit of GBP he will "pay" 1.5499 USD

- Say the price quote is: USD/JPY 122.52 / 56

If the customer sells 1 unit of USD he will receive 122.52 JPY
If the customer buys 1 unit of USD he will "pay" 122.56 JPY

The Dealing Spread

The smallest increment in a currency quotation is called a "pip" or "point". I use the two terms interchangeably. This refers, with the exception amongst the major currencies of the Japanese yen, to the 4th decimal point.

A buy position opened on the dealer's offer price can only be closed on the dealer's bid price, if the quote has not changed. This difference between the "bid" and "offer" made by the dealer constitutes the dealing spread and includes the mark-up of the dealer. This results in an immediate cost in establishing a position in the spot forex market.

For this reason it is not necessarily correct to say that spot forex trading is a zero-sum game. Although there is a buyer for every seller and a seller for every buyer, the cost of the trade drains money out of the markets and into the pockets of the service providers.

Spreads can vary from dealer to dealer and also from time to time because of factors such as liquidity or the business model of the dealers[11].

CONTRACT SIZES

In the spot market the parties can decide from time to time on the size or value of a deal. A fixed contract in the spot market is known as a "lot".

In the wholesale, inter-bank market, deals will normally be to the value of 1 million units of the principal or base currency. The foreign exchange brokers play an

[11] During 2004 most retail market makers started to excessively increase spreads around the most keenly watched US data release times.

important role in the establishment of a lot and deal size. Generally the following deal sizes are common:

GBP/USD	£5 million
EUR/USD	€10 million
USD/JPY	$10 million
USD/CHF	$10 million

In the retail market (how we trade) the lot size is conventionally $100,000 of the base currency units. A typical USD/JPY transaction will be done with lots worth $100,000. But also in the retail market brokers may offer different lot sizes. A minimum lot size of $10,000 units of the base currency is now freely available and some brokers have even introduced $1,000 lots or no specified size at all. These are called mini-lots and I consider them extremely important for all traders with starting capital of less than $50,000 dollars. Some of my students come to me after attending courses in which they were told it is all right to trade $100,000 lots with as little as $2,000 accounts. That's gearing of 50:1 and spells financial ruin. It's simple maths. If you have a small account then mini-lots are your best friend.

CROSS CURRENCIES

When we refer to ***cross currency rates*** we mean a currency pair in which the dollar is neither the base nor the terms currency. An example would be "pound-yen," in which the GBP is the base currency. Either currency can be made the base currency in a cross rate quotation, although there are standard pairs based on quoting conventions: euro-yen, euro-pound, euro-swissie (Swiss Franc), pound-yen, etc.

Some of the major cross currency pairs are:

EUR/GBP; EUR/CHF; EUR/JPY; GBP/JPY; GBP/CHF; CHF/JPY

MARGIN

Traders and investors sometimes wish to increase their exposure to a particular financial instrument without putting up additional money. This can be achieved by increasing ***leverage*** (or gearing) by putting up a percentage of the needed capital as collateral – a margin deposit.

In the spot foreign exchange market (where we trade) this is the norm, rather than the exception. As the parties have to take on each other's credit risk, parameters for gearing and associated margin ("collateral") are very flexible.

The use of margin to gain leverage is best described as a way of “borrowing” the additional currency one wants to speculate with.

Typical margin requirements found in the Internet currency trading market place:

Table 3.6

Lot size	**Minimum account**	**Fixed amount**	**Percentage**
$500,000	$50,000	$25,000	5%
$100,000	$10,000	$500 - $5 000	½% - 5%
$10,000	$250	$50 - $100	½% - 1%

LEVERAGE

Leverage (or “gearing” – the word I prefer using but it means the same thing) simply means to trade with “borrowed” funds. It implies that the value of the currency transaction engaged in is higher than the amount the trader or investor has on margin.

Leverage is a double-edged sword. Highly leveraged positions can lead to large gains if the exchange rate between two currencies moves as anticipated, but conversely will cause large losses if the exchange rate moves in the opposite direction. This is one of the very simple and important aspects of trading I insist my students understand. If there is a common denominator to be found amongst unsuccessful traders then it is their failure to understand or to ignore the devastating effects of too high gearing.

Leverage wipes out those traders who do not respect its power. Leverage is not a “magic wand” that you can use to replace a lack of trading skills. By the time you have finished reading this book you will be sick of hearing this, but not nearly as sick as you will feel if you get wiped out by not taking heed.

Even if you decide you don’t want to trade yourself but want instead to place your money in a managed account to be traded on your behalf by a professional trader or portfolio manager, acquaint yourself with their leverage policies. If it exceeds the norm (3:1 for example is, in my opinion, high), think again. High gearing gives high but unsustainable returns. The wins turn to losses and eventually wipe-outs. See 9.3 below “The cost of trading.”

Leverage explained

This is an explanation of leverage. Once you understand this I will deal with the application of leverage within my trading system. It is important that you fully grasp the operation of leverage.

Real leverage

Real leverage is a function of the margin available and the value of open positions. Real leverage is calculated by dividing the margin into the total value of open positions. Therefore a trader with $10 000 margin will have leverage (or gearing) of 10:1 when trading one $100 000 lot. If this trader loses money and his margin drops to, say $4000, his real leverage, trading one lot of $100 000, has increased to 25:1. Simple? You'd think so but there are enough people trading FX today who don't or can't make the sum.

The effect of leverage

Leverage amplifies the movement in the relative price changes of two currencies by the factor of the leverage in a margin trading account.

Gearing	% price change in market	% price change in account
100:1	1%	100%
50:1	1%	50%
33:1	1%	33%
20:1	1%	20%
10:1	1%	10%
3:1	1%	3%
1:1	1%	1%

If the EUR/USD price changes by 1 per cent, say from 1.0000 to 1.0100 the effect in a leveraged margin account, trading one lot of $100,000 would be as follows:

Gearing	Margin (USD)	% Price change in account
100:1	$1,000	100%
50:1	$2,000	50%
33:1	$3,300	33%
20:1	$5,000	20%
10:1	$10,000	10%
5:1	$20,000	5%
3:1	$33,300	3%
2:1	$50,000	2%
1:1	$100,000	1%

Cost of Leverage

In the above example a spread may be 5 pips, translating to a $50.00 cost for the transaction.

As is the case with profits and losses, the relative value of transaction costs also increases with the use of leverage:

Gearing	Margin (USD)	Cost as % of margin
100:1	$1,000	5.00%
50:1	$2,000	2.50%
33:1	$3,300	1.50%
20:1	$5,000	1.00%
10:1	$1, 000	0.50%
5:1	$20,000	0.25%
3:1	$33,300	0.15%
2:1	$50,000	0.10%
1:1	$100,000	0.05%

That is all you need to know, but know it well. When we start to look at my system I will tell you the story of Long Term Capital Management, a bunch of whiz kids and experienced traders who had the most spectacular wipe-out in trading history because they were over-geared.

THE COST OF TRADING

The actual costs involved in trading need a quick mention for they can become substantial. Service providers are in this business to make money. The fact that they provide a service is because they believe that their best opportunity to make money in this market is by providing a service rather than trading.

There are no free lunches. However many retail traders think there are. Retail market makers like to advertise “commission free” trading as a way to lure people from the stock markets and other online markets to the forex market. Trainers of forex traders like to advertise free training, for a smallish fee, or a smallish subscription fee for what is promised to be the gold embossed map to the money printing press called forex day trading.

It is vitally important that a prospective currency trader look at his trading from a business perspective. There is a cost to trading FX. The cost is in the spread between the buy and sell price quoted by the “commission free” market maker.

As mentioned earlier this cost is part of his income. The more trades done by a client the greater the market maker’s revenue. The market maker will go to great lengths to entice you to trade more, in other words to do more and bigger trades. Market makers pay “introducing brokers” a rebate from this spread-generated income if they introduce new clients to the market maker.

Remember that the first thing you do when you press the BUY or SELL button to establish a new position in the market is to incur a cost. On a $100,000 lot that cost is say $40.00. This does not seem a lot, but if you are enticed to do, say, four to ten trades a day, 22 days a month, it adds up to $3,500 - $8,800.

You must be aware that this is money you pay upfront (per new trade). Now considering that you might have a small account of $10,000 and you were on a course where you were encouraged to trade frequently using a 5 or 10 or 15 minute time horizon averaging four trades a day over a month, and assuming you have a 60-40 win–loss ratio, you will actually make a net loss. The reason is the cost of trading.

You will have to make a return of 35% on your $10,000 in a month, just to break even. You don’t have to believe anything else I say in this book, but believe this: 35% per month, every month has never been done by anybody, and especially not by the person who hawked you your course.

Mini accounts do not solve the problem, the maths stays the same. I do not say it can’t be done for a month or two, but I do say it can’t be done consistently for a period of time, approaching anything resembling the type of expectations of financial freedom created by certain unscrupulous ‘trainers’.

The answer of course is to trade less, more selectively, and with greater patience, i.e. let your profits swell so that proportionally speaking they more than off-set the cost of trading.

Make a mental bookmark of this for every time you feel, while reading the rest of this book, that I am being unfair or unduly heavy-handed in my opposition to short-term time frame trading systems as the way to riches. It is the way to riches only for the service providers, the money-making alliance of market maker and introducing broker. There is a good reason they will try to convince you to make many trades with high gearing. That's how they make their money, and you are paying for it.

TECHNICAL ANALYSIS

In a strict sense there isn't any risk – if the world will behave in the future as it did in the past.

Merton Miller - LTCM, Nobel Laureate

<u>Definition</u>:
Technical analysis is the study of price related data as an aid to investment decision-making.

The theory of technical analysis is that the known prices are the best source of market information as they contain all the useful market information (and the market participants' reaction thereto), and that repetitive price patterns can be expected in the future.

Volume as a workable data set is not readily available in the currency market.

I've stated my views on technical analysis. It has its place. But knowing what that place is, that's the trick. I traded stocks and bonds, I used indicators. Volume indicators are very helpful. If a lot of people are buying a stock, not only is it likely to rise, but supported by the volume, it is likely to **continue** rising.

Volume as a workable data set is not readily available in the currency market. This is a result of the currency market being decentralized, unlike formal exchanges where volume is known for each given set of transactions and time period enabling these exchanges to make volume readily available, together with price information, to all participants. All I am saying is that if a pillar of technical analysis is not available in a given market such as currencies one should seriously consider the merits of applying technical analysis as a profitable approach to trading currencies.

Where in the Newtonian physics, momentum = speed X mass, in the financial markets momentum = speed X volume. This makes technical indicators that include volume in their calculation or that are used in conjunction with volume indicators less effective in the currency market.

Perhaps this is the reason most professionals use mainly fundamental analysis as their chief decision-making tool and technical analysis only in an auxiliary function. Why would you, the beginner, attempt something the seasoned professional shies away from?

Time Frames

Because of the exceptional liquidity and high volatility in the currency markets the time frames of traders tend to be shorter than in the traditional markets, such as equity markets.

Easy accessible credit to increase leverage also contributes to the fact that traders have ever shorter time frames, while in other cases, such as with the inter bank spot dealers and market makers, seconds may make a difference between a big loss or profit.

The longer term volatility of currencies makes a buy-and-hold strategy untenable in currency trading. On the other hand, probability theory suggests that on shorter time frames (days, weeks), the statistical chance of beating the odds and dealing with the inherent higher randomness of short-term price movement becomes less.

Behavioral economics suggest that the effect of randomness and the impact of negative impulses on a trader or investor is up to 2.5 times greater than the effect of positive impulses. That is why I try to avoid ‘noise’. I define noise as everything that is not ‘relevant information’. Noise translates into small up and down price movements. I ignore it. If you ‘listen’ to all the noise, you will be deaf, and broke, in a year. How to not to listen is as much a skill as how to listen. It is an important part of my trading.

Add to this the pressure of the retail online market maker / introducing broker hype that blows up the excitement of fast moving markets, multiple trades a day, the virtues of tick-by-tick prices, narrower and narrower spreads, and one realises just why there is such a high failure rate in the financial market place, including the FX market.

Successful trading requires one to find a workable balance between activity, time frame, cost, leverage, expectation and realisation.

FUNDAMENTAL ANALYSIS

Despite its scientific pretensions, economics still remains more of an art than a science.

- Robert Kuttner

<u>Definition</u>: **Fundamental analysis is the study of driving forces behind price changes as an aid to investment decision-making.**

In the foreign exchange market this means taking into consideration the macro economic variables that impact on short and long-term interest rates as well as geo-political factors influencing international capital flows. Again, it is about what the big guys are doing, and figuring out why they are doing it and then doing the same thing on a smaller scale when they are doing it.

Interest Rates

Not only the absolute interest rates, but also the differentials between interest rates and the expectations as to how these differentials may change, are factors impacting on decision making based on fundamentals.

Economic Data

Fundamental analysts have to consistently follow the release of macro economic data of the countries whose currencies they trade and analyze.

Depending on the stage of the economic cycle in both countries, relative to the global economy and regional economies, different economic indicators may have more or less importance.

Generally the main economic data factors influencing the currency markets are:

- Employment data
- Consumer confidence data
- Manufacturing / production data

It should also be noted that because the US dollar is the dominating currency and the US economy is the dominating economy, the US economic data releases influences all currencies and currency pairs (as it do all markets).

TRADING THOUGHTS ON ECONOMIC DATA RELEASES

Economic data releases can assist quite a lot in making good, profitable trading decisions. Although some traders use all sorts of straddling tactics around the volatility of data releases I discourage this. The smart money discounts, before the announcement, what the affect of the announcement will be. It is a bit of a guessing game. The trick is not to be too cute but rather to take profits if it spikes in your direction, or sit out completely.

I think that more and more wild speculation is occurring around keenly awaited data releases by the growing number of retail traders. Online brokers suddenly saddled with additional risks they have difficulty offsetting with their clearing brokers, causing risks for themselves (and their clients). They have to now take steps to minimise these risks and so some brokers will not allow you to place orders shortly before certain data releases.

This whole approach to making money on data releases is, to my mind, cavalier. Placing huge bets with highly geared positions on data announcements is a dangerous game. As explained above it also affects market pricing before and after the releases. Prudent traders will usually stand aside, leave the circus to the clowns and return an hour or so later when calm has returned.

But understanding data releases and the affect they have on the market will add another arrow to your quiver. It's a good place to test your understanding of how the market reacts to news, how the different role players see the same price, and to what extent rumour and expectation plays a role in the market. It's all part of the training you need to become a better trader.

Also take note that these really big price moves surrounding fundamental events are not necessarily on high volumes. That is why moves often retrace, and retrace sooner rather than later. It is only at a very important juncture, with a number of factors hanging in the balance, that one event may cause a fundamental trend change and no retracement takes place. But this dynamic does not happen too often. For example, even with an event like 9/11, where the dollar took a 5-minute 300 – 400 point dive, it made up all its losses by mid October. The multi-year slide that came afterwards was based on economic fundamentals and not on a single event.

Some rough research I did showed that during a period of just more than two years up to August / September 2004 out of roughly 13,000 hourly periods only 35 periods had a points move in EURUSD of more than 100 points. Most of these occurred during the typical hours of US economic data releases. Several took place on the monthly employment report – the first Friday of the month, some were induced by "Greenspan speeches" and some others were related to the Iraq war in early 2003.

RELATIONAL ANALYSIS

> **<u>Definition</u>:**
> **Relational analysis is the study of the relationships between price, time and driving forces behind price changes as an aid to investment decision-making.**

Relational analysis is a key part of my trading success. Remember PET or Price – Event-Time mentioned in Part 1?

Price-Time Relationships

Price volatility plays an important role in pricing financial instruments. Volatility can only occur with the elapse of time, and the longer the time period in which absolute price movements occur, the lower the volatility.

Event-Time Relationships

External factors impacting on currency prices may be correctly referred to as "events". I consider my trades based on the occurrence of such events and the impact that events may have on my view as a whole in terms of *when* to trade or not trade. Events refer not only to external events but also to 'internal' events. Although events in your personal life will not affect the price of the US dollar vs Japanese yen it will surely affect the value of your margin account.

My state of mind, recent success or losses, these too are important events.

Event-Price Relationships

Events may have a direct and immediate impact on currency prices, which may cause excessive temporary volatility and changes in liquidity. As the impact of the event is discounted (“worked through the system”), volatility returns to normal levels.

This comprises about the sum total of what you need to know from a theoretical point of view. Some of you may have this background already, others may have encountered it here for the first time. For those who are finding it all a bit overwhelming I suggest you register a demo account at one of any number of brokers – a quick search on the Internet will suffice – and press some buttons not worrying too much at this stage about profit and loss. You will get a feel for how the business works and the functionality of the different trading platforms.

Part 4

Using the edge

"You've got a goal, I've got a goal. Now all we need is a football team."

- Groucho Marx, Actor

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Introduction

Now we get down to the nitty-gritty of how to trade. I am going to examine all the different edges you have as a trader, identify each one, and look at how you can make maximum use of them. The trick is not to rely on one or two but to use them together. Your aim is to develop them, one building on the other until they form a solid foundation upon which you execute your trades. Some edges are simpler to understand than others. It is hard for a beginner to understand that his own discretion is in itself an edge. Some edges are more important than others. No matter how good your system is, if you are over-geared it will not work in the long run. Like Long-Term Capital Management you will blow up. And they had two Nobel price winners, several experienced traders and some quantitative financial whiz kids and a very sizeable loot. These were all edges they had. How do you compare?

A trader is dependent on hyper-critical thinking. If someone says “A”, a trader must immediately react with, “why not B?” If a trader catches himself thinking “UP” he must have a built-in safety system cautioning “no, perhaps DOWN”. Take gearing for example. The availability of high gearing in the retail forex market is punted as positive. It’s punted to be risky but risk can be managed by cutting your losses quickly. Now, if I, as a contrarian, don't like the "risky" nor the "losses" part, what do I do? I consider exactly the opposite: "not risky", "cut profits".

I have the discretion of using low gearing. This allows me to accept the downside and wait for the market to come back in my direction. In other words knowledge of what not to do, how not to trade, can be turned into a positive edge. I have also just illustrated combining two edges (discretion and low gearing) and this is what you want to work towards so that eventually you can trade using all your edges without thinking and applying each one individually. It's a bit like a golfer's swing. The golfer may use separate and distinct practise methods for each part of his swing, how to address the ball properly, top of the arc, moment of impact, and follow through. By combining all these practised lessons he is able to make a smooth swing.

Part 4 also looks in some detail at the specifics of my trading system. Just to remind you of what I have said about a trading system: it's my business plan and incorporates all aspects of trading. Not only the opening and closing of positions but also the run-up to pressing buttons, the stuff that happens before I even get close to the market. Things like goal setting, understanding trading as a business, these are edges I can give myself before I open a trade. Do not ignore or underestimate their value. Many struggling traders have defeated themselves before they begin trading. Don't be one of them.

Chapter 10

Pre-trading edges

When my phone rings and on the other end I hear a voice, and the voice says, “Hi, my name is Joe, and I want you to teach me how to trade in the currency markets,” my first thought is “Why?” Why does Joe want to get into a business that has such a high probability of failure? Does Joe know what he is letting himself in for? Does Joe know that he may have to take pain? This is important, both for Joe as a student and for me as his mentor – I need to know that Joe knows that expectations are important because **the nature of Joe’s expectations are directly related to his success or failure as a trader.** I will ask Joe some questions. Is he a novice or a struggling trader? How much and what kind of experience does he have? And I will also want to know something about Joe himself. I tell Joe that I have a standard form he must fill in. How he fills in this form will determine his trading career. Joe fills in the form and emails it back to me. Unbeknown to Joe he has just taken the first step in applying my trading system. He has started formulating his goals. In a sense this book is nothing more than the documentation of a process, from first telephone call to trading live. And what Joe tells me right in the beginning is going to shape his trading career.

What is it that Joe wants? Does Joe even know? Is Joe embarking on this business venture because he wants some spare cash, a bigger house, is he bored, does he like the idea of a quick buck, is he interested in the financial markets as an intellectually stimulating challenge? What are Joe's motives? I need to know this. Motives are part of my trading system. So clearly my trading starts long before I start buying and selling. It's starts when I set my goals. Joe must want to make trading a business and a business of trading.

KNOW THAT TRADING IS A BUSINESS

"The basic rules of business are the same whatever it (the business) might be. The basic requirement is always common sense"

Sir Charles Clore, businessman

If you've decided to trade FX you are actually starting a business. Most start-ups fail in the first year for reasons that have nothing to do with their core competencies; the chef can cook, the builder can build. They fail for other reasons related to business. Cash flow, competition, insurance, and soon the owner is shaking his head and closing his shop for the last time and thinking the same thoughts as those before him. What if…? If you are going to fail as a trader it is likely to be unrelated to your 'core competency'. It will be related to your goals (unrealistic), your fear of losing (psychology), your success (over confidence). And how do you measure your success – a value judgement based on returns over an arbitrary period? Most people don't think about this at all.

What is a realistic measure of success for this start-up venture? When will Joe be able to say "I am on the right track"? A lot of novices think that after demo trading successfully for a few weeks they are on the right track. They fund a live account and lose the money. They weren't on the right track. Is the start-up businessman, struggling in his second year, just keeping his head above water but proud as punch that he is developing his skills, broadening his experience, meeting his goals, firmly convinced that next year and the year after that will see growth and expansion. Is this businessman a failure? No, he is likely to get upset if you called him that.

One of the best known global brands is McDonalds and McDonalds franchises have made many millionaires out of ordinary people. These franchisees don't do anything fancy. They don't try to reinvent the wheel. Sure they have to have start-up capital. But they realise they aren't going to make their franchise profitable because they flip burgers better than the next guy. The point is they don’t try to do anything extraordinary. Their business plan is simple and trying to be cute or clever is not part of it. Stick to the rules that made the millionaires.

I am the last person to promote mediocrity, but when you think business plan basics, its best to be a middle-of-the-roader. Your personal blood, sweat and tears, your personal dedication and discipline will be what cause your business to excel.

As I have mentioned before, you are going to be annoyed by my persistent critical approach to short-term time frame trading attempts. I know a person who made a huge success of a gas station. He used all sorts of ingenious ways to add value, for instance by arranging the delivery times of gas at times he could benefit from the contraction and expansion of the gas (he took delivery in the night or early morning and as a result he received more gas per volume, because it was cooler and the gas contracted.) Lots of little things added up to big profits.

Timing – cool periods – was important, and then things had to get done quickly and efficiently. This same successful businessman then attempted currency trading using short-term time frames and placing undue importance on timing. His first attempt at currency trading was a disaster. To be successful in trading one must not be “pip wise and pound foolish”. Look at the bigger picture.

SET PROPER GOALS

Setting goals for a business is important. But let’s take a look at goal setting. Since you can be honest, focused and clear about what your motives and expectations are, since you can be in charge of this and it is not subject to the market, your edge starts here. You have the power to define your own goals. I don’t want this to sound like a cheap motivational speech. It is everything but, and it may end up saving you learning an expensive lesson. However, this first edge is so often ignored and so important that I would like to illustrate what I mean with an example. What sort of profits is Joe expecting to make? Does he want to live off the money he makes from trading or is it going into a savings account for when he retires? The answer to these questions will also affect the way in which Joe trades.

The questionnaire I sent Joe contains several questions regarding his financial status, including whether his funds are discretionary funds (funds he can afford to lose). By this I don’t necessarily mean spare cash lying around. I am just trying to establish whether the money Joe will be trading with, if he loses it, won’t mean his financial ruin. A person whose livelihood is at stake faces different pressures. This is an important question apparently unrelated to trading itself, the business of opening and closing positions. But only apparently, because a trader who is trading his house has a different view of open and closed positions than the trader who is trading discretionary funds.

So, what category of funds you intend using is inextricably linked with the way in which you will trade.

HANDLE PRESSURE

Business is Darwinism: Only the fittest survive.

Robert Holmes – Australian financier

We all know the saying, “when the going gets tough the tough get going”. Trading is tough most of the time and has a tendency to swing unexpectedly between easy and difficult, up and down, periods of waiting and rushing. All of this causes mental stress. That is why it’s such a mental game. You must bring the right mix of attitude, goals, savvy, insight, and tools to the party.

The trader with his house on the line is under pressure from the word go. P-R-E-S-S-U-R-E, there is a lot of it in this game, enough to test anyone’s metal. Losing money you can’t afford just adds to that pressure.

So you can see my system, the way I give myself that all-important edge, does not start with the market. Consider the consequence of this statement. At some point I will have to enter the fray. Once I’ve done that by taking a position in the market I have crossed the Rubicon and there is no turning back. I have not surrendered control, but I am limited in my options. So every advantage I can maximise, every event over which I have maximum control, is an edge in my favour and the first of these events is goal setting. The type of goals I set will determine the type of trading I need to do. Without haste, with time to reflect, change my mind, without pressure, I can set my goals, and be realistic about these goals I have set, and thereby give myself an edge.

ORGANIZING YOUR TRADING BUSINESS

"The seeds of every company's demise are contained in its business plan"

- Fred Adler, company director

Trading is a business, a start-up business and business is a process, process needs planning, planning requires a system. That is why I equate my system to a business plan. Trading is a business with goals, the trading system is the business plan to reach those goals. It is far more than candlesticks and price movements.

That is why my system has two legs, it exists and functions in two worlds. The one leg stands outside the markets – you, your goals, your expectations. The other leg stands inside the markets. *Both* are part of my System with a big 'S' (system with a small 's' refers to specific trading strategies, methodologies and relational analysis which all fall under the heading of **Real Time Analysis**.) In both these legs I am looking for advantages that I can swing in my favour. I am always looking to add to my edge. I want to be the casino taking the punter's money. I don't want to be the punter. In the long run he loses.

Let me take the business analogy further and sketch you a diagram of what my business plan looks like.

My system requires Joe the Trader to combine the functions of a CEO, COO and CFO. It's not as complicated as it sounds and I don't mean this literally in the sense it is used in the business world. I just want to impress on you the point that currency trading is more than pressing buttons. It is more than focusing on today's intra day price moves and market information. I also believe that winning traders have this sense of themselves as engaged in a business venture, a specialised business venture, but a business venture nonetheless.

As the CEO Joe must have a vision for his company and set himself realistic goals for attaining that vision. Policy decisions on how the company must be run are taken in the boardroom where Joe guides the discussion and gives his inputs. Since Joe trades by himself and for himself, this is a self-referential discussion but that is valuable. Joe is learning an important process and it is part of shaping his trading thinking. Trading has a lot to do with a dialogue with oneself. Holding opinions, testing them, mulling over issues. Clearly it would be advantageous to not only talk with oneself and this is where a mentor comes into the picture. But don't simply look up your mentor hoping to find an answer that you have not found for yourself. At least have an opinion before chatting to your mentor. There are very few obvious rights and wrongs in this game anyway.

As the COO Joe is responsible for seeing the practical execution of his bigger business plan. Here he uses the resources available to him (relational analysis, 4x1 trading, median trading – all of which I will discuss in detail) to achieve his goals. With razor thin profit percentages, is their pricing policy adequate? Is cost of trading acceptable and what are cost to profit ratios? This is what is most often referred to as a trading system, a systematic approach to trading the markets. It is also most often where the failure occours because all three Chief Officers need to work together in order to close the gap I referred to in Part 1. If you recall I said the movement of currencies take place in the real world in real time, and any approach to trading currencies that does not recognize this fact and make allowances for it is an approach that will have a fatal gap, a gap between the approach (system) and the real world, and into this gap is exactly where the money disappears. It is natural for a beginner to want the accuracy and certainty mechanistic trading systems appear to provide. But this is an illusion. As the COO of my own trading start up I know that currency markets move quickly and respond directly to available news and information. It is my business to make sure that my system / business plan can come to grips with this market and so I have designed it to be agile and nimble. It must have the ability to analyse what is happening this instant, anticipate the likely impact of future events, and relate seemingly disparate pieces of information. Yesterday's news is old news. Old news disguised as news is a liability a COO can't afford. My system, if it is to be worth anything, has to accommodate, analyse and provide 'answers' to what was happening around me in what I have come to call **real time**. That is, the here and now.

At the same time, given the responsibility of operating my business, I have learnt that perspective is crucial. So I stand back from the market in order to get a fixed picture of how things look, that is, a picture of something that is not moving, or moving very slowly. I monitor it on a daily basis and if at any time the CEO or CFO needs to know what is happening 'out there' I can give them an answer.

As Joe gains experience he becomes like all good company helmsman. People who are good at business perform certain functions well and exhibit similar traits. Joe becomes calm, rational, he is not impulsive, he is always well prepared, he does not panic and his judgment and discretion develop to the point where he considers them his biggest assets.

BE SCEPTICAL, BE CRITICAL, BE WARY

"You must never confuse genius with a bull market."

- Nick Leslau, CEO of Burford

Being sceptical is an edge – trust your judgement and common sense.

I will encourage Joe to be sceptical of my system, and of his own as he develops it. I subscribe to the idea that a theory is more likely to be correct the longer it withstands testing. But that is something different from saying it *is* correct, always. That may seem a small difference but forgetting it will cost you money and many people make this basic error. It most often occours when they are doing well. It is a 'success induced' error.

A foolish trader observes a hundred swans on a lake. All are white. He bets his house that all swans are white. The smart trader says I'm happy to bet that the next swan I see is likely to be white, but I'm not going to bet my house.

It is the classic problem of induction and a process of faulty reasoning which was pointed out by David Hume, an 18th century English philosopher. Its application in trading is both interesting and instructive. Simply put, Hume warned of the dangers of making general laws or statements based on specific and finite observations. Be careful he said of going out into the world and observing swans, a hundred of them, all white, and then proclaiming all swans are white. That is induction, moving from the specific to the general. (Hume also pointed out that this process also only works if the logic of induction itself works.) Does this seem like splitting hairs? You might agree that it is a cautionary tale as regards the swans and that perhaps a greater sample of swans should have been taken before reaching a wild conclusion.

But what of water freezing at zero degrees Celsius? If it has happened a million times and I have observed this a million times then can't I state it as a general rule without fear of contradiction? Well we do, all the time, and we do so because it is practical. But we forget Hume's warning at our peril particularly if we are dealing with currency markets rather than the freezing temperature of water.

Don't get caught out. If your system works ten times in a row, don't believe it is sure to work the eleventh time. Don't swap your armour of exception management and judgement for uncritical belief. I know my system, I like it and trust it, but only up to a point. This is what I want Joe to learn. I encourage him to read, to form his own opinions, to hold different views. Once traders think they are really clever or really good, once they think they have a system that can't be beat it is only a matter of time before they take pain. Very smart people have made the mistake of forgetting that their system is not foolproof. No story illustrates this better than that of Long Term Capital Management, a tale of dizzying success and spectacular failure. They forgot Hume's warning and nearly caused a financial market meltdown. It was a simple mistake, they believed that markets are generally efficient, which is true, and they bet on this theory but somewhere along the line they forgot the word 'generally' and substituted it with 'always.' That's a big difference, in this case several billion dollars worth of difference. The essence of the story is worth recounting.

Markets can stay irrational longer than you can stay solvent
– John Maynard Keynes

In 1993 John W. Meriwether, a well-known trader on Wall Street, approached Merrill Lynch with a plan. He wanted to replicate the successful Arbitrage Group he ran at Salomon Brothers, but this time on his own. He had taken the fall at Salomon for a bond-rigging scandal and he wanted to clear his name and prove his undoubted worth. Meriwether was an excellent trader and his reputation, though tarnished, remained intact. He persuaded Merrill Lynch to come up with a strategy to raise cash, while he, Meriwether, would put a team together and devise trading strategies. Long Term Capital Management (LTCM), an investment company that for the next 5 years would dominate the financial landscape, was born.

And what a team it was. The lure of big money, the scope of the project, Meriwether's reputation and his engaging personality pulled in the top traders (many of them his old buddies from Salomon) whiz kid mathematicians and two Nobel Prize winners in Economics. It was indeed a dream team and they were going to bust the bank. They very nearly did, but not in the way they had imagined.

Their strategy was essentially simple. They would take advantage of small mispricings in the market and bet that these mispricings would be corrected based on their belief in the theory of the efficient market. Using excessively high gearing they traded these discrepancies watching them converge time and time again.

The money rolled in. They were racking up returns of more than 40 percent a year, year after year. Wall Street was amazed and envious. They also disliked many of the LTCM traders who had not endeared themselves to their erstwhile colleagues by being secretive, aloof, and arrogant. They were clever, and they knew it. But the results were indisputable and everyone wanted a piece of the action. Investment banks, central banks, the who's-who of the financial world, impressed by the team and its credentials, invested. Sumitomo Bank, German Dresdner Bank, and Italy's Central bank were only some of the high rollers. There were pension funds, high-worth individuals and the LTCM partners themselves. Everyone was clamouring to get in. LTCM's trading system had been developed by some of the finest minds in the business. Perhaps they had finally cracked the secret of the market some awed analysts whispered. In less than two years the firm's equity capital had grown to $3.6 billion. Their assets had grown to the sum of $102 billion meaning they were leveraged at 28 to 1. By 1998 they had $4.5 billion under management. Geared, their exposure was astronomical.

In May of 1998 rumours started spreading that all was not well at LTCM. The markets were not acting as they had expected – **they were not being efficient.** LTCM was bleeding but they backed their system and kept on trading. But the interest rates gaps, instead of converging, widened. What were the chances of this happening? They fed their computers with info and calculated the probabilities as infinitesimally small that spreads would continue to widen. They kept trading. Rumours were starting to circulate in the market that Russia may default on its debt. They fed the computers with more statistics. What they got back was reassuring. A one-in-a-million-year event was required for them to go under. They kept on trading, their gearing frighteningly high. In disbelief they watched as day by day they lost millions. The market wasn't doing what it was supposed to do. It stayed irrational.

"Stuck in their glass walled palace far from New York's teeming trading floors, they had forgotten that traders [markets] are not random molecules, or even mechanical logicians…but people moved by greed and fear, capable of the extreme behaviour and swings of mood so often observed in crowds." [1]

And other traders, banks, everybody who had wanted in when the going was good saw that LTCM was floundering and they closed in for the kill, taking advantage of their predicament by giving the bleeding company unattractive quotes, making margin calls, and keeping the liquidity out of the market. LTCM was mystified. Why didn't the market have an appetite, why couldn't they offset their trades? By September LTCM was dead, having lost a staggering $4 billion in four months. In two days in August and September they lost more than $500 million on each day. Reputations were ruined, fortunes lost, and the New York Federal Reserve had to intervene in order to prevent a global financial crisis. What had happened?

[1] Roger Lowenstein, When Genius Failed

In an interview with Brett Fromson in www.TheStreet.com, Roger Lowenstein, author of the book *When Genius Failed*, a story about the rise and fall of LTCM, said the following:

"There are two morals in it. One is the tale about the limitations of human intelligence bordering on genius and …. the risks of extreme intelligence when not tempered by judgment. Others who might have a different perspective than the three or four or 12 geniuses themselves. And as it relates to the financial markets specifically, I think it's a cautionary tale about inherent limits of models, of historical lookbacks."

In short, LTCM had made two mistakes. **They had not adequately accommodated the occurrence of exceptional real time events into their trading strategy and secondly, they had over-geared their positions.** Russia defaulting on its debt was an exceptional event with an unforeseen knock-on effect in Asian and Latin markets causing in turn even more unforeseen and unexpected events. If the brains behind LTCM could have stood back and forgotten their systems and models just for a second, it is possible they would have gotten a clearer picture. But instead of using their judgement and discretion, they chose to back their system. To be fair, perhaps they were already in too deep, and there was little that could have salvaged the situation but reading Lowenstein's gripping account of the crisis leaves one without doubt that at some point brains, experience and discretion had taken a back seat to faith in a model based upon inductive reasoning: it had always worked in the past, it would continue to work in the future. But the model was clearly not coping with an exceptional situation. What to do with the black swan?

Even though they knew their model was at best a representation of reality and the traders knew that it did not work mechanically, and that the traders were not simply robots, at some point, because of a combination of past successes, hubris and zeal, and despite being aware of the "fat tail" theory – the idea that unexpected disasters should be expected – they lost their judgment and their heads.

LEARN FROM HISTORY

As LTCM was haemorrhaging Meriwether realised they needed money fast to stay afloat. He approached George Soros to ask whether he would invest. The billionaire speculator had made his name when he shorted the Sterling in September 1992 because he thought it was overvalued, netting $1bn dollars in the process. Soros said yes, he'd put in $500m if Meriwether could raise another $500m to match it. What is interesting is their contrasting views of the market.

“Long-Term envisioned markets as stable systems in which prices moved about a central point of rational equilibrium. I had a different view,” Soros noted. The speculator saw markets as organic and unpredictable. He felt they interacted with, and were reflective of, ongoing events. They were not sterile or abstract systems. As he explained it, “The idea that you have a bell-shaped curve is false. You have outlying phenomena that you can’t anticipate on the basis of previous experience.”[2]

Soros believed in real time events. So do I. I see the currency markets as unstable systems in which prices move about a constantly shifting, central price range. And so should Joe. And you.

I don’t want Joe to trust his system, at least at first. He knows so little that he is merely having fun with randomness. If you trust a system after a month you fool yourself. You can trust a system when it routinely banks money for you, and then only up to a point as the story of LTCM illustrates so graphically. That will take time because a certain minimum period is required to test your system before you can say anything meaningful about its performance. Part of the reason for this is precisely because the market is ‘reflective of ongoing events.’ You simply cannot take a static slice out of it and presume that this is reflective of anything. It is not and can never be because the market is a constantly changing river made up of millions and millions of souls and each one, each little act of every market participant changes its nature, however slightly. That is why the market is never fully knowable. You must know this, you must know what you can and can’t know. The people who lose money are the ones who think they know more than they do. They also think they can know more than is possible for anyone in the market to know.

You should not consider the LTCM story a Wall Street story only. It is a ‘your-street-story’ too. Only the scale differs. All the ingredients are the same. Cool customers. Savvy. Focused. Organized. Global markets. Margin. Leverage. Small price inefficiencies. A well worked out plan. Maybe you short a bit on experience and you probably don’t have a Nobel Prize in Economics, but you have common sense, as they did. Before they blew up they became spectacularly successful and considering investor demands and expectations, four years is a long time to be leading the pack. Won’t you feel pretty smart after four successful years, exceeding your goals? Especially if it is the first four years.

[2] Roger Lowenstein, When Genius Failed, pg 149

Whichever way you look at it this story explains the fact that the market consist of exceptions to the rule thus making it ill-suited to, rigid, rule-based systems, particularly when they rely on the re-occurrence of consistently repeating patterns – in this case the efficient market hypothesis. From a real time perspective the market consists of exceptions to the rule.

Any business approaches excellence in service and products if it excels in the way it handles exceptions to the rule. The bread-and-butter operations and systems are necessary to build and maintain a business, but the exceptional profit more often than not comes from the way the business applies efficient solutions to the tricky situations, the exceptions, the big "problems". Your trading business will not be different. You need the right processes to put you on a profitable road, but the real profits will emerge from your exception handling processes.

"The minute you start talking about what you are going to do if you lose, you have lost" – *George Shultz, statesman and businessman*

This is one of the problems most traders face. They build many loss-making trades into their systems. Losses become run of the mill stuff. This is a mistake. They will not make money. Losses should be confined to the "exception management" aspect of your trading business. You are not here to buy and sell currencies at a loss. You are doing business to buy and sell currencies for a profit. What vendor is going to sell 40% or 60% of his products at a loss, especially the big ticket items? Especially the items he financed (geared in currency trading parlance)?

Simplified, there are two risks in this trading business. Blowing up or getting nowhere.

My system recognises the fact that there are periods that you will have big pay-offs. If you can in real time realise you are in such a period you will have a big pay-off. But a consistently growing equity, week on week, month on month, can lure you into complacency. I remind you of my "lucky investor", whose margin account I featured earlier. His investment coincided exactly to the day with a DayForex Capital Management big pay-off lasting two months. I realise this.

The trick is to work at not losing what you have gained, while keeping busy and looking for another payday and be prepared for the exceptions. Make peace with inconsistency. It will stand you in good stead.

"Consistency is the last refuge of the unimaginative."

- Oscar Wilde, writer and wit

Joe would do well to learn some LTCM lessons:

- No system is fail-safe in real time. Maintain a healthy distrust.
- No one, and no system, is smart or good enough to beat the effects of over-gearing.
- Real time events are important.
- The only picture you need is the bigger picture.
- In trading, make provision for the impossible. Exception management can't be left to your system.
- Judgement is more important than genius. Legendary pit trader Tom Baldwin believes the "smarter you are the dumber you are".
- Be shrewd, not clever, there's a difference. Use your judgment. Your judgment takes precedence over your system.
- If your margin depletes no other trader is going to fill it up overnight (or ever).
- You are alone, accompanied only by the consequences of your decisions.

Slowly, with time, Joe will test his system, modify it and improve on it. And then a state of what I can only describe as 'sceptical optimism' will have developed between Joe and his system. To be able to trust anything in this market is priceless. Like many traders developing a system Joe will be tempted after a few bad trades to chop and change. I will encourage him to resist this. One of the reasons Joe will want to do this is because of the exaggerated affect negative experiences have on us.

NEGATING NEGATIVE AFFECTS.

For some reason we experience negatives more negatively than we experience positives positively. Nassim Taleb in his book *Fooled by Randomness – The hidden Role of Chance in The Markets and in Life*[3], gives a good example of this phenomenon. Taleb asks us to imagine an investor, a retired dentist, who has a live feed to the fluctuating fortunes of his portfolio. Let's assume the portfolio provides him with a 15% return with 10% volatility (or uncertainty) per annum…

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[3] The one trading book you should read next.

'….. [That] translates into a 93% probability of making money in any given year. But seen at a narrow time scale, this translates into a mere 50.02% of making money over any given second….Over the very narrow time increment, the observation will reveal close to nothing. Yet the dentist's heart will not tell him that. Being emotional he feels a pang with every loss, as it shows in red on his screen. He feels some pleasure when the performance is positive, but not in equivalent amount as the pain experienced when the performance is negative.

At the end of every day the dentist will be emotionally drained. A minute by minute examination of his performance means that each day (assuming eight hours per day) he will have 241 pleasurable minutes and 239 unpleasureable ones. These amount to 60,688 and 60,271 respectively, per year. Now realise that if the unpleasurable minute is worse in reverse pleasure than the pleasurable minute is in pleasure terms, then the dentist incurs a large deficit when examining his performance at a high frequency.

Consider the situation where the dentist examines his portfolio only upon receiving the monthly account from the brokerage house. As 67% of his month will be positive, he incurs only four pangs of pain per annum and eight uplifting experiences….Now consider the dentist looking at his performance only every year. Over the next 20 years that he is expected to live, he will experience 19 pleasant surprises for every on pleasant one!…

Viewing it from another angle, if we take the ratio of noise [for our purposes, random price movement] to what we call nonnoise…then we have the following. Over one year we observe roughly 0.7 parts noise for every one part performance. Over one month, we observe roughly 2.32 parts noise for every one part performance. Over one hour, 30 parts noise for every one part performance, and over one second, 1796 parts noise for every part performance.

A few conclusions: Over a short time increment, one observes the variability of the portfolio, not the returns. In other words, one sees the variance, little else. …Our emotions are not designed to understand the point. The dentist did better when he dealt with monthly statements….Perhaps it would have been even better for him if he limited himself to yearly statements…..Finally, this explains why people who ,look too closely at randomness burn out, their emotions drained by the series of pangs they experience. Regardless of what people claim, a negative pang is not offset by a positive one (some behavioural economists estimate the negative effect to be up to 2.5 the magnitude of a positive one); it will lead to an emotional deficit.'[4]

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[4] Nassim Taleb, Fooled by Randomness, p. 56-59

You can't handle too many negative responses. Knowing this in advance, minimising the amount of negatives you will have to cope with in a trading life, is a huge edge. You make bad trading decisions when you are down. Add to this the fact that the big boys, the banks and the hedge funds, don't sit and look at 5 or 15-minute price graphs. And they are the guys that move the market. Your system needs to accommodate what the big boys are doing by approximating the way they look at the market. If you don't then apart from the psychological pain randomness causes, you will have to deal with real pain that money loss causes. You will experience the point Taleb is making, over and over. Get too close to the market and you take pain. Of course a year is too long, even a month, but every ten minutes is too short and when you start to find yourself flustered, uncertain, you are the dentist looking at his portfolio in too short time increments. Find a balance that works for you. Most people watch too much, get too close, and evaluate the system obsessively without giving it time to breath and properly show its merits and flaws. Few people err by watching too little.

Joe will learn that he has to have a system that allows him to pace the market. Say the market drops 500 points. The news is awash with bears forecasting another 1000 points to the downside over the medium term. Everyone has an opinion. But Joe must be able to watch this, from a distance, and get in when he feels comfortable buying (assuming his long term view is up). Some people operate on higher frequencies than others. That's fine, as long as you don't get too close to the market. If 'too close' is the only frequency that make you comfortable you probably shouldn't be trading currencies. The point is that your system must not only accommodate the reality of the market, it must accommodate you. Watching the market won't change the price by one percent of one percent. It's a natural to want to 'will' the market in your direction but it is about as useful as ice in a snowstorm. When LTCM was bleeding, the partners

> *'Grim and determined….got to the office at dawn and worked late into night, as if their physical presence alone could stop the haemorrhaging.'*[5]

It didn't help. The story of LTCM needs to be taken to heart. When really smart people who really understand the market crash and burn, there is something to be

[5] Roger Lowenstein, When Genius Failed, p. 157.

learnt. Understanding the market well is not sufficient. It is a prerequisite, and a very important one, but it needs to be paired with good judgment.

By now Joe is probably coming to the realisation that his business plan or system is a guide not a gospel. That he is going to have to exercise good judgement. He has probably got an inkling that the rules are fine when all is fine, but they can become a hindrance when exception management is called for. Learn the rules, forget them, manage the exceptions. And finally, at the heart of all successful trading is one single hard irreducible fact: the odds, in the long-term, always prevail. What does this mean? Let's take a look at the role of randomness in the life of a trader.

Trading is about getting the odds in your favour, and then giving them time to make you money.

UNDERSTAND RANDOMNESS

I've touched on randomness before. Now it is time for Joe to get a proper understanding as to why randomness, or rather understanding the role of randomness in the markets, is one of the biggest edges he can have.

Odds imply probability. Probability is a measure of the likelihood of an occurrence, in our case the likelihood that the market will go in a direction that will benefit our position. If the odds are in your favour the probability that you will win increases with the elapse of time. The shorter the time frame the more random the event, even with the odds in your favour, the longer the time frame the less random the event. Thus in the short term the outcome is unpredictable, in the longer term it is more predictable. Why is it important for Joe to understand this?

As a species we abhor randomness. It scares us. Random events are unpredictable, risky, dangerous, costly. We compensate by creating order. Where we can't create order we imagine it. If we do this in the market place, if we imagine patterns and order where there is nothing but randomness we do so to our detriment. Yet traders constantly fall prey to this desire to see illusory reoccurring patterns. These patterns may be there, but there predictive power is negated by the much more prevalent randomness.

It is not possible to gather useful technical price information, relative to the main drivers of currency prices in the short term (for day traders) from a very short time interval like five minute graphs. You are merely observing prices ticking up and down randomly. I maintain that there is no such thing as **an intra day** "**trend"**. However, since our trading strategy is premised on our view of the underlying, “fundamental” trend, we need to identify a trend, the probability of a market continuing in one direction for a period of time that stand in some useful relation to our long term and intermediate personal and operational goals.

This is where we lay our cards on the table. If we are wrong about the fundamental trend then we are going to struggle. If we are right about the trend then we can back ourselves. This is important to understand. A trend does not simply move in one direction, smoothly, on and on, up and up. It retraces, going down, sometimes quite far, before re-establishing its direction. But it consistently makes higher highs and lower lows.

We take a view on the prevailing trend by studying the underlying fundamentals. We need to have good reasons for saying why we think this currency, over the long term, will strengthen.

In a sense we are involved in an arbitrary random exercise when we enter the market in the short term (intra day) but we are in fact betting on the likelihood of a positive outcome in the long run because, and only because, our “dip buying” is based on the longer term odds being in our favour because we have correctly identified the underlying trend. Understand this and you will understand the essence of my system. See, no rocket science there.

The shorter the time frame Joe chooses to work with the greater the randomness he has to deal with. We are not wired to deal with randomness. When we win we like to think it’s because of our own insights; when we fail it’s bad luck. Often it is simply the randomness of events, a terrifying thought to the human mind that needs some order (comfort) to make sense of an unpredictable world. This need is so strong that often we superimpose our need on reality. If you are too close to the market, if you are trading too short term, randomness will rule you. There are a very small percentage of currency traders today who make money intra day – open and close all their positions each day. You are not going to change that statistic. Rather join the larger group of traders who have an inter day time frame – they may keep positions open for a week or more allowing the benefit of trading with the trend to make money for them.

Systems that like to work with risk/reward limits and work with fixed and quantifiable mathematical odds are dangerous. Let’s talk odds for a minute to illustrate why these systems are based on faulty logic. Casinos are businesses that know something about using odds to make money. Consider the following. If you are playing black jack in a casino, the mathematical odds in favour of the casino are actually quite slight, about 3%. But that doesn’t mean that for every $100.00 you gamble the casino on average takes $51.50 and you $48.50. No, you usually go home broke, or with considerably less than $48.50. Why is that, given the only slight mathematical odds in favour of the bank?

Because the casino leverages its 3% advantage very effectively. It serves you free drinks to impair your judgment, house rules require you to play first, you can't freeze a bad hand to buy time to come up with a plan, and you can't manage your losses. Casinos make money not only because they have the odds in their favour, but because they maximise the odds that are already in their favour. If you are playing blackjack as well as it is possible to play the game the odds are 3% against you. If you are distracted, angry, reckless, betting on long shots, the odds against you have increased. The longer they keep you at the table the more time they have to let the odds work for them and the greater the likelihood that they will take all your money. It's the same in the market. The longer you are in the market the more time you give the odds that are in your favour a chance of doing their job. You must be the casino and let someone else be the punter. The casino wants volume. There is a direct relationship between the number of punters that come through its doors and the bottom line just as there is, for example, a direct relationship between over-gearing and losing money quickly.

Casinos have state of the art surveillance systems to catch cheats. Though 90% of them get caught, they still try. It's like 90% of the losers in the currency markets. They try to 'cheat' a market that won't be cheated. Beyond a certain point the odds can't be manipulated. A person basing his trading decisions on supposedly recurring patterns he sees on a 5 minute chart is 'cheating'. His time frame is too short and what he thinks are patterns are not. They are simply random representations of a series of prices over a given time. It might work today and tomorrow and for the rest of the week. But ultimately each day is a coin flip in the life of the market and eventually he will end up close to 50 / 50, a roller coaster ride to Never-never land.

A good system allows you to leverage (I use the word 'leverage' now in the non-trading sense of 'increase' but keep the image of a lever in mind) the advantage you have because you have picked your long-term trend correctly. Let's say for argument's sake that by identifying the long-term trend correctly you have the equivalent advantage of the casino's 3% mathematical odds in your favour. You may think 3% is not exactly a huge edge in your favour. But what if you could increase those odds using all the small pre-trading edges we have looked at, and the trading edges we are coming to. You have your discretion and judgment, you have your system, and the timely, intelligent use of these advantages pushes up your odds considerably. Or you can choose to be angry, impulsive, frustrated, rash, reckless undisciplined in your trading. These are factors within your control that have nothing to do with the long term trend but which can increase or decrease the odds in you favour. You can choose to jealously horde all your possible advantages and focus them on trading successfully. This is the free exercise of choice over which you have control.

If you want to have a look at how this works in practise using real time analysis and median trading, email me and ask me for a longer term trade-by-trade track record of 2003, the period featured in the daily graph in this Part. drforex@dayforex.com

THINKING IN PROBABILITIES

"Fate laughs at probabilities"

- Edward Bulwar-Lytton, author

Being able to think in probabilities is one of the biggest assets Joe can acquire as a trader. Trading is about understanding probabilities. That is to say, being comfortable with random outcomes because over a given time they will turn into consistent results. This presupposes a transition period, that period where randomness is no longer randomness but a probability of a certain outcome. Note, 'a probability of a certain outcome', not a certain outcome. Unfortunately this transition period where randomness morphs into probability cannot be clearly demarcated. It is fluid. But understanding the concepts will give you an edge. This method of thinking where you don't sweat the short term price changes but wait instead for the longer term move, this is another way of forming a picture which accurately reflects the nature of the market and its dynamics.

If my assumption is correct, that trading is not about certainty but about probabilities, then what I want is to make sure that the odds are in my favour. Probability relies on a certain minimum sample of events before a reliable pattern can be discerned. In a casino that would mean a certain minimum number of hands at the black-jack table. In trading it would mean an elapse of time and a change in price, i.e. the long term underlying trend asserting or reasserting itself.

This is one of the features of thinking about currency trading that Joe will struggle with. He is being asked to think both fluidly and flexibly on the one hand, and rigidly or statically on the other. Joe wants either a fixed point or predictable volatility, not both. Unfortunately he will find neither and trading is about learning to live in a world of fluidity and a world of fixed points at the same time. This takes a good deal of practice.

Joe will be required therefore to think on a small picture level and on a big picture level and he will be asked to do this simultaneously! It is not easy, but with practice Joe will become proficient. He will be able to distinguish small, irrelevant random price moves form the bigger more telling moves. Clearly there is a grey area where the two overlap, what I call the transformation stage, but the important point here is for Joe to understand that the market will require him to think in this manner and he can start to practise by looking at smaller price movements and then zooming out, standing back, and getting a bigger picture and finally overlaying the two, relating the one to the other. Traders are constantly asking themselves, what is the market telling me, must I attach importance to this latest price move? Being able to give the right answer more often than not is what it's all about. Those traders who have developed this dualistic thinking have an edge.

A trading system is nothing more than a business plan which creates a favourable context within which you can make good trading decisions using your judgment and discretion.

You now have a considerable edge and it wasn't given to you, it can't be given to you, by some formulaic, mechanistic, mathematical approach. You created this edge. You identified the long term trend, you waited for the dips, you kept your gearing low, you didn't fuss about timing, you identified your goals and your expectations are realistic.

This is how I want Joe to think about trading, using a system that maximises all possible advantages. I want Joe to think like the casino, not the gambler at the casino. I want Joe to make all the 'house' rules that are within his power to make, rules such as when to trade, how much to trade, when not to trade, what goals to set. He has understood that these are advantages that are *available* to him, for free. It's a huge advantage to be able to manage losses, or to decide when to take profits. One of the reasons casinos make money is because they minimise the discretion you may use. The critical exercise of my free choice is one of my most important trading tools. It makes me the casino; I'm betting with, not against the odds. Deal the cards, don't have them dealt to you.

SUMMARY

Before we move on to trading edges let's quickly recap the pre-trading edges we've looked at.

1. **Goal setting – being realistic. What do you want out of trading? Are you using discretionary funds or is your livelihood at stake? There is enough pressure in trading as it is.**
2. **Trading is a business and business requires a business plan. My trading system is my business plan in which I have identified my goals and the steps I need to take to realise those goals.**
3. **My discretion and my common sense are great advantages. I do not trust my system absolutely. I remain sceptical, testing and improving my system all the time.**
4. **Knowing that the market is not fully knowable because it reflects ongoing events that are often unpredictable I do not waste my time worrying about things I have no power over.**
5. **I know that negative results exceed positive results in their affect on me and consequently I minimise my exposure to such bad influences.**
6. **There is an element of randomness in the market place that requires me to think in probabilities. Because I back the long term trend I can ignore the occurrence of random events and wait for consistent results. Thinking in probabilities is a skill I can choose to acquire.**

Chapter 11

Trading edges

REAL TIME ANALYSIS

"Life is what happens to us while we are making other plans."

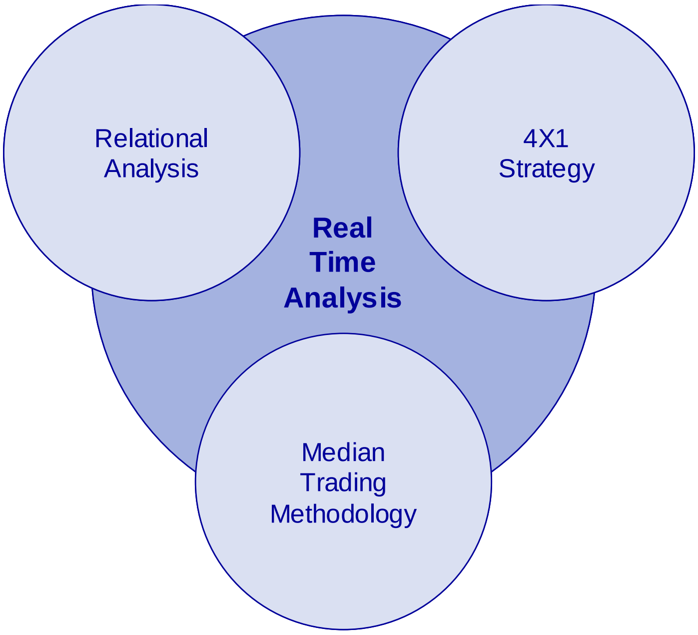
- *Thomas La Mance*

I had traded bonds successfully, making handsome returns. Whatever I was doing certainly didn't involve complicated formulas or expensive software; it was pretty ordinary. Yet, though I was clearly doing something right I hadn't thought too much about what it was until I started my current business. I mapped out a business plan for currency trading and key to that business plan was the fact that I did not want to trade forever. I wanted others to trade for me and to do that I had to leverage my ability as a trader. If I could teach others to trade they could trade for me. In order to do that I had to start formulating the stuff in my head, get it into a more or less intelligible order, and then put it down on paper. If you are wondering why I should want to share my strategies, methodologies and systems with you then the answer is that it is part of my business plan. I am addressing this issue because I always ask the question, and so should you, why would somebody go to all the trouble of telling other people how to trade successfully while he could be doing it himself? I guess there are lots of reasons and one of them is certainly that some people (many people) don't know how to trade but are very good talking about it and so they hope to make money selling books, systems, seminars and software. However there are many legitimate reasons to share. Many successful traders have a passion for what they do and think it's a great way to earn a living. They want to give others the chance to do the same. Others, besides liking trading, like teaching. I am one of them, I like the interaction with my students and I learn as I teach. But basically this is not about being a nice guy. I'm doing it because it's part of my business plan – it's good for my business and my business is a forex trading business with two core competencies. The one is my trading, my ability to make money in the currency markets; the other is my ability to teach others to do the same. When my students end up trading for their own account I get a small commission on every trade. It is in my best interest for them to have a long and prosperous trading life.

"A defeated man does not make a good philosopher"

- *Jean Dutourd, historian*

By this stage Joe is getting a little itchy. He signed up for training in currency trading but he is a little confused by the direction it is taking. The talk has been metaphorical, of currency highways and lions tails, business plans and CEOs, and what is all this stuff on blackjack, odds and casinos? Joe voices his concerns to me. I understand where Joe is coming from. I tell him that's fine, soon I'll give him the nuts and bolts but I would like, before we start, to make a prediction. Once Joe has finished the initial training and starts the real business of trading and grappling with trading he is likely to encounter periods of frustration. I'm doing what you told me, applying the principles, using the system, but it's not working. My prediction is that Joe's struggle to close the gap is because of his focus on the hard science of the system to the detriment of the soft science, the stuff he felt was a little airy-fairy, the pre-trading edges. That's fine and probably natural, it's part of the process, but I wanted to flag it before we continued. I will encourage Joe to go back, to integrate the soft and the hard science of trading, and to continue doing so.



It is time for Joe to put on his Chief Operating Officer's (COO) cap. We are going to get down to the business end of trading. You'll recall my System with a big 'S', my business plan, required a Chief Executive Officer, a Chief Operating Officer, and a Chief Financial Officer. Joe has been getting restless in the CEO role so we have put in a transfer for him to the Ops Room. This is where the plans are drawn up and the buttons pushed. The guiding principle in the Ops Room is called **Real Time analysis.** I call it 'real time' analysis because I like to remind myself that I am up against the coalface making decisions about real time prices and events (remember Soros' comment that the market is reflective of 'ongoing events').

It is my overarching principle. It's the how and what of trading that Joe will have to learn. Real time analysis is what I use to make my trading decisions and it rests on three pillars, three edges that increase my chances of success.

- It relies on my 4x1 strategy deployed within a median grid or comfort zone.
- Median trading is the *method* I use to employ my strategy.
- And it relies on relational analysis. It is what is lacking in so many trading strategies, the intelligent relating of price, event and time. You will only see this information on the charts by looking at them from a specific angle, looking through them as it were, to what is behind and hidden, the deeper meaning. This takes practice but it is a priceless asset.

I am going to discuss the components of **Real Time Analysis** in the order of 4x1, median trading and then bring it together with relational analysis. But first, some important aspects of traditional technical analysis.

Get your facts first, and then you can distort them as much as you please.
- Mark Twain, American author

This is important because my three main trading edges (4x1 strategy, median trading, and relational analysis) are based on certain assumptions I have made concerning Technical Analysis (TA) and Joe needs to know what these assumptions are before we proceed. I consider my views on TA as an edge, call it a background edge to my actual trading edges, but an important edge nonetheless for my views on TA are critical for if I cannot get Joe to see the merits, or at least some of the merits of what I am saying, then my trading edges will not help him much.

What I am going to tell Joe about technical analysis is going to take him a while to absorb. In the email Joe sent me he said that though he had never traded before, he had read a couple of books and made a cursory study of TA which he thought very exciting. I am going to tell Joe that I believe that TA has a place in my trading strategy but it's not a huge place. It's a matter of "horses for courses". Joe is also going to hear that a lot of the TA stuff he has read about just doesn't work, or rather, it doesn't work in currency markets. By the time I'm finished Joe is going to be shaking his head. That's fine. I'd rather have him shaking his head than losing his money.

On your run-of-the-mill retail currency trading and training websites they talk about technical analysis and almost every one of them says the currency market is ideally suited to technical analysis. Rubbish. It's ideally suited for them to make money from you. .

A very interesting email popped into my inbox recently. It concerns the Euromoney Forex Forum 2004. It is probably the major international forex market event, frequented by all the major players, banks, funds, and governments. These guys move the market, not you and me, not even all of us together. Now, what analysis do they use?

Fundamental	41%
Technical	26%
Flow Information	16%
Quantitative	17%

If you start out as backyard technical analyst and make it the be-all and end-all of your strategy and methodology, you are in for a hiding. You miss out on 75% of what the big guns work with, the people who move the market. Add to this that when you use TA you actually look at timeframes these guys do not look at, you use complex indicators and formulas, and there you sit in splendid isolation. Relational Analysis attempts to turn this problem into an edge. We relate the relevant fundamental analysis with short term time frame technical analysis, add the Real Time effects, events, news, market dynamics and our money and risk management strategies.

TECHNICAL ANALYSIS EDGE, UNDERSTANDING ITS LIMITATIONS

"Statistics are no substitute for judgment."

- Henry Clay, American statesman

The first trading edge Joe needs to understand is the proper application of technical analysis (TA) within currency trading and specifically the limitations of TA. If I were a stock trader I would no doubt make far more use of TA than I do as a currency trader. Stocks gave birth to TA many years ago, it's where TA was developed and recently, the last thirty years or so, has seen TA all but take over, partly as a result of computing power and the ubiquitous PC that can run software packages that offer a plethora of TA tools, all available at the press of a button. It's therefore understandable that TA should, willy-nilly, find its way to the currency markets that have their fair share of hi-tech Internet based trading platforms, real time charting and price feeds. But people forget that TA had its origins in a time when real time info did not exist in the way it does today, where information did not arrive simultaneously at traders desks as far apart as London, Timbuktu and New York. While TA is always necessarily historical, a happening in the past, it moves even further into the past because of the speed at which current events are absorbed, analysed and distributed as information, and so TA becomes even less useful for the currency trader whose market is moved by these real time events. Leisurely examinations of past prices will be punished by a fast moving market. TA became the pillar on which stock trading decisions were based, but stock markets and currencies, as I have said, are chalk and cheese.

Reminiscences of a Stock Operator by Edwin Lefěvre is still, to my mind, one of the finest books ever written on the art of trading. Livermore, the subject of the book, had an insight early on in his trading career by realising he was an ‘outsider’, always slightly behind, never quite up to speed, behind the curve, out of step. Winners were clearly doing something right, something he wasn’t doing, but what?

He knew it could not simply be luck. There were consistent winners and over a long enough period to suggest that their trading was systematic, based on some sort of guidelines that won more often than it lost. That was when he realised that these winners were ‘inside’, they were seeing the real market, they were not guessing. So he set about becoming an insider. He was trading in the early 20th century. There were no TV analysts or Internet newsletters, no voluble consultants, no think tanks.

But there were prices and he learnt to watch them, when they speeded up, how they distributed, when they slowed down, how they retraced. He got to know their rhythms intimately. He made money. Then he lost it. He lost it because he was no longer an insider. Telex had been developed and others were getting info before he was. He got hold of a telex and learnt to read it. Once again he became an insider and made money. The book is about a lot more than that, but this one point I want to impress on you.

Think about how you can become an insider and how you can stay an insider. I am not hostile to all forms of TA but I do believe, and with some conviction, that its overuse will make you an outsider. That is another way of saying that most of the TA library contains information that will not help you become an insider. Livermore wasn’t wedded to anything, not to TA, fundamentals or analysts. He did what every good trader does, assessed his market and asked himself how he could swing the odds in his favour. If he had found a talking dog that could give him an edge he’d have bought him a collar and a lifelong supply of dog food. I take this cue, the point being that I trade in the currency markets and as I will illustrate there are tools employed in the TA toolbox that are very clearly not suited to the job at hand.

TA comes out of a society and a context where real time info did not exist. In currency trading real time info is the norm. Understand that a paradigm shift has taken place once you step into this world. New rules apply, old rules must die. Someone in the third tier of Microsoft does not move Microsoft stock with an announcement. Someone in the third tier of the BOJ does move the Yen with an announcement. It is as simple as that. This nullifies, if not completely, then to a large extent, the usefulness TA has in the market I trade in. Suddenly you are in a world filled with chattering. The trick now is to be able to distinguish between idle chatter and the real thing.

Consider how one Friday there was a big sell-off on the euro. Nothing unusual for this market but see how the market commentators reacted. One commentator said it was because of a remark made by the Belgian Minister of Finance that the strong euro was hurting Belgian exports. Another commentator picked up that the French president had made a passing comment about the euro after a G7 meeting that could have been construed as euro negative. Everyone was looking for a reason *based on what someone had said.* But to what extent did these comments have anything to do with the sell-off? With time you will learn what to discount and what to discard. Unfortunately it is not something you can learn in a textbook. My daily briefings are a dialogue with students on what the market has been and is 'telling' us. If you are interested in having a peek email drforex@dayforex.com

What applies to TA and stocks applies equally to fundamental analysis and stocks. Highly paid analysts and accountants trawl the financials of a company, speak to its directors, clients, asking experts in the field if the sector's future is rosy or rancid. Of course, now we have the added problems of crooks in suits massaging the books, giving a sick patient rosy cheeks. The Enrons, Worldcoms and Parmalats, have made it even trickier to rely on financial statements. (That's another thing I like about currency markets. It will take a scam of some proportions to 'massage ' this market, all $1+ trillion daily dollars of it spread out across the globe). But let us for the moment assume diligence and honesty. Traditional fundamental analysis is ten weeks old by the time it hits the markets. Ten weeks! That's a life-time in my world where an employment report becomes irrelevant minutes after it has entered the market. Ten weeks is sloth speed. We zip around at high velocity in this beehive of euro, dollar and pound trading. I need the tools that can do the job where I am, in the currency markets, now, in real time, that is, what is going on this minute, perhaps yesterday and tomorrow, but not ten weeks ago or hence.

Remember the story of the Pennsylvania Dutchman I recounted in Part 1? He was unhappy about his investment and wanted to see the man at the helm and so he got in his car and drove to see Mr Reinhart, the president of Atchison, Topeka & Santa Fe Railroad to ask him some questions. This story is illustrative. We don't have the luxury of time to do this. We also can't, even if we wanted to. There is no Mr Reinhart for us to go and have a chat to. But there is another point this story illustrates. The Dutchman was using real time analysis within his trading context. His unfavourable impression of Mr Reinhart was based on a real observation (Mr Reinhart's liberal use of expensive stationary), in the man's office, then and there. Within his trading paradigm he made a sound decision based on sound observation in real time.[6]

[6] Edwin Lefèvre, Reminiscences of a Stock Operator, p. 208

In the currency markets the only fundamental analysis worth anything is **Real Time Analysis**. For me that is nothing more than a week. My long term view may be influenced by deeper underlying causes, but I am day trading. Where the dollar is going to be next year, or was last year, does not help me push my button now. That's the paradigm shift, and Joe will have to make it.

TA: THE FUN AND THE FLAWS

Joe's been doing pretty well so far but every now and then he balks. Two weeks ago, after I had made disparaging remarks about his latest favourite indicator, Fibonacci retracements, he laid down a challenge. Perhaps I had been sounding off. I told Joe that Fibonacci numbers were invented by Leonardo de Fibonacci, a medieval mathematician who was asked to come up with a formula for calculating the growth in offspring of two procreating rabbits producing procreating offspring. Fibonacci developed a sequence of numbers with predictive value. Somehow this sequence has found its way into the markets but I told Joe that I failed to see how it could fruitfully be applied to currency trading. Joe said, fine, but perhaps I should then state for the record what TA I use, and why. Fair question.

If it has to be animal procreation then a more accurate analogy of how the currency market prices move is lions, rather than rabbits. Lions mate as follows. The female comes into heat. She is then covered by the male for a period of a few weeks, everyday, many times a day. As an exhibition of virility it is unrivalled in the mammal world. The male lion can cover the lioness several times in an hour. Then there are quiet periods where little activity is noted. Suddenly with renewed vigour, the lion mates with his companion. Each mating event is relatively short but accompanied by much activity, noise and biting. In between not much happens. This is analogous to how the currency markets move: short, sharp periods interspersed with longer languid periods where the markets seem to lie about, gather energy, before resuming with a short burst of activity.

The indicator is only a part of the strategy, the tip of the iceberg. It's all the stuff below the water that you need to know about. Because if you don't you will be like the Titanic, full steam ahead until your keel gets ripped out by what you didn't know was there.

So Joe, here it is in a nutshell. I make no use of any indicators, except my ‘Japanese follow through indicator’, which I will discuss later. In short I divide TA into the good (support, resistance, trend lines) the bad (most “pattern type” indicators) and the ugly (indicators that generate lots of confusing squiggles and lines and patterns). But that’s just me. If you want to read about indicators there are plenty to choose from. Bollinger Bands, Elliot Waves, Oscillators, MACD, Moving Averages, Slow Stochastic, a parade of exotic names. If you want to know about technical analysis in the currency markets the best book on the subject I’ve read is Cornelius Luca’s *Technical Analysis Applications in the Global Currency markets*, 2nd Edition. I am not making a dogmatic statement, “indicators don’t work”. It’s just that I can’t figure out how to make it work for me and so I can’t teach Joe how to make it work for him. I think the reason they don’t work for me and why they probably won’t work for Joe is because they were developed by serious technical analysts over years and years with much blood, sweat and tears. They work for these analysts. John Bollinger and his Bollinger bands, RN Elliott and his Elliott waves, Tuschar Chande's Chande Momentum Oscillator, these analysts *invented* the tools they work with. Shortly after I started using CNBC Europe as my main information service on the world markets I caught John Bollinger on a short interview regarding the US stock markets. Of course I was expecting him to slap up charts and start talking TA. Nothing of the sort. He gave lots of fundamental analysis without any reference to his Bollinger Bands. This tells a story on its own. Indicators work for their inventors because they are the culmination of years of work and experience.

If you think you can pick up a textbook that describes one of these indicators, read it, and then mechanically apply it profitably, you are going out into a rainstorm without a raincoat. It’s akin to watching Ernie Els playing golf, reading his book on how to do what he does, and then signing up for the pro tour.

Traders who successfully use indicators are doing a lot more than just asking the indicator to generate buy or sell signals for them. They are probably successful traders *already*, that means they have learnt the golden rule of swinging the odds in their favour and then allowing the odds time to do their work. The indicator is only a part of their strategy, the tip of the iceberg. It’s all the stuff below the water that you need to know about.

Take moving averages (MA) for example. They supposedly show the direction of the trend. They are only valid on daily graphs and the most often used are the simple 200 day, 100 day, 50 day, 35 day and 21 day MA's. You don’t learn zip on a MA 200, 100, 50, 35 or 21 in helping you make a day trading decision in the currency markets. Some say a nice day trading signal is a MA 50 crossed by a MA 13; trade in the direction of the cross. I don't. This only works on daily graphs and these types of crosses do not occur often enough for day traders to exploit them. Not only don't they come regularly enough but Joe may be a victim of the rule of random distribution and the five crossovers in a row that are false signals. Does it render the indicator false? No. Is Joe a bad trader? No. But these false signals have induced Joe to enter the market only to watch the 'cross' now 'uncross'. The pressure to anticipate a 'cross' mounts. Joe is now entering trades because he thinks his indicator is going to do something in the future. In effect Joe has doubly distanced himself from the markets. He is not even trying to guess what the prices are going to do next, he is trying to guess what the indicator, based on the prices, is going to do next. I tell Joe that I get sea-sick just looking at indicators. I much prefer a 'fixed point' like my median grid and I try to find such a fixed point that gives me a context and a perspective from which I can judge recent price action.

While I was writing I had a look at the daily MA200 (simple) of EURUSD. As luck would have it, the MA 200 is all the buzz. The EURUSD price recently crossed below the MA 200. Fuelling anticipation that it will now move away from it and the dollar will recover, and isn't there rate hike fever in the US, and amazing jobs reports and economic growth. Well, that was a month or so ago. During this time (about three weeks) the MA 200 was actually crossed 15 times intra day. But don't despair. We are at a major juncture. Just add the MA 50 (simple) which is heading straight for the MA 200 simple. Anyone can see it is going to cross to the down side and that means, sell the euro.

"Uhh waiter, can I have the MA 13 please?"

"Yes sir, what would you like today, Simple, Weighted or our day's special, Exponential. "Make it the special."

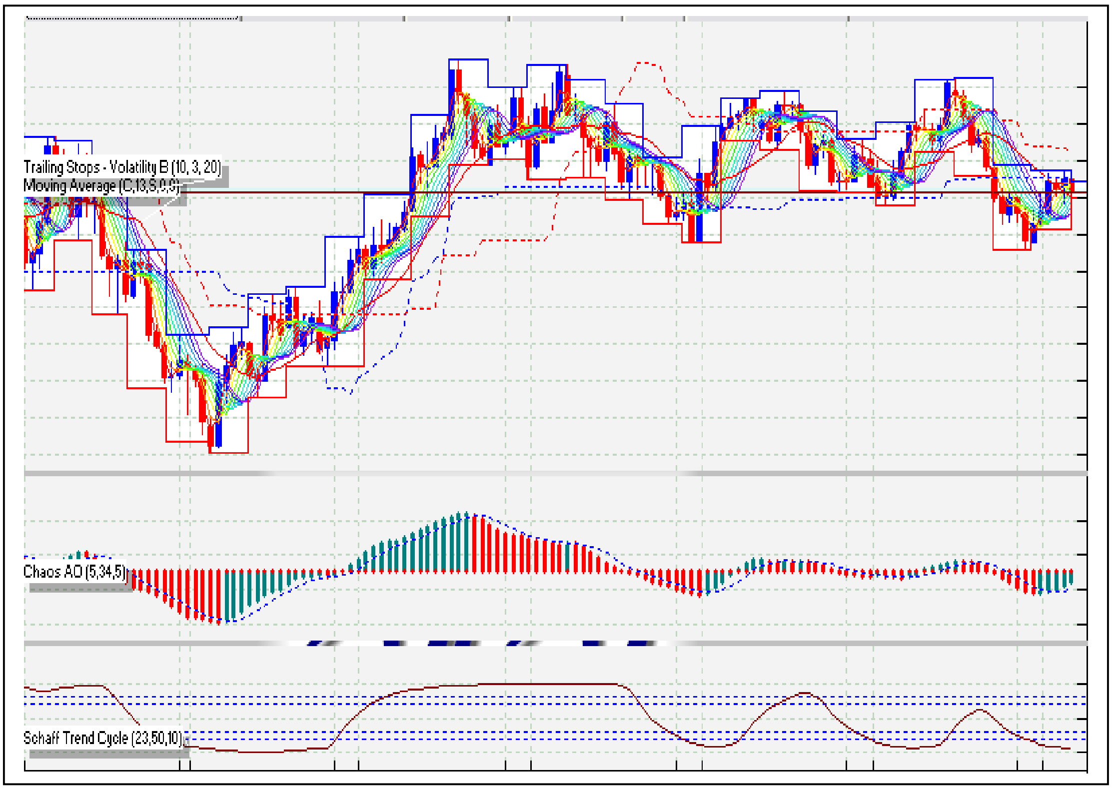
"Yes sir, will be right back. Oh, Sir, I almost forgot, what price would you like, High, Low, Close, Open, Median, Typical or Indicator ….?"

"Uuhm … you know what, on second thoughts, just give me a triple Scotch.

I tell Joe to consider the following: his indicator gives him a buy signal. That means because Joe is trading with a specific broker who is a market maker – someone who makes the prices and quotes them to Joe – Joe is receiving quotes from his broker and no one else. Another broker may have given a different price at the same time, a price that may have elicited a different response from the indicator. That's how arbitrary it is. Buy signals, pin-point entries, forget it. I'm saying choose a level, near support if you are trading up – and that level can vary with 30 to 40 pips - and get in. That's all there is to it.

I remind Joe that I believe one of the reasons he can be successful is because he will not blindly follow the losing crowd in the methods they use. One of the ways in which you can tell a loser is by looking at his trading screen. It will be busy, a work of modern art with snaky, squiggly, curvy lines, dots and points, entry and exit signals, flashing lights. We are going to sidestep that trap - and use only the absolutely necessary TA.

Picture 4.11.1



Technical Analysis uses historical prices to identify trends – I use that. TA uses historical prices to identify support and resistance levels – I use that. Overbought and oversold indicators are just a complicated way of judging current prices relative to recent price moves. I do that anyway without recourse to indicators. One of the problems of these indicators is that they are lagging, all of them, they are simply telling you what has already happened. Your common sense is just as powerful as any indicator in determining for instance overbought or oversold levels if you have a sensible point of reference (like a median grid) and if you can train your common sense to be disciplined. The predictive power of indicators, for real short term traders is largely negated in the currency market because of the persistent external events that may cause radical price moves in relation to the most recent moves.

TRADING WITH THE TREND, MY LONG TERM EDGE

"Never forget that only dead fish swim with the stream"

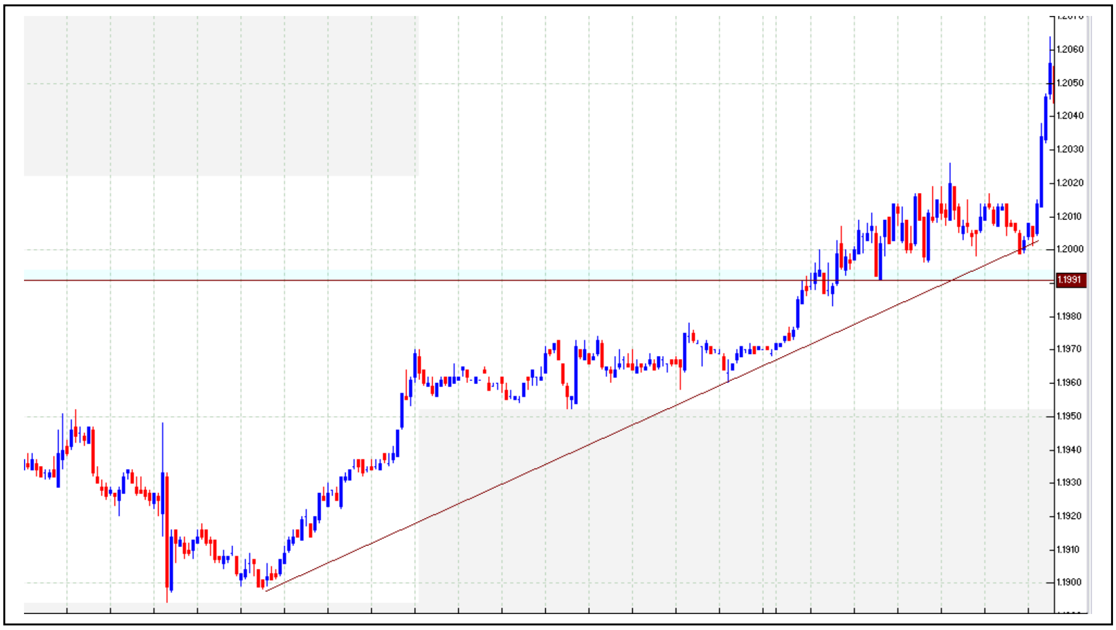
– Malcolm Muggeridge - writer

This is a big edge, the building block of our trading system. Joe wants to know why, if I am so sceptical about "everything", do I rely on trends? For the same reason I rely on anything in trading. There is a good probability that a trend is leveraging the odds further in my favour. A trend is just a bias of opinions that the market is likely to continue doing what it has been doing and to continue doing it for some time to come. There are underlying fundamental factors which cause this bias of opinion. That's all, no more. But remember, I'm in the process of accumulating odds in my favour. I've taken a look at this or that currency, noted the angle of it's climb, the time it has taken to reach the point it is at now, and examined the underlying fundamentals supporting this strength. I throw in a little bit of sugar and spice, mix it up, sit back, suck my thumb, and say yes, it's a trend. I am not being flippant. It's just that I want Joe to understand that it's not wizardry or cold maths that establishes trends. It's people, and if people can disappoint you trends are likely to too. So I don't worship at their feet. I just watch them, mindful that at some point this trend is going to change direction. When doing so it is going to be a bit frantic. Until it does, it's broad back is a nice place to climb on to and make money.

Currency prices move either up, down or side-ways over a period of time relative to other currencies. This is called a trend. Some people will speak about intra day 'trends' - this is nonsense, there is no such thing. **All you get intra day is movement, not trends.** A sharp two hour move on the EURUSD is not a trend, it's just a move. Trends are called trends only when they have been in existence for a certain minimum period of time. A day does not qualify as a minimum period of time.

Example of a strong up trend, ending in a typical overshoot. (Picture 4.2.2)

Picture 4.11.2



With a little bit of perspective … It was a 5 minutes period up move on one day! A down day! (Closing lower than the previous day and lower than the open). Picture 4.2.3

Picture 4.11.3

I want Joe to understand that trends have different time frames for different market participants.

For investors:

- Long term – in the investment world “several years” qualifies as a long term
- Medium term – from several months to one or two years (sections of a long term trend)
- Short term – several weeks to several months (sections of a medium term trend)

For us day traders:

- Long term is some theoretical concept associated with your whole career as a day trader
- Medium term is the investors’ short term
- Short term varies from one to a few weeks

If you want to identify a trend look at daily charts. (See picture 4.2.4) An up trend is defined by drawing a line through rising bottoms, a down trend by drawing a line through falling tops. If a daily close is outside a daily trend line theory says it may reverse. Often it does not reverse, it consolidates and then continues. Get a time frame, a reference point and your own perspective on what’s going on.

Picture 4.11.4

If you really want to lose perspective, start identifying intra day “trends”. There are easier ways to go crazy. Before you know it you will be on the highway of death. You should have one mission only and that is to identify speculators' medium or long term trends. And trust the old saying 'the trend is your friend.'

SUPPORT AND RESISTANCE

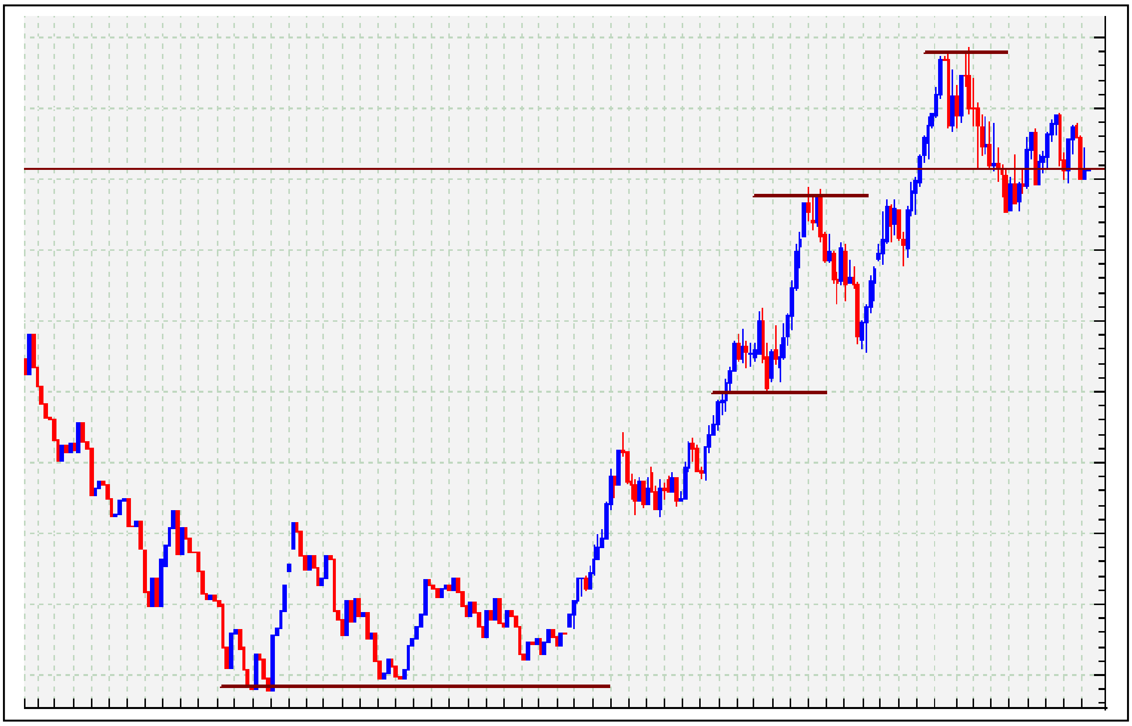
"When everyone is bearish , a market must go up because there are no sellers left; conversely, when everyone is bullish , a market must go down because there are no buyers left."

- *Unknown*

Anywhere where you can combine points by drawing a horizontal line through bottoms (use candle sticks) will be a support level. This is a bottom where buyers won out over sellers causing the price to rise. Do the same at the top, this time for resistance levels. Here the sellers overwhelmed the buyers and pushed prices down.

I use horizontal lines. They give me nice fixed points. I want some fixedness in this market. It's comforting, if nothing else. Remember, resistance overcome can turn into support and vice versa.

Picture 4.11.5: Support and resistance



Why is this an edge? Prices bounce off the support or resistance, testing it and reinforcing the fact that it is a support or resistance level. A very important thing Joe should know is that prices will seldom test a level more than three times before either definitively breaking through it or definitively retracing back from that level. Also, support and resistance levels are not clean straight lines, but price levels with a variance of 30 to 40 pips. Just as you shouldn't try to pin-point your entries don't try to pin point to the pip a support or resistance level. "Pip wise, pound foolish".

OVERBOUGHT / OVERSOLD LEVELS

I use these all the time in a very simple straight-forward manner without having to call up indicators, and it is related to my one directional trading strategy and my median grid. Prices are always seen relative to the median price level. (A level we identify subjectively based on recent price action and a view of the fundamental trend, and recent price action in relation to the fundamental trend. The further a price is from the median level, but still in the median "comfort zone", the more overbought or oversold it is for me. I tell Joe to imagine he is trading up, in the direction of the underlying trend. There is a retracement (a move down against the long term trend). This is called a dip and Joe is betting that before long the trend will re-establish itself. Said differently, the market is oversold and buying will start again. Joe buys because he thinks the market will go up. Why? Because the fundamental trend is up in this case and the market will take longer time and a bigger price change to become overbought and shorter time and smaller price change to become oversold. There is therefore more room for error trading with the trend, buying oversold levels than trading against the trend selling seemingly overbought levels. As long as the trend is up, you will have many seemingly overbought levels, causing bi-directional traders serious problems. Joe has merely identified a trend, waited for a dip, bought it, and is now waiting for the trend to continue. Its not the timing that counts, but the wait.

Other charting options to establish O/B and O/S levels are deviations from short moving averages and Bollinger Band interpretations.
An interesting indicator in this regard on the major currencies can be the number of short or long futures contracts at a major futures exchange such as the Chicago Mercantile Exchange (CME) and New York Mercantile Exchange (NYMEX).

Summary:

That's it – these are the TA fundamentals that give me an edge and they form an integral part of my strategy and methodology to identify buying levels from which to profit using one directional trading within my median grid/comfort zone. Joe, if not won over, may be a little more sceptical about his use of indicators. He is starting to accept the role of randomness in the markets, he has distanced himself from the need to time his entries to perfection, he does not require the same level of certainty. Joe has had his first glimpse of this market's true nature. It's an important step for Joe. It is for me too, because if I could not get Joe to open his eyes and see, whatever strategy I imparted at this point would have been valueless. Joe has also not simply accepted everything I've told him. I like that. His scepticism will help him to develop his own system.

Chapter 12

The 4 X 1 Trading Strategy

ONE CURRENCY, ONE LOT, ONE DIRECTION, ONE PERCENT EDGE

"Everything should be made as simple as possible but not simpler."

- *Albert Einstein*

Joe deserves something a little more concrete, my 4x1 strategy. I have a methodology which I call median trading. My 4x1 strategy is employed using my median trading methodology. My system of relational analysis brings it all home. Together, these three pillars are what **Real Time Analysis** stands on. Let me just make something clear at this stage. There is a difference between the transfer of know-how and the transfer of facts. The former is experience made practical - what I am going to deal with now - the latter is theoretical, what I have already dealt with in Part 2 and Part 3.

ONE CURRENCY EDGE

On my suggestion Joe opened a demo trading account that allowed him to trade with fictional money. I told him not to worry too much about making money. I wanted him just to get used to the feel, how the platform worked, what currency trading looked like, and asked him to send me his trading records after a few weeks. I saw that Joe had traded the euro, the yen, the Swiss franc, and the Australian dollar. When I asked him why he said he felt he had a better chance of success if he 'spread his net.' We discussed the matter and I pointed out to him that, for example, the fundamentals that move the yen were very different form those that move the Swiss franc. This meant that Joe had to concentrate on two disparate sets of information. Given that there wasn't more money to be made in one currency rather than another I advised Joe, as I do all my clients, to concentrate on one currency, to master it before moving on. In order to master a currency you have to understand its fundamentals, its relationship to other currencies, the various fixed interest rates, bonds and the gold market. You have to be able to put any news related to that currency into its proper perspective, slot it in, almost without thinking. Euro and Sterling are quite similar, and tend to track each other. But the Swiss franc is a 'safe haven' currency and will do well when global security is an issue while the yen, the base currency of a country with huge surplus exports, and on the other side of the globe dances to an entirely different tune.

Joe actually seemed quite relieved that he was being asked to focus on one currency rather than a basket of currencies. He said he hadn't really thought it through but that it made sense to befriend one currency properly rather than have a passing acquaintance with several. I gave Joe an exercise. I asked him every time he opened his demo account to imagine that he was the chief trader of Deutsche Bank opening his office door in the morning and saying to himself, I am the chief trader because I'm good at my job. I'm good at my job because I know this particular currency like the back of my hand. I've studied it as though it were fauna. I know its habits and habitat, how it lives, what it likes, what spooks it, what emboldens it. I want Joe to understand that there was only experience separating him and the chief trader, not magic, no special insights, no 'insider information.' Sure Deutsche Bank have rooms filled with highly paid analysts churning out analysis but the chief trader had to make his decisions in exactly the same way Joe did. The playing field was level.

Get to know your chosen currency. Become intimate with it. Later, when you become more proficient, you can trade several currencies but remember, no one currency is better, or easier, than another. In a certain sense there will always be one denominator, the US dollar. I want you to know that I don't think it is necessary or wise to trade the pure crosses, excluding the US dollar. Because of much lower volumes the whole ball game changes. Events, most of which you may not even be aware of, unless you make a permanent study of them, tend to have a bigger impact on relative price moves on a short term time frame. It's a temptation when you are doing poorly on one currency to switch to another thinking that this will improve your lot. Why should it? If I've lost money trading the euro and I know why, I'm then in a position to rectify the situation and keep trading this currency for a profit. But if I'm closing losing trades and I don't know why, switching to the yen isn't going to help me. It's a question of discipline as much as anything else. Resist the temptation to change. There are one-off opportunities in a currency, but they are rare. It's not going to help. These people keep jumping, euro, yen, pound, back to euro, but it's all the same and they just end up confused and dispirited.

I want you to keep in mind my earlier casino example. The challenge we are facing is to transform the odds in our favour - we want to be the casino. And secondly, we want to leverage (in the non-trading sense) whatever odds we do have. Concentrating on one currency is a good way to do this. You stay focussed, keep matters simple, and maintain discipline.

I currently trade the euro, and occasionally the pound. But I am not wedded to either currency. There is nothing inherently attractive about the euro (except liquidity), or any other currency for that matter. At time of writing the euro is in an up trend against the USD because of certain basic fundamental factors. If these factors change I reconsider my position. If I decide there has been a basic shift I look for another currency, preferably a one-way-play. But until such time I keep trading my currency of choice.

ONE LOT EDGE

"When you combine ignorance with leverage, you get some pretty interesting results."

- *Warren Buffett – investment guru*

If you are too highly geared you *will* fail. Understand this, and you are nine tenths of the way to trading success.

I don't literally mean one lot. I just mean "low gearing/leverage". In other words I am talking about a small position size relative to your capital. To trade with gearing means you trade with more money than what you have: you lever your available capital. If you are geared 100:1 you are borrowing $100 for every dollar you have. If you are geared 2:1 you are borrowing $2 for every dollar you have. How much you are *allowed* to gear depends on your agreement with your broker. How much you *should* gear, well that is an entirely different matter. If you are too highly geared you *will* fail. Understand this, and you are nine tenths of the way to trading success. Misunderstand this, or ignore it, and you will fail. I am not exaggerating. It has a place in my top five all time edges. When Joe filled out my questionnaire he told me that though he had never taken a currency trading course before, a friend of his had attended a course. I asked Joe whether his friend was still trading. Joe said no. I asked him the name of the company that had presented the course. When Joe told me I was not surprised that his friend was back at his day job. This course, like so many others, had their pupils trading with gearing of 20:1 and more. I find that unconscionable. There is a duty on any mentor or trainer to warn students and clients of the dangers of over-gearing as a matter of principle. But to actually *teach* them that it is OK to trade with gearing as high as that borders on the criminal.

I want to make a distinction some may find confusing but it is necessary to understand the concepts further explained in this book. I distinguish between an "entry" and a "trade". An entry is one position at one specific price. A trade may consist of multiple entries at different prices or times. This is a core aspect. I use a multiple entry strategy. These entries together make up a trade. Here I differ from the majority traders who place all their trades in one basket, so to speak. Because most systems are signal-based and rely heavily on exact, pin-point to-the-pip-timing, the trader places full confidence in the signal and trades to the maximum according to his system's risk and money management principles. Exactly because I do not rely on timing I can have a multiple entry strategy.

An average gearing per entry up to 2:1 or 3:1 is acceptable. Per trade gearing will be higher at times but that will depend on my trading methodology, i.e. where the price happens to be on my median grid. High gearing makes me uncomfortable and I don't like to trade when I am uncomfortable. It is easier to make good decisions when you are trading in a comfort zone.

Exactly because I am very confident in my fundamental analysis and my comfort zone, demarcated by my median grid I can make several entries at different prices and prices levels, all constituting one trade. How long this trade takes and what exactly the profit will be I am not too sure or worried about when making the individual entries.

A couple of weeks had passed and I asked Joe to show me his latest trading records. I noticed that he had abandoned all currencies but the euro. It wasn't helping him. His demo equity was down by half. Joe's gearing was too high. I asked him whether he knew how to calculate his gearing. Joe said he didn't but had read my notes on gearing at the beginning of the book and taken precautionary measures to make sure that his gearing wasn't too high by closing positions when they were getting too far out of the money. I told Joe that in general it was a good principle to cut one's losses, but that apart from the inherent dangers of trading with too high gearing Joe was not allowing himself yet another chance of stacking the odds even more in his favour. Because Joe had heeded my warning on gearing he was instinctively applying a risk management strategy by closing the position when it was looking ugly. But he had missed a trick. Joe was taking one position (entry) at a time. What he should have been doing was opening multiple positions. But first Joe had to learn the very easy equation by which he could calculate his gearing.

He was trading $100,000 lots. I asked him how big his initial margin account was and he said $10,000. That means that Joe was geared at a minimum 10:1 (divide size of account into the lot size). Having only $10,000, I suggested to Joe to trade with $10,000 lots instead of $100,000 lots. Let me just digress here for a moment. It doesn't matter that it was demo money. There are certain rules you have to follow, demo money or not. Remember that story that you use only 2% of your brain capacity consciously? What does the balance do? Fill your head? It works, subconsciously. You should not underestimate this. From day one on your demo account you should trade with the amount you will use when trading live. Your subconscious gets tuned into many aspects of your trading system, including emotional reactions (almost like a lie-detector) your conscious mind discards. Thus if Joe was trading one $10,000 lot at a time his gearing would be 1:1. If he opened a second $10,000 lot his gearing would be 2:1. If Joe opened ten $10,000 lots his gearing would be the same as if he had opened one $100,000 lot, namely 10:1. But consider this. If Joe had opened ten $10,000 lots staggered at intervals of 50 points, his gearing would be the same, but not his risk. Some of his lower positions may be in the money. I am not hereby advocating 10:1 gearing. I am just saying that if you think I'm talking rubbish and you are going to gear 10:1 anyway then give yourself a better chance by buying ten $10,000 lots at different price levels. Mini lots ($10,000) have changed the face of FX trading for the smaller retail trader. Previously the smallest lot you could buy was $100,000. Some brokers now even offer $1,000 lots. Of course lot size is only relevant in relation to the size of your trading account. Using $100,000 lots is perfectly acceptable if you have a $100,000 account. Your gearing would then be 1:1 (same as $10,000 lot with a $10,000 account or $1,000 with a $1,000 account). Do you see the relevance of opening an account with an amount suitable to your goals? If you want to make $10,000 a month, you are not going to learn much by using $1,000 if you intend to open a $100,000 account. Neither will it help you to open a $200 mini account and trade $10,000 lots if you later want to open a $5,000 account trading $10,000 lots. You have to practise on the same gearing ratio you will trade when it really matters. Don't ignore this. I have seen too many perfectly intelligent people, using all the principles to make money that works for me, except this one, and it shows.

A large chunk of trading success has nothing to do with systems, analysis or psychology. It's about capitalising your account sufficiently or trading what you have in your account with reasonable gearing. It's the same thing. If you stop reading now you probably know ninety percent of what trading is about. There is no quicker way in trading, and there are many ways, to stack the odds against you, than by over gearing. The reason most novices don't heed the warning is because they have been conditioned by the marketing wizards to think a stop loss close to the market at a highly geared position is the be all and end all risk management and highly geared positions is the professional norm. This however is a big distortion of the truth. Take for example a trader with a margin of $5,000 trading one $100,000 lot. This is what Joe's friend was doing because that is what he had been taught. Joe's friend wasn't dumb, he'd done his maths, and he realised that he needed to have a loss strategy or pretty soon he would be wiped out. Well he was wiped out, but not in the way he had thought. Here's what happened. He was trading with gearing of 20:1. The currency market moves on a regular basis anywhere from 70 to 200 points in one day. In order to protect himself Joe's friend had to use tight 30 point stops. In other words, if the market went thirty points against him he would be stopped out for a loss of $300.00. He felt that was reasonable but he had underestimated how volatile this market is and he was being stopped out more often than not. After being stopped out four times, he'd had enough. He decided to give himself a little room, handle the swings, 50 even 100 points. What is Joe's friend's gearing now? It's not 20:1 anymore – his margin is down to $3,800 (his four losses of $300 each) and he is still trading one $100,000 lot. It's moved up over 25:1. Joe's friend is a strict technical trader. Fundamentals are for fundamentalists he was told. He enters another trade. Unfortunately for him, he does so just before a US jobs report release which is unexpectedly bad. The market, in a flash has moved against him, 50 points in one minute. He decides he'll sit out the downside. Then 75 points, he's still hanging in there, but finally, at 100 points, five minutes later the pain becomes to great and he bails out for a loss of $1,000. He now has $2,800 left on margin. His gearing is 35:1. He feels he was unlucky on the last trade, 100 points is a big move and his technicals did not warn him. He thinks that because his perspective of the market is small (at the time of writing the pound dropped 400 points in a single day). So he decides to try again. The market goes up by twenty points. He is elated and banks a profit of $200 dollars. His margin is $3,000 and he is on his way back. His confidence is high. He opens two positions. The market promptly drops 150 points. He bails out at 130 points. On that move with his two positions, he lost $2,600. He has got $400 left. He tries to scalp (take small profits quickly). He wins, he loses. He is down now to $200. His gearing is 500:1. A twenty point adverse move will finish him off. *Twenty* points! – that's what this market does to warm up, before it's had its coffee, before it's even got out of bed. The currency market moves 20 points *in its sleep*. Don't make the mistake to think your friendly broker's margin call policy will save him. It won't. Most only look at the opening of the trade if there is enough margin, and he wont be able to add new positions, but they will gladly allow him to reduce his account, to say, 25% of the original minimum requirement to open the position. Now why would they do that? Wouldn't it be in their interest to automatically close him at $2,000 in the example? No, because they have to spend a lot of dollars in systems, marketing and the like to convince him to place his margin with them in the first place. They need a profit. Where is Joe's friend's money? The CFO of the market maker is managing it, allocating it to the payroll. That $5,000 dollars will come in handy when they need to pay the marketing wizards and the dealers' salaries. What business do you want to be in, funding market maker's payrolls or trading currencies for a profit?

Why trade like that if you don't have to? The people who do, reason it from the other side, with high gearing I can make, not lose, lots of money quickly. That should tell you everything. There are no free lunches, no quick buck. If you're thinking that's the way to go I suggest the casino. You'll lose your money there too but you'll have more fun, and probably more of a chance. It is also easier to rationalise your losses away as bad luck. In trading you have to consider the aspect of your own contribution, after all, you made well-considered decisions, equipped yourself with technical and fundamental analysis and risk management know-how on a good training course. It's tough to rationalise all of this away as bad luck.

Joe's friend got wiped out completely by the market moving only 175 points (two times 30 points, one times 100 points, plus 15 points), well within the parameters of a sensible median grid or comfort zone. If instead he had used one $10,000 (10K) lot the market, to wipe him out, would have had to move 2,500 points against him! You choose.

There are online brokers and market makers offering cash prizes for the best returns in a month. Winners post returns of up to 250% for the month. Impressive but misleading; what the brokers don't tell you is how long these traders are around after they receive their prize. Their records are posted and almost without exception they are trading with dangerously high gearing. The brokers don't mind. They are the casino and the punter is losing his money to them. The charlatans, use these figures, slightly adjusted, by the insertion of one little word to convince you to try the same. The word is "per", 250% **per** month. Look up what "per" means. It means "for every", like in "for every period", 250% for every month. It's not going to happen.

You should be able to make money trading currencies without high gearing. If you can't make money trading 1:1 (for each dollar you have you trade one dollar) you wont make money simply because you gear up. Thus, I am advocating multiple entries (I'll say more about them in time), gearing up a little if you want to, but never at the top, always at the bottom of the market, relative to recent price moves. So, if you decide to, as a rule, trade with gearing of 3:1 i.e. for every one dollar you have, you trade with value of three dollars, that will be your 'ONE LOT'. Thus you are entering the market with $30,000 dollars (give or take, depending on the base currency) or with three mini (10K) lots considering you have the minimum $10,000 in order to trade with $10,000 lots at a 1:1 gearing ratio. Do not, ever, be tempted into thinking A-HA here is a BIG SIGNAL and I am going to up my gearing significantly. Be disciplined.

The second major advantage of low gearing is that it allows you to use multiple entries. Your chances of making money by entering on two levels at 2:1 gearing is better than entering at one level on 4:1 gearing. (Assuming you trade with the fundamental trend)

Joe wants to know if one can gear too low. Sure, you want to make money, and if you are not prepared to take risks then you have the option of a 32-day-call-account. Find a balance that suits you. Be comfortable. You don't need to go higher than 3:1, at least in the beginning. Once you open a trade you have to define your risk, i.e. how much you are prepared to lose on this one trade. Remember the trade can consist of several entries, which you can't really define other than in real time, as prices change. Instead of telling yourself how much money you are going to make, rather ask yourself how much money you can *afford* to lose. Many professional traders say somewhere between a two and five percent loss projected per trade is prudent. Now five percent of $10,000 is $500, so trading a 10K lot means the market can move 500 points before you need to take your loss. If you trade two lots then it's 250 points, still some swing even in a volatile market.

Joe is pleased to hear – he didn't know this – that he can 'scale' down a trade. If you bought 40K in one go you are not compelled to sell all in one go. You can sell 10K at a time. For example, you are in the market with 40K (4:1) and the market moves against you. You are starting to feel uncomfortable, but at the same time you are pretty sure that the trade is sound, perhaps not sound at 4:1 gearing, but sound at 3:1 or 2:1 gearing. You have the option to scale down, take smaller losses backing your feel that it is a good trade and will turn giving you profits on your remaining open positions. You close one 10K position - Your gearing is now 3:1. If that's a little high still you can close another 10K. Now you wait. If the market continues to go against you, you can close your remaining two open positions. Or it goes for you and the remaining 20K may become profitable. This option to scale down, selectively reducing your trades, is an edge, even though it may be a negative edge, a type of 'crisis management edge'. The casino has an all or nothing approach. You can't choose to lose in increments. Having that flexibility in trading is an advantage. As long as you are confident that the basic set up of the trade consisting, possibly, out of multiple entries, is correct, and your confidence is vindicated, it pays off to stay in the market as long as possible. Allow the position some time to mature.

As I've already mentioned, the second major advantage of low gearing is that it allows you to use multiple entries. Your chances of making money by entering on two levels at 2:1 gearing is better than entering once at 4:1 gearing. It is simple, you have more arrows in your quiver. If you take the 'one big arrow' approach, then once you've shot your bolt, it's over. You've surrendered some odds that could otherwise have been in your favour. The reasons for this are the nature of the market you are trading in. It does not reward precision shooting with a high-powered telescopic rifle.

I consider multiple entries vital to trading success. They reduce your risk and allow you to accommodate the volatile nature of the FX market better. One big entry smacks of an all or nothing psychology which puts me off. If I'm wrong I still want to be around tomorrow to put it right. I don't want to be like Joe's friend, betting the house on a single trading idea. Multiple entries have another virtue. They give me the opportunity to divide my trades into different time frames, short term and medium term. Let's say I've got two entries, one at EURUSD 1.2500 and one at 1.2450. The first one I've entered with a gearing of 1:1, the second one with a gearing of 2:1. I flag my 2:1 as my profit for the day, if it should go into the money. My 1:1 trade I set aside as a longer term trade. I allow it longer swings (time wise) and larger swings (price wise) in and out of the money. This way I am working on two time frames, adding another notch to my multiple entry bow.

ONE DIRECTIONAL EDGE

"Bulls make money, bears make money and hogs get slaughtered."

- *Wall Street saying*

It's time to examine Joe's demo account once more. Not only has he stuck with one currency but he is clearly understanding the vital concept of gearing, and using it to his advantage. But Joe is shorting (selling) and longing (buying) with equal abandon and I count a more or less equal distribution of sells and buys in his trades. Fifty percent of the time Joe is long and the other fifty he is short. My introduction to Joe of my one direction strategy does not go down well at first. Joe immediately points out what so many of my students feel when they start trading currencies: One of the most prominent aspects which lured me to the market is that it is a two-way market. And this market is so volatile, why not take advantage of it both ways, trading up and down? Why not indeed? (And your median trading lends itself perfectly to trading two ways.) It seems to make sense, if you think it is overbought, sell the damn thing, if it's oversold then buy it. What's the big deal? Joe's asking some searching questions. I need to back up just a little in order to provide him with satisfactory answers.

One of my strategies to swing the odds in my favour is to identify a currency which I think is a 'one-way-play'. That is, a currency, which, because of fundamentals, is likely to strengthen over the medium- and long-term what I call the "fundamental" trend. If the currency is a one-way play, it's obvious that you will be trading it in the direction of its trend more often than you would be trading its retracements. Statistically you will have either more, or bigger profits and buy using prudent gearing strategies you will have much less losing transactions, or entries. But still, even if Joe has accepted my premise that this is a sound strategy his question remains, why not trade the retracements (go short)? In other words, Joe is happy that with this approach that one would be buying more than one would be selling, but why stick only to buying when this market offers you so many opportunities both ways. On the face of it this is not a very easy one to answer, but I believe that a one directional approach to trading is very necessary.

It is important that you understand that there are no certainties in this market. That means get rid of the mind-set: "I am going to enter the market when I AM SURE it will go up or down."

My first reason for trading in one direction only is because it teaches you discipline. If for no other reason than this, have a plan and execute that plan with discipline. In a certain sense two way trading is like playing chess against yourself. It's quite difficult to reach anything but stale mate. From another perspective it is nothing other than a rudimentary way to hedge your bets.

The second reason is patience. A one directional trading approach teaches you the important virtue of patience. It's not possible to adjust to the pace and rhythm of the currency markets without experiencing it first hand for some time. Nothing is going to happen today for the last time. There will always be new opportunities. I want Joe to understand that there is great value in being able to sit back and watch. Patience allows your entries to mature. Considering that you in any case do not know if the next relevant price movement after your entry is going to be up or down, patience becomes an important strategy together with your risk management and position management to build an edge.

The third reason is that buying and selling, trading in both directions sounds nice in theory but in practice it is very difficult. You must take a position in this market. Have a bias, and back that bias. If you constantly switch allegiances, you end up, rather quickly, in a mess. You sell when it rises, you buy as it drops, you don't have the advantage of backing your long term trend. Most people may have experienced times of "on" and "off" scenarios, like the electrical power for instance. It is much more difficult to manage a situation where the power is intermittently on and off than when you know it is either on or off. The same applies in currency trading. You need as much comfort as a trader as you can get. Your mind is not naturally attuned to handling probabilities, chance set-ups and the type of randomness the currency market presents. Don't make things more difficult than they already are. It's always easy to be clever after the fact – see here, was a retracement, I could have sold and made money. But in real time, you don't know this, is this a hiccup of twenty points before it goes on in the direction of my long term view? Is this a hundred point retracement? Is this a deep retracement, perhaps even a trend reversal? This game is hard enough without complicating it further. I tell Joe that for me simplicity has value.

The one directional approach really has an influence reverberating through all aspects of the trading system. Our one currency is defined in terms of one fundamental trend. That is the one direction we trade in. Let's say it's trending up on a price chart. I buy the dips. On a balance of probabilities I have a much better chance of making money this way. Either more dips will turn into bigger profits or I won't have shorts on tops to cut short. I don't want to add selling the tops to this equation. The currency that is trending in my direction allows me to hop on for the ride. It gives me dips where I can buy the currency slightly cheaper. I like that. At the same time I keep my eyes and ears open for signs of reversals, corrections, (break of trend line, support, median levels). The moment I add top selling to my dip buying I have to double up on this looking out for warning signals. I have to consider a multitude of other factors now related to loss making and managing potential downside per entry or per trade when prices are in the bigger scheme of things at levels where profit taking and managing upside should have been the main concern.

My **one direction** approach dovetails nicely with my **one currency** approach, different sides of the same coin. That doesn't mean I am not constantly looking out for other one-way-plays. I am not married to the EURUSD. I am just having a great love affair with her at the moment and I have since before she reached parity with the dollar. In a certain sense I feel it would be cheating if I shorted her.

Fifthly, and perhaps the most important reason, is the issue of timing (once again). Joe has to understand that I can hardly talk to him on my strategy of one directional trading without mentioning timing. Joe is already sick of my old hobby horse, he's covering his head with his hands. I don't care. Wait until Joe loses all his money, then he'll really feel sick. But I don't want to be intentionally repetitive so I am going to make a sub-heading under **One Direction** and not call it timing but trade triggers – Ok Joe? Different sides of the same coin.

TRADE TRIGGERS (what makes you push the button to enter the market)

I personally think the most difficult aspect of trading is the decision to enter the market. I always say, give me an open trade and I will close it for you.

The aspect most of my students struggle with is to let go of the concept that there is no recipe, no formula, no indicator that can pinpoint entries or generate reliable signals: two lines crossing, an oversold market, a percentage retracement. Here is the very best I can do on when to enter a trade, the golden rule that works for me: more often than not I enter a trade because of my perception that the price now, relative to recent price action, is HIGH or LOW, as the case may be.

When you think about trade triggers, you must consider that the main characteristic of the currency market is its immense intra day volatility relative to what we think a nice profit is, say 30 - 40 points. Think about that for a minute. It has important implications. It means there is no way that you are consistently going to pinpoint this market's intra day turning point within 20 pips. Therefore my trigger is based on something conceptually different from the traditional TA approach with its attempt at precise price picking.

Price levels

I base my triggers on **price levels.** A price level is a price range of 20 - 40 pips within a quadrant within a median grid near support (trading up) or a lower extreme. Once I've entered the market, it's irrelevant whether it then immediately goes up or down. I mean it's nice if it goes up, but the point is that if it goes against me, it does not invalidate my decision. That is crucial to understand. What the market does immediately after I've entered it is purely random, it is not predictable, and therefore I don't sweat it.

It's like catching a train. It's as if I'm newly arrived in London, I want to get to where the action is, the city centre. I need to get to a platform in order to catch a train. I see there are trains coming by every five minutes. The only information I have is that these trains are all going in my direction and they will take me to where I want to be and it doesn't really matter which one I catch. Some of them will take longer to get there, in fact some of them will initially take me further away from my final destination, but all of them will get there eventually. I don't know what routes these trains are taking, only their final destination. But this is an important bit of information. Say I take the third train that comes along. It's the express, I don't know this, remember, and its first stop is my downtown station. If I get off that train and pat myself on the shoulder and tell myself what a clever traveller I am, I am clearly fooling myself. It was an arbitrary decision I made. There were no clues, no information that this train would follow the most direct route. I could just as easily have chosen the first train and after having to endure a circuitous route berated myself for being so stupid. That would have been equally unfair. Consider the information I need and the action I must take in order to reach the city centre. The first is I have to know that these trains all travel towards the city centre. The second is, knowing this, I must get on one of them. It is simply a matter of getting to the right platform, waiting for a train, and hopping on it. If I'd gone to the wrong platform I would have ended up going in the opposite direction of where I wanted to be. Your view on your medium term or long term trend has to be correct. Then you have to get on the train. If you miss it, don't worry, another train will come along. Whatever you do, don't panic if you miss a train, don't start running after it. You will fall on your face or get run over by a train going in the opposite direction. Don't chase the market. Wait, there will always be another train.

It's always nice to be in the money five minutes after you have entered a trade. But that is just luck, nothing else and if you think it is your skill, you're bluffing yourself.

Relativise timing

What does this mean? It means that at any given time literally millions of people are looking at the same price as you are but with completely different views on what it represents. Your particular price is a comically trivial reason to buy, given the diversity of legitimate views, particularly if you have taken this position based on an arbitrary signal. The only way you can remotely justify your position is to say that in the bigger scheme of things I felt that this was a low price relative to recent price action, and I bought with the cautious expectation that it would probably go up. And that is all there is to it.

There is an interesting statistic on Wall Street.

- *During the five years up to 31 December 1997 the NYSE gained 24.6%. this entire profit was produced in just 40 days. Would you be able to predict which days they were?*
- *In the 864 months between 1926 and 1997, where stocks averaged 10.4% per year, 61% of those months were profitable. Yet, if you took away the top 72 months – just 8% of the total – your total return would have been zero. Removing 8% of the time eliminates 100% of the profits.*
- *Even at the US Trading and Investing Championships, where top professionals trade real money (their own), few succeed. Of 3,500 entries in one series of contestants, only 22% of entrants made any money at all. Only a handful managed to keep pace with or exceed the S&P 500*

Ordinary people Extraordinary Wealth – Ric Edelman

This market does nothing for a few hours and then it spikes, up or down; or nothing for a few days and then it spikes up or down; or nothing for a few weeks and then it spikes up or down. Take any timeframe you like, if you miss the spikes, or even worse, you are facing UP and it spikes DOWN, you are going to feel pain. And because it will spike against you sometimes, I consider it an important part of my strategy to be able to handle this spike, and wait for it to come back to take my profits. That "waiting for it to come back', that is what I mean by one directional trading, and patience. It is important that you understand that there are no certainties in this market. That means get rid of the mind-set: "I am going to enter the market when I AM SURE it will go up or down." You can't be sure. If you are your mindset is false. One directional trading is intimately related to the concept of timing, in this case not worrying too much about timing the market. One direction takes the sting out of the worry, it's what gives you the discipline and the patience to have the time to allow the odds to do their profitable work for you.

THE ONE PERCENT EDGE

"A profit a day keeps the bailiff away."

- *DrForex*

Joe is now trading his demo account with one currency, low gearing with multiple entries and he is doing it all in one direction. Yet he is very frustrated. He tells me that he watches as his system generates profits and then watches these profits disappear as the market goes against him. Why, I ask him. Why what, asks Joe? Why do you let your profits disappear? Because I am giving the odds time to work in my favour says Joe. I am running my profits.

Joe's dilemma, when to take profits, is a dilemma all traders face no matter how experienced they are. Some benchmark is needed. Let's look at it theoretically. If you want to make a 100% return on your money in whatever time frame, you need to bank 100 trades and each trade must be equal to 1% of your capital. Or you could bank fifty 2% trades, or one 100% trade. But that's theoretical. The reality is that you must understand something of the volatility (how much and how quickly prices go up and down) of the currency market in order to start targeting an optimal pip movement for profit purposes. I like about thirty to forty pips. That's because it fits nicely with my time frame – I'm a short term trader. If I'm geared 3:1, that's about 1%. The maths is simple.

Lets say I trade 10K lots EURUSD. We have $10,000 on margin. One pip = $1-00 profit. If I gear 3:1, namely I trade €30,000 EURUSD one pip move equals $3-00.

If you look at the daily volatility of the market over the period of a year, eliminate the top and bottom 20% extreme moves, and focus on the remaining 60%, you have the sort of price volatility which combined with one direction "dip" buying and multiple entries gives you more than ample opportunities to make money. The flip side of the volatility that delivers the profit is the same volatility that expunges profits, that is when the market moves against your chosen direction. If you are lucky you find yourself out of the market at the time of the counter-move; if you're smart you see it as a dip; if you're smart *and* disciplined you patiently let the dip mature, and you buy it. All that has happened is that ‘negative’ volatility (going against your direction) has created an opportunity.

Cost averaging

By adding multiple entries when the price “dips” you make use of a sound investment principle namely “cost averaging”. This is the basis on which mutual fund investments work. By buying at regular intervals at different unit values you average the cost of the purchases and overcome the problem of timing, which bears high risk because if a trade is dependent on timing you lose if your timing is bad, win when it is good, but you never negate the problems and the difficulties inherent in trying to time the market.

In order to explain the complete paradigm shift you will need to make this work for you, lets look at the example of highly geared specific timing-type trading. If you trade at 10:1 gearing in a market which can just as easily go 30 to 40 pips up as it can go down, you will have to consider placing your stops 20 pips away if you want to work on not losing more than 2% of your capital on any given trade.

What happens?

No multiple entries. You can’t buy dips relevant to the bigger picture price moves. Your entry is your trade. You snuffed out all your chances before you began. Because you make quick losses, and you have to ascribe to some system acknowledging you may make several losses in a row, you now need to run your profits.

But now what happens?

The stop-loss is not triggered, not because you have placed it below some sensible support, but maybe your entry signal came when the day’s dip has been run, causing the potential “remaining” price move and profit to be less (after your entry). You can’t afford to carry these trades, at risk of turn-around. You trail your stop-loss. The market goes up another 50 pips, but you need a 3:1 risk/reward ratio and you want to close out at + 60 pips, and there seems to be resistance at around 70 pips. The market turn short at +40 pips. Your trailing stop snuffs the trade out at +30 pips. That 30 pips can’t make you happy.

I am as happy as they come, because I took 35 pips on the deal, my 1 per cent, or even a fraction of 1%. 0.33 or 0.66 per cent. It all adds up. Just like your emotional deficit and your too-close-to-the-trade stop losses all adds up. It simply overwhelms your profits because on each of those losses you lose emotionally and you lose the money you pay as the cost of the trade. You can’t understand why, if you are cutting your losses and running your profits, you are still losing. You may also still have some trouble in understanding how I can cut my profits and run my losses and win. The answer is in the discretionary application of the 4 X1 strategy.

A young student approached an old sensei having his afternoon meditation under the Lotus tree. He asks him what the secret of his trading success is. The sensei replies: ‘When I see profits on the table I take them.’ Joe now understands that there is more to this statement than simply banking a profit as soon as it appears. The word ‘profit’, as used by the sensei, captures the entire world of his trading, all the edges he has identified and used, and it distils it into this one concept. Because edges include goal setting, strategy, patience to let the odds do their work, discretion, the sensei, when taking his profit is not only closing an in-the-money-position. He is closing a mini chapter in his big trading book filled with similar mini chapters that are written in the language of edges. The profit represents the accumulation of edges. The sensei tells Joe to think of profits as an avocado pear. Once the avocado has been peeled it has a finite life-time within which it can be eaten. If it is simply left on the plate it will turn black. Take your profits before they decay. Time will allow them to ripen, too much time will turn them rotten.

Summary:

Choose one currency to focus on a one-way-play in the direction of the trend, keep your gearing low, and set yourself a target. Remember that low gearing implies the flexibility of several simultaneous entries, all with low gearing. Cost averaging. Losers most often violate the one direction strategy. They will buy in the morning and sell in the afternoon. Pretty soon they have no view, no patience, no discipline, lots of confusion and no money. Be patient, allow the market its retracements. These are dip buying opportunities. Take your profits. A ‘profit a day keeps the bailiff away.’ Multiple entries give flexibility. You have more options, take some profits now, allow others to mature.

Chapter 13

My methodology: Median trading

Joe is coming along nicely. He has bought into my **4x1** strategy. I can see from his latest trading reports that not only is he sticking to one currency with low gearing, but he is also buying on multiple levels. He still doesn't like being out of the money on some of his positions. I say to him, who does? Think of it as the 'office politics' of trading. It's inevitable and a pain but you've got to learn to live with it and to manage it. A trade has got a life. See yourself as a talent spotter. You spot a young sports talent. You sign him up. It's just not rational to expect of him to beat the world in his first match. A trade can spend a relatively long time as a deficit (out-of-the-money) before eventually living op to its promise. I've told Joe that he should feel encouraged. Even though he can be impatient, taking a profit too early, he clearly understands the importance of buying the dips and then giving his positions time to mature in the direction of the underlying trend. But his trading is a little raggedy and that is not surprising. Joe has no fixed perspective. These buying and selling levels I talk about keep avoiding him. The daily plethora of fundamental information and the dynamics of price action on intra day economic data releases only contribute to his confusion.

Joe needs a better context within in which to make and execute his decisions, and, having done so, evaluate his decisions. The time is ripe for Joe to be introduced to median trading. Used properly, Joe can now swing those elusive odds another percent or two in his favour.

THE G-FORCE OF THE MARKETS

Median trading is my way of applying my **4X1** strategy. It creates for me the context within which I ply my trade, the hill from which I survey the currency highway. It gives me a perspective of the market that is large enough for me not to be a victim of randomness but small enough to suit my goals as a day trader. It is also useful because it sets parameters with 'quadrants' based on price levels which in turn create comfort zones, making my decision-making easier and better. Apart from its practical usefulness, it also creates a zone within which I can operate calmly. Please note that while median trading is based on sound statistical principles, the theory that prices return to the mean (average), our time frame may be a bit small to rely on this, particularly if the market is trending strongly in one direction. If the market is in a period of sustained sideways movement, the median grid becomes more effective. Really I just want Joe to understand that the concept of the median grid is more of a 'context creator' than it is 'price forecaster'. The important thing is to be right about your long-term view, and if you are, your median grid will work nicely to deploy the complete 4 X1 strategy and become a winner.

One of the perennial problems that beset so many "pen and paper" technical analyst students, is the inflexibility of their "system". They've tested it over a month or more, it produces wildly exciting returns on paper and a high percentage of correct signals. But the entire system is predicated on certain narrow expectations of market behaviour. The market is bound to disappoint with its characteristically uncharacteristic behaviour and exceptions to the rule. The strictures median trading places on the market are far wider, more forgiving of seemingly large random movements. So, if the market trends I search for the strongest trend and trade it in the direction of the trend; if it is a ranging market (going up and down – sideways trend) I stick to my median trading principles and I am comfortable (note though that it is definitely more difficult, at least emotionally to trade a choppy market than a strong trending market).

I try to base my system, and specifically median trading, as far as possible, on sound statistical principles, in this case the tendency exhibited by prices to revert to the median. Unlike the universe that is continuously expanding, currency prices tend towards where they come from, i.e. the median. This is especially true of the long term. I have successfully used this tendency (I put it no stronger than that) for short term trading.

The phrase ‘reverting to the median’ is linked to the concept of ‘overshooting' – currency prices spike or 'overshoot' - they move further than was reasonably expected and this begs the question “further from where?” The answer is from the median price range. Over any given time-frame currency prices swivel around a median price or price range. Therefore it simply becomes a question of finding a median range that is workable, given the fact that we are day traders, to plot it, and trade it.

How to draw up your median grid *(comfort zone)*

I seem to have Joe’s attention, we are dealing with the sort of practical stuff he likes. I tell him to go to his demo account and put up a chart of the EURUSD. Most charting programs give about a month's data on 60 minute charts, and that is all you need. Zoom out till you see on your 60 minute chart at least three weeks to one month’s data. Identify the support and resistance levels at the top and bottom. Draw horizontal lines at those levels. In between these lines, somewhere roughly in the middle will be a concentration of price action spanning 20-40 points. This is the median to which the price reverts. Nothing should stop you to use two hour and four hour graphs to help with deciding on a comfortable trading zone.

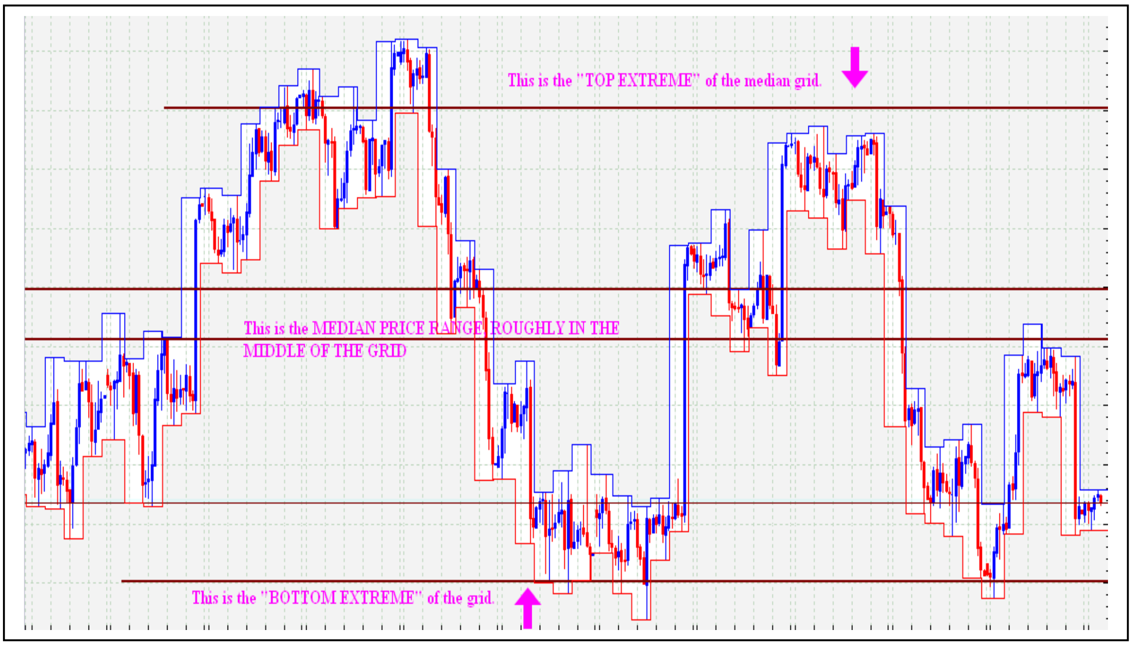
I ask Joe to take a critical look at the picture. I want him to examine it closely and tell me what he sees.

Lots of space in the top and bottom of the grid. Good observation. Joe is right, prices do not spend a lot of time at the two extremes (top and bottom, the resistance and support, or overbought and oversold levels)

Thin straight lines near the top and bottom. Joe is saying that spikes occur around the extremes.

Joe has noticed that the middle of the grids are ‘busy’ the tops and bottoms are ‘quiet’. Quite right. The prices spend most of the time somewhere around the middle of the range.

Picture 4.13.1: The basic Median Grid Structure



See larger example at the end of Part 4, Chapter 4.

There seems to be a frequency, says Joe, if one looks at the whole picture. It's as though there is more noise in the middle near the median. What Joe is observing is not only that prices swivel around the median but that they move from the one extreme to the other, pausing at the median as they do so.

Joe has noticed something else. When the extremes, top or bottom are broken, the price movement creates a new grid, or the start, possibly, of a new grid. Quite correct for what Joe has noticed is support turning into resistance and resistance turning into support.

Joe says that he also sees the prices bump up against the median from the bottom or bounce off the median from the top. Joe has picked up that the median is in itself a form of support and resistance.

One must consider that these are very subjective principles. But that is fine. It is after all not a magic wand. It's a framework. One can search in historical data and find perfect fits but that is not going to do Joe, or you, any good. Averages and common sense play a role in establishing these levels as working levels. What you primarily need is a comfort zone, where you can, with some measure of certainty, expect price action to do this and not that.

Comfort zones will obviously differ from person-to-person. Remember this is all very discretionary. Starting with how you draw the median grid. The placing of the median within the grid is much less important than the identification of the main demarcations of the comfort zone, the two extremes.

Understanding the bigger picture of price moves relative to real time events and the current data used to evaluate fundamental trends and trend changes is necessary to place your median grid effectively. This whole concept also only makes sense with the type of low gearing I use. Otherwise you must be prepared to accept huge volatility in your margin account. Draw-downs of 60% and more shouldn't bother you, nor should periods of astounding profits excite you. I however do not think it is a good idea. Maybe it is the "greed or fear " factor, maybe something else, but it just seems like the average trader does not have the psychological make up to accept that kind of volatility in his account and stay cool.

The following pointers should assist you in placing your median grid effectively:

- What is a generally effective grid size? One must consider the percentage changes in currency values over these periods. As volatility changes one must be able to adjust. Always leave room for error. There is no place for hard and fast rules. Although the nominal number of pips will differ, the percentage change of the US dollar against most currencies will be pretty much the same. In general on EURUSD 300 – 400 pips would be effective and on GBPUSD 400 – 500. This equates to about 2.5% - 3% changes in euro and pound terms.
- If the fundamental trend is up and the last month's price action was up, or the intermediate trend was up your median grid should allow for continuous breakouts to the upside. That is, you should answer the question: if it brakes and establishes a new level, where will the first stop be? You wont go too far wrong if in this case you adjust the upside median extreme in increments of 150 points.
- If there is a counter fundamental trend move, as a rally fizzles out, your lower median extreme will be under constant attack and it is prudent to allow, if the lower extreme is breached, for a complete grid change. In other words you will need patience for it to establish a new low around 300 – 400 points south. It is in your hands whether you want to try to exploit this expected down shift or if you are going to wait for it to show a bottom and then trade again with the fundamental trend.
- At some stage this counter trend will be worked through the system and one can confidently pick the dips and expect further downside to be much less severe, i.e. a complete new 300 – 400 point level may not be established, but rather new lows of 100 – 200 points. The reason is more and more fundamental and longer-term traders will perceive these as "bargain" levels and start building their position with the fundamental trend. This stage can cause very "choppy" trading in an

ideal median grid and one should adhere, non-discretionarily, to the median trading principles in order to exploit volatility.

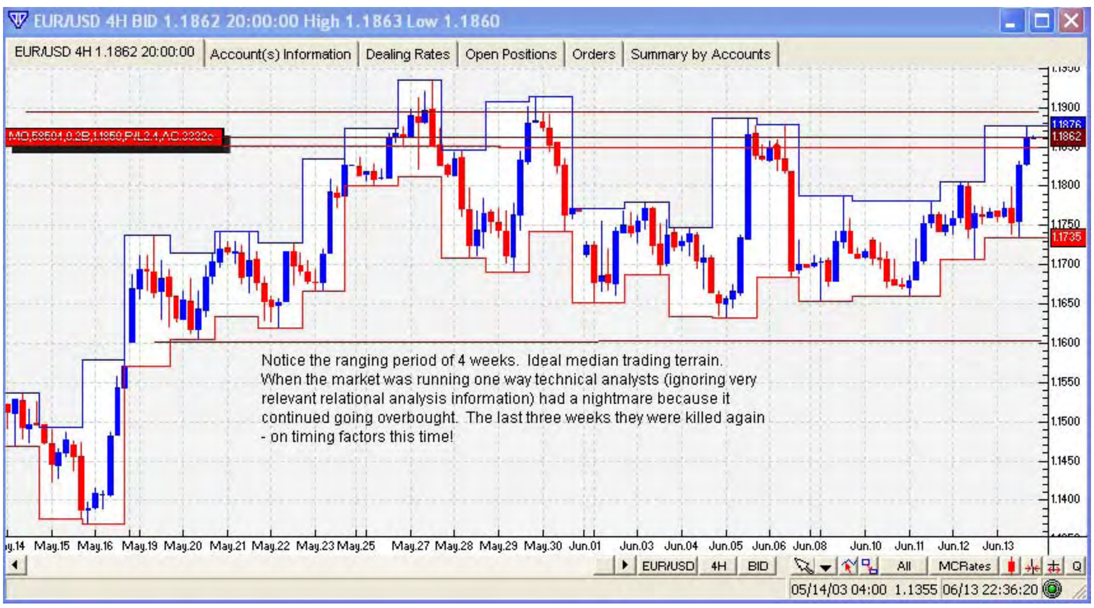
- From the above it should be clear that you have a different approach at the higher and lower extremes of your grid, depending on your view of the fundamental trend. If you assume the fundamental trend is up, you will trade the breakouts at the top extreme, but you will be more patient on the lower end, not necessarily trading breakouts against the fundamental trend. During strong trending periods with the fundamental trend, i.e. rallies in the trend you will completely discard the idea of trading towards the median against the fundamental trend rally. That is usually where the two-way traders make a mistake.

How to use your median grid

Now Joe can either choose to see a lot of horizontal lines or he can use them to be his reference point, a tool to provide perspective and scale, and that makes it very useful. Consider the following alternatives involving prices: close to the median - expected to move away; close to the extremes - expected to move towards median; if it breaks an extreme - in the direction of the trend you expect it to continue; if it breaks extremes against the longer term trend - you must anticipate the possibility of a deeper correction but also an imminent return to the median area (i.e. false breaks).

A perfect median range is to be seen in picture 4.4.2, May – June 2003.

Picture 4.13.2: Example of classic median range period



If one broadly accepts that currencies move in levels of 250 - 400 pips, then somewhere in the middle of this move the median range will be found. What happens sometimes is a price move from one extreme, say the lower extreme, straight through the median level up to the top extreme. The price then makes a U-turn and heads back in the direction of the median, as it did from 5 - 6 June 2003 from 1.1650 up to 1.1900, back to 1.1700, and a return to the top extreme all in a matter of a few weeks.

4X1 STRATEGY WITHIN THE MEDIAN GRID, COMBINING MY EDGES

Remember, 4x1 is my strategy, the median grid my methodology, and because we are intent on piling edge upon edge, accumulating them slowly but surely, I want to show Joe how I deploy my strategy using my methodology.

Joe now has a pretty good idea of how to draw up a median grid as well as the type of price movements that occour within such a grid (swivelling around the median, testing extremes). If you will recall I said that a median grid was a method to apply my **4x1** principle strategy (one currency, one lot, one direction, one percent). I've asked Joe to think about this; how he can use the median grid to ply the 4x1 strategy.

One currency - Joe is reasonably happy now trading a single currency. He thought that drawing median grids for several currencies would be a hassle. Better and easier to track one currency. Fine, let's leave it there and move to one lot (low gearing).

One lot – Once Joe had understood that the basic dynamic of price movement within a 300-point grid, the issue of gearing seemed a lot simpler. Previously he geared up and down on a whim. Now he saw the danger of higher gearing at the top extreme and the sense of higher gearing at the lower extreme, mindful of course of breakouts. With price on the median, and the possibility of a move either way, gearing should also be kept sensible.

One direction – After working his way through median trading Joe is a lot less sceptical of the virtues of one directional trading. Now, with support and resistance levels placed in context on our median map and clearly marked, dip buying becomes more comfortable, trading in the direction of the perceived longer term trend easier, and waiting for buying levels less like sitting on hot coals. I understand Joe when he says it is tempting but with extremes on the grid clearly drawn, and break-outs, particularly at the top visually represented, its easier to grasp the possible frustrations that could materialise if you short the market against your long term view only to watch it then break-out in the direction of your view. Besides, trading in only one direction will require you to make many decisions, more than you want to; trading in both directions will double this load. Try to minimize the amount of times you are required to ask yourself each day, should I or shouldn't I?

One percent – Take your profits when you see them, keeping in mind that a profit is not simply an in-the-money position, it's an in-the-money position that represents the culmination of your trading system which includes your median grid.

Don't overcomplicate median trading. Keep it simple: the market moves in ranging areas of around 300 - 400 pips; it may gyrate a few times at the median and cover the whole area without breaking either the top resistance or the bottom support; if you have identified such a median range correctly you can trade comfortably within that range.

Here is the arithmetic: say you have $10,000 on margin and you bought EUR right at the top extreme thinking it was going to break-out. It doesn't and instead it turns around and goes all the way to the bottom extreme, 300 points with gearing of 3:1. In worst case scenario you will be down 10% on your account, not nice, but no death blow. You are now at the bottom extreme with the option of buying towards the median. That is the worst case scenario. It can, and often does stop at median support, or you can scale out as it drops.

Understand that the median grid also gives you a context within which to practice risk management. Obviously any buy in the top area (above the median) is a higher risk trade than one below the median (assuming the trend is UP) because the pressure of the longer term trend will pull it up, towards the median, past it and towards the top extreme - offering more than your one per cent every now and then, and allowing you to take your profits in the 'top half' of the grid. It is not to say the top half can't be a buying level. It can, but it is a higher risk buy so adjust your gearing and number of open positions.

Break-Outs

A word on break-outs (when the price moves out of the median extremes, either top or bottom, and establishes new levels).

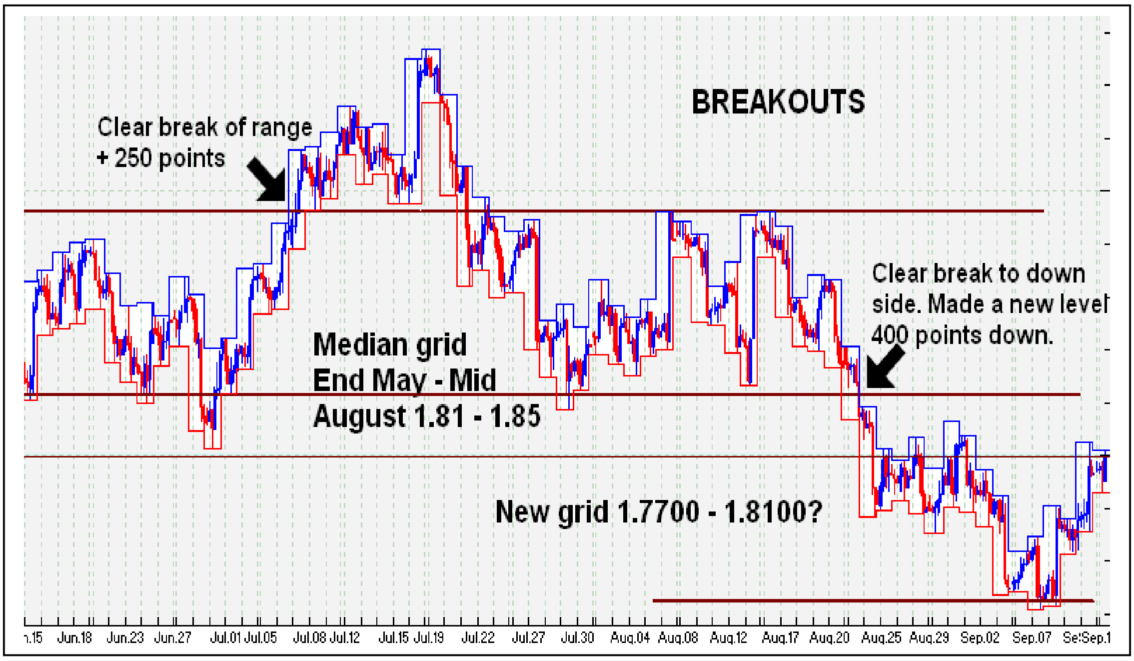
A trade, for example away from the median at the top side of an up trend, is no sure bet, but often you have been trading it up from the bottom extreme or the median and you are feeling confident riding the broad back of a bullish up trend. Pause, and think again. You are taking a chance, gambling on a break-out. The theory says that more often than not the price will revert to the median, go down. You need to be aware and sensitive to this. Try not to carry losing positions right through the median grid range if the price does revert. Losing positions should be cut based on the following considerations:

The emotional impact it is having on your trading and the degree to which it is preventing you from spotting and making use of good buying opportunities within the grid. How pre-occupied with temporary losing positions are you? This will depend on your capacity to take 'pain'.

It will also depend on your account size. Someone with a much smaller account, say $3,000, does not have the luxury of a trader with a $10,000 account and will start to feel the 'pain' sooner. (We are talking trading 10K lots here.)

Remember "scared money never wins" you must identify price ranges where you feel comfortable, and the moment you feel uncomfortable you must exit the position. No regrets. The ideal therefore is that the median trading range as presented by the market (i.e. the 300 pip top-to-bottom ranges, the daily 70 - 100 pip gyrations and the "noise" levels that could easily be 40 - 60 pips of the 70 – 100 pips), should as far as possible match your personal comfort zone as defined by your margin account size, the number of lots you have entered at different levels and the size of draw down per entry and trade you are prepared to take.

Picture 4.13.3: Example of classic breakouts



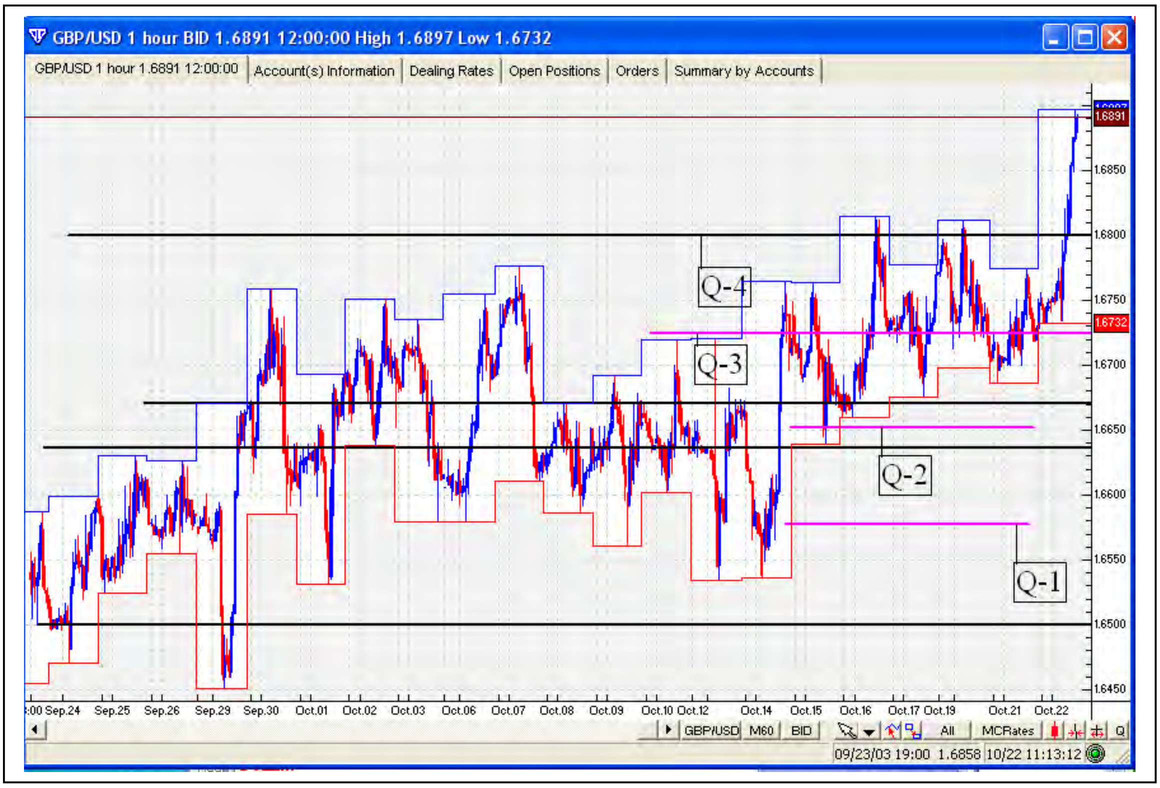
By creating a grid using the support and resistance most evident on a 60 min chart at the bottom and top of the screen and a level or range of about 40 pips roughly in the middle where most price action occurs you are really doing no more than superimposing your median grid on the bigger trend in order to gain a perspective and to create some fixed point in an ever-changing market without losing sight of your long term bias.

I remind Joe of the searching questions trading asks of us all. In this case it is putting to you the question, can you simultaneously grasp and hold, without apparent contradiction, a state of motion (trend) and a state of rest (the grid) and make sense of it. We have discussed the importance of being able to think in probabilities. Consider the median grid a visual aid or a graphic representation of precisely this sort of thinking. It may be useful for Joe just to briefly revisit what I said about thinking in probabilities. The first time he read this it may well have sounded contradictory, difficult and vague. What he now knows about median trading, and having learnt how to identify and then fix a median grid, I hope that he will have a clearer understanding of the dynamic interaction that takes place between randomness and probability.

Quadrants

You should further subdivide your grid into quadrants, four levels (300 / 400 pips divided by 4 quadrants equals 75 / 100 pips per quadrant). The bottom two quadrants will be your prime buying areas (Q1 and Q2). You will also trade up and away from the median in Q3, just above the median, but by now you should know enough to show caution in Q4 (the top quadrant). There will be times when, for a number of reasons, the chances of a breakout increase and then I like to position myself to catch that breakout. These reasons may vary. There may have been repeated testing of resistance or some important fundamental factors are telling me that a breakout is more likely than a retracement. If you are wondering why I keep the median lines horizontal rather than the more often used channel lines and trend lines, the answer is simple: the markets are dynamic enough, there is an overload of movement. I want to introduce some static, fixed reference points against which I can evaluate the latest price.

Picture 4.13.4: Median quadrants



EXITING A TRADE, A DISCRETIONARY EDGE

Though this is similar to profit taking it is not the same – I may want to exit a trade in order to stop further losses. The point is that I have discretion as to when I want to exit (close) a trade and this gives me an edge. Lets take a quick look at triggers for exits. The most important aspect that should trigger my exiting a trade is simply, do I have an acceptable profit to bank? If the answer is yes, I climb out. And if I am out-of-the-money, the question is equally simple, has the fundamental set-up that made me enter this trade changed? If the answer is yes, I climb out. Often, when managing downside one hears advice such as, if you feel uncomfortable with your losses then cut them. Though on the face of it this sounds prudent and reasonable I am not sure how helpful it is, particularly given the fact that I know how exaggerated the negative impact of bad news is. In other words, my position may seem worse than it actually is. The trick is to try and remain as objective as possible. By simply using an 'am I uncomfortable test' I may be imposing my psychology on the market. Of course, if my level of discomfort is of such a nature that it begins to cloud my judgment then I am better off getting out. It's something of a balancing act.

I coined the phrase ***'A profit a day keeps the bailiff away'*** when my own frustrations at seeing my profits vanish before I took them outweigh my patience to let them run. This is a difficult aspect of trading since letting your profits run remains a sound way to trade. But it is psychologically better because the pain of seeing your profit vanish is greater than your pleasure in taking it now. Think of it, if you are unsure, as an acceptable profit for the *trade*, rather than the day. The relative size of the profit is important. The profit size must be in line with and contribute to your personal time frame as well as chosen time frame. Just consider that the trades entered into below the median (trend up) will have more potential to mature into larger profits than those entered into above the median where you should be quicker in taking profits.

There is an old saying amongst traders, 'cut your losses and let your profits run.' That's a hell of a lot easier to say than to do. Also, exactly what this means may differ from trader to trader and market to market. But it has merit, and my approach of multiple entries allows you not only to reduce your risk but increase your profits. If you have two entries, allocate one as a short term trade. If your profit for the day has materialised, take it, and leave the second entry to mature. If the market then goes against you, fine, because you will now be at a lower, and probably better, price level for buying.

Joe has come a long way in a short time. His trading record is improving as he applies his new skills. His most recent trading report shows that Joe now has a real chance of becoming one of the 10% who trade successfully. But he is not there yet, and importantly, if he fails the next step, he'll never be there. Joe is applying what he has learnt very well, in fact he can't apply it any better. Yet, he is still not making money. You see Joe lacks the final ingredient to glue it all together. I've asked him to go back and just read through the introduction again, noting the metaphor of the highway, the issue of noise (irrelevant price movement, irrelevant information) and what I had to say about 'closing the gap.' This must be fresh in his mind as we get to the third pillar of **Real Time Analysis** called **Relational Analysis**. I want him to visualise the trader who has mastered the technical aspects of trading. He understands his system, he has a grasp of price action, he is a competent analyst, there is very little that he lacks. But it is that little that he does lack which makes all the difference. It's the gap he can't close, it's the gap the money disappears into. It's time for Joe to close this gap. The bridge he'll use is called **Relational Analysis**. This is what brings it all home.

Summary:
We have covered a lot of ground. The concept of median trading, its uses, how to draw up a median grid - look for major support and resistance over about a month's period, about 300 points from top to bottom – and finally how to deploy our 4x1 strategy using the methodology of our median grid. I have alerted Joe to expect prices to either just go up and down in this range swivelling around the median, or break either the top or bottom resistance / support and establish a new range where again it may just go up an down for some time.
As long as the price is within my median grid range I am in my comfort zone, because I can make a bad buy near the top and still be alive to trade another day if it goes all the way to the bottom extreme.
Further, the median grid helps me set some points of reference from which I decide whether a price is high or low or neither, relative to recent price action. Quadrants further refine my median trading and I draw my quadrants starting from the bottom of the grid and working to the top of the grid and create four quadrants numbered in order Q1 through to Q4. If the longer term trend is up, Q1 and Q2 are prime buying areas (trading towards median).

Chapter 14

Relational Analysis

Relational analysis is the skill of listening to what the markets are telling you, and making money from what you hear.

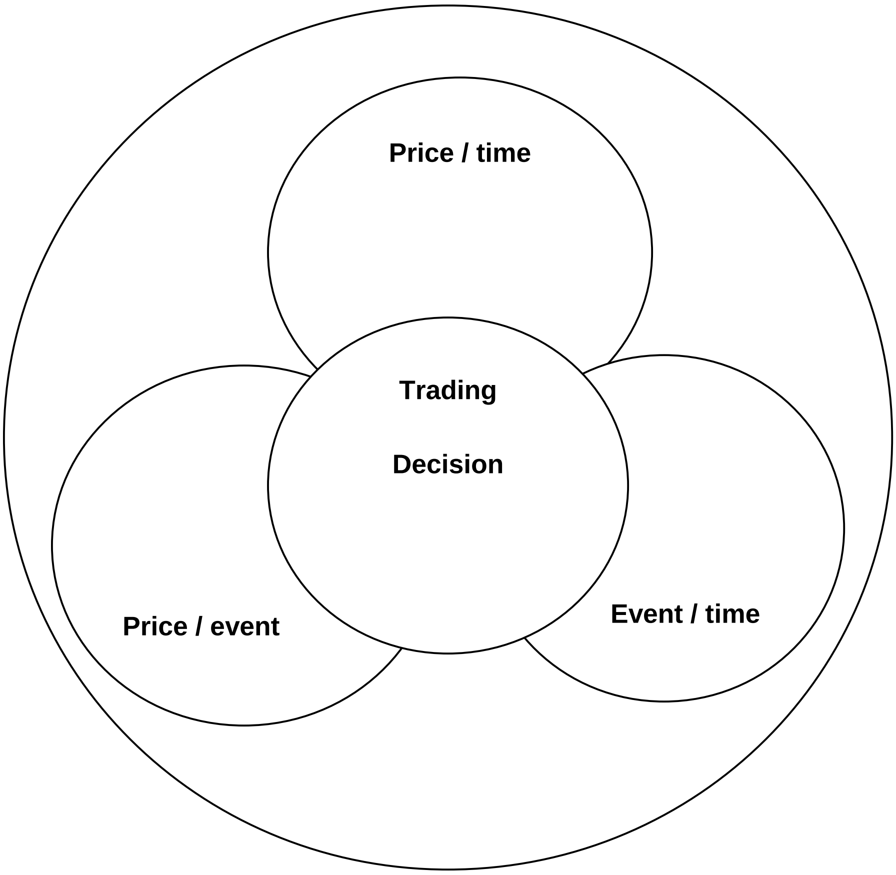
The character of the currency market consists of three interrelated components: price, event, time. The person standing with the lion's tail in his hand usually concentrates on only one or two of these basic facts, and excludes the third, or has a view of all three but doesn't know how to relate them. But it is the often complex interrelatedness of these components, and understanding them or not, which makes or breaks a trader. If a price has not changed significantly for a considerable amount of time, it is telling you something. If a price is changing significantly over a short period of time it is telling you something else. If an event (for example, a rate announcement) is a week away it will have a different affect on price than if the announcement is tomorrow. Markets discount the impact of events the closer they are. Relational analysis is the skill of listening to what the markets are telling you, and making money from what you hear. It is only one component of my system. I don't trade information without a strategy (4x1) and a context and a comfort zone (median grid), but its a very important component. It's what allows me to 'tune' my ear to the voice of the market, to get in really close. It is the passage that leads to the room in which the insiders are gathered.

PRICE –EVENT-TIME (PET)

My PET subject. It relates to not only what is happening out there but in here, in my head. A price may be low, relative to recent prices, but for you it may be high since you bought at the wrong time and you are taking out-of-the-money pain. It's an event taking place in your head but it is as important as an objective rate announcement. PET is about two sets of facts: those in the market and those in your head. All successful traders have their own version of PET. I just want to emphasise that mine, when dealing with events includes psychological events within the definition of events. It doesn't matter whether they are 'real' in the sense that an interest rate hike is real, or in my head. They are all real if they affect or influence my trading.

Time and time frames differ depending on the size of your account and the price volatility. The Bank of Japan (BOJ) has, compared to your $10,000 account, an infinite time frame. The BOJ has deep pockets and a big war chest. Their motive is not profit in the same way you are profit orientated. The idea behind PET is to enable me to trade my time frame and reach my profit goals without ignoring what the big players are doing. So by relating PET (price, event, time) one to the other and all to the whole, I make better trading decisions. If you ignore PET interaction and simply trade with Technical Analysis (TA), you will be at a disadvantage from anyone using PET effectively.

For now I want to take a closer look at what I call **real time information** and how to use relational analysis. In Part 3, I gave you an exposition of how the 24-hour-global FX-day runs its course, starting in the east with Sydney and Tokyo and ending in the west with the close of the US markets. Let's see what we can learn from this day.



GET WITH THE BEAT (THE RHYTHM OF THE DAY)

He who thinks everything must be in bloom when the strawberries are in bloom doesn't know anything about apples *– Greek proverb*

Most of us have a daily rhythm and if you don't plan to spend most of your time on currency trading, try to make only the smallest possible changes to your daily rhythm. Make these changes to accommodate the dynamics of the currency markets.

The centre of the currency universe is London, i.e. on average your best chance of significant moves are during London trading hours, in essence 08:00 CET (Central European time) 6 hours before EST (New York time) and about 16:00 CET.

By far the greatest volumes of currency transactions go through London, the second-most through New York, and then Tokyo. So whatever your current hours, this dynamic exists and plays an important role in currency price moves.

The global financial markets 'close' when the NYSE closes, i.e. CET 22:00.

I have instructed Joe to spend time watching CNBC. After a week we had a discussion. I asked him what he has learnt. He knows the name of the presenters, their time slots, he has noted the currency ticker in the bottom right hand corner of the screen. Joe is also suddenly bearish on the euro. This is interesting. Joe says a ‘big guy’ from a ‘big bank’ has called the euro down by 1,000 points before the end of the year. Joe’s worried. I ask Joe if he can remember this pundit’s name. Indeed says Joe, and when he tells me the name I pull up a monthly chart. I tell Joe that this self-same expert called the euro back to parity with the dollar after it had retraced from a high of 1.1850 to 1.0900 in 2003. Instead the euro stopped, turned, and is trading, at time of writing, at 1.2750. Joe did what most people do when they first watch ‘experts’ on TV. He believed them. They wear suits and they work for big companies with impressive credentials. They sound convinced of what they are saying. Unfortunately they know as much as you and I do, and often less. They’ve got to say something when interviewed and ‘I don’t really have an opinion at this stage’ will not get them invited back. But to verbalise to yourself that you do not have an opinion may be a very good trading decision at a given time. It’s no disgrace. On the contrary, it exhibits a sound understanding of the market. The point I want Joe to understand is that people who work for a salary, who get bonuses and company perks, live in a different world to you and me, the day trader. If the day trader is going to be cock sure, enamoured of himself, spouting certainties at the drop of a hat, he isn’t likely to have an extended trading career. He may however do well in television. Good traders keep to themselves just as they keep their heads down. They don’t boast or brag. They are cautious, sceptical and rarely venture opinions. That does not mean that I don’t listen to anyone or anything on TV. There are a few analysts I like, mainly because they take views and follow an approach I am comfortable with. Perhaps there is no inherent merit in my liking them since it may just be that you like what you are comfortable with and not because it is in itself worth anything. Whatever, I mainly use CNBC to feed me the basic facts – and that takes some analysing, distinguishing the chaff from the corn.

I have suggested to Joe that he not listen to opinions but look at facts and then form his own opinions. From now on Joe is going to be working full time developing a second nature, an information filtering system that allows through the big important pieces of relevant information and filters out the noise and irrelevant news. I’ve given Joe some clues as to what facts he needs to look at.

- US stock markets, primarily DOW at NY close
- What day - and time - important economic data releases (limited to US releases) take place
- “His” currency close and the daily move since then
- Gold close for the day
- If the day economic data was USD positive or negative

- If DOW ended on a high or a low or nowhere
- If the USD correlated with DOW, or not, at the end of trading
- Also, any news that came out in the last few hours (NY time) that might be relevant

That's it for now. I'm going to give Joe some time to see if he can start relating these facts to each other. While he does so, it's time for an intermission.

> **What distinguishes winners and losers in a market where information plays such a crucial role is, firstly what information they look at, and secondly what conclusions they draw from this information.**

If you really can't live without indicators then use my Land-of-the-Rising-Sun-Follow-through-Indicator. Sorry, I don't have a good name for it. But it works as well as any indictor and better than most, and I guess my tongue-in-cheek-title is to make the point that keen observation and sharp common sense can give you your own 'indicator' and you can give it any name you wish. Here is how it works.

Remember, there are three distinct trading days in every 24-hour day. First the Japanese arrive at their desks, check the news, check the client order books, have morning meetings, read the analysts' research and start trading. (Tokyo is the third largest forex centre). Then they have lunch come back and start winding down for the day. Just as they shut down their computers the European markets, and an hour later London, come on line. And shortly after they have returned from lunch the New York traders jump off the tube and settle behind their screens.

When I was studying exegesis (the critical explanation or interpretation of texts) I was developing a skill I never guessed would come in handy in the world of trading. Exegesis requires one to transport oneself into another time and place. What would it be like to be a Hellenistic Greek, a Corinthian trader, or a Roman consul? What did they think and feel, and why? This ability to put yourself in another person's shoes is a most handy tool for a trader. I've practiced putting myself into the shoes of Japanese trader's and institutions.

So, the first part of the trading day, while we are still fast asleep, takes place in the east, with Japan leading the pack in size and significance. What the Japanese trader is thinking, and why he is thinking what he is thinking, is important to me. Because when he shuts down, I go online, and, more importantly, London follows me an hour or so later. So, I don my kimono and put on my Japanese thinking cap and try to figure out why the Japanese trader has done what he's done. For example he has a long open position in-the-money at the end of his day (my morning). So he asks himself, is London going to take the market up and fatten his position further, or is London going to sell down and he better close his position. He is also thinking to himself that when London wakes up they are going to look back at how the East absorbed the news, read the market, and took positions. So when, over a period of time (several days), the Japanese trade the market up and come the end of their day the market is still up, i.e. they are bullish and because for a number of reasons they do not expect London to take it down, London tends to agree and a follow through ensues, pushing the market up. My daily briefing sessions to students and clients is in a sense nothing more than a value judgment on the Japanese position and what it may foretell for the day.

Think of the market as a very good chess player, a grandmaster. If you are an amateurish wood pusher with amateurish moves looking for fool's mate and easy advantages, you are likely to lose the game. You need to be thinking a few moves ahead, anticipating counter-moves and what your own reaction to these counter-moves is likely to be. What distinguishes winners and losers in a market where information plays such a crucial role, is firstly what information they look at and secondly what conclusions they draw from this information. Today, with 24-hour channels dedicated exclusively to business, the proliferation of newsletters, the Internet, chat rooms and guru get-togethers, the challenge is no longer where to find the information, but how to sift through it.

Now remember there is no consistent direct relationship between say, the DOW closing price and early Asian currency moves, but if day after day you note the figures, your subconscious will start picking up patterns and relations your rational mind can't and wont.

It's called "gut feel". You will develop this over time by practicing. You can't trade 24 hours a day. Get enough sleep and switch off so that you can start fresh. Information overload is a real danger. It can make you unsure and unconfident just as it can make you overconfident. It can also deafen your sceptical ear and rob you of independent thought. When everyone is saying the same thing I start to worry especially if they all say the same as what I think. Don't become a price watcher once you've taken a position. The price isn't going to change because you are watching it.

I would say there are two commentators that I quite like (both on CNBC). All that I mean by 'like' is that if they have a strong view, I will have to be pretty sure of myself to go against them. The first is, Ben Pedley (from Singapore) and Nick Hastings in London. Why do I like them? Let me be clear, they don't call the market for me but they do give me the very short term 'buzz', especially Ben Pedley who is the bridge between Asian and European trading. I come away feeling I have the latest important news. And that is what its about - I want the information; if I have the information I can put it into practice myself. So I like them because unlike a lot of other analysts they give me the facts uncluttered with their opinions.

It is not in your best interest to read or listen to too many opinions. This one says euro is going up, the other says it's going down. Two reports, two different opinions, which one will you choose? Add a third or fourth and soon you are confused. In general its about gathering the most up to date news, unadulterated and unfiltered by the analysts, and forming your own opinion based on this news.

The news has a rhythm, practice listening to this rhythm. Get used to the beat. It's background, a hum, a distant but ever-present noise, snatches of a global conversation. You are back at the ancient crossroads thousands of years ago where dates are being traded for salt, where two donkeys are worth a camel, and where gossip is exchanged. Its hard to believe that in this age of technical innovation and lightning communications, of great computers and sophisticated systems, that markets are still moved by gossip, by fear and greed, by human emotions. But they are, and learning how to listen to this global but ancient language will make you a better trader.

Always ask yourself, what are they thinking in Japan, London, New York? What are they feeling, and why? Transport yourself, put yourself in their shoes. We are all looking at the same information. No one has an inside track in the currency market. It's too big. The chief trader of Deutsche Bank is no different from you. He wants to make money. He doesn't like losing money. He is listening and he is watching. You must learn to do the same.

You know by now what moves currency prices. It's the big boys, the large funds, central banks, commercial banks and proprietary traders. Huge financial institutions do not decide, using TA only, where they invest millions or billions. They decide it on fundamental factors - economic fundamentals. It's very simple: They want to make a good return relative to other returns for a specific time frame, three months, a year or many years. They will shift millions or billions over international borders or between currencies, and park the money in the places they believe will give better returns. That's it. This is what drives currency prices:

- Interest rate differentials
- the hope of economic up-turns and equity market gains
- bond / treasury market investments
- gold and other commodity market investments

This was one of the tricks Joe was missing. I noticed a trade on his report that had gone against him, big. He had longed the euro, doing everything right. It was in Q2, his gearing was appropriate, he was trading it in the direction of his long term view. Except that Joe entered the trade one hour before a very important announcement concerning interest rates. The announcement was euro negative and Joe, instead of waiting until after the announcement to enter a trade, was now out of the money.

Let me recap. If you want to make money from short term currency trading you have to at least:

1. Take note of all fundamentals
2. Figure out the effect of fundamentals on short term trading
3. Never ever make a total boo-boo on the fundamentals. You'll end up dead.

Joe tells me he is having difficulty in getting to the bottom of what I'm saying. That's all right. We are dealing here with multi-layered and complex issues. I am going to explain to Joe what I mean borrowing from the world of soap operas.

THE DAILY SOAP OPERA

News is like a soap opera. It has a "flavour of the day" - Dick has just expressed his love for Dora - and a storyline, for example a dynasty in danger of being swamped by tragedy and internecine fighting, turns to its youngest member who must leave behind his callow youth and take up the mantle of responsibility in order to save the family legacy. The story line is the bedrock. It doesn't change quickly or easily. Flirtations and new affairs are frequent. There are many flavours but only one story line. Dick's love for Dora is a flavour, unless it goes to the heart of the story.

Learn to distinguish flavours from story lines. At the time of writing (beginning 2004) the story line is strong euro, weak dollar. The flavour may be a dollar positive event causing temporary weakness in the euro before it re-establishes the storyline.

In practice this typically involves announcements of figures (production, payroll, inflation) that represent flavours, but which may over time, if consistently pointing in one direction, start to alter the story line. Dicks' love for Dora is starting to threaten the dynasty. Previously it was a side issue, considered by all to be a passing fling. An economy can basically be in one of two phases, an up-turn or a down-turn. The relevant fundamentals differ vastly depending on the phase. During a down-turn eyes are focused on signs of improvement. The down-turn or up-turn is the basic story line.

We focus on the engine room of the economy – IP (Industrial Production), job creation (less lay-offs), inflation, PPI (Production Price Index), CPI (Consumer Price Index), etc. These are the ‘flavours of the day’. During the first phase of the down turn one usually has dropping IP (Industrial Production), rising unemployment, and so on. After a while, and after interest rates have been lowered and other measures taken, the market starts to expect improvement so they anxiously watch the IP and PPI growth (Production Price Index), employment reports, durable goods orders and consumer sentiment surveys. During an upswing the market is worried about 'overheating', so everyone watches 'inflation', CPI (Consumer Price Index) and PPI. If PPI and CPI are above target or too high, interest rates will be increased to cool-off lending and accelerate contraction of money supply.

So now I’ve got Joe watching CNBC thinking ‘Days of our Lives.’ You’ve got to love trading. During my daily briefing session with students I discuss and analyse with them the story line, the flavour of the day, and how the two are interacting. We watch and closely monitor the soap opera. If a new character appears on the scene we immediately ask ourselves how he might affect the balance of relationships. Joe’s got the story line down, now I want him to relate the flavour of the day to it.

The crux of analysing economic data is to work out to what degree the market is focusing on it.

No data release stands isolated. The most important economic data is the US data. It must be seen in the context of other related releases and also the previous releases of the same data. The figures themselves are not that important, but the *expectations* of the figures are. So is the number of releases contra expectation. Say for example there is great expectation for a series of good figures and instead they all come out badly, the market will probably react viciously on the last release of the figures, because 'it all adds up'.

If one release is unexpectedly different from the rest it will usually cause a very short-term reaction because it is a new flavour rather than a change in storyline, but given the context, the market will wait and see what happens next month. If the following month’s release confirms the unexpected shift of the previous month, a larger reaction can be expected because punters may now be talking of a new story line rather than just a new flavour.

The crux of analysing economic data is to work out to what degree the market is focusing on it. Speculators take positions on the expectation that a release will support their position. If the release is contra their expectations a wild covering of positions ensues leading to short term volatility as some traders cover their wrong positions and others take profits on the covering (and their 'right' positions). There is scientific data on this. After any release with an unexpected outcome there is very high volume and excessive volatility for 15 minutes, more (than usual) volatility for 2 hours, and then everything is forgotten after another 2 hours and it's back to normal. I very seldom trade announcements. They are just too tricky, too many knee-jerk reactions and whip-lashes.

THE RIGHT THING THE WRONG WAY

Let's revisit the trader who does everything right but gets the wrong results. Why is that? He is reading everything right, but it just won't work. It's the old void, the hole between what he is doing and reality. The problem is largely in his head. He is involved in 'past time analysis' or 'crystal ball analysis' or 'Stochastics analysis' instead of a type of analysis that will reap dividends – **real time analysis** is one option.

The theory of TA is that everything you need to know to predict future movements can be gleaned from past prices. I've never understood what that means. Over the last year for example (2003) I bought euros. TA was telling me sell, the price is overbought**, real time analysis** was telling me the opposite. The euro strengthened. I get better results looking at the present (real time) than at the past (TA).

But be careful, there is a lot of information. When I talk of real time information I mean *relevant* information. The trick is to take just what you need. Interestingly, though I believe psychology plays an important role in trading, the advocates of a sound psychological approach to trading tend to neglect info and particularly real time info. It is irrelevant whether the info or the event is out there or in my head. It doesn't matter. All that matters is whether it affects my trading. If it does, it's an event and I take notice of it. If my wife is sick, it's a real time event, if my goal has been achieved, it's an event. If the price is low, but for me, given my situation, and all things being equal, is high, then it's high.

Let me give you some practical examples. From 11th November 2003 to 11th January 2004, using no more than 2:1 gearing I returned just over 60% on my accounts. However, from 11th October to 11th November 2003, I lost 20%. These were significant events that I had to factor into my trading. When I was losing I was thinking: my goals are receding in the distance, I am not reading the market, I'm losing, I'm wrong. Prices suddenly all seemed high. Any swing made my stomach lurch. In this mood a 1% profit or loss on my portfolio was just that, 1%, but it's internal cost was much higher. I was standing too close to the highway, there was too much noise and all I could see was a blur. By the time 11th January arrived the real time info in my head was different. The prices swung and it did not bother me, my goals were clear, I was less emotional.

I did the best thing I could do given my emotions and state of mind. I stopped trading.

It is easy to say you should trade unemotionally. I don't think it's possible. Everyone takes pain. To tell someone to trade without emotion is a fatuous piece of advice. But recognising that your feelings and personal events are events similar to rate announcements, for example, helps. Recognising that you are not in a state of mind to trade is a cultivated decision that can save you a lot of money. I had been longing euro since it reached parity with the dollar. I kept longing it up to 1.1850. It went a little further (1.1933) and then made a big retracement to about 1.0750. I wasn't sure of my long term view anymore. I shorted the euro. I lost money. I realised I didn't know what I was doing. So I did the best thing I could do given my emotions and state of mind. I stopped trading. In June and August of 2003 I simply didn't trade. It was tough at first, but it was the right decision. I got my perspective back and climbed on the euro revival wagon in September. I had some technical hitches with my trading platform recently. It was tiresome and very frustrating. I squared all my positions until the problem was sorted out but I was still giving my daily briefing to clients and students even though I was not actively trading. When I read my calls now they seem especially lucid and accurate. Objectivity, distance, perspective – I think it's less a quest to turn yourself into an ice man than to recognise your limitations and to act decisively when your emotions are affecting your trading.

Joe has been watching TV now for longer than can be good for anyone. He says he is not sure what he has heard or learnt. Joe is underestimating himself. Before I asked him to watch CNBC, I had sent him a copy of one of my recent mentor chats and asked him to read it. He confessed that he could not make head or toe of it. He said it was English but that was about all he understood. Joe had not been primed. Now the same mentor chat made a lot of sense because he understood terms, references, words, analogies. Joe's ear had become attuned.

>> Chance favours the prepared mind (Floor Is Open To All Users)

:DrForex > Hi there
:DrForex > Just want to listen to man on telly
:DrForex > BOJ no rate change
:DrForex > BOJ sold 203 billion dollars yen to keep yen steady
:DrForex > trade deficit today
:DrForex > budget deficit 521 bln
:DrForex > UK CPI today
:DrForex > no fireworks expected
:DrForex > there is a note about eurodollar contracts, yesterday a massive 312000 contract short dollar were closed
:DrForex > the interesting thing is the shift to dollar long (shorts were closed)
:DrForex > probably the reason why Asia today had no interest in euro or gbp
:DrForex > Review:
:DrForex > :DrForex > the risk is in that simple saying, if it should go up and it doesn't it ill surely come down
:DrForex > :DrForex > one must just keep that in mind and not unnecessary add positions willy nilly
:DrForex > :DrForex > right at the highs just because time went by
:DrForex > I had that in mind or later today
:DrForex > GBP made a spike to 1.8650 and there was something to bank
:DrForex > but euro went nowhere since Friday morning
:DrForex > with big time retracements
:DrForex > I think best will be to wait for the trade data today before considering to re-enter
:DrForex > and altogether be more patient on further additional) nilly willy entries
:DrForex > Russian banking crisis ...
:DrForex > slashed capital reserve requirements in half ...
:DrForex > that may cause some 'flight to dollars'??
:DrForex > yen gave back 130 since yesterday morning
:DrForex > I just think there were too many short term speculating dropping dollars
:DrForex > and with central banks not joining the party the momentum ran out
:DrForex > I'll rather wait for further weakness this morning before acting
:DrForex > Gold down in Asia to 403 (-3.5)
:DrForex > oil flat @ 39
:DrForex > DOW flat +25
:DrForex > futures flat +5
:DrForex > PLAN:
:DrForex > with euro just 20 points above post jobs report support see it tested
:DrForex > and gbp maybe to test 1.8500
:DrForex > with support holding one can look at buying, but if it breaks
:DrForex > and US figure is better than expected see another 100 points down
:DrForex > which will then be a buying level I think
:DrForex > but for the moment first look for the test of support as indicated
:DrForex > eur around 1.23 piercing it down to the 1.2270
:DrForex > i.e. the support LEVEL is that 1.2270 - 1.2320 post Jul 2
:DrForex > I don't think GBP will go back all the way to 1.8300 support, but you never know on a bad figure today
:DrForex > market is still thin because of holidays also and GBP usually have an elaborate downside
:DrForex > OK, that's it, no one way good news this morning back to hard grafting, teeth gnashing, stomach churning, hand wringing, dip buying
:DrForex > eur 1.2360; gbp 1.8560, jpy 108.60

Summary:

Trading in the currency markets is more than having a strategy. It requires real time information to make real time analysis in order to make a real time decision. You have to put this all together and it takes practice. Ninety percent of traders can't, they want something cute, neat, simple. That's why there are lots of losers and only a few winners. You have to take into account the interrelatedness of all financial markets, stock exchanges, futures prices, bond markets, oil market, gold market, and not just their individual prices. Institutional and other large investors are active in all these markets. For our daily purposes the most important market is the futures market. I check the futures index early morning and then later on when the CME (Chicago Mercantile Exchange) opens. This gives me an indication of the prevailing mood. Some traders look for meaningful correlations between the NYSE (DOW) and USD, but beyond a certain point, and that point is reached very quickly, they are wasting their time. What you can look for and find, with practice, is a feeling, a rhythm. The story line is fixed, until it changes when you least expect it. By watching each episode of the soap opera you will be in a better position to anticipate this change and react quickly to it. With time and experience you will get the feel for what is important, what may be a turning point, what is noise and what is meaning.

Real time analysis is necessarily a holistic approach. The traders who fail generally make the same mistake. They try to reduce trading to one little aspect, for example the 'trigger' that makes them enter the trade. The eternal struggle to time their entries in the hope that they will never be out-of-the-money. One needs to have a holistic approach. Psychologically it is not easy, scientifically it is problematic (randomness, probability theory etc). One needs an inner drive to beat the odds, beat the market, and beat yourself. It is not a simplistic exercise that can be mastered by learning a few tricks called 'technical analysis' or 'fundamental analysis', or 'trading psychology'. Nothing works in isolation in trading. Because the market is complex it requires a large view. **Real time analysis** does a job for me. It takes my 3% house advantage as if I were the casino and transforms it into a higher probability for trading success. It makes me the casino, not the punter. It relates disparate pieces of information and places them in lucid perspective so that I can make good trading decisions.

Chapter 15

Risk Management

I had to pull back, which I did with alacrity because my principle is to survive first and make money afterwards

– George Soros, speculator

Live to trade another day is what Mr Soros is saying, perhaps the most important risk management principle of them all. If for some reason you are in a position which threatens your trading career, act immediately. Tomorrow may be too late.

I have watched Joe develop over the last several months into a competent trader, a little rough around the edges, but on his way to leaving behind the 90% who don't make money in this market. But the currency Joe has been trading has made a deep correction. Joe's equity is looking sickly. He is down 50%. His positions are all out of the money and each day they are getting worse. I ask Joe what he wants to do. He says he doesn't know. Joe looks at me blankly. It's not his fault. So far Joe has only learnt how to make money. He has not learnt how to manage a losing position. Strictly speaking this is not true. Joe has learnt quite a bit of risk management, but it is not directly related to the ugly situation on his screen.

LIMITING RISK

Risk comes from not knowing what you are doing

– Warren Buffett, Investor

Stop further losses

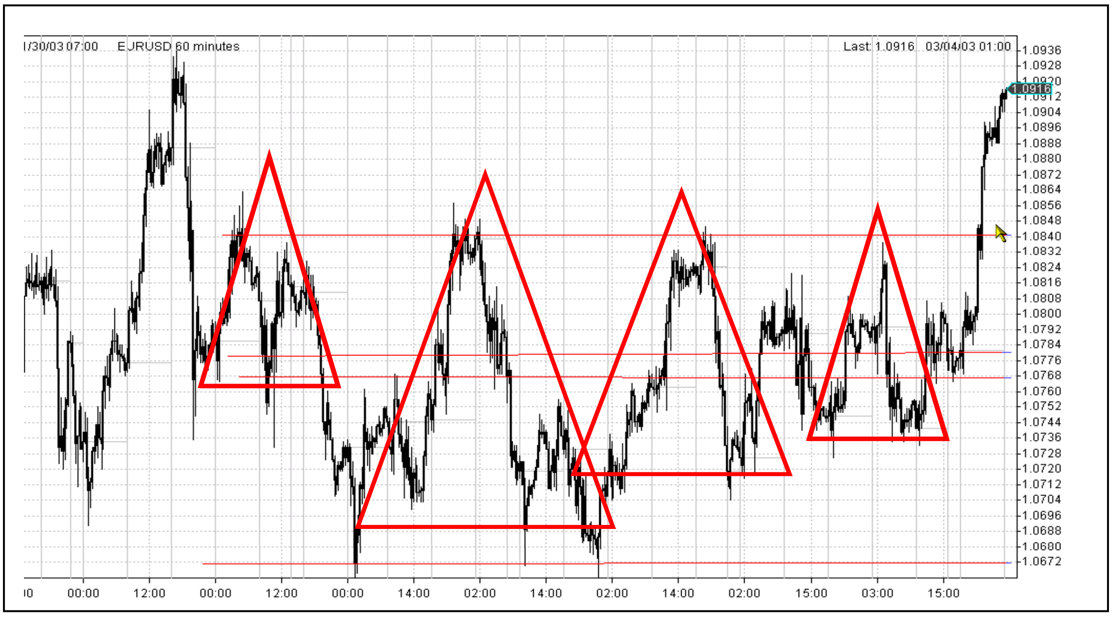
Risk management doesn't start with where you decide to put your stops or cut your losses. A consistent feature on the landscape of losing traders is stop losses. They rise above the charred earth of a wrecked trading landscape like big, ugly boulders. Most losers think that the alpha and omega of risk management is to learn how many pips away from your entry to place your stop loss orders. That is not the way to manage downside. Stop loss orders are certainly a feature of risk management, but they are only a footnote. Horror, cry some traders, heresy cry others. What are you on about? Don't you know the old adage of cutting your losses and letting your profits run? There are many ways to skin a cat. Losses can be cut in a multitude of different ways. Stop losses are not the only way to contain losses and in my opinion, when they are used they are either overdone or not properly applied. And, yes, let your profits run and do cut your losses. The question is how?

But the first thing I want Joe to realise is that he has already been applying risk management strategies by limiting himself to one currency, low gearing (and multiple entries) and one direction. If you take less risks you have less risks to manage. Cold comfort, says Joe, look at my position. But Joe is wrong. He has been trading demo for three months and this is his first serious draw down. Most rookie traders will have two drawdowns in the first month. So Joe *has* been 'managing' his risk, he just hasn't been aware of it. First I want Joe to understand this before we turn to his 50% draw down. Because it's paper money, Joe agrees, but I can see he is a little edgy. That's good, Joe is taking his demo trading very seriously. The gap between demo and live trading is big. Though you can never close that gap, the closer you simulate real conditions and entertain real feelings about your demo trading, the smaller the gap. I just want to mention this because it is related to risk management. Your attitude to money plays a role and shapes your attitude to trading, and specifically losing money. Many of the top traders have disciplined themselves into an attitude were up and down are pips on a screen not dollars in the bank. This helps. Often novices are wildly successful on demo but crash on live trading. It's because on demo they were seeing pips and decisions came easy. Live they were seeing dollars and losses hurt more than they could handle. Let's take a quick look at our 4x1 strategy and its inherent risk management virtues.

One currency – Focus, simplicity, knowledge.

One direction – There is an optimal amount of trades you can make before you are trading too much. The tendency to lose money as a result of over trading has been statistically fixed, there is a direct correlation and though it may vary from person to person, over trading is a danger. Our one directional approach has a built-in trading hand-break (Q4 of the median grid). You will recall that it requires patience, waiting for the dips to form, a time for waiting not for trading. Because Joe has been using this strategy he has traded less. By trading less he has brought down the risk of losing money. Good risk management.

One lot & multiple entries – Low gearing that allows for multiple entries and cost averaging. I have a few 'darlings' in my trading family and multiple entries is one. It just makes so much sense that I can't imagine trading any differently. Not only does it improve my odds on success, it represents my mindset, my approach to trading. One entry, one loss, one profit is representative of a different mindset, an all-or-nothing approach which the currency market rewards with loss. Think of multiple entries as a form of pyramiding.



You can build an ordinary pyramid or a reverse pyramid. Reverse pyramids come from the 'investing world' where time frames are much longer. They don't work in short term day trading. A reverse pyramid means you will identify the trend and buy say one lot at the lowest level. As the trend develops and you get into the money you buy more lots with higher gearing. For example, you buy one lot at EUR 1.1500, keep it and buy two lots at 1.1600, keep it and buy three lots at 1.1700, keep it and buy four lots at 1.1800 and so on. You can see an obvious flaw. Even a small retracement will write off most of your profits. A better approach, should you want to buy on the up (in the direction of the fundamental trend), is to decrease you gearing as the market goes up, or, if it is dipping to buy with low gearing, and if it dips further to buy again with higher gearing, broadening the base of the pyramid.

We trade intra day and within comfort zones of about 300 pips, and since we want to trade the volatility we need to work with our different price levels and quadrants by increasing gearing in the levels below the median and in the levels above the median one can still trade in the direction of the trend but with lower gearing.

COST AVERAGING

This is nothing other than one of the must prudent investing principles ever developed: cost averaging. It is the basis the mutual fund (or unit trust) industry builds on. A mutual fund consists of units with "X" price based on underlying stock prices. If the price is high you buy less units. If the price is low you buy more units. But the unit price is depended on the underlying stock prices. If you have $100,000 investing capital and you buy a mutual fund at once with all the capital your timing risk is especially high. It can be the best buy or the worst buy depending on what happens on the stock market in general. If you do not want to take that risk you can scale in your buying by cost averaging the price at which you buy. You will for instance buy $8,000's units on the first of every month. At the end of the year you are fully invested and you have bought in total at a price cheaper than the highest and dearer than the lowest. You have prudently limited your most significant risk, namely short term timing risk.

When and How?

Proper downside risk management asks only two questions, when and how? The two are related. If the answer to the question 'when' is now, then the second question 'how' comes into play. Joe is sitting with a 50% draw down because he didn't have an answer for these two questions. Joe had neither quantified the loss he was prepared to take nor thought about ways to minimise it and so he had watched out-of-the-money positions worsen and worsen, paralysed to do anything. He missed an edge by not quantifying what he was prepared to lose *before* he started trading. It would have cost him nothing, his mind was clear and there was no pressure on him. Instead now he is down 50% on his capital and that is not a nice place to start doing your draw down sums. It is therefore very important for you to be clear on what you are prepared to lose before you start trading.

Let's say a 25% draw down is the most pain Joe wants to take. But 25% is not the answer to his 'when' question. Joe must not sit around passively and watch until the 25% 'when' question is answered. What's he going to do then? Hope the market turns around and goes back up? Because that is all he can do. By being passive he has denied himself the opportunity to act. Joe should start asking the 'when' question at 10%. If he does that the 'how' question follows.

Essentially what Joe has done by fixing a point (10%) is he has said to himself that this is no longer an opportunity, a dip, I'm looking at a problem. How do I fix it?

Joe can decide to close all his positions and take the loss. But that doesn't make sense because then Joe is back to the situation sketched above where he waited for the 25% draw down and bang! The all-or-nothing approach. In other words if Joe wants to take all his losses at 10% of his total capital he should be asking 'when' questions before 5% draw down is reached. Joe can decide to scale out of some of his positions, reduce his gearing. After that, if he thinks some sort of support has been reached, he may even want to buy again. If Joe decides he wants to do that it should still be with downside risk management in mind. That means that should his buy turn to profits he can consider off-setting it with an out-of-the-money position to further reduce his gearing with no net loss, or a small one, or even a small profit.

The option of hedging is also open to Joe. Hedging is when you buy and sell the same currency. Not all market makers offer hedging as described above. It can however be achieved by trading on two accounts. Say Joe is a 100 pips out of the money on a buy. He's view is that the market will continue to fall, at least in the short term. Joe can hedge his position by opening a sell. Now his position is safe from further deterioration. Hedges can buy you time, and give you and opportunity to sit back and devise a strategy, but they can also be complicated to handle and I would not recommend them for the novice.

I want my risk management strategies and particularly the way in which I handle my downside to be in line with my overall philosophy of trading. My strategy and methodology for taking my losses is the same as for taking my profits. A one shot, one off, all-or-nothing, take losses too soon or take them all at once is as counter-productive to my success as a trader as this approach would be to taking my profits.

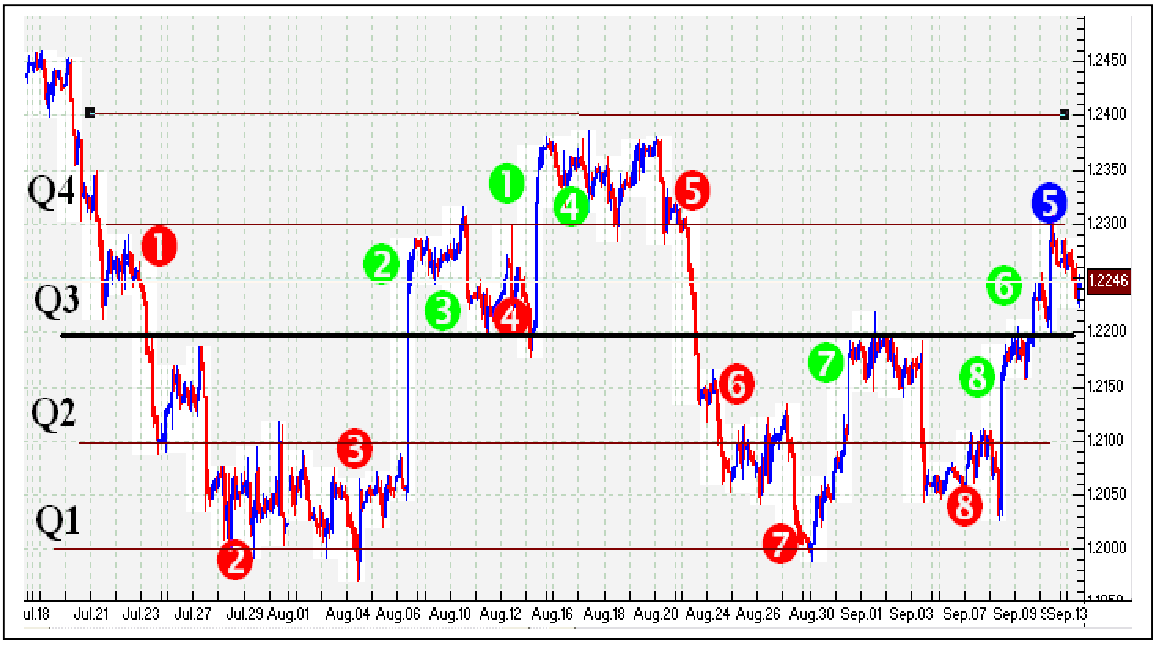
Up or down, in or out of the money, my basic approach to the market does not change. You can quantify your loss beforehand. That, and the fact that you can manage downside, are odds in your favour. These are odds which many unsuccessful traders ignore, partly because it involves the unpleasant business of losing money, partly because when losses start mounting cool heads turn hot. The blackjack player can only manage his loss, a bad hand, by hoping the dealer busts. The odds are against him. If the dealer is showing an ace, and the player is holding a weak hand, the likelihood of losing his bet, all of it, is high. The blackjack player has to see it out, he can't wait for a new dealer, tomorrow, new house rules. In minutes he will be asked if he would like another card or if he is staying put. He can't ask to surrender his bet in order to buy time or to wait until the dealer dies of old age. He must finish the game. It is all or nothing.

This is not the case with trading. You can wait, and scale down or scale out your entire position selectively. This would be like having the option to wait for a new dealer, or having the option to reduce your bet. This is a big advantage and yet it is often overlooked.

Let's put some figures to these concepts.

Let's assume we are trading EURUSD with a fundamental view that the euro will strengthen. We are confronted with a median grid of 1.2000 to 1.2400, with some small, temporary overshoots on both the lower extreme and higher extreme.

We have $10,000 on margin and we are prepared to gear our total trade exposure up to 15:1, preferably not more than 10:1, and then over a large price range only. Per entry we will gear 2:1.



1. Entry in Q3 after nice dip at 1.2250
2. Entry #2 in Q1 at 1.2050, carrying $400-00drawdown (4%) on #1
3. Entry #3 in Q1 a few days later at 1.2050 after flirtation with lower extreme (support), gearing now 6:1. If data release kills us we lose roughly 8% on taking the knock on clear break of lower extreme. If we are lucky we drink champagne.
4. Exit #2 in Q3 at 1.2250 for excellent 200 points = **$400.00**
5. Exit #3 in Q3 at 1.2200 for 150 points = **$300.00**, still carrying #1. Now back to 2:1 gearing.
6. Enter #4 in Q3 (things look up) at 1.2250.
7. Exit #1 and #4 in Q4 at 1.2350 for 200 points and another **$400.00**
8. Enter #5 at 1.2300. Oooops.
9. Enter #6 at 1.2150. Oooops. A few sleepless nights.
10. We are geared 4:1, far out of the money, but close to support of lower extreme and enter #7 in Q1 at 1.2000. Up to 6:1. Prayers to the gods. *They who don't take risks don't drink champagne. They who don't take risks don't drink champagne. They who don't take risks don't drink champagne. End of prayers, time for action.*
11. Pop the corks! Exit #7 in Q2 at 1.2150. **$300.00.**
12. This is fun. Enter #8 at 1.2050 in Q1.
13. Pop the corks! Exit #8 at 1.2150 in Q2, exit #6 in Q3 1.2250 for **$400.00.**
14. This leaves us with #5, slightly out of the money and **$1,800.00** profits or 18% on our capital. Not too shabby considering we are trading euro up and the net price move was euro down and most of the time we were trading in a technical down trend!

When you trade currencies you should limit your risk in exactly the same way. This is the purpose of multiple entries at different levels. You average your cost of purchasing the currency. You are only fully invested if the market did move from your first benchmark entry at a higher level in your median grid to the lowest level, Q1. You did not take unnecessary risk at the higher levels, nor at the lower levels. Time is also on your side, by cost averaging you will be amazed how many times the market turns in your direction just as you are fully invested. It has to do with that greatest virtue of them all for traders - "patience".

You can therefore see how to use multiple entries to adjust your gearing and risk. Your risk and money management thus centres around gearing and the one lot, one direction, multiple entry strategy.

MORE ON STOP LOSSES

My students and clients who come out of a trading background where stops are the alpha and omega of their risk management technique have some difficulty in adjusting to my approach on stop losses. I think some of them even experience it as cavalier, which it is not. My approach is well considered, tested and produces consistent results. I am not passing comment on systems that use stop losses except if those stops are too tight (placed too close to the entry level). They don't work. You are not seeing the market for what it is, a volatile agent which will stop you out more often than not with its random intra day movement.

Prudent money management says your average loss size should be smaller than your average profit size. In that case even if your win-loss ratio is no more than 50% you will make money. I can't fault the logic, it is just not my approach. I do not advocate a money management approach where you only have a 50% success ratio of positive entries. On my managed accounts my ratio of profitable entries is 85% and better. Perhaps it boils down to the same thing. If you have a high percentage of profitable trades you can afford to have bigger losses because you have less of them. It is a difficult one this because as soon as you admit that you take bigger losses than profits you are flying in the face of the old truism, cut your losses and let your profits run. But on closer examination I don't think you are. Here is why. What is a profit?

Remember the old sensei who took his profits when he saw them because he understood that each profit, when he took it, had done its work and was the end product, the culmination, of his entire strategy. He does not want to 'stop profits' with stop losses. A stop loss must never be a 'stop profit.'

A profit has a life-time and part of that life time it may spend out of the money. Letting 'a profit run' includes all of its life and that includes the time it spends on the wrong side of the tracks. A profit shouldn't be your pal only when it comes into your neighbourhood. I let my profits run, both when they are in- and out-of-the-money. At some point an out-of-the-money 'profit' has lost a lot of its potential to make good. I know when this moment arrives because I have quantified my downside and when this potential profit reaches the first of my warning zones, I no longer treat it as an errant friend capable of reform. Don't marry your trade but give it a chance to make you happy.

A rule of thumb for when you should seriously think about stopping a trade out is when the existence of the set-up that made you enter that trade, no longer exists. Remember the set-up has not disappeared simply because you are out of the money. Many factors, including gearing may play a role. Your comfort level plays a role, psychology plays a role, you may have a sick child, trouble at work, it doesn't matter what it is but if it's playing a role it's playing a role.

I want Joe to understand that stops can be used in different ways. That sometimes they are about protecting profits instead of cutting losses. And stops should be placed with due consideration of the support levels in the market. For example, if you buy euro at 1.1800 and there is strong support at 1.1720/40, place your stop below 1.1720, even below 1.7000. **The ideal of course is that no stop is triggered.** If you place your stops beyond support levels you are increasing the odds, even if only slightly, that the market will not trigger your stop. Buying on dips also increases your chances of not having your stop called into action. If you buy a dip of say 50 points from the most recent high and place a stop 100 points away from your buy it is 150 points below the recent high. Generally a stop of 30-40 pips from your entry is too tight.

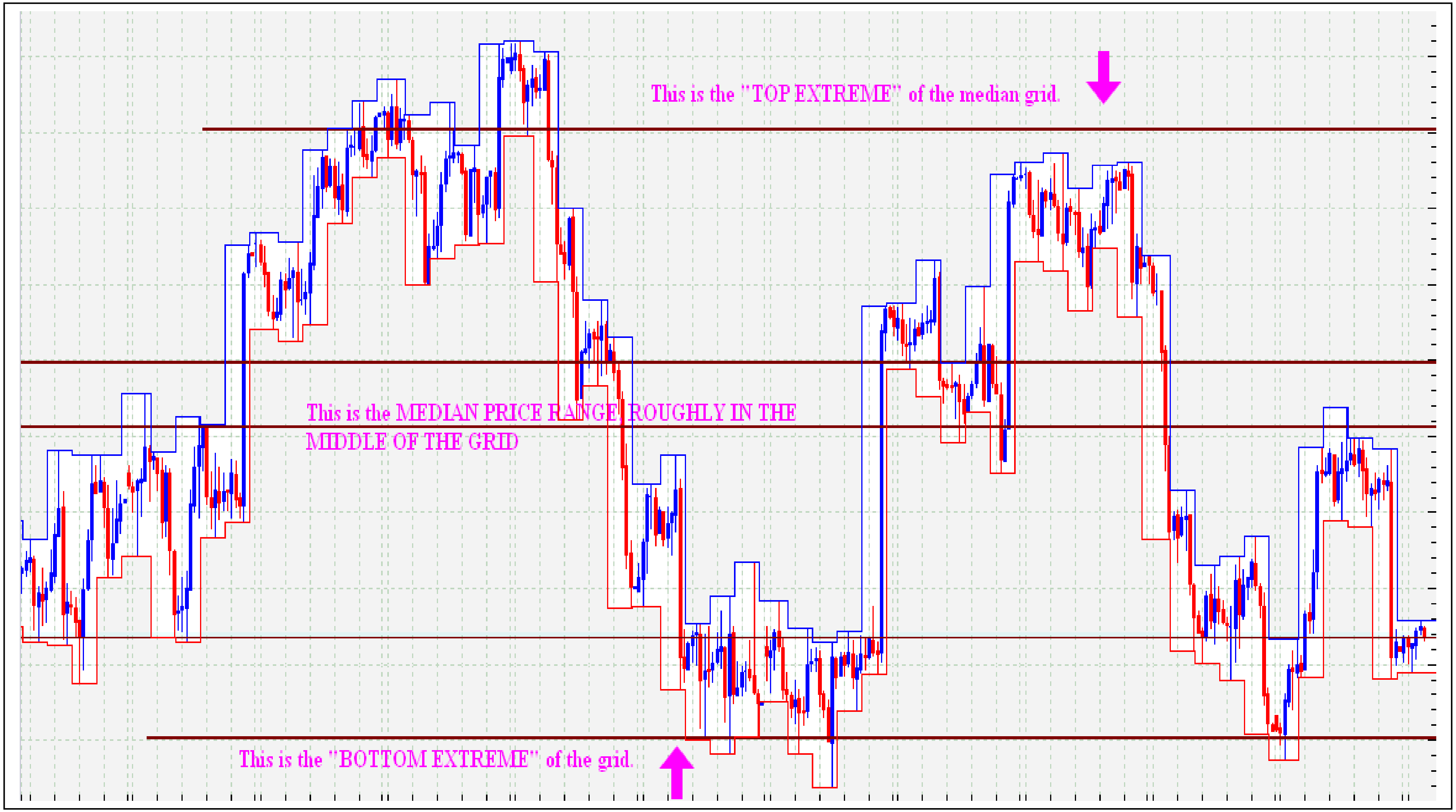
Let's get back to Joe's problem, his 50% draw down. Joe is going to have to take some pain. And he is going to have to apply what he has learnt, retrospectively, that is, he will have to shift his draw down to 75% and start to manage it. I would not recommend this to Joe if he was trading live, but since it's a demo Joe can practice. Taking my advice, he scales down some positions and banks some losses. His gearing is a little lighter. He gets a perspective of where the price is relative to recent price action by looking at his median grid. Still confident of his long term view (one direction) Joe enters a buy. He has quantified his downside at 75% (remember please that it is only for purposes of this exercise that Joe can gain experience in handling a draw down. I do not recommend 75% as a draw down figure) and this brings him some peace of mind. He has drawn a line in the sand. Two weeks later Joe promptly informs me that not only has he handled the draw down with a total loss of only 10% but he is back in the market with in-the-money positions. Joe may have been lucky, the market could have gone down further, but the point is that Joe gave himself a chance. He did not panic and close all his positions at once. He did not just gear up, hoping to buy himself out of a mess. In fact he did not do anything that was not the mirror image of what he would have done to make profits. In short Joe was consistent and was 'rewarded' by a loss that was not fatal.

During our struggle with this text the last few months I got some startling new insights on how to actually apply my main premise on stops. "Place a stop where it will not be triggered". A stop-loss is actually a "stop further losses" on a trade and losses only occour on trades, not on the individual entries making up the trade. This must be well understood. Is it at all possible to trade without stops, in the sense that a stop does not result in a net loss "at the end of the day"? Can we prevent the appearance of a black swan to turn our little apple cart? The answer to this question is yes, I believe. The concept is simple. The application difficult. To understand it you must however be very well trained in the concepts described in this book. I invite you to explore this together with me by contacting me at drforex@dayforex.com.

Summary

Proper risk-management is an edge that you must cultivate. It starts with your low gearing, multiple entries, and one directional strategy. If you build pyramids have them pointing up with the broadest part of the base at the bottom. Don't use stops to stop profits. Quantify, beforehand, what your draw down maximum is, and plan, before you reach it, how to minimise your losses. This will cause less pain. Minimising your losses in line with your trading system. If you do this your handling of losses will mirror the way you handle your profits.

Median trading basics



CONCLUSION: THE LUCKY FOOL

…the lucky fool, defined as a person who benefited from a disproportionate share of luck but attributes his success to some other, generally very precise, reason.

– Nassim Taleb

What is all this stuff we have been talking about? What have we really been saying? I'm asking because Joe looks like a rabbit caught in the headlights. He's got too much information to relate, 4x1 strategy to median trading within the context of Price-Event-Time, checking his goals, taking his profits, oops, a slip on gearing, this is not a dip, what's my draw down again…? Chuck it out the window Joe. If it's all too busy get rid of it and replace it with a very simple picture that looks like this. We are taking a bet, a well considered educated bet. The bet is that we have correctly identified the medium or long term trend and that we are going to trade that trend to make money within the clearly identified time frame of our goal setting. The rest, all the stuff going around in your head, is how we maximise our chances of success and avoid obvious and stupid cock-ups. That's it Joe. We are backing ourselves on this one simple little bet, based on our insights into the fundamentals that govern currency movements.

We have taken a small advantage (the 3% I have used is just because that was more or less the casino's advantage in our previous example) and amplified it using a combination of discretion or common sense, and mathematical probability. Under the heading 'discretion' we have, time (letting odds do their work; allowing a position to mature), managing downside (scaling out, off-setting trades), taking profits (a profit a day keeps the bailiff away), dip buying, relational analysis (price, event, time), multiple entries and more; under the heading mathematical probability we have, for example, low gearing and median trading; and together, with all the other small advantages we have collected one by one, accumulated, piled one on top of the other, until we have that solid weight that swings the odds pendulum in our favour.

Why I say that at the heart of our approach is a bet, or a discretionary exercise of our critical and informed faculties, and not a mathematical formula, is because at the core of all successful trading you find good judgment, not good maths. Maths can help you along the way, but make it your cornerstone and you will have problems. The essence of the market, it's soul, cannot be expressed in mathematical terms. This is an essential and vital truth to grasp about currency trading and one which many people avoid because it requires you to confront uncertainty and to take responsibility for your decisions. Once I start to talk of 'swinging odds in my favour' or 'a higher probability of success' you may want to point out to me that I am reducing the market to maths. I don't think I am. All I am saying is that there are no 'hard facts' in this business, facts that can point to a predictable outcome. In a court of law an accused is convicted when the hard facts point to guilt, and guilt beyond a reasonable doubt. 'Beyond a reasonable doubt' is a higher probability than you will ever encounter in the markets. We do not have this luxury, nor do we have the luxury of hard facts. But we do have 'circumstantial evidence', and enough of this, if not amounting to a hard fact or certainty beyond a reasonable doubt, creates an edge with which we can make money. But you have to know where to find this 'circumstantial evidence' and then, once having found it, you must know how to use it. And that, Joe, is what it is all about.

After reading Taleb's book on the role of randomness in markets and life, I set myself this task: I wanted to be able to answer one question. How can I confidently say that I am not a lucky fool?[7] Taleb provides convincing evidence that much of trading and success in trading by so-called 'experts' is no more than the lucky streak of a lucky fool. 'Fool' because these people thought they knew more than they did, and ignored the role randomness plays in success and failure. Their style and approach to trading suited the particular market they were in but only for a discrete period of time. Once the market changed they burnt out. The 'stayers' are those that are wiser, cleverer, they know what they don't know and because they also know the limits of what it is *possible* to know in the market. I find this liberating, it frees me up to concentrate on that which is knowable, to concentrate my efforts on that which will give me returns. I am not a lucky fool. I know this because my system is based on good judgement and sound maths. I am not a lucky fool because I know how to identify and collect my circumstantial evidence, and apply it to make money. I am not a lucky fool because I know what a fool I am. I am a cautious fool who, if bird watching in lion country, keeps looking over his shoulder.

I am a fool who is not soon parted from his money.

[7] Nassim Taleb, Fooled by Randomness

Epilogue

Quo vadis?

At the start of this book I made the point that even though I can tell you what methods I use to trade successfully, it will be difficult for me to convey them in such a manner that you can simply copy them and make a success of your own trading. At some point you need to find your own formula for building your own bomb. But you should at least now have a comprehensive view of how I approach the markets. This is very valuable information for you have acquired a certain perspective, albeit my perspective, it has a winning track record.

I also made the point that I wanted to write this book out of a sense of frustration I felt when others couldn't seem to put to use what was working for me. I suspect that the reason for this is not necessarily an inability on the trader's side but rather the problems inherent in conveying complex issues.

This book, I hope, does much in the form of preparatory work, but even so it cannot do justice to all the perspectives and nuances inherent in real-time analysis and median trading. The latter, the way I practice it, requires you to do away with much which is considered "sacred' in trading, and if you have read attentively you will remember me burying more than one holy cow. In other words to become proficient in my method, you have to make a paradigm shift in how you make decisions about your trading.

Let me try to explain this a little better. As I see it, in most trading systems a specific detailed historical price "set-up" defines a trade at a specific moment at a specific price. If and when the set-up occurs the trade is "on". Especially for traders with the very, very short term time frames (even in terms of short term traders) these set-ups may be very fleeting, before the "opportunity" is gone and the analysis, or search for a new possible profit opportunity starts again, with no memory of the previous "set-up". For traders with longer time frames the set-ups will be less frequent but also not so fleeting. There may also be a "redevelopment" of exactly the same set-up, a recognisable pattern. But whatever the system a little bit of magic exists when a trade is "signalled" or "triggered" or "on". The trick, therefore, is in being able to spot the magical set-up according to a predefined set of rules.

Median trading can also be used to enhance this approach by giving a backdrop against which to evaluate the developing set-up, and especially to see a new trade in its proper perspective to previous trades. This in itself is very useful to struggling traders. It allows them to develop a "historical consciousness" with regards to trades.

I, however, use it differently from what I have just described. In a certain sense identifying a median grid can be compared with the typical situation described above, but what goes within that grid, once established, is a new world. Trading on a day-to-day basis I move further away from conventional technical analysis. Analysis is important in choosing a currency, in choosing a direction (the fundamental trend) and so on. Analysis is important in drawing up and positioning your grid. Analysis also plays a role in managing your risk within the grid, especially considering the external price shocks caused by events such as the economic data releases. But in the end entries are made and trades put on based on other principles, principles that have more to do with relationships between prices and actions (buy or sell) and levels in different timeframes, and shorter and longer term goals, than anything else.

Decisions based on real time events, the core of successful trading. You have taken the first step, getting the right perspective. In my mentor program I spend a lot of time on the second step which is a combination of refining the first step within the context of live trading and learning how to manage exceptions. My mentorship also offers more than that, including daily briefings – my take on the market. My mentorship involves:

- Further clarification and fine-tuning of the 4X1 strategy
- Tailor-made goal setting and planning analysis
- Evaluation of your progress
- Advice on “leverage management”
- Exercises to become comfortable with the principles
- Guidance on relational analysis – “traders economics”
- Fundamental trend watch information
- Which currency should be the “one”?
- Real-time analysis
- Daily Briefings
- Participation in the development of an “automated” median trading model

Most current traders will find the concept of multiple entries and cost averaging the hardest to swallow because it seems to go against much which is conventional wisdom in currency trading.

In a sense it is a waste of time to relate more details at this stage. After all you must develop and trust the principles you use to develop a system that has any chance at all in the long run to becoming, and staying, profitable – for you. You simply can’t do that if you don’t take up the pick and shovel and start digging.