BIRD WATCHING IN LION COUNTRY

FOREX TRADING EXPLAINED

2010 EDITION

(Revised, Updated & Expanded)

Dirk du Toit

About Dirk du Toit

www.dirkdutoit.com

www.dayforex.com

www.forex-trading-explained.com

www.bird-watching-in-lion-country.com

Contents

Preface

The first version of BWILC was written during 2004 and published at the end of that year as an ebook. One of the reasons I chose the ebook format was because of the fickle nature of the online retail forex trading industry. It was new, constantly changing, and an ebook would be ideal for quick adaptation. My target audience was the typically confused novice trader, confused because his first introduction to the market was the overwhelming diet of intra day trading with technical indicators as only toolset.

To be in a position to write a preface five years later to an updated and expanded version of BWILC is a sign of success. The book is still in demand. It has sold in over sixty countries, and this despite its contrarian trading methods or its promise of success but only with blood sweat and tears. Five years is a long time in the forex market where quick fixes are the norm for aspirant traders looking to get rich without having to work for it.

BWILC is contrarian. And five full years later it is still on the road less travelled, and still going strong. I suppose in one sense the central question I wanted to answer for myself by writing this book was why so many smart people, but so many forex losers? It's not as if the losers were doing crazy stuff. On the contrary. These are smart people who read, researched, studied, planned. Then they traded, and failed. Why?

- They have apparently conquered the basic psychology about greed and fear. In fact, they know more about behavioural finance than many successful traders.
- They obtain more than a decent understanding and skill at applying technical analysis to intraday prices.
- Some even put this to work within the framework of fundamental drivers or news trading.

- They know a lot about money management.

It looks like they have the whole package, but still they fail. Why?
I spent a lot of time thinking about this and it was only through a process of interaction with BWILC readers who decided to join my personal mentor programme and were becoming successful traders that I began to realize what was wrong.. It wasn't that BWILC was contrarian. It wasn't contrarian enough!

People simply did not understand the deep differences between successful forex trading and what they were generally attempting. People were seduced with a message tainted at its core. It looked good but it was a pig with lipstick. If marketing wizards said to these people you can become fabulously rich in no time with no effort little money and less risk, who was I to tell them they were deluding themselves?
The one thing I did have in my favour was the market. The market has a way of teaching lessons that I can't. I knew the market was going to take their money. And it did. That is why a lot of my clients arrive at my door as patients, bandaged and hurting. Then I tell them exactly what they don't want to hear, which is that trading is tough, that you need lots of time, lots of effort, some money down as trading capital and some invested in resources like training and even then you still run the risk of losing it all. That's what I tell them and that's what I am telling you. But it's working. My mentorship programme is growing so quickly that I have to limit the numbers. (Oh yes, you also need luck. But chance favours the prepared trader. And the more you practice the luckier you get!)
The new BWILC is based on the feedback of readers, clients and my mentoring students. There is one thing I want to say up front. BWILC has repetition, but that is for a specific purpose. Each repetition of a topic or a subject is subtly different. The market is a very difficult animal to understand. You need to mull over it time and time again, but from a slightly different angle. I have tried to weave that method into the fabric of the book. Just let it seep in.
There are areas of my trading approach I did not emphasise enough - I have embroidered on these. There are others I have put in for the first time. I deal now in some detail not only with median trading but how my daily briefings are applied to the median grid, in real time, using relational analysis.
One miscalculation I made was how literally people would take some of the things I wrote. I have tried to clear this up.
The 2009 edition has been, I hope, greatly enhanced and enriched. I have split Part 4 and added a new Part 5. This means there is a lot more detail about 4x1 strategy, especially the 5th "one" and I have included much more about the median grid trading methodology. Finally

I have replaced almost everything I have said about relational analysis and I have included an extensive example of relational analysis, fresh out of the oven, end of November 2009.

But it is incumbent on me to warn you that relational analysis cannot be taught in a static text / context like a book. It can only be taught in a dynamic context like an online community where you can on a day-to-day basis observe, learn and eventually own the ability to do it yourself.

Ultimately what I would like to achieve with this book is to convince you, by giving you my best effort at this time, to give me some of your time going forward. I was quite open about this in BWILC 2004 and I was attacked for this on a popular forum. I said: reading this book is not going to be enough to make you successful. You will need more. All successful people acknowledge the role mentors play in their success. I will mentor you to help you reach your realistic goals in forex trading.

We are in a brave new world, a Wiki world, a world where the wisdom of the crowds rule, where online communities encourage and empower their members to reach for and achieve their individual goals. This book is therefore also an introduction to my private online community where you can think together. But ultimately my book is based on the principle that in order to be successful in your personal forex trading business *you need to own your own brain.*

I hope to see you join our forex family in due course, but first you have to understand the need for a paradigm shift.

Dirk du Toit
Pretoria, December 2009
www.dirkdutoit.com

Foreword to the 2004 edition

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 my approach would be in this book, what the essence was I was trying to distil. It became clear to me after mulling it over that what I wanted to convey was 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*

Contents

Introduction

You've probably heard of $E=mc^2$. It's Einstein's famous formula. 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 connection to the atom bomb. But that's about it. You are not going to understand the detail.

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.

There is a good chance that you have your own formula, a forex trading formula, and with it you may succeeded in blowing up a few demo forex trading accounts as well as a real money account.

And your formula probably looks a bit like this:

Learn technical analysis. Determine high probability trade setups. Do not risk more than 2% of your account. Place a stop loss order. Run your profits, cut your losses. Repeat this unemotionally and systematically.

I have a growing corpus of evidence that this formula, highly touted and popularly advanced, is what causes sincere and intelligent beginner forex traders to blow up forex trading accounts.

Yes, there are a percentage of successful traders using this exact formula. But it is a very small percentage. According to anecdotal evidence not more than one out of ten people that attempt trading (any market) make a success of it, and in forex trading many say this percentage may even be lower.

Successful trading is elusive and challenging. The problem with defining success is that in trading there simply is not something like instant success. Today's mega profit is simply the basis for tomorrows devastating loss. Managing a trading account over a long period of time is a complex endeavour. Success only belongs to those who can stay the course. Today's success is simultaneously the seed for tomorrow's greed that can end in disastrous failure.

Forex trading is already a well-trodden path. Many have set out on the journey during the first few years of the 21st century. The amazing thing is that most of them don't even properly make it out of the starting blocks.

Lets have a look at another formula, my formula, 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. But you won't be able to, and I will tell you why in a minute.

But first let me be clear about what I have said above. I have issued you a challenge that requires endurance and staying power. If you want to trade for a lifetime and you are not trading in three year's time, you have failed. Many don't even make it past three weeks or three months. What usually happens is they blow up and then, after a rest they return saying to themselves, this time will be different. They are the sincere, intelligent traders I have mentioned. But their problem remains. They come back with the same formula and they reapply it, compounding the error. Their problem is they have never started off properly which means they are always heading in the wrong direction. Even before they start trading they are mentally unprepared. Their expectations are unrealistic, they want something for nothing, they think trading is easy.

Why most people won't make money with any formula in trading is due to their idealistic view of trading, how fast the art / science of trading can be mastered and what can legitimately be seen as success or at least good progress on the road to trading success.

If you recognise yourself in this description I really hope this is the last time you return to the starting blocks.

It is certainly my intention to help you to set out on the right course, to negotiate the myriad of obstacles in many shapes and forms, to become confident in what you do and to stay the course on the road to success.

Chapter 1

Who is this book for?

I ask all my mentoring clients to describe systematically the journey up to the point they have decided to join my mentoring program. These responses are fascinating and a rich source of understanding the problems of beginner traders. I have used it to improve my efforts to help others and also improve on BWILC.

I have decided to include one particular description (from a new "Class of 2010" participant) which I have received very recently at this point in order for you to understand who I am updating and revising BWILC for. It really says it all.

1. In Jan 2009, I was looking to start another potential INCOME producing stream. I thought about a few business models but on further evaluation, it was concluded that they all need large capital investment upfront plus fixed monthly expenses until the day the business breaks even. There is no guarantee of success plus I have the hassles of dealing with problematic employees, vendors and customers; rental, inventory and a host of overheads in a typical business.
2. I thought for the same amount of capital and energy, I might as well be an equity trader. At least I did not have to keep putting money in every month until it's profitable (unless I'm a really bad trader that keeps blowing my account every month) or in the worse case lose all my money as 95% of all new start-ups fail within the first 2 years. So my final opinion is trading is not any riskier than starting a new business. Plus if I get it right, the growth potential is unlimited and maybe a lot quicker than traditional businesses.

3. The idea is very attractive, so I started to research further on which instruments to trade, equities, options or forex ?
4. Equities is complicated with too many companies to go over, research and monitor. Options is even more complicated with all the “greeks”. So that leaves Forex and it seems to satisfy my requirement.
5. I was not going to gamble with my money, so I thought to educate myself first before jumping in. Bought a few books on Technical Analysis and started reading.
6. I also think that I need to immerse myself in this totally new financial world by watching news like Bloomberg to get a feel for everything.
7. After reading some books, I started to visit some forums for ideas on how to put all that I have read together.
8. From forums and websites, I had a basic idea and roughly drafted my simple trading plan. I have decided to trade the 4 hr charts, using the EMA on daily timeframe for directions and using the 1hr timeframe for entry.
9. I signed up for an unlimited demo account in May 2009 and started to observe the market without entering any trades using my plan as well as to familiarize myself with the Metatrader platform.
10. My trading plan seems good, so I was ready to start papertrading. Around June 2009 with a demo account of US$5000 and a leverage of 1:1 I tried to trade . However, whenever I enter a trade, a window will pop up saying I had insufficient funds. I tried to overcome this by changing to even smaller lot size (my lot size was based on 2% risk) but it still didn’t work. So I opened another demo account but this time with US$10,000 and I picked their lowest default leverage of 1 : 100. This time, it worked ! So I assumed that’s the lowest leverage one can possibly go.
11. I kept brief notes of my trades.
12. For the first week of actual papertrading, I made about 6%. And so I thought 10%/ per month should be doable. I was confident.
13. However, by July I had almost given everything back to the market. Then I convinced myself that I needed to add more indicators to make the trade as ‘high probability’ as possible.
14. Now I have almost 10 indicators on my charts!!
15. With so many entry conditions that has to be met before I can enter a trade, the number of entry signals got reduced and I tried to, as other traders say, exercise discipline. I was aiming for high quality trades, not quantities.
16. It made sense. So I followed my plan and my account went back up again after catching one or two good trades. Then it went down again after hitting a few stop losses.
17. Time went by and I was constantly scanning through the 6 major pairs for entry signals. I needed to bring my account back up again to positive. There were feelings of restlessness and frustration as I waited for days for potential signals to appear. I worried about missing the signals since they were so hard to come by, I had to constantly keep an eye on the charts and staying up late in the night. And guess what, the setups often occur during New York and London close time just when I gave up waiting and went to bed!
18. I thought it will improve my odds of getting good trading signals if I increased the number of currency pairs from 6 to more than a dozen.
19. I signed up for another demo to start afresh.
20. Couldn’t cope with monitoring more than 3 trade entries unless I pulled the trigger with TP (take profit) and SL (stop loss) in place and forget about it because I have to monitor the rest for signals. But when I did this I limited my potential profits to about

30 – 40 pips per trade. That's not what I wanted, I wanted to ride the trend after all the waiting.

21. So there must be a better way. I was told that real professional traders do not use indicators because they are laggards. Pros trade based on price action, supports & resistance and pivot points.
22. I felt insecure without all the indicators on the charts so I made another complete set of charts with very minimal indicators, only candlestick and 1 or 2 MA moving averages). They are a lot easier to see now and when I feel unsure, I can always refer back to the 'old' charts.
23. However, I still had to wait for price action setups but they are a lot more frequent now. Looks good.
24. Later, I found that I also had to constantly monitor every candlestick forming because it may start to give reversal signals again. Price action seems to be very short term trading.
25. It is apparent that it is not as easy as it looks, but I ask myself why is it that some people can achieve success with it? How can some people claim they have a success rate of 60-80% when I seem to be struggling to achieve even 50%.
26. At this point, I reduced my risk to 1% as I did not want my demo balance to suffer from severe drawdown. But the disadvantage with this is when I do get a good trade, I made less.
27. Maybe I was not managing my trades well but half the time I don't even get to the point to manage my trades. With the few good entries I had, I was able to manage it to over 200 – 300 pips over a period of 1-2 days. But most of the time it's reversal after only 20 – 30 pips.
28. I started looking at other techniques. And when I tried them, they always seem to work for the first couple of times and then they don't anymore.
29. 3-4 months of paper trading has passed and I am still not profitable. My equity curve is whipsawing up and down.
30. Maybe I am missing something here. Someone in the forum says to take into consideration the news releases each day as well.
31. Market sentiment is important too, I learnt. So I checked out the Commitment of Traders report to see if it helps to make sense of everything.
32. Back to more reading and research on the CoT.
33. By now I am getting very confused. Some websites say we only focus on the 'long' and 'short' in the Non-commercial category because these are positions held by large professional traders such as hedge funds etc.. and the Commercials such as banks tend to hold their positions for longer term. While some others say we should look at the commercials because they are the banks and they are the ones that move the market.
34. Tried taking these into consideration when I traded but the currency pairs do not seem to be responding as they should from the news releases or the CoT information. In fact they seem to be doing the very opposite. So I dumped them.
35. Do not trade the news I read, 30 minutes before or after. Close all positions before the release. But I was thinking, how can this be even possible when there are news being released everyday, one after another within an hour's vicinity. If I follow this rule, I will not be trading at all. This will only further reduce the number of entries.
36. I felt at this point, I had better get a mentor because it's already 10 months gone and I am not any better. However that's easier said than done as there are so many so-called 'gurus' or mentors out there offering their services. Everyone's claiming to be able to shorten your learning curve and turn you into a real trader within a few months. Who do you believe ?

37. That's when I came across the BWILC methodology being mentioned in one of the forums. I looked it up and even though the book did not fully answer all the problems I faced trading, I believe it more or less gave me the idea that I should be looking at the bigger picture here. I know that's the right way to go and I thought I was doing that with the 4 hrs and daily charts. Somehow I am still getting caught in the headlights. It seems like my perception is still wrong.
38. So I enrolled in the DrForex mentor program.

As you can see, this person almost spent a year with really no progress. It is tangible how difficult it is to make a decision amongst all the information and then to apply whatever system or approach you decide on for a long enough period of time in order to develop some confidence in it.

In short then, this book is for those who are looking for a different approach they can have confidence in. 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 write this book for everyone who is caught in the same trap of system hopping, of not knowing who to believe or what to believe for everyone drowning in systems, offers and advice about this system, that technique and these procedures.

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 doesn't reach past my knee. The not-so-useful pile reaches the roof, including books on currency trading.

In the five years since 2004 there has been an explosion in books on forex trading. Not only people like you, but many investment professionals too began seeing the forex market as a tradable asset class and started to take currency positions for the sake of speculating.

I want my book to be useful to you. 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 are hard to write principally because they don't skirt the difficult issues. If trading were easy everyone would be doing it and no one would need trading books. But because trading is hard, good trading books are hard to write because the tough concepts, the vitally important aspects of trading success, are often intangible. They are elusive. 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 probably creates more losers than any other market. It is very misunderstood. It has enormous potential, and enormous potential to hurt. 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. But many can testify to the fact that after several free and not so free introductory courses usually offered by friendly forex brokers it seems like all the buckets of cash end up with the brokers.

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, but it is central to trading success. All successful traders have it).

The main reason why there are so many poor books on forex trading is because of stock trading which is the source of the "how-to-trade" industry. Let me explain this.

---

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

The forex market is a very different animal from the stock market, and this goes deep. But looking to make a quick buck, authors rehash hoary old theories of technical analysis and apply them without thought to the forex markets without ever properly considering why technical trading for stocks can't seamlessly be applied to currency trading. You need to make a fundamental mind shift.

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 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. This usually comes in the form of aggressively marketed 'surefire systems' you can execute blindly after reading an ebook, watching a few DVDs, attending a 90 minute webinar about a super-duper technical system, and then make money in your sleep.

> "My secret formula, which can be yours for only $159.00, 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…"

But let's get back to the real and teasing problem: 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.

It is five years since the first edition of BWILC and I have picked up an interesting correlation between the schemas developed in the internet marketing market and the forex trading market, which is an ideal market for internet marketers.

It is fascinating to see how things have developed. A few years ago you have received emails like these:

- Hi Dirk, How to use momentum in your trading.
- Hi Dirk, Mechanical trading system
- Hi Dirk, 84 pips with this one technique

In these examples above the offers generally had to do with some **trading technique.**

During the last few years the tone of offers became much **more marketing orientated** and things like scarcity, minimum effort and minimum time to be spent to become rich, in other words the idealistic wishes of the “target market” are being reinforced the whole time with no consideration for the difficulties of the forex trading endeavour that is underlying all these products, offers and schemes.

The bottom line is that today you are not only confronted with trading and training systems that are inherently flawed but also do you have to content with scientific marketing by people that base their strategies on books like: *SUBLIMINAL PERSUASION – Influence & Marketing Secrets They Don’t Want You to Know!*

The irony is that instead of getting closer to a point where he can grapple with the complexities of trading the aspirant trader find himself amidst a **scientific duel amongst marketers** to gain maximum sales in a very short time.

People are not making money in droves because they are not even getting close to a point where they are indeed the purveyors of scientific effort to make a success of trading. Instead of moving closer to the solution it is as if a new set of hurdles are stacked up in front of them. They became the prey of lions of a different breed!

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 one golden thread that runs through all of them: they tell it like it is. The authors do not lie to themselves and therefore they do not lie to you. **Brutal honesty is necessary in order to be successful in trading.** This is very difficult but it is the tool you must develop in order to know 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, whether as a small trader or 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 world of financial markets, trading and speculation. (Part 3 “And All that Jazz...” of this book also contains some very basic information in this regard).

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 courses 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. They are frustrated, 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 here, including the assumption by the tutor that his knowledge and skill is transferable as **principles**. I don’t think it is but I will expound on this later, but whatever the case, 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 (for the sake of the argument I will accept their bona fides because many tip services are scams). What they, the tipsters, 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. You have to own your own brain. And you can.

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. For at least one trader BWILC made an incredible difference.

FX Street is probably the most popular forex portal site and every year they have a trading competition**. In 2007 the FX Street live trading contest** was won by Torsten Kruger and he afterwards indicated that his success was based on BWILC. Second place was one of my mentoring clients. Nobody else made positive returns in that competition.

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. 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.

It was great to see that the 2009 winner of the FX Street live trading contest won while he was refining the BWILC approach on my mentoring programme which he has joined during the financial market turbulence of late 2008. In his private blogging area in the Forexclinic community he ascribed his success (65% net profits over a three month period) to the BWILC approach referring to the fact that of more than 40 participants initially there were only three with positive results at the end of the competition.

The *Aha!* experience

It's a mistaken and disastrous belief that someone can teach you that one thing, that special something, that will make you a good trader. 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, what I call the "***Aha!***" experience. They were ready, but not yet ripe. 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 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.

A word of caution. Just as the internet has facilitated communication it has also given anyone with something to say a soap box. It is what *Andrew Keen* describes in his excellent book ***"The Cult of the Amateur"*** – it has become easy to bluff your way as a mentor. Mentorship, like the US dollar, has been devalued.

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 compete in this professional environment. ***The answer is "yes", you can.*** 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 work reliably and appeal to finicky, small, choosy, retail traders. 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.

The good news however, is that by 2009 the forex market has been regulated in many countries. It is today a safer place to be than when I first wrote about it several years ago in the first edition of BWILC. We will also address the issues of regulation especially where it impacts on the way you trade, i.e. where regulation went over the top.

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 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 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 the market and they look at too short time frames which only serve to increase the effects of randomness. **The one thing they should make smaller, position size, they actually make bigger,** oblivious of the real effects of gearing, how to use it as a friend, and how dangerous it can be as an enemy if not properly used or understood.

They dream about "consistency", surefire systems, exact entries, exits and stops, high probability setups 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 side. **They haven't been listening. They've been eavesdropping**. Being able to <u>listen</u>, 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, the cello, the 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 be in a position to according to what you hear.

Unlike some trading systems, my system begins before any buy or sell buttons are pushed. ***It begins with 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, finally, 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: a **personal forex trading business.** 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 $1,000.00. 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.

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 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 about 50 pips, depending on relevant factors such as account size and gearing and short term price behaviour. 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 for price

movement just to comfort myself. I accept it. The market moved. I don't know why. That's it, let's get on with things. No one can tell you what is happening all the time**. Most of the time it's just randomness.** You will also learn that while it is difficult not to describe trading in terms of "time frames" I believe one should make much more of **"price frames"**. In other words a much more relevant factor is **the distance a price moves** rather than the time frame in which you observe that particular price move. The time it may take a price to move, say, 300 pips against you is less important than the fact that you should contemplate that it indeed can move 300 pips and what the value of each of those pips are and how that will impact the value of your trading account.

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 or series of events. 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 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 $3.2 trillion 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 "The Edge" is about identifying the edges you have and looking at sensible ways of increasing these advantages.

Part 5 "Applying your edges"

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, 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 naïve. Don't be a bird watcher in lion country.

Part 2

Understanding the edge

“Chance favours the prepared mind”

- *Louis Pasteur*

Contents

Chapter 6 Elements of a proper trading system

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's just the way it is. These traders make up 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 an illustration. 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, and tawny coloured. 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. They know they are in potentially dangerous territory. After all they are trading, with money. Yet, they see something sticking out of the bush, and they give it a yank, to 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 cast about for a clear image of this 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 because you need to have a fixed picture while at the same time you need to 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. Potential winners and losers are divided very early in the process.

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 something foreign and hope for the best. Don't pick something up if you don't know what it is. It's risky. Yet you will be amazed by how many people do just that. They are rewarded by an unpleasant market 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 trading life and 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, and why a lot of traders can't see it 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 you cannot ignore the realities of the market you are trading. 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 five or fifteen minutes 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 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 larger 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 inbetween 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 anymore 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 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's picture is too small. 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. They have carefully selected their vantage point. 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 car from another. And because the winner is set back from the highway, there is less noise. The winners can see the bottlenecks, and predict with greater accuracy whether this particular traffic jam is serious or not (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 not 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 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, ie 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 nine 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 underground? 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, 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 flirt with, 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 be forced 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, and 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 range of price movement you consider significant over a given period. I want to introduce this critical aspect: price ranges. In the second half of 2008 we experienced a once-in-a-lifetime event in the currency markets when the financial system (the Interbank credit markets) ground to a halt. Liquidity evaporated. Nobody wanted to lend a cent to anybody else. Thus in a hitherto unimaginably short time we saw massive price changes. Moves that took decades took place in weeks. Events (big, fast price changes) that happened once or twice a year were occurring two times a day and three days in a row! In other words, from the BWILC perspective **price frames** are more important than time frames. More about this later.

Your chosen significant 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 will merely be 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 50 to 100 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 hundred 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 principles 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 it is impossible on any given day to predict the direction of the market because you are for the most part at the mercy of randomness, how is it possible, you may legitimately ask, to write a **daily briefing** in which I 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 be flipping 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 or fifteen minute charts are the same. To call whether the next five minute period will end up or down is exactly like flipping a coin. Go try it. Prove it to yourself. **These five minute periods have no memory. So why watch them for signals?** People do, but very few make money doing so. 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, and have a sound money management strategy. 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.

This story is from 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*

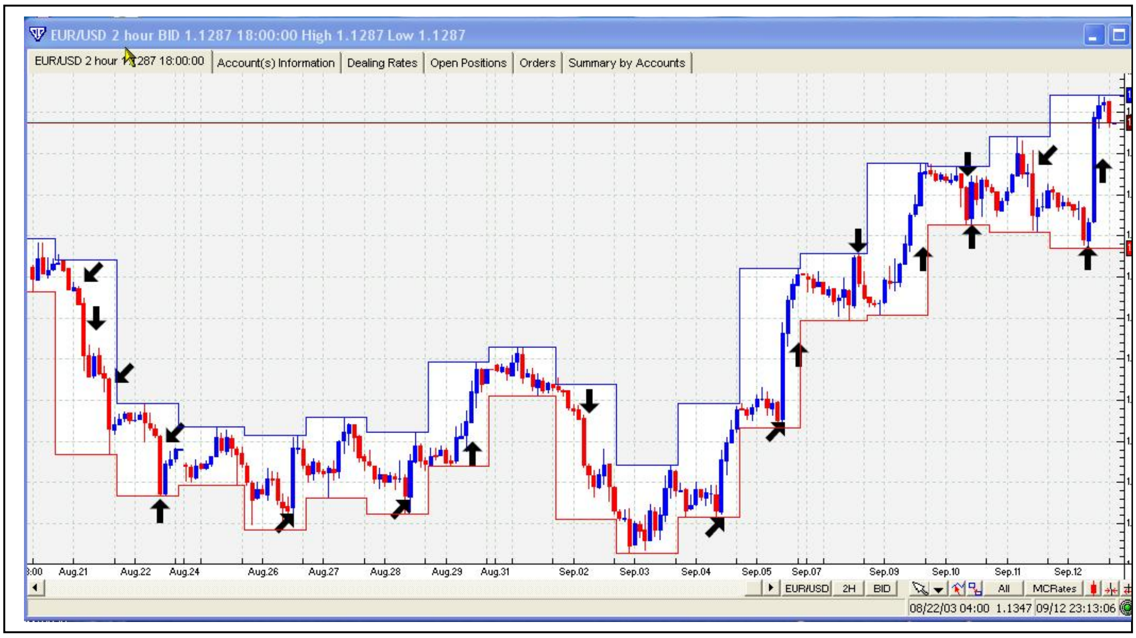
[1] Edwin Lefêvre, *Reminiscences of a Stock Operator,* p. 208

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."

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, perspectives, 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 five minute graph. That is why intra day currency price graphs look like this – the whole time:

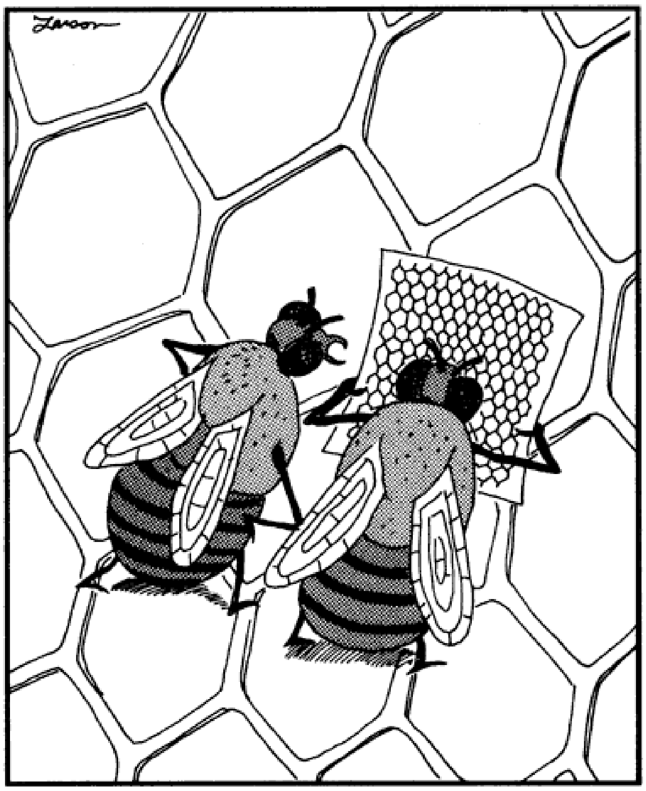


You are looking at lion country.

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 technical indicators or patterns 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 only 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.



“Face it, Fred—you’re lost!”

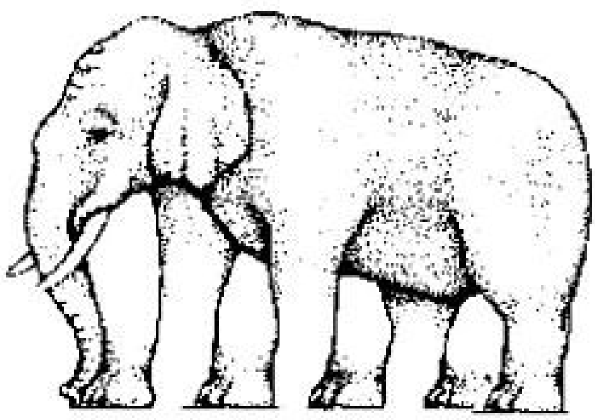
DISCRETION

I don't have a neat description of what "type of trader" 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. This means I do rely on the interpretation of historical price moves up to the very real-time moment I have to make a trading decision. But there is a really important difference between my approach and yours (if you are a technical trader who uses indicators and looks for meanings in patterns). The difference is this: While we agree that all the information is in the price I consciously apply a discretionary judgment about the composition of this information. Whereas you say "the information is in the price and that is all I need to know, since that is all everybody else knows" (and this is exactly where we diverge) **I say "the information is in the price and what do they know that I don't know** and what does it mean that they (some traders) acted on "this or that information"? And what if a lot of the other traders out there don't know that the first lot acted like this? 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 Apple's shares rise and fall on an insignificant throwaway comment by Steve Jobs? Probably not. But let Ben Bernanke chairman of the Fed sneeze, and currency markets catch a cold. When he speaks at a bankers' conference or university meeting on an economy related topic there will be reporters who will transmit what he says to news services like Reuters or Bloomberg. This will hit the screens of traders world-wide and the particular choice of words of a journalist (maybe with a finance or economics degree) interpreting what Bernanke has said and feeling he or she must relate it, even if there is no obvious connection, to say US monetary policy and interest rates may cause a little knee jerk reaction in price, based on nothing much at all. This may sound like an 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. Deep connections are what close this gap. If you can find the text that provides the answers in real-time in every conceivable situation, that provides all the deep connections to solve the riddle that is the answer to short-term value in currencies well, then you've got it made. But my view, and I need to be frank on this, is that you are deluded if you think you are going to find it in an ebook (even an ebook as detailed as this one), a 30 minute webinar, or by being a member of these open forum communities and purchasing the twentieth forex robot "that changed the face of currency trading" for $147 at *Clickbank* from a supposedly retired (at 25 years of age) "bank trader" now residing in the Bahamas.

DIFFERENT MOTIVES

You have to consider that some participants in the FX market will do exactly the same trade at roughly the same time 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 big 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. They may consider a 2% - 3% price range as important. Think about the investment horizons of these major players. They may differ from yours with as much as a year.

Take Jim Rogers, the colourful ex partner of George Soros, for example. He took a view against the dollar in the beginning of the 21st century. He also decided to send his little daughter to Chinese classes and suggested she consider the value of being a farmer (or marrying one) in a world where more mouths continuously need to be fed from less farmland. The US dollar 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. He speculates in the shorter term in commodity futures markets or buys shares in global resources and farming companies to benefit from cyclical market moves. 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. This affects spot prices. Rogers is regularly a guest on CNBC and Bloomberg television and while he has no qualms in expressing his views about what and where to invest he doesn't say a word about when – he simply says he can't time the market. Think a bit about that, a wildly successful speculator who has timed, in macro perspective, three huge multi year global markets doesn't consider timing the market one of his strengths. Currency transactions on a day-to-day basis amounting to several trillion dollars of notional value are done for reasons that have absolutely nothing to do with the short-term fluctuations of the currencies. 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. A pension fund may have rules saying they may only invest in global shares on specific blue chip indices and may have to purchase pound sterling because of a change in the composition of the London Stock Exchange's *Footsie* index.

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 these short term flurries.

So you can see how important it is for us with shorter time frames and smaller price frames 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

About the Edge

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 bother me. It won't happen to me, they say. This seems injudicious. If you are going to 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 the big lions start to prowl. 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. 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

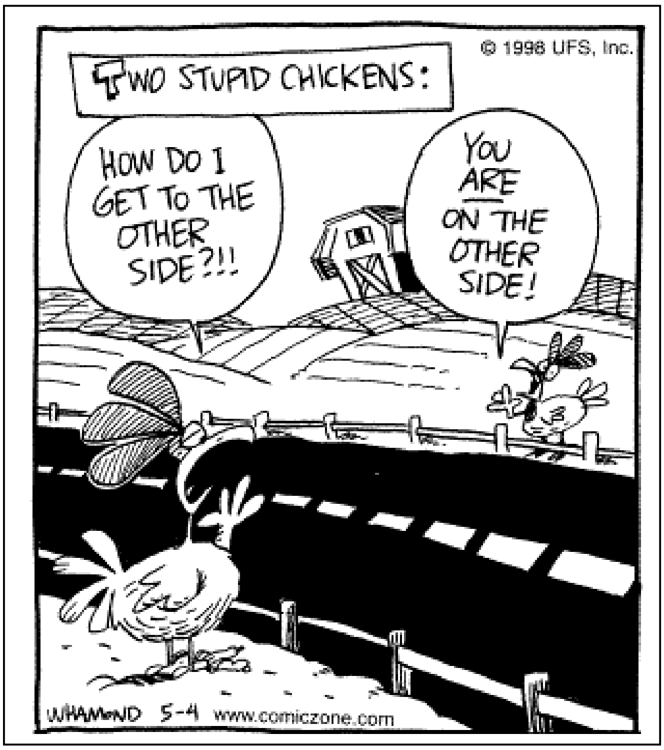
There are many advantages which traders simply ignore. They either don't know they exist or they know of their existence but don't think or understand that these are advantages which can give them an edge. In a sense trading successfully is nothing more than the conscious accumulation of advantages until the odds, in terms of probabilities, 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 they are hopelessly wrong. I believe that trading involves more luck than most people would care to admit, but it is certainly not gambling. Chance favours the prepared trader. 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 about 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.

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 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.



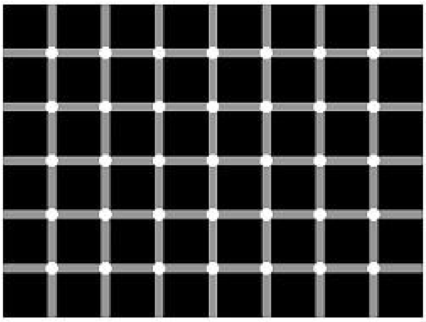
At the heart of my trading system is understanding what my edge is, and then intelligently using that edge. Casinos do that extremely effectively. They only have a small mathematical advantage but they use this and other non-mathematical advantages to make large amounts of money. You need to understand 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 losses) 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 what I believe is 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 now and for the next few weeks, 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.

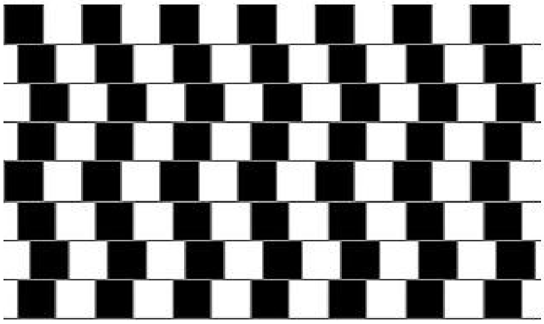
DEALING WITH RANDOMNESS

Our minds are not wired to deal with randomness.



Count the black dots! :o)

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



Are the horizontal lines parallel or do they slope?

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 and disorder without letting it affect you negatively. This is not a comfortable proposition but it is a necessary one for trading success. Many losing traders are obsessed with this issue. They crave certainty in a profession which has none.

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.

They turn to tactics which seem to eliminate randomness and uncertainty, they like training courses, ebooks and webinars which provide mechanical buy or sell signals with **exact** entry and exit points. 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, going up, going down, before continuing further up. And you can bet your bottom dollar that these interim ups and downs will often exceed your expectations (i.e. the moves will be bigger than you expect). You need to be able to take the pain of uncertainty. Not only do you need to have an edge on which your trading system is predicated but you must also know that one of the underlying principles of that edge is that you perpetually trade "on the edge", the edge of the ledge.

This picture shows a ten week period expressed in 4-hour intervals during H1 2008 of the GBPUSD. Each blue candle represents a close higher than the preceding 4 hour period and each red candle represents a close lower than the preceding 4 hour period. The length of the candle represents the price range during the 4 hour period. I suggest you use the zoom function to enlarge this picture and then ponder the question: "will any of my array of technical indicator courses contribute to me making money in this environment"? Keep in mind this is not 5 minute intervals during a sunny afternoon, this is a two month period and 4 hour intervals. Your typical short time frame based intra day approach sees each one of these four hour candles as "long term"! The randomness we have to cope with in the currency market is not limited to the miniscule sub-hour time frames.

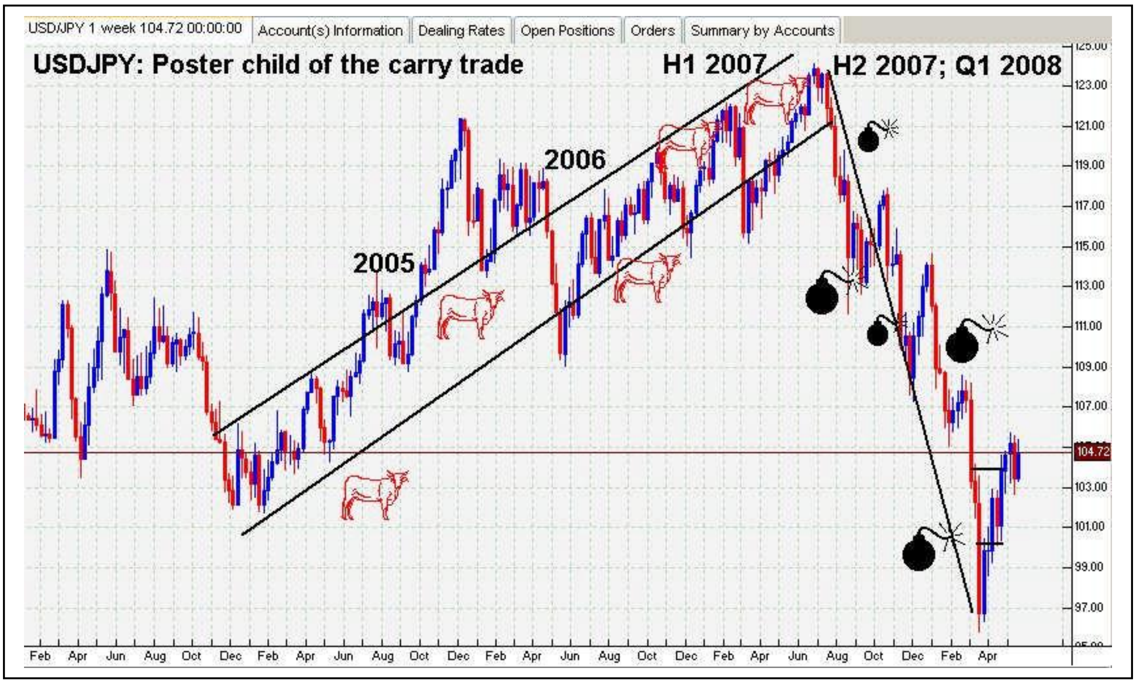
Are you getting the picture? Do you begin to see what I mean with an edge? Do you really think you have an edge simply because you have heard of or seen a few carefully selected samples of a technical indicator supposedly showing exact entry and exit signals or correlations in the sub-hour scenario?

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 in 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 provides "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, and he will not know 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 have confidence in your edge. Gaining confidence in your edge is a function of experience in applying it and reaping benefits from doing so.

There is a ***Zen Buddhist saying: A path cannot be taught, only taken**.* In the words of billionaire philanthropist and philosopher George Soros, it is a matter of reflexivity – a kind of feedback loop.

For this principle to translate into "successful" trading it should begin to become clear that you need time. Much more time than you might have afforded yourself up to now to find a successful way to trade. There simply aren't instant solutions to anything worthwhile in life.

Be careful of "sure bets", even ones that have an extended track record. Let me give you an example. From 2005 through 2007 a lot of newcomers to the forex market participated in a successful strategy, the **carry trade**. Things went well and many a supposed market wizard came to the fore, concocting strategies based on the fairly simple carry trade: sell a currency with low underlying interest rates and buy a currency with high underlying interest rates on margin with, say 10:1 leverage and turn a neat 50% a year, almost "risk free". You see, there is a feedback loop, an element of reflexivity in the carry trade also. The currency with the higher underlying interest rates attracts investment and thus also has capital growth from an investor's point of view. This lures more and more unsuspecting traders to simply accept the inevitability of easy money and soon they are lulled into believing that "almost risk free" is in fact "risk free". Then the lions roared....



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 mechanically. 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?

Some of the elements of the edge lie in your understanding of the structure of the market, the role of randomness, the role of probability thinking, the absence of certainty, the ability to recognize you might need a paradigm shift to accommodate these in a trading strategy which must return a decent profit in an environment dominated by randomness, the exact kind of environment our brains are not wired to handle very well.

Therefore the question about the innate ability of a person to be successful comes to the fore. 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 and character traits.

Take for instance the whole issue of "not trading emotionally". This might not be too difficult for a rational, introverted, right brained control freak, but what if you are an extroverted, ebullient, excitable left brain dynamo? No trading for you? Obviously not. It is even possible that you can incorporate your strong emotions and make them part of your system and even a strength of your system and trading strategy. If no two people are alike then no two trading systems are alike even if they share the same foundation.

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, and 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. Maximising advantages - 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 personal trading business.
2. Honesty - 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 extremely important. In

currency trading real-time time is the only form of time there is. Before you can change a trading decision you need to change your mind about what's real in the prices before your eyes. I think the way that almost all losing traders apply stop-losses so diligently (you will find that almost every losing trader blames stop losses for his failures) is essentially a disconnect on this level. They are not honest in terms of being prepared to change their mind in real time. No, they want to determine the trade and place a stop-loss before entering the trade. Why? Because they want to dodge the issue of having to grapple with the question: must I change my mind based on the evidence in front of me? Their craving for certainty and their refusal to think in terms of probabilities is the reason they lose.

To do what I am suggesting, to function in real time, is extremely difficult. Reality is never easy to face. Tipping your hat to reality, acknowledging its existence, is how you close the gap between almost making money and actually making it. There is a fundamental 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. Testing in the real world - Trading is educated 'betting' not mathematical formulas. The essence of the market cannot be expressed in mathematical language, although certain 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 can't say that they <u>are</u> right. All I can say is that they stand up to rigorous testing, and the longer they stand up to testing by more and more traders just like you 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. Understanding the maths - 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. Pressure - 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 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.
6. Dangers of perfectionism – Avoid perfectionism. Perhaps the market is perfect, I don't know. We are not perfect, that I do know. It really helps not to be a perfectionist. It will help if you can "let go", if you don't mind being wrong and can change your mind.
7. See the big picture – All good traders have this ability. It will be in your better interest if you are "big picture" orientated, in other words lean towards "strategizing" rather than accepting what you are told. Add to this a healthy dose of skepticism regarding anything that crosses your path purporting to be truth.
8. Be tentative, be bold - Be tentative when you take risks but decisive when you take profits.
9. Read - It would be to your advantage to have an interest in foreign affairs and global matters and while I don't advocate you taking up Economics 101, educate yourself about the financial markets. Something like *The Economist* comes to mind.
10. An appetite for risk - You must have a very healthy risk appetite, you must be able to handle losing money. If you are not prepared to take risks you may want to consider an alternative career.
11. Patience – You need it, and lots of it.
12. Think long term - You need a long-term outlook and instant solutions should not be part of your thinking. You are not going to have a successful personal trading business in the long run by making a large amount of money today and losing it tomorrow.

13. Don't be greedy - In order not to be fearful you must learn not to be greedy. By not being greedy you can save yourself from being exposed and sucked into the whole "cottage" industry of trading psychology.
14. Common sense – Work on it, train it, develop it.
15. Be serious - The fact that you are serious about trading as an alternative to your career should manifest in the way you go about your business. Show that you are serious, that you are prepared to invest time, money and the effort required.

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. In trading when things get tough they get really tough, but when the trades go your way it all seems so easy that one wonders how it was ever any other way. 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. Every day 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 away 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 seventeen of the best traders of all time. Each one is more different than the other, each one has his own approach, each 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 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 trader", 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 their 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 have made. The truth is more likely that they are affiliate marketers of every new system professionally presented by a marketing wizard.

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.

I want to say something that may sound strange about mentors and mentoring. Apart from the fact that there is a big difference between an ebook author, a team consisting of a computer programmer and Internet marketer eyeing the lucrative forex trading industry, a coach running an online trading programme and a true mentor, you will probably be astonished to hear that you may not find a true mentor as much as a mentor will find you.

Confusing an ebook peddler or webinar presenter for a mentor maybe the end of your trading career. I want to illustrate this with a question I recently received via email:

> *Also, please tell me if you are a mentor for scalping or you mentor for long term trades which exceed a day.....*

Underlying the question is a misunderstanding of what mentoring means. There is a huge difference between someone that teaches the ins and outs of some miniscule methodology and a true mentor.

Tiger Woods had his father Earl who was both a coach and a mentor. During the years Woods had several trainers and coaches, but he only ever had one mentor.

Playboy

When I was still a little cautious trading treasuries on margin I had a mentor with whom I had discussions 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 approach to trading, 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.

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

He talked of ‘Playboys’, referring to those traders who used technical charts, and said using them was as useful for trading as looking at pictures of naked women. 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.

This second edition of BWILC, 2010, has seen more than the young kids who have come and gone. Hundred-year old institutions like Bear Stearns have vanished. The company my mentor worked for went under recently. But my mentor could take the treasury business with him, setting up his own “shop”. Take your profits (money off the table), he’d say, that’s what we are in the game for. That’s why I live by the motto, ‘**a profit a day keeps the bailiff away**’ but don’t take this too literally. I am not advocating strict day trading where you close all your trades before you leave the office. That would be insane in the currency market for someone in your position. If a bank dealer (note, not a proprietary trader, but a dealer that executes the bank’s clients’ forex transactions) has to go home square it doesn’t mean you have to be square every day. If it makes sense for futures traders in Chicago’s pits, where procedures like “limit down” or “limit up” have a huge impact, to exit all their trades before the floor empties and everyone goes to the closest bar, it doesn’t mean you have to adapt that simply because you have to go to work, bed or bath the kids!

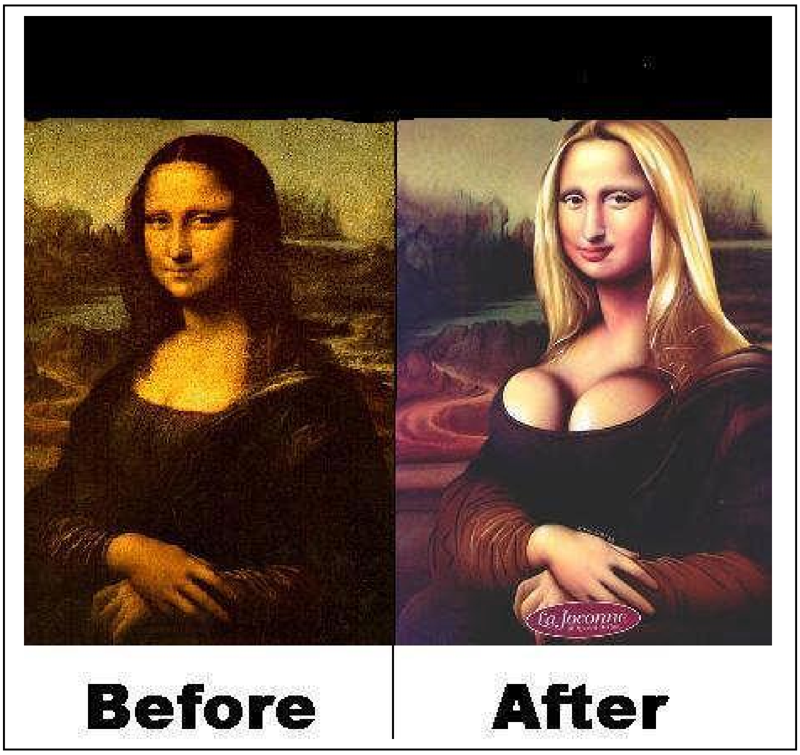
“Leave something for the others, we all have to eat” is another of his favorite reminders. Every morning I would chat with him, just five minutes, the most important five minutes of the day.

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 truths these ticks represented. I recalled one of the smarter moves I made as a young student. 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 fifteen 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 my early days as a trader 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 trading for a living (I had no other sustainable income stream) taught me was that the market doesn't care 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 of trading seriously. It has nothing to do with making trading decisions but it is a much-neglected aspect of trading psychology and it can have a major impact on the long-term success of your trading endeavour. **I strongly believe in, and recommend to you, a second non-trading related income.** In most cases this is not a problem. Most readers will be in a position where they have a sustainable income and maybe they hate their jobs but believe me, the money is essential if you want to develop a successful trading career.

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 instant wealth were made for those who were prepared to spend two or three days 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. For many their computer did become an ATM, dispensing their money into the forex market!

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” that, apart from being expensive (fees for the 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 5:1 or 6:1 at the higher end 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 other markets and each other, the influence of gold on currency prices, I studied the global drivers – what really moves the currency market. The change from local treasuries 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, "good economy", "bad economy" indicators, 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 today. 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 plan included the passive income. **I found the marketing model of the forex brokers at that time (2000 – 2002) fascinating.** They made use of introducing brokers, which basically meant that you are paid a fee based on the trading volume of "your clients", ie people you introduced to open and fund and trade on a real money account with that broker.

The unscrupulous "trainers" were introducing people to brokers to trade but they had no concept of how to train these traders to trade profitably over the long term. How they thought this would generate long-term passive income I don't know. **So clearly it is in my best interest that you do well**. I want you to trade for a long time and trade profitably. 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. I am telling you this for a reason. I want you to understand the architecture of the forex world, its players, and how they make money. You need to understand that trading is more than just pushing buy and sell buttons.

I have a motto: **Don't leverage your account, leverage your ability.** If you look at Wall Street, big investment banks, successful hedge funds, these are all institutions that understand how to leverage their ability. You may think that your goal, your only goal, is to trade yourself to riches with your own funds. But do you have enough money to do that? Imagine how much more effective you can be if you learn to trade profitably, and **leverage that ability by trading other people's money.** All I am saying is keep an open mind. There are many ways to reach your goal.

Here is an example from one of my own clients, who, by keeping an open mind, by designing a proper business plan, by thinking long term, and by leveraging his ability, now uses this ability as a successful trader.

Client Ben (not his real name) joined my mentoring programme in mid 2006. After about a year he stopped. I was a little surprised. It was a bit unexpected. Then, about two years after he had left, he sent me this email:

> *About 3 and a half years ago you mentored me in the Forex. Since then I went on to become a registered CTA and a member of the NFA. I (we) manage investor funds with institutional auto-traders …. We created a robot blended portfolio…. We have real-time performance since June of last year at just over 70%.*

Ben, you see, had a long-term goal. He wanted to turn his ability into a self-sustaining business. BWILC got him started, but he did the rest. I love these kinds of success stories.

There is no reason you can't do it too.

Trading is not a spectator sport

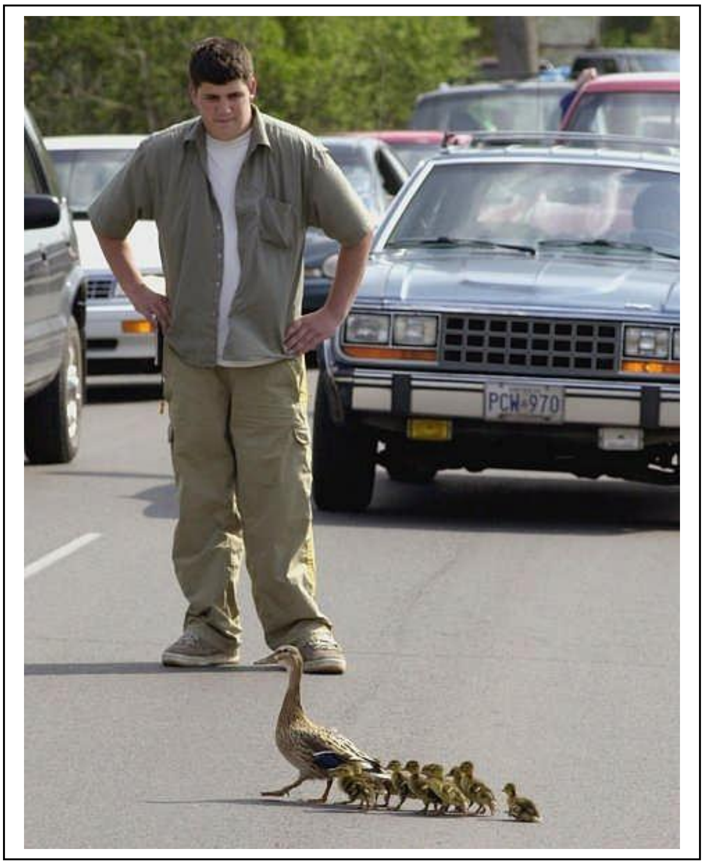
Once, while I was still trading treasuries, I went over to my mentor's workplace. I had always kept away, isolating myself, trying to do my own thinking. The head of the firm saw me and afterwards he came up and asked me 'So, are you a better trader now?' He knew. You can't learn trading by looking over 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.

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.

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 economists and journalists 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. When I am wrong I lose money. I care, I care a lot. Get a mentor who cares. Someone who has been there. If my clients (both investors or self-traders) don’t make money DayForex will close its doors. But I am still around after a decade, and for me that’s proof that I am doing something right.

Mentorship on the highway of death



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 if you start below a minimum amount of 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.

It is obviously natural and necessary for anyone considering forex trading to think about the money. How much can I make? Although trading is about much more than just the financial bottom line you cannot consider this as a serious venture if you don't think about the money. This question comes up, even before people join my mentoring programme, and that is how it should be. You should be asking this, and you should be worrying and calculating and thinking. Trading uses time and money and resources. You need to make more than you spend, or lose. But it is hard to get a proper grip on this at the outset. For one thing you have the marketing machine of the forex brokers to contend with.

This is a key part to trading that most people are blissfully unaware of. For their business to work, they (the forex brokers) need you to open an account and fund it and begin to trade on it. The marketing wizards know all the tricks. They are experts in psychology, buying psychology. They have devised the mini and micro account. You are invited to start trading with anything from $25 to $500.

There is currently an advertisement running in South Africa by a Mediterranean island-based forex broker on how to supplement your monthly income. This advertisement runs on pay-TV. Its viewers are part of the middle- and higher income groups. The ad urges you to open an account with R1,000 (rand) and trade $20,000. The rand exchange rate the last year was mostly between R8-00 to R10-00 against the US dollar. So what is the South African public hearing? Take a fraction of your monthly income and supplement your monthly income substantially because the calculation is simple: If I make 2% on $20,000, which is $400, times the exchange rate, you have an additional R4,000 per month – that pays for a decent 3-Series BMW! Yeah right.

Under-capitalization also causes 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.

DON"T 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.

The collapse of Wall Street, the disappearance of venerable financial institutions like Bear Stearns, has helped me greatly to force home the point about leverage. Take the above advertisement I alluded to. Before the crash an advertisement like this, offering you leverage of 160 to 200 times your capital would hardly raise an eyebrow. Starry-eyed wannabee traders wouldn't listen when I told them that they would crash and burn. Bear Stearns got slaughtered with leverage of 30:1! Think about that. This advertisement is offering you six times the leverage that killed off an American institution that had within its four walls some serious computing power and experience. Where is Lehmann Brothers? Merrill Lynch? Goldman Sachs has become known as "Government Sachs". What did they all have in common? Leverage that was too high. Leverage is a very powerful tool, but losers use it to great effect to destroy their trading capital rather than build it - simply because they underestimate its destructive force.

DON"T 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 follow however that your trade is in the hands of lady luck. That is because 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 good level may be 50 to 100 pips below where you thought it was, or more. **Trading levels must also be seen in perspective.** We referred to Jim Rogers 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 $1 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 that do not take into account 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.

DON'T 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**. Warren Buffet famously remarked that if history books were the key to riches, the Forbes 500 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.** In mid 2009 the US SEC (Securities an Exchange Commission) considered banning certain automated trading practices that operate in milliseconds (in and out) but create the illusion of huge volumes. It is estimated that a large percentage of trading volume increases on the New York Stock Exchange in the last few years were based on these phantom trades that leave a volume trail but no change to discernable prices for the human trader! This means that even stock traders may be overestimating their volume indicators.

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.

DON'T BE INFLEXIBLE

Yes, have a system, but when the facts change adapt, employ that animal instinct to survive, use your discretion. Remember what Charles Darwin said. It is not the strongest or the fittest that survive, but the most adaptable.

DON'T TRADE AGAINST THE "FUNDAMENTAL" TREND

It is vital to understand what constitutes relevant information, and secondly, once you have that 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 imminent 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 that 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 imminent central bank intervention. I don't take positions against central banks. If you want to, make sure you have more bucks than brains.

DON'T 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 if you believe in discretion and the power of discretionary trading as I do, 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**. 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 too 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.

DON'T 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 your 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 and your character. They don't matter to the market. The market doesn't care. But they matter, and they should 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. Individual traders should see their trading as a "Personal Forex Trading Business".

DON'T 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 and consistently correct buy or sell signals through a variety of market conditions in the long run. Yet people use them repeatedly as if the act of simply trying the same thing again will somehow change it. Rational, intelligent people, do this, over and over. **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?

DON'T BE ARROGANT

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'. 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.

DON'T TRADE TOO SCIENTIFICALLY

Trading is not an exact science. In fact it may not be 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 not offering you "just another system". Actually, **I am offering you a whole new approach to trading the forex market**, 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 – after all it is a Personal Forex Trading Business. If someone starts a part-time plumbing business he will print business cards saying *"Joe Soap Plumbing"*. By extension your card should read *"Joe Soap Forex Trading",*

IS, NOT OUGHT

Your trading approach 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 is. Which is a different way of saying only a small minority really understand what the market is. Desire, need, fear, greed, something, I don't know what, 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 approach 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 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 showing him the value of the bigger picture.

The big guys make a wave. You can choose, surf it or drown. Imagine yourself as say, a welter-weight boxer 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.

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 opponent's 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. 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 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 that 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 market often surprises the amateur trader. 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 leverage. 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% of 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 & 5) 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 some of the material herein abbreviated, my **An Introduction to the Foreign Exchange Market.** As a member of the ForexClinic community you can download a copy of this on www.forexclinic.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.**

Contents

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 governments. Monetary policy will not primarily focus on the value of the currency but will use other measures to influence the currency such as

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

- 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 $3,20 billion in 2008, 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. The newest kid on the currency block is the Chinese Yuan (Renminbi). China, with its population of 1.3bn people and its skill at manufacturing goods cheaply is a huge nett exporter of these goods, and consequently it has a large balance of payment surplus. China has long been accused of currency manipulation, pegging its currency at a fixed rate against the US dollar since the early 1990s until about 2005 when it allowed some relaxation by pegging its currency against a basket of currencies. What this means is that they manipulate the value of the currency according to the values of a fixed basket of currencies, not entirely free-floating but not a fixed peg either. Since the float the Chinese Yuan has strengthened from 8.27 to the USD to 6.80 to the USD. Chinese financial markets and infrastructure have traditionally been poorly developed and exchange control has hampered the Yuan from becoming a real option as a reserve currency. But many of

---

[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.

these issues are now being addressed and the Chinese currency may play a pivotal role going forward.

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 which is changing millions of dollars in order to make an investment in another country, or Walmart buying toys for the Christmas shopping season.

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.

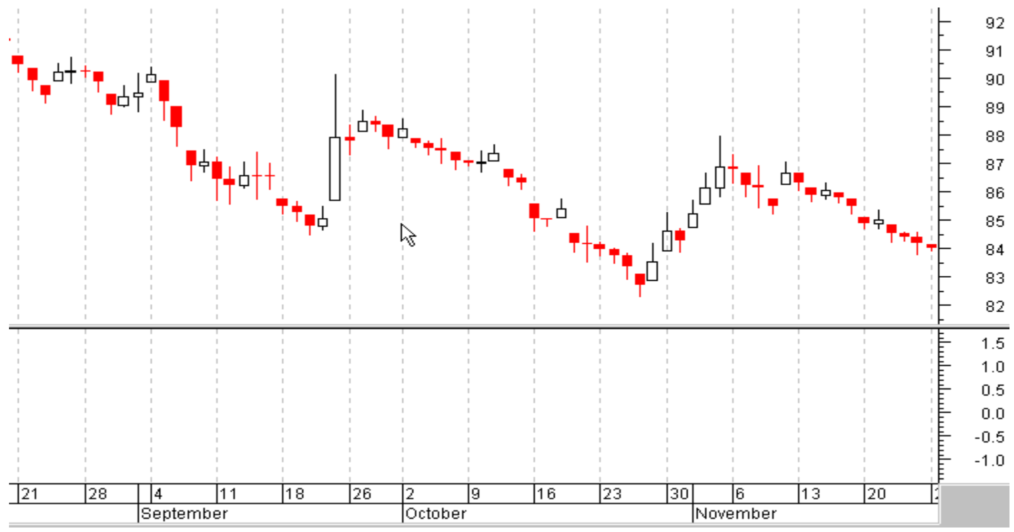
INTERVENTION

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 (the big white candle in the week of September 18th), continued to weaken against the dollar from the intervention level, roughly .85, which caused a spike to roughly .91 and then it fell back to below .83 about a month later. Repeated interventions in the following months were required in order to stabilise the euro against the dollar. I keep this old example in BWILC for two reasons. I have an emotional attachment to it. It occoured during the first weeks of my direct interest in the currency market and I can still remember the reverberations it had in the bond market while I was in my second year of trading. It was also the single biggest daily range until October 2008 and the credit crunch. Not even the tragic events of 9/11 produced such a daily range. But then came 2008, the illiquidity, the fear and with that the herd behaviour, and it all caused such volatility that we will for years to come think of the market in terms of pre- and post-credit crunch.

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: Japanese stance July 2009

Rintaro Tamaki, Japan's new deputy-finance minister for international affairs, hinted Friday he would continue his predecessor's largely hands-off currency policy, making it unlikely he will actively seek to thwart rises in the yen. Tamaki also said he will maintain the policy of keeping the nation's $1 trillion foreign currency reserves mostly in dollar-denominated investments such as U.S. Treasury bonds. The deputy-finance minister, the finance ministry's top currency official, effectively decides whether to intervene to sell or buy the yen to affect its exchange rates with other currencies.

"If you ask me whether we have ruled out intervention, I say that's not the case," Tamaki told reporters. "We'll make a decision in line with our basic stance that rapid fluctuations in exchange rates are negative for an economy."

Example: Bank of Canada: August 2009

On 4 August, Canada's finance minister threatened intervention in the currency market, after the Canadian dollar hit a 10-month high earlier in the day. *"We are concerned with any rapid changes in the valuation of the Canadian currency vis-a-vis the US currency. We watch that everyday. There are some steps that could be taken to dampen that. There are, from time to time, indications of some speculation in the Canadian currency that is not justified in market terms," he warned, and added: "the bank retains considerable flexibility in this regard and will use that flexibility if necessary."*

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 effect on the other major currencies.

From 2003 to the beginning of 2004 the BOJ (Bank of Japan) was 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.

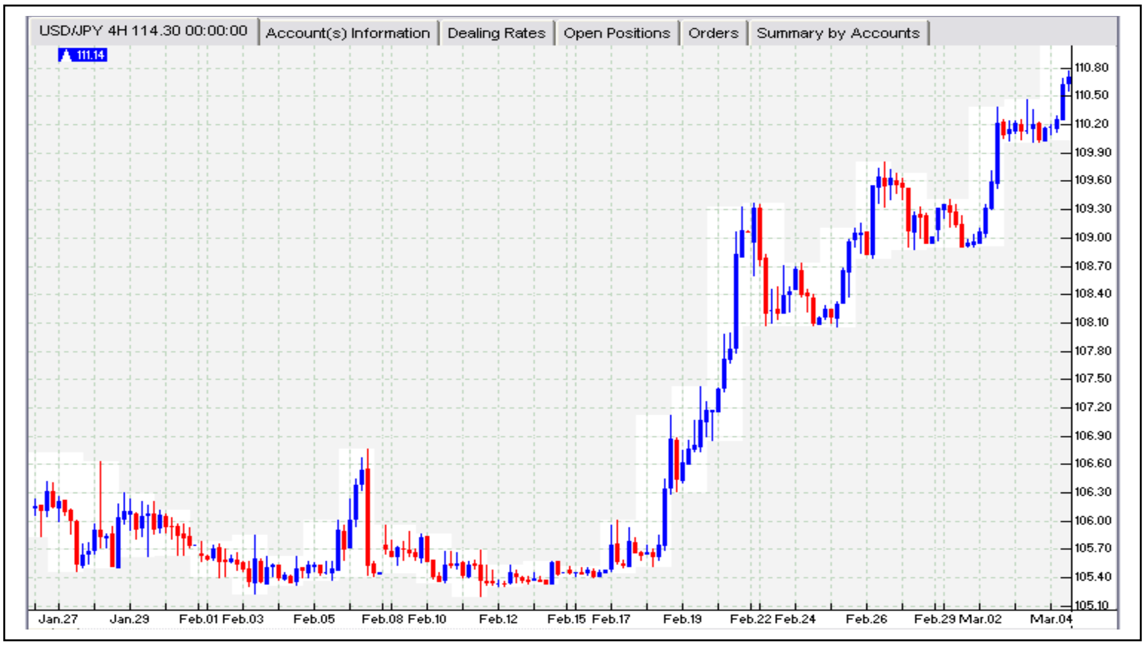
The BOJ often made use of 'verbal intervention'. This is a method of preparing the market, warning them as it were that the BOJ is thinking of intervening and this can in itself weaken the yen. It's a bit of a cat and mouse game. What the BOJ does is to set a target level of the yen versus the US dollar, 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.

After the BOJ stopped intervening in March 2004 there was a lull and for a few years there was no meaningful intervention from any major central banks. But with all the easy credit sloshing around it wasn't long before a bubble started developing in the carry trade causing currencies with higher interest rates like the Australian and New Zealand dollars to strengthen beyond their normal economic fundamentals. These countries are dependent on commodity-based exports and prefer weaker currencies (the stronger the currency the less competitive their exports). Hence a new interest in intervention began with the RBNZ (Reserve Bank of New Zealand) first threatening to intervene and then actually intervening in June 2007.

LONDON (Thomson Financial) - The New Zealand dollar fell sharply after the Reserve Bank of New Zealand confirmed it had intervened in the foreign exchange market today in response to 'unjustified' gains in the kiwi dollar. The New Zealand dollar has in recent days risen to its highest levels against the dollar since the currency was freely floated in 1985, and was trading at 0.7632 usd before the intervention. Following the announcement the currency has traded as low as 0.7477. The bank's governor Alan Bollard said they had intervened as they regarded the exchange rate as 'exceptional and unjustified' in terms of economic fundamentals.

The RBNZ said "foreign exchange intervention is an ongoing process" and it "will not be commenting publicly on its specific intervention activities". It confirmed that it "does not attempt to defend a particular level of the exchange rate", but "to send a signal that, in the Bank's view, the exchange rate is out of alignment with the economic fundamentals".

This intervention wasn't very successful. The market was in its last carry trade throes that began to deflate in late July and August 2007 after the first signs of mortgage–industry-based derivative product problems. The following graph also illustrates the enormous power of natural market forces. After intervention the market continued to strengthen to above 80 cents and then crashed as Bear Sterns' problems caused a rapid and disorderly retreat from leveraged risk trades.

In another surprise move, showing the new tendency to move back to intervention, the Swiss National Bank began direct intervention activities during 2009 as part of their rescue plan for their financial markets, banks and the Swiss economy generally. Their intervention was and is targeted specifically at the EURCHF exchange rate. See the graph below.

Interventions these days are rarely done abruptly and without warning. Central banks like dropping hints. They don't want to surprise the markets or scare them. They try to be predictable but of course they can't be too predictable. So continuous jawboning or formal comments will give you a heads up, and this creates opportunities for traders around interventions, either on the back of the central bank intervention or by exploiting the resultant overshoot in price.

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

The next few pages contain serious geeky stuff but interspersed you will find some of the major themes in the currency market that drive the long-term trends. (Understanding these trends is a vital part of a good retail forex trading plan.)

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 Sidney 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.

THE ECONOMISTS BIG MAX INDEX JULY 2009[6]

Value Meals

The hamburger standard

	Big Mac prices		Implied PPP† of the dollar	Actual dollar exchange rate July 13th	Under(-) / over(+) valuation against the dollar, %
	In local currency	In dollars*			
United States‡	$ 3.57	3.57			
Argentina	Peso 11.5	3.02	3.22	3.81	-15
Australia	A$ 4.34	3.37	1.22	1.29	-6
Brazil	Real 8.03	4.02	2.25	2.00	+13
Britain	£2.29	3.69	1.56§	1.61§	+3
Canada	C$ 3.89	3.35	1.09	1.16	-6
Chile	Peso 1750	3.19	490	549	-11
China	Yuan 12.5	1.83	3.50	6.83	-49
Czech Republic	Koruna 67.92	3.64	19.0	18.7	+2
Denmark	DK 29.5	5.53	8.26	5.34	+55
Egypt	Pound 13	2.33	3.64	5.58	-35
Euro Area**	€ 3.31	4.62	1.08††	1.39††	+29
Hong Kong	HK$ 13.3	1.72	3.73	7.75	-52
Hungary	Forint 720	3.62	202	199	+1
Indonesia	Rupiah 20900	2.05	5,854	10,200	-43
Israel	Shekel 15	3.77	4.20	3.97	+6
Japan	Yen 320	3.46	89.6	92.6	-3
Malaysia	Ringgit 6.77	1.88	1.90	3.60	-47
Mexico	Peso 33	2.39	9.24	13.8	-33
New Zealand	NZ$ 4.9	3.08	1.37	1.59	-14
Norway	Kroner 40	6.15	11.2	6.51	+72
Peru	New Sol 8.056	2.66	2.26	3.03	-25
Philippines	Peso 99.39	2.05	27.8	48.4	-42
Poland	Zloty 7.6	2.41	2.13	3.16	-33
Russia	Ruble 67	2.04	18.8	32.8	-43
Saudi Arabia	Riyal 11	2.93	3.08	3.75	-18
Singapore	S$ 4.22	2.88	1.18	1.46	-19
South Africa	Rand 17.95	2.17	5.03	8.28	-39
South Korea	Won 3400	2.59	952	1,315	-28
Sweden	SKR 39	4.93	10.9	7.90	+38
Switzerland	CHF 6.5	5.98	1.82	1.09	+68
Taiwan	Taiwan $ 75	2.26	21.0	33.2	-37
Thailand	Baht 64.49	1.89	18.1	34.2	-47
Turkey	Lira 5.65	3.65	2.45	1.55	+2
United Arab Emirates	Dirhams 10	2.72	2.80	3.67	-24
Colombia	Peso 7000	3.34	1,961	2,096	-6
Costa Rica	Colones 2000	3.43	560	583	-4
Estonia	Kroon 32	2.85	8.96	11.2	-20
Iceland	Kronur640	4.99	179	128	+40
Latvia	Lats 1.55	3.09	0.43	0.50	-13
Lithuania	Litas 7.1	2.87	1.99	2.48	-20
Pakistan	Rupee 190	2.30	53.2	82.6	-36
Philippines	Peso 99.39	2.05	27.8	48.4	-42
Sri Lanka	Rupee 210	1.83	58.8	115	-49
Ukraine	Hryvnia 14	1.83	3.92	7.66	-49
Uruguay	Peso 61	2.63	17.1	23.2	-26

*At current exchange rates †Purchasing-power parity; local price divided by price in United States ‡Average of New York, Chicago, Atlanta and San Francisco §Dollars per pound **Weighted average of prices in euro area ††Dollars per euro

Sources: McDonald's; *The Economist*

"*WHEN demand is scarce and jobs are being lost, no one relishes a strong currency. A country with an uncompetitive exchange rate will struggle to sell its wares abroad and will also cede its home market to foreign firms. A weak exchange rate, by contrast, encourages consumers to switch from pricey imports to cheaper home-produced goods and services. So which countries have cheap currencies, and which countries have expensive currencies?*

The Economist's Big Mac index, a light-hearted guide to valuing currencies, provides some clues. It is based on the theory of purchasing-power parity (PPP), which says that exchange rates should equalise the price of a basket of goods in each country. In place of a range of products we use just one item, a Big Mac hamburger, which is sold worldwide. The exchange rate that leaves a Big Mac costing the same in dollars everywhere is our fair-value benchmark.

The dollar buys the most burger in Asia. A Big Mac costs 12.5 yuan in China, which is $1.83 at today's exchange rate, around half its price in America. Other Asian currencies, such as the Malaysian ringgit and Thai baht, look similarly undervalued. Businesses based in continental Europe have most to be cheesed off about. The Swiss franc remains one of the world's dearest currencies. The euro is almost 30% overvalued on the burger gauge. Denmark and Sweden look even less competitive.

Care is needed when drawing quick conclusions from fast-food prices. The cost of a burger depends heavily on local inputs, such as rent and wages, which are not easily arbitraged across borders and tend to be lower in poorer countries. So PPP gauges are better guides to misalignments between countries with similar incomes.

On that basis, the markets have been kindest to British exporters. A year ago the pound was overvalued by more than a quarter on the Big Mac gauge. Now it is close to its fair value against the dollar and looks cheap against the euro. That shift has upset some other EU countries that had relied on selling to spendthrift British consumers. But after years of struggling with an overvalued currency, British firms will feel they deserve a little mercy."[7]

[7] THE ECONOMIST, Print Edition, July 16th, 2009

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.
- Monetary and central bank policy actions.

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. The ability of central banks to change interest rates and therefore currency exchange rates also contributes to distortions of PPP measurements. At time of writing the EURUSD exchange rate is close to 1.5000 while the PPP rate is around 1.2000.

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 Rise and Fall of the Carry Trade

Any currency transaction involves two countries, which may have different local interest rates. If there is a large discrepancy between these local interest rates there is an arbitrage opportunity. You borrow money in the country with low interest rates, say, Japan where the overnight rate is very low and currently at 0.1%, sell the currency and deposit the money in a country with high interest rates, say Australia or New Zealand where interest rates are traditionally in the region of 6% to 8%. (Not so after the credit crunch of 2008 as all countries have dropped rates to stimulate lending and prevent economic contraction or recession.) Assuming you have strong banking relations and can clear 5% net on the transaction, then you will have a very good deal. Now assume you use some leverage of say 5:1or 10:1 and you can make really good money.

Another way to do the transaction which is much more common is to invest the proceeds of the loan in higher risk bond markets, equity markets and, during speculative frenzies, in commodity markets.

The implication of the transaction is that you will borrow yen from a Japanese bank, and in order to invest in, say, Australian commodity shares you will sell the Japanese yen and buy Australian dollar. If you are one of a herd of hedge funds and investment funds and other speculators all basically doing the same thing at the same time (as long as the interest rate differentials make the transaction viable) what will the impact be? Lots of yen supply means the yen will weaken and lots of Australian dollar demand means the Ozzie will strengthen. Isn't that great? After all you are short JPY and long AUD, you bought AUDJPY.

The carry trade therefore leads to the strengthening of the higher interest currency and the weakening of the lower interest currency.

Here is an example of a very simple carry trade transaction which is possible to do in your margin account as retail forex trader.

Assume the Japanese interest rate is 0.25% and US interest rate is 5.25%.

Assume you have $10,000 in your margin account and decide to leverage it 10:1.

You will sell JPY, buy USD, thus buy USDJPY, 100,000 and earn an overnight interest equal to (-0.25% + 5.00%) - (broker mark-up) x 100,000 / 365.

Let's say in this case the broker mark-up is 1%, your gain is 3.25 x 100,000 / 365 = $8.90 per day. If you hold this position for a year, you have made $8.90 x 365 = $3,250 which is 32.5% on your $10,000 margin. Not bad.

But that is not all. Since you have just joined the "carry-trade party" buying the USD like everybody else versus the JPY, the USD strengthens due to all the demand. Assuming you did your carry trade at 100 Yen to 1 USD) and after a year it has strengthened to 120 Yen to 1 USD, you have made 20% on your holding of 100,000 USD, thus you have made 200% on your $10,000 in addition to the interest of 32.5%, for a total of 232%!

Obviously this sounds too good to be true and unfortunately it is. A naked carry trade is extremely risky, especially if its leveraged like the one above. The risk lies in the potential for some external market factor to go against the grain of the carry trade and cause the JPY to strengthen. And if the market catches on to this everybody heads for the exits and tries to reverse their carry trades, ie sell USD (in our example, AUD, EUR, GBP, or whatever the high-yielding currency was they chose) and buy JPY. This dynamic looks like this:

The carry trade is an extremely important factor in the forex market. As I have explained, the majority of carry trades are done by large investment funds, and not small retail forex traders like you. As a result a dynamic develops in terms of which the “funding currency” (the one with the low interest rate where the money is borrowed) strengthens every time stock markets fall and when stock markets rally the carry trade booms.

Margin traders in particular can get a double whammy from carry trade unwinding. First emerging markets (or riskier markets) begin to tumble and they lose there, and then they have to convert holdings back to USD in order to meet margin calls, thereby exacerbating the strengthening of the JPY (on which they were short) to pay off the loans, and then reconvert again to USD.

This was the dynamic that has caused the price action during every episode of disorderly carry trade unwinding, as explained by this graphs of AUDJPY, USDJPY and AUDUSD for Q1 2008 which saw a spectacular “carry unwind” episode.

The carry trade will continue to be an important driver of currency markets and as we emerge from the 2008 crash one can expect a resurgence of carry trade strategies. Therefore the currencies of the countries that will increase interest rates more rapidly and sustainably than other countries will have an underlying driving force. At the time of writing it seems as if the AUD and some Scandinavian currencies like the NOK will initially lead the pack.

US interest rates are at very low levels and due to trillions of dollars created to address the financial collapse there may be a time that the Fed will have to rapidly increase interest rates in order to prevent inflation from escalating. (Inflation, for the typical investor (me and you), is a big problem since it eats away at the value of long term investments and therefore general monetary policy is to accept low positive inflation but not runaway inflation.)

Interestingly enough, due to the extremely low levels of US interest rates since the credit crunch of around 0.1% – 0.25% and the fact that the US Fed is likely to keep these rates as low as this for as long as possible it seems like there is a new carry trade developing where the USD is used as funding currency for speculation in commodity markets, especially gold.

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
WASHINGTON (MarketWatch) - Imports of goods and services into the United States rose for the first time in nearly a year in June, driven by higher oil prices, the government said Wednesday. Excluding oil, however, imports fell to the lowest level in five and a half years. The U.S. trade deficit rose to $27 billion in June from a 10-year low of $26 billion in May, the Commerce Department estimated. Most of the increase in imports and exports in June was driven by higher prices, not higher volumes. In inflation-adjusted terms, the trade deficit fell to the lowest level in nearly 10 years.

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.

National debt, Twin deficits, and reserve diversification and "a strong dollar"

Balance of payment issues affect currency values but only over the longer term. Theoretically large national debt and deficits are unsustainable and the weakening of a currency is necessary to assist in reducing the debt load and deficit. The US debt situation through the first decade of the 21st century shows record increases in debt levels and 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.

Let's examine the real world relevance for retail forex traders of this somewhat nerdy stuff. I am just going to use the USA as an example but these principles are universal.

First we must distinguish between "debt" and "deficits".

> *"A debt is the amount of money owed. A deficit is the shortfall in a current budget. For example, if we begin the year with a $6 trillion national debt, and in the following year we spend $1 trillion more than we bring in, we are running a deficit of $1 trillion. At the end of the year, that deficit will increase the debt to $7 trillion."*[8]

Any country needs money to make it work. It has to pay salaries and spend on government programs. It gets this money form taxes and government bonds

[8] Wiggan, A, The Demise of the Dollar, John Wiley & Sons, 2005

(treasuries, gilts). Bonds are a huge source of income for governments, and the bond market is the second largest market after the foreign exchange market. Bond and foreign exchange markets are also inextricably linked. (That is why I could easily make the transition from trading in our local bond market to trading in the global forex market.)

But what is a treasury or a bond?

It is a loan. Someone, usually a large institution like a bank, has lent money to the government by buying a bond. It is debt the government owes the bond holder. The government borrows money to supplement its revenue from taxes. It's easier and less risky politically, than raising taxes.

The government, after they decide how much money they need, fix a schedule for new borrowings, called "debt issuances" or "treasury auctions".

Here is a recent example (August 2009).

> *Another record round of Treasury auctions is scheduled for the coming week and could prove a disadvantage for stocks if rates continue to rise. The Treasury plans to auction $37 billion three-years Tuesday; $23 billion in 10-years Wednesday, and $15 billion in 30-years Thursday.*
>
> *http://www.cnbc.com/id/32337268*

Money is borrowed at a bond auction. These auctions basically work like this. The $23 billion 10-year treasuries will pay a fixed interest ("coupon") of say 4% per year for ten years and then it will repay the principal amount also. The auction is the primary market where primary dealers (big banks, institutional funds) bid to lend money to the government at the highest possible rate. But because it is an auction the government will take the lowest bids. This may sound odd. Isn't the rate fixed at 4% as stated above? Actually how it works is that the bidders bid a specific rate to have the privilege of getting a guaranteed 4% for the next ten years (guaranteed by the US government which is supposed to be the safest investment in the world). That income stream of 4% a year on say $100 million may be worth money in the future. Whatever rate they bid is what they believe it is worth today, and that is the going 10 year rate. But if interest rates change in the future, getting a sure 4% per year can be a better or worse deal, depending on whether interest rates increase or decrease. Let's say the market (bid) rate decreases to 2%, then having a sure 4% per year looks good and the bond becomes more valuable. The original primary dealer who owns the "paper" (bond certificate entitling him to the interest and capital amount) can sell it at a profit. Simply put, when interest rates go down, bond prices go up. If rates go up, having a 4% ten year bond is unattractive and you may have to sell at a loss if you can't hold it to maturity.

That's the source of treasury loans. At these auctions there are two groups of bidders, namely the primary dealers – authorized banks and institutions - and also indirect bidders which include all other institutions and also foreign governments or central banks.

The US total debt is currently increasing hand over fist due to huge deficits. These are the so-called twin deficits, the budget deficit and the trade deficit. Addison Wiggan in Demise of the Dollar, p. 8, gives a good simple explanation:

> *"We're living beyond our means. It's as simple as that, and something is going to give. The federal budget deficit – annual government spending that is higher than tax revenues – adds to the national debt at a dizzying rate, making our future interest burden higher and higher every day. Our trade deficit – bringing more things in from foreign countries than we sell to the same countries – has turned us into a nation of spendaholics. We've given up making things to sell elsewhere, closed the store, and gone shopping. But we're not spending money we have. We're* ***borrowing*** *money to spend it."*

Who lends the money to the (US) government? Ordinary citizens and corporations through their banks and pension funds and endowment funds and insurance companies, and foreign countries, especially Japan, China and oil rich countries are the main lenders. They lend it primarily via the treasury auctions. This means that these countries own trillions of dollars of treasury certificates on which the US government must pay the interest as well as the principle at the end of the term. So the US has become a huge debtor state.

The following two factors are important regarding the US dollar. First, in order for the US to change from an importer nation to an exporter nation and improve their trade deficit, the US dollar needs to weaken and this will make US exporters more competitive and thereby bring down the trade deficit. This actually did happen from 2003 – 2007 when trade deficits were well above $50 billion per month because the USD declined against major currencies including the Chinese Yuan. As a result the deficits dropped to below $30 billion per month by 2008 /9. (But there is a down side to a weaker dollar. Suddenly the millions of barrels of oil they need have become more expensive.) Second, a weak and weakening US dollar has an interesting consequence on the repayment of those billions of debt to creditor nations. It works like this. Say Japan has bought 100 billion dollars worth of bonds in a specific year at an exchange rate of 120 yen to the dollar. "Bought bonds" mean "lend" 100 billion dollars to the US. In order to do that they had to exchange yen for dollars and they had to fork out 120 x 100 billion yen. The US will now pay, say 4% interest per year plus at the end of the term, the $100 billion. Assume the dollar now drops steadily to 80 to the yen, then $100 billion at 80 = 80 x 100 billion yen, which is a lot less than 120 x 100 billion yen. So the Japanese lose and the US wins, and it is large amounts of money we are talking about. Thus there is a big incentive for both the US and Japan to prevent their currencies from getting too far out of sync with each other.

Because trade deficits are a longer-term driver, and not as direct as interest rates they are 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.

Finally lets have a look at "currency reserve diversification".

The dollar is the world's reserve currency. It is the most widely held currency, and is also generally the transactional currency for global payments including for most oil, gold and other commodity transactions.

Every country needs to hold some reserves of other countries they transact with and especially the world's reserve currency:

> *"(1) They may need to accumulate balances for transaction purposes such as to cover purchases of goods and services or to service debt coming due if there is a temporary shortfall in export earnings or temporary closing of access to international capital markets. (2) They may want to accumulate a stock of foreign exchange holdings beyond that point as insurance against sudden stops (or reversals) of capital inflows. (3) They may want to resist appreciation of their exchange rates in order to sustain the rapid growth of their exports. (4) Finally, they may have a view about the optimal allocation of the government's financial investments."*[9]

[9] Institute for International Economics. Working Paper Series. 2006.

During 2008 the formal level of currency reserves worldwide was:

USD	64%
EURO	26.5%
POUND	4.1%
YEN	3.3%

If the US dollar continues to decline at the pace it has been and if the debt levels continue to increase and so also the deficits, it may be problematic for some countries to have so much US dollar reserves, preferring other currencies, and this is an ongoing theme that surfaces every now and again in the currency market. However, the two largest holders officially of US dollar reserves, China and Japan, are not on a diversification spree like Russia and some oil nations who have physically changed US dollars for euros.

It is however clear that China has an interest in diversification and China is buying, through state-owned banks and companies, global companies, especially in the commodities sphere. China has increased its gold reserves tremendously and began to call for more expansive use of the IMF Special Drawing Rights – a type of international currency used for aid purposes to poor countries.

During November 2009 India bought 200 tonnes of gold from the IMF in order to diversify its reserve holdings.

Combining this knowledge about reserve diversification with the extreme levels of US dollar strength during the 2008 financial crisis helps to understand where really significant technical support levels may be in the currency market, always useful for a trader.

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 ("overshooting" simply refers to the tendency currencies have to increase or decrease in value more than they "should" because of volatility. They then pull back to reasonable levels and settle in where they "should" be, more or less. Precisely 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 credit bubble that built up through 2004 – 2007, due to the US Federal reserve keeping interest rates too low too long, and thereby feeding a lending binge, regulatory changes, and the development of all sorts of derivative products linked to home loans, burst, and this led to some spectacular currency overshoots that were directly linked to the sub-prime home loan backed securities, and the unwinding of large carry trades.. As a trader you had to have your wits about you. Trading for large periods of 2007 and 2008, and even in to 2009, was very tricky. This period set a new standard for overshooting of exchange rates as well as volatility. What used to be considered extreme price moves, became the norm on daily, weekly and monthly ranges.

See below some examples of currency overshoots that took place during the recent economic collapse.

One could argue that everything sub 1.50 / 1.45 was a final overshoot, about 1,000 – 1,500 pips. GBPUSD has corrected since mid March '09 with more than 3,000 pips to regain the 1.70 level.

Similarly one can argue that the AUDJPY overshot on the upside roughly above 90 and on the downside below 70, a level which it regained convincingly within a few months.

These kinds of moves aren't normal for the currency market. They took place during the greatest financial crisis to hit our markets, but they do serve as a graphic illustration of the overshoot principle. In the long-term generally the range is smaller (the overshoot range) as currencies tend to have rather narrow price ranges by comparison to the graphs above. But you still need the big picture view, the step-back picture, as a short-term trader in order to build for yourself a robust trading system that can withstand anything the market throws at it.

ARE YOU READY TO TACKLE THE FOREX MARKET?

Above we described the main drivers of foreign exchange on a macro level, ie what is behind the decision making of thousands of treasurers of global companies involved in importing and exporting goods, as well as global money managers and investment funds, sovereign wealth funds and even central banks. You have to keep in mind that especially pension-based global investment funds, which are huge, generally have a pretty low expectation regarding returns. What they are interested in is stable returns and the protection of capital as well as beating inflation. Therefore it is important for them to make sound long-term decisions. The price moves of weeks or months really don't interest them. However, what is extremely important for you, the short-term trader is *how* they make these decisions

It isn't necessarily that they have an army of in-house strategists specializing in foreign exchange. No, the advisory services are pyramid-like and the large pools of capital are at the bottom of the pyramid. The advisory channels are at the top end and information filters through to the lower levels through very narrow "channels".

RETAIL AND WHOLESALE

There are two very distinct sections in the financial markets, the wholesale sector and the retail sector. The wholesale sector is the big analysis and information factory with the analysts, economists and strategists for rent. Investment banking groups and also normal banks, which provide foreign exchange services, churn out all the research that distill this geeky stuff and provide it to their eager client base of smaller banks and other investment institutions.

The fantastic growth in foreign exchange turnover since 2001 mainly took place in the retail sector, not the wholesale sector. The implication of all this is that the type of advice looked for by the wholesale sector is not concerned with the specific path many currencies take to get to their end point over say two, three or five years. They know it will be a bumpy road. But they want to have strategies that are concerned with 12, 18, 24 months ahead as they want to allocate capital to low-risk-high-return (relative to their objectives) investment areas.

Then there is also a huge group that is indeed interested in a shorter, but still not short, time horizon. It comprises hedge funds and other money managers, as well as treasury departments that are dependent on cyclical market developments in the business and economic cycle.

It is important then to know that when the forex market is characterized as a trending market, it is not because there are relatively big intra-day or even intra-week moves that are sustained in one direction and thus fulfill the definition of a trend (higher highs or lower lows) but because there are durable trends over months and years.

It is one of the main premises of this book that to determine these trends is not really difficult once you understand the bigger picture and know where to look and how to weigh different contributing factors to the core drivers of the currencies you are interested in. But since there are a number of such drivers with different impacts over different time horizons, one strategic move a trader can make to simplify things is to limit the number of currencies he wants to analyze and trade.

So there you have it. Two of the four main ingredients of the “magic” forex formula: “One direction and one currency”.

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.

Whenever you begin trading, you do so in the midst of a long-term trend. You have no control over it. The trend is the trend. Whatever happens in terms of large forex moves over the next few months after you have entered the market will probably have a huge impact on your experience and early profitability. And a lot of it may just be luck. Let’s take a few scenarios.

Trader A started in the beginning of 2005 as part of his New Year's resolutions.

Trader B started in May 2006 with a live account after "learning" to trade with some technical indicators. Underlying his indicators are a combination of moving averages. By April his moving averages indicators all pointed up. He ends his first month of demo trading rolling in demo money. He rushes to open a live account.

Trader C began his demo trading in February / March 2008 as an intra-day trader applying technical analysis methods and using very short time horizons. He became enamoured with Fibonacci analysis and retracements and this worked like clockwork and everything was going well for him. He also used intra-day pivot points. He perfected his timing. He limited his losses with tight stop loss orders, 20 – 30 pips away. On August 4th, 2008 he did his first live trade.

I hope you can see that any realistic attempt to become a sustainable forex trader has to have a non-negotiable long-term mindset. You simply cannot make any conclusions about your abilities after a few months of fooling around with charts, indicators, pivots, Fibonacci's, Elliott waves and thousands and thousands of miniscule time intervals. 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 or a ranging period like these real life illustrations above his short-term price charts will be misleading, seemingly clearly giving signals to buy this or sell that even on short time frames. This type of back-testing merely serves to confirm faulty judgment.

The scenario that confronted Trader C above was a "once in a lifetime", the "black swan" Nassim Taleb wrote about. It is instructive that while the stock market was crashing in the early stages of the second half of 2008, Taleb made huge returns for university endowments he was trading for.

Very short-term traders have this one inescapable problem: this so-called "once in a lifetime event" actually repeats itself over and over again in the miniscule world of sub-hour trading. The demise of the family life and "family fortune" of so many families was the result of sub-prime lending practices. Sub-prime became a derogatory term. Well, if you take a good, hard look at sub-hour forex trading you may come to the same conclusion. The perfect storm that hit the financial markets in 2008, hits the sub-hour forex trader on a regular basis. Here is the most recent example and as you can see it doesn't look totally different from the real-world perfect storm that mauled Trader C.

The above graphic shows a few weeks of sub-hour intervals, a mere 400 pip range for almost 6 weeks. Here you have the equivalent of three perfect storms in a six week period *because* we are looking at sub-hour intervals. In other words, *you* have created the storms by choosing to sail these waters (short timeframes). Believe me, the market has enough up its sleeve without you also creating problems for yourself. And the challenge to you as a trader is to build a system robust enough to withstand the storms you can do nothing about.

They will come along and they are tough to deal with. Why make more problems for yourself than you need to? The challenge for every trader is to build a boat that can sail through the once-in-a-lifetime financial storm when it comes, and not to build a boat and then go looking for every storm you can find.

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 3.2 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 $50,000,000 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*."[10]

Table 3.2: **Growth in foreign exchange turnover**[11]

Year	Daily Turnover	Year	Daily Turnover
1977	$5 billion	2001	$1.2 trillion
1992	$ 1 trillion	2004	$1.88 trillion
1998	$1.5 trillion	2007	$3.200 trillion

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." [12]

Keep in mind that the figure of $3.2 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.

[10] Cross, Sam, Y. The Foreign Exchange Market in the United States, Federal Reserve Bank, 1998, p. 15.
[11] Long, K. Electronic Currency Trading for Maximum Profit, 2001, Prima Publishing, p. 20.
[12] 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 described the way individual traders can anticipate how prices follow through from one market to another in Part 5.

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
- New Zealand dollar
- Norwegian / Swedish kroner

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.

<u>Example:</u>
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.

<u>Example:</u>
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.

"<u>Investors</u>"

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)[13]. 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
- Sovereign wealth funds[14]
- Other companies
- Individual high net-worth speculators
- Trading advisors / money managers
- Individual "retail" speculators who include "retail" money managers

---

[13] 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.

[14] A sovereign wealth fund is a government investment vehicle which is funded by foreign exchange assets, and which manages these assets separately from official reserves.

Sovereign Wealth Funds (SWF)

These funds are not a new development in the institutional investment universe - the first one was in fact created in 1953 by Kuwait, but since 2000 their popularity in cash rich countries soared. These state-controlled funds are often found in cash flush Asian and Middle-Eastern countries with big trade surpluses. Low yielding government bonds are not the most exciting way to manage your forex reserves and so they are always on the outlook for new, innovative and profitable ways of doing the same thing.

By 2008 the total capitalization of sovereign wealth funds was $3.8 trillion. Most of this vast fortune belonged to a handful of sovereign funds like Abu Dhabi, Kuwait, Norway, China, Singapore and Russia, all countries with oil.

It is uncertain what influence SWF will have on global financial markets. During the crises of 2008 some of these SWF were approached by the major US investment banks in trouble asking for help to save them from bankruptcy.

It is safe to assume that these funds are major players in the long-term currency markets and being speculative in nature (their purpose is to achieve higher returns than the traditional bond investments used for foreign exchange reserve management) they may have agendas that supersede the immediate concerns of short-term traders. They also clearly have enough money to influence futures markets, stock markets and thereby, indirectly, currency markets and currency market sentiments.

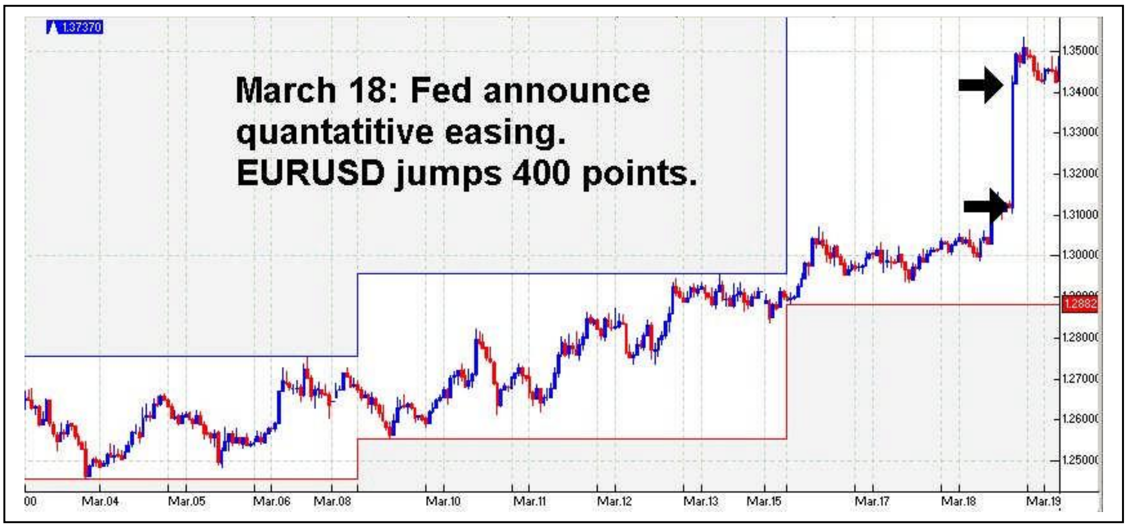
Central Banks (Governments)

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.

Central banks also have a direct impact on currency markets. Monetary policy requires intervention in the market, be it interest rate adjustments, or, since the crash of 2008, new indirect interventions like quantitative easing and the outright purchasing of mortgage-backed securities. Let’s take a look at a practical example.

Most major central banks meet once a month or once every six weeks in order to evaluate interest rates and other policy matters. Their meetings are keenly watched as central banks generally release either explanatory statements (US Fed) or hold a news conference (ECB) in which they explain their outlook or recent decisions.

All markets are focused on these meetings and their outcomes. However the outcome may affect different markets (stock, bond or currency markets) differently and these reactions may also differ based on the expectations that particular market had of the announcements as well as where in the economic cycle the country is when announcements are made. Generally the *expectations* of interest rate changes cause larger forex movements than the *fact* of interest changes.



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.

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

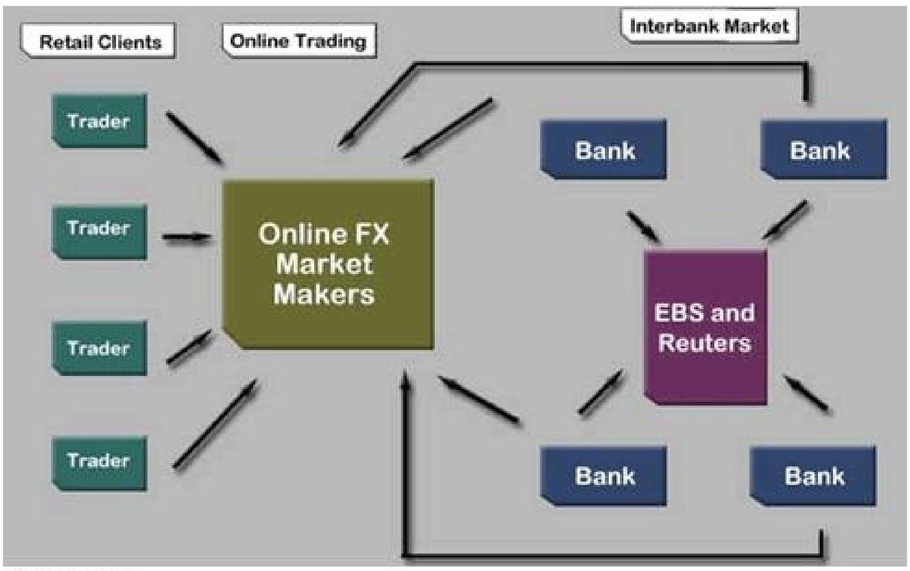
- Indicative price of EUR/USD 1.2990 / 1.2995 is offered to the customer;
- Customer requests to buy EUR (1.2995);
- Broker searches to match with another client wanting to sell at 1.2990; or
- Broker searches for best deal (in terms of market) with several market makers;
- Broker relays trade to best price, and makes profit on spread differential

How prices are made

It is important to distinguish between two types of prices: indicative prices and dealing prices. Prices originate in the wholesale or Interbank market. You still find telephonic pricing but now it is mostly electronic pricing. Just as in any quote system, different participants quote different prices.

There are two main Interbank pricing platforms, Reuters and EBS. They provide wholesale and retail prices, that is, prices for the Interbank players, and prices for you and me. Providers like LavaFX and FX All provide electronic dealing prices to the retail sector including your friendly forex broker. 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 banking dealing rooms allowing retail dealers and traders to analyse liquidity and anticipate price changes more effectively.

Here is a simplified graphical representation of the decentralized forex market structure, courtesy of FXCM:



Source: FXCM

Straight-through-processing technology has become more prevalent in the last few years and most of the typical individual retail traders' broker platforms these days employ straight through processing most of the time. These are also known as "non-dealing desk" platforms. Effectively prices are streamed from service providers like FX All and LavaFX to me, you and our respective trading buddies' computers and cell phones, without making a pit stop in the forex brokers' dealing room. This way we are a little bit closer to the Interbank market pricing dynamics, including variable spreads. Warning: losers didn't become losers because their brokers added some fat to the spread and "traded against" them and "ran their stops" and used other unsavoury tactics. Most trades take place without any dealer intervention. Nothing will save you from a fundamentally flawed trading approach, strategy and system.

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. Real-time 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.

Some retail forex providers offer volume data. There is some debate about the value of available volume data. Volume can be derived indirectly from tick data on the Reuters and EBS quote systems, but this is not necessarily indicative of any real trading volumes. Also remember that these systems don't include all trading taking place but only a section of the market that is trading. The other option besides Reuters & EBS is that the retail forex broker indicates local volume traded by its own clients. But I won't make any bets based on the prices and volume traded on by other retail traders. They are just too small a segment of the market as a whole.

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.

This is due to the different sources of pricing, effectively hundreds of dealing rooms quoting simultaneously and obviously these quotes, though very close to each other, are not the same, and one must never forget that the dealers in these Interbank dealing rooms are not there to make money for you, but for their employers.

The forex market is not where you come looking for altruists.

Here is an interesting graphic provided by FX All, showing the logos of banks they derive prices from for over 300 currency pairs:

PERSPECTIVES ON RETAIL FOREX MARKET MAKERS / BROKERS

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

Terry Smith – renegade broker

Brokers

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 (your deposit in a live trading account) 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.

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.

The sales pitch

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, charting and technical indicators
- Free demo account
- 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 / micro lots
- Start trading with $25 or even $1
- Funding your account with credit cards
- Unlimited currency pairs
- 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.

- **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.

  Example

  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.

In other words, when a forex broker says “Leverage = 100:1”, they mean you can trade up to 100 times your capital in your account. Leverage is calculated by dividing the size of the position you take by all the capital in your account. For example, assume your broker offers “leverage of 200:1”. Now say you have $10,000 in your account and you decide to trade a USDJPY position on a so-called “Standard Account” or “standard lot”, i.e. USDJPY 100,000. Once you open the trade, at say, USDJPY = 100.00 your leverage is 100,000 / 10,000 = 10:1. And your equity changes with $10.00 per pip. You could also have traded USDJPY 350,000 and then your leverage would have been 350,000 / 10,000 = 35:1. And if you are completely idiotic you could have traded 2,000,000 / 10,000 = 200:1, the maximum leverage offered. Every pip would cause your equity to change with $200-00. Just opening the trade, before the market has even moved, will have you down 6% if the spread is 3 pips. (You have just paid, to open a trade, what a pension fund is happy to make in a year. To be wiped out completely you need no more than a 44 pip move in the wrong direction).

- **Mini & Micro lot accounts:**

  This is a very positive development. In the early days of retail forex trading there were only 100,000 unit lots. Then people were “advised” to open accounts with at least a few thousand dollars, like $3,000 or $5,000. Their leverage in other words was in the region of 20:1 ($5,000 account) to 33:1 ($3,000 account). Add to this that people were so encouraged (and excited) by all the new and free technology and indicators and tick price data that they would attempt several trades a day. Most were wiped out. But now, with mini accounts, traders without a lot of money have the opportunity, for the very first time, of trading with sensible leverage.

  Unfortunately the marketing wizards got involved again. The mini and micro **account** was born. Mini and micro lots are good, don’t get me wrong. But mini and micro **accounts** are not so good, because all that happens now is that the old 100,000 / 3,000 scenario repeats itself. Now people fund a mini account with $300 and trade 30,000 to 60,000 units with 100:1 to 200:1 leverage. Absolutely nothing has changed. The $300 account loses, with a $30,000 position one third of its value with a measly 30 pip price move against it after paying a 3 pip spread. Back to square one.

People delude themselves into thinking that because they trade with smaller amounts they will do better, but mathematically they are taking exactly the same ludicrous risks!

Here is some good advice. If you can't fund a trading account to the value of the minimum transaction size you should first save up until you can. Since minimum transaction sizes at many brokers are as low as 1,000 units it means you can probably get away with $1,000 to start with, but you then need to ask yourself a few tough questions:

- Do I have realistic expectations or do I think I can change $1,000 into $100,000 in a short period of time, simply because I have the opportunity to use high leverage and my deposit is "small change"?
- If you have realistic expectations is it worth the time, effort and mental energy?

- **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" and "high probability" 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) and fret about a spread of 4 or 5 decimals. I am not going to do it.

Let me tell you what I do, and the account featured at the end of the book in the Appendix 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 use high leverage. I will use low leverage and enter positions at several strategic levels and when I talk about low leverage I mean the total leverage of all my positions combined is low.
- I will not place a stop loss, I use mental stops or opposite orders to offset the initial position 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 what I call a “price level”. Anywhere in or around a price level is good enough.
- I will not use some *hocus-pocus* guaranteed-to-make-you-rich technical analysis system.
- I will take my profits quickly (most of the time). “A profit a day keeps the bailiff away”.
- I will not use miniscule time frames to try to pinpoint trades with technical tools linked to those time frames.
- Oh yes, I will not study the trading methodology of a mini account trading competition monthly winner or demo account trading competition 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.
- Talking about cash prizes: One of the more common schemes of brokers today to get people to fund accounts or refund accounts is to offer “bonus” money. It sounds like a great deal. Fund your account with at least $5,000 and get a 10% bonus deposited into your account. But if you look at the fine print it says: “Bonus money can only be withdrawn after you have done so many “standard lot” trades in three months. “

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 1.3779/1.3783, indicates the dealer is prepared to buy EUR at 1.3779 and sell EUR at 1.3783. The client, conversely, will buy at 1.3783 and sell at 1.3779.

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 0.8400 pound sterling
EUR/USD	1 Euro equals, say 1.3950 US dollar
EURJPY	1 Euro equals, say 135.00 yen
EUR/CHF	1 Euro equals, say 1.2500 Swiss frank
GBP/USD	1 Pound sterling equals, say 1.7500 US dollar
GBP/JPY	1 Pound sterling equals, say 190.00 yen
USD/JPY	1 USD equals, say 97.50 yen
USD/CHF	1 USD equals, say 1.0860 Swiss frank

Figure 3.5: **Major currency quotations**

Symbol	Bid	Ask	High	Low	Net Change	% Change	Last Updated
EURUSD	1.42878	1.42920	1.42908	1.42898	-0.00031	-0.02	21:07:14
USDJPY	95.410	95.452	95.442	95.405	-0.029	-0.03	21:07:15
GBPUSD	1.65753	1.65825	1.65791	1.65807	-0.00031	-0.02	21:07:18
USDCHF	1.06989	1.07029	1.06995	1.07001	0.00019	0.02	21:08:10
AUDUSD	0.84258	0.84306	0.84310	0.84258	-0.00048	-0.06	21:07:37
USDZAR	7.9941	8.0116	7.9941	8.0106	0.0010	0.01	21:08:06
XAUUSD	954.95	955.65	954.95	955.40	0.00	0.00	21:07:26
USDCAD	1.08685	1.08733	1.08750	1.08712	-0.00031	-0.03	21:07:57
EURGBP	0.86181	0.86211	0.86191	0.86192	0.00006	0.01	21:07:10
EURJPY	136.329	136.401	136.446	136.334	-0.085	-0.06	21:07:15
AUDJPY	80.382	80.476	80.460	80.407	-0.081	-0.10	21:07:35
GBPJPY	158.145	158.293	158.274	158.196	-0.081	-0.05	21:08:16
EURCHF	1.52861	1.52912	1.52890	1.52903	-0.00024	-0.02	21:08:07

"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."[15]

[15] 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 1.6595 / 99

If the customer sells 1 unit of GBP he will receive 1.6595 USD
If the customer buys 1 unit of GBP he will “pay” 1.6599 USD

- Say the price quote is: USD/JPY 102.52 / 56

If the customer sells 1 unit of USD he will receive 102.52 JPY
If the customer buys 1 unit of USD he will “pay” 102.56 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. Now many brokers are providing quotes to the 5th decimal point. This is an interesting development which came together with Straight-Through-Processing and ever narrowing spreads which should pay for several layers of service providers. This new 5th decimal point pricing can be quite confusing and if you thought 4th point decimal pricing caused a disco-light effect when prices start jumping, then 5th decimal point pricing will make your head spin (and you will probably get worse and not better prices.)

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[16].

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

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 a minimum value of value of 1 million units of the principal or base currency. The foreign exchange brokers play an 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 introduced 1,000 lots or no specified size at all.

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.

We are currently in a recession because of the US housing market collapse. Therefore at this stage housing data is very important. At other times the market may receive it with a sigh and a yawn, but now it gets the pulse racing and the fingers dancing on the keyboards.

The main economic releases that influences currency markets (with differing impact at differing times) are:

- Interest rate expectations
- Employment data
- Inflation data
- Consumer confidence data
- Manufacturing / production data

Why and how they affect markets differently on different days is a subtle and complex business and I deal with this using my relational analysis tool (see Part 5. Understanding these changing economic variables and their influence on price is vital and that is what makes relational analysis such an important tool. It's a dynamic code breaker. 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.

A few years ago more and more wild speculation was occurring around keenly awaited data releases by the growing number of retail traders. Online brokers were suddenly saddled with additional risks they had difficulty offsetting with their clearing brokers, causing risks for themselves (and their clients). They had to take steps to minimise these risks and so some brokers would not allow you to place orders shortly before certain data releases. New STP systems also meant that everybody gets better dealing quotes from higher up in the forex pyramid and these prices display real world characteristics, like non-fixed spreads which widen substantially around 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.

The above numbers went completely out of sync during the crisis of 2008. I did another count and found an astonishing increase of 2,000 percent in the number of 30 minute periods of a 50 or more pip movement during the height of the credit crunch (October, November 2008).

RELATIONAL ANALYSIS

> **Definition:**
> **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 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.

RETAIL FOREX MARKET REGULATION

The retail forex market is a very new compared to traditional markets. Over time these traditional markets have become well regulated. Not so for forex. It was too new, too big, and we were all looking into a big regulatory void.

It is difficult to sum up the essence of regulatory and legislative import. They differ too much in the various countries. I will concentrate on the US, the UK and the EU (European Union).

The focus of regulation should be on “counter party risk”. In practical terms this means the risk that if you deposit $10,000 in a forex broker’s bank account it will be there in the morning, and when you ask for it you will get it, pronto.

In the US forex brokers are expected to have a large amount of unencumbered capital and in the UK money must be held in fully segregated accounts. Client and company funds may not be co-mingled. As a rule of thumb these US and UK companies are a safe, or safer, bet than companies registered on tropical islands.

Unfortunately, especially in the US, regulators began to meddle in the trading processes making both forex brokers and their trading clients unhappy. Some of the regulatory changes made in 2009 affected the detail of a few of my own trading strategies. But it is all part of the game and you have to learn to roll with the punches. One very positive change which became effective in November 2009 is a limitation on the maximum leverage US regulated forex brokers can allow traders to indulge in. Where leverage of up to 400:1 was previously the norm it has been limited to 100:1 on major currency pairs and 50:1 on others. This has been enforced by setting 1% and 2% respectively as minimum margin requirement for transactions. As I have explained before, leverage of 100:1 and 50:1 is still ridiculously high to trade properly but it is a step in the right direction. At least you don’t have people trading $200,000 and with $500 in their account.

Hedging

To understand the value of hedging you have to think like a trading institution with different traders who could take opposite positions from each other according to their trading mandates and discretion. For example a trading fund might have a trader A trading short-term strategies and a trader B trading medium-term strategies and a trader C trading long-term strategies. They may also have analysts focusing on major currency pairs only and offering some analysis on all of these time scales. At any given time the very short-term analysis and the long-term and medium-term analysis may differ in the sense that in the long-term strategy it is better to hold, say, long USDJPY positions but in the short- and medium-term strategies short USDJPY positions are better. In an institution these “conflicting” positions can be managed easily but usually the institution will, on a daily basis, “mark-to-market”, i.e. determine the net value of its whole market position. In order to determine the net value, opposite positions will be set off against each other and that way the institution can determine the real net value of its USDJPY positions. The idea is that the institution knows its exposure, long or short USDJPY on an accounting level, without the individual strategies being stopped out, closed out or changed on a daily basis.

I hope you can see the advantage this gives an institution with different strategies.

Forex broking software migrated towards allowing individual traders the option to hold opposite trades like an institution. For the typical losing trader with a trading style that involves finding one high probability trade in a currency pair and then doing a highly leveraged trade at that moment and that constitutes his whole trading book, the idea of multiple simultaneous trades, including opposite trades, is irrelevant.

But for the discerning trader with an institutional mindset, the trader who applies a strategy with different timeframes the option of having simultaneous long and short positions in one currency is important.

Setting off trades for investor funds at large trading institutions may well make a good regulatory sense, but why on earth they want to apply this principle to you and me only the regulator will know.

However, the US regulator thought it was a good idea to ban US regulated forex brokers from allowing their individual own account trading clients (you and me) to maintain opposite open positions on their accounts since May 2009.

In the trading strategy espoused in this book the use of hedging is a valuable risk management tool. I therefore recommend brokers that allow it.

It seems as if the reason the US regulator has banned hedging is in an effort to force individual traders to mark-to-market on a per second basis. It is mind-boggling why this approach was chosen to regulate some potential unsavoury practices.

The way the US regulator has enforced this “per second” marking-to-market was by forcing US brokers to execute multiple trades in the same currency pair on a FIFO (First-In-First-Out) basis. In other words if a trader opens a position “A” long

USDJPY at 90.00 in a long term strategy and later the same day a second position "B" in USDJPY at 91.00 in a short term strategy and he then decides to close the short term strategy trade ("B") for a decent profit, say at 92.00, the US regulator decided the broker must close trade "A". To be fair, on a mark-to-market accounting basis this doesn't affect the net value of the traders account, but it surely does affect his profitability potential, especially if hedging is part of his strategy.

Generally forex trading software for individuals has allowed what is called "per ticket" execution, in other words in the example above the trader would be able to close trade "B" first. This is not possible anymore at US brokers.

In the trading strategy espoused in this book the use of "per ticket execution" is a valuable risk management tool. I therefore recommend brokers that allow "per ticket execution".

DayForex is an introducing broker offering introducing broker services to individual traders, especially those utilizing the BWILC trading principles. Because of the recent regulatory changes in the US we have set up introducing agreements with reputable brokers in reputable regulatory areas in order to accommodate our clients and allow them maximum opportunity to benefit from the trading strategies explained in Part 4 and Part 5.

To find out more about these brokers and how you can use our introducing services to your benefit please visit www.dirkdutoit.com .

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 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

The edge

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

- Groucho Marx, Actor

Contents

OVERVIEW

- **Why trading is a business**
- **What trading is not about**
- **Edges: what they are and how to use them**
- **Real time analysis – know this and you'll know it all**
- **Technical analysis v fundamental analysis (do you know which is the right one in forex trading?)**
- **Currency correlations**

Introduction

Now we get down to the nitty-gritty of running a personal trading business. 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. It is important to note that while the edges you have are objective, the way you string them together and use them is subjective, and unique, because it is YOU that is trading. There is a dynamic relationship between your objective edge and your subjective use of that edge. Your personal trading business is not a franchise like McDonalds. It is very specific to who you are.

First and foremost, 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 accommodate the downside much more by allowing prices to fluctuate in a wider range than anyone with high leverage can do. I therefore have much more room for error in terms of the "timing" of my entries and exits. 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 a personal trading business. Just to remind you of what I have said about a this: it's your 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 you even get close to the market. Things like goal-setting, understanding trading as a business, these are edges you can give yourself before you open a trade. Do not ignore or underestimate their value. Many struggling traders have defeated themselves before they begin trading by deluding themselves into believing that trading is limited to the following:

- Turn on your computer
- Fire up your trading platform
- Start your 15 minute charts
- Apply your magic formula for finding great trades
- Find an exact entry price
- Place a stop-loss at 2% "risk"
- Find an exact exit price

- Execute
- Repeat

Don’t be one of them.

Trading is demanding

There is a pervasive misconception that prevails even amongst experienced trading writers and commentators and that is that it is possible to trade without emotion, to get into a zone where you are cool and calm and rational, no matter what.

Trading will involve far more of your life than you anticipate. This has nothing to do with the hours you spend doing things associated with “trading”, like analysing the market fundamentals and market dynamics, making your trading decisions, executing trades, evaluating trades, and closing trades.

The forex market is awash with get-rich-quick-schemes based on magical trading systems that require very little of your time. It is part of their appeal. Switch on, wait for the signal, enter, make money, and switch off. If you can see through this rubbish you have taken the first important step to becoming a trader and running your personal trading business. The reason I say this is because trading will demand things from you, including an investment of your emotions. I think it is glib to try to teach someone that it is possible to trade unemotionally.

The fact is that the constant presence of complete uncertainty regarding micro (current trade) and macro (medium term goals, like weekly or monthly targets) outcomes causes the permanent strain traders find themselves under. This strain is elevated to stress by over-leveraging positions and taking ridiculous risks as this causes magnified swings in trading account equity. When you look at your account playing yo-yo you will experience strong emotions. Ego kicks in, the need to be right, your system, your technical analysis that you have invested in, you must show the others that you know what you are doing.

How to overcome these issues in your trading business, irrespective if it is a part-time business or a full-time business, is to institute procedures and processes to mitigate the effects of randomness (which you cannot control) by implementing a comprehensive trading plan grounded in the reality of price behaviour and market dynamics and following systems and procedures to maintain control over as many aspects of your trading life as possible. Then you need to recognize those you can’t control. The benefit of such a “control what I can and accept the rest” approach to your personal trading business is that it is in line with a proper entrepreneurial approach to any business. Starting any business is pretty stressful and new entrepreneurs have a lot of things to do that have uncertain outcomes and thus they have to deal with the stress of uncertainty.

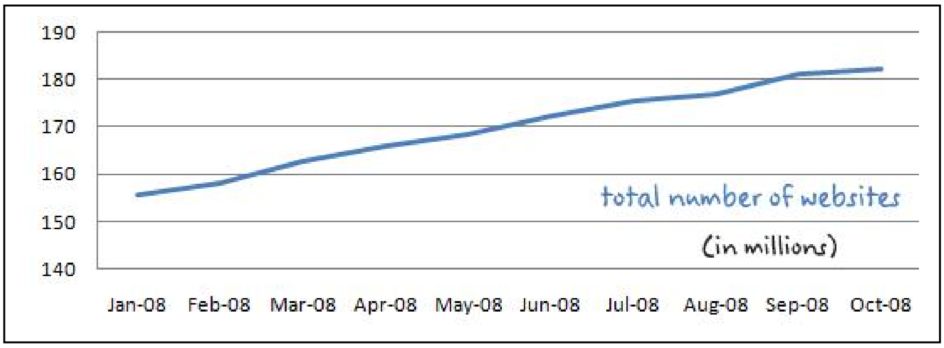
Trading is a personal business

Often the root of trading failure lies in thinking about it as something other than a business. Something exotic, easy, not a job, something you can do anywhere in the world, something that will quickly deliver to you financial independence. It is in fact a job. But it is my belief that what most people fail to grasp is that not only is it a job, but it is a job with unique challenges. Let my explain what I mean by way of comparing it to another job. If you are a trader you probably have some sort of an entrepreneurial mindset to begin with so lets compare it to an internet marketing business.

Internet marketing is a fast moving and dynamic field. You constantly have to keep abreast of the latest developments in order to stay one step ahead of your competitors. This is a central challenge to any business: outperforming the competition. In your internet business you need to know about webinars, videos, viral marketing Web 2.0, keyword mining, automating sign-ups, social networking and so on. In the Internet marketing space what counts is the latest “proven” approach. You have to be able to adapt your business to incorporate the latest developments in the field. Many of the incremental improvements in an Internet marketer’s business is automation through some software or programme skills. For instance you need tools to do keyword mining or automation of signups to hundreds of social networking sites or the automation of a specific sales process.

But what about trading? It is very different. You want consistency, you are wary of new fads, you can’t have a different approach from one week to the next. What you want is a track-record for your client and you are your client. That is what makes trading so tough. You are facing yourself and the market. There is no one else. In a personal trading business the older and more sustainable your business processes and tools, the better.

In a Internet marketing business you need to distinguish your website from amongst 200 million others.[1]



In a Internet marketing business you have fierce competition but in trading you don’t compete against others for a slice of the pie.

[1] Extrapolated from 182 million in October 2008 as counted by Netcraft.

Here is a list of the top 10 forex traders in the world in terms of volume.

Rank	Name	Volume
1	Deutsche Bank	21.70%
2	UBS AG	15.80%
3	Barclays Capital	9.12%
4	Citi	7.49%
5	Royal Bank of Scotland	7.30%
6	JPMorgan	4.19%
7	HSBC	4.10%
8	Lehman Brothers	3.58%
9	Goldman Sachs	3.47%
10	Morgan Stanley	2.86%

But you are not competing with them, or with the other small traders like you. You are simply trading.

It is you, and your confidence that you can trade, your actual trading, the outcome, and that is it. You are not marketing anything to anyone, explaining a product, or yourself, you are not trying to come across as trustworthy or sincere or smart.

The one element almost universal to other businesses which you don't find in a personal trading business is "marketing'. That at least should be a comfort for all of you out there who believe they can't sell anything.

Let's get to trading edges. We are going to introduce two distinct types of edges that you need to integrate into your personal trading business. First we will look at pre-trading edges (Part 4) and then we will investigate the trading edges that should form the building blocks of your system (Part 5).

There is a joke about a traveller who stopped an Irish policeman in a small remote village and asked for the road to Dublin. After a while of uhhming and ahhing the policeman said: "*If I were you sir, I wouldn't start from here!"*

Don't think you can start here on the mechanics of the system without an understanding of what has preceded it. It must be part of your thinking and it must be the context within which you apply the final bit of information I will give you now. To paraphrase that Zen Buddhist saying again: *"[trading] is a path that cannot be taught, only taken"*.

Chapter 10

Pre-trading edges

Your first edge is your own expectations and managing them. This is not airy fairy, this is a real edge and will directly influence how you trade and what trading decisions you make.
My phone calls from prospective traders usually go something like this. “Hi, my name is so-and-so. I want you to teach me how to trade forex.”
Why? Why do you want to get into a business with a high failure rate, stress, where you will have to take pain. I need to know that you know this. I need to know what your expectations are because **the nature of your expectations are directly related to your success or failure as a trader.** So I will begin by asking you some questions. Are you a novice or a struggling trader? How much and what kind of experience do you have? And I will also want to know something about you. I have a standard form that you will have to fill in. How you fill this form in will determine your trading career. Once you have filled in this form and emailed it back to me you have, probably without knowing it, taken the first step in applying my trading system. You have started formulating your goals. I guess in a sense this book is

nothing more than the documentation of a process, from first telephone call to trading live. And what you tell me right in the beginning is going to shape your trading career.

What is it that you want? Do you even know? Are you embarking on a business venture because you want some spare cash, a bigger house, or to make a living? Are you bored? Does a quick buck appeal to you? Are you intellectually stimulated by the financial markets? What are your motives? I need to know this. Motives are part of my own trading system. So clearly my trading starts long before I start buying and selling. It's starts when I set my goals. I need you to be able to communicate to me and to yourself that you 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 personal business unlike any other. 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 because of cash flow, competition, insurance, and soon the owner is shaking his head and closing his shop. 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), or said differently, these factors are actually part of your core competency as a trader, it's just that you haven't realised it. 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, but what is a realistic measure of success for this start-up venture? When will you 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 not, and similarly the trader, if he has defined his goals properly.

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 McDonalds 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 causes 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. He arranged for the delivery 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 – in his case selecting the cool period – 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. If you are going to approach it as a business, try to find useful parallels. Think of a business that has a perishable commodity, like a greengrocer. The greengrocer buys in fruit and vegetables. He sells them at a higher price. That's how he makes his money. But each product has a sell-by-date. Now if the market was always the same and demand never fluctuated, then planning would be a lot easier. But now demand drops, and he is going to be sitting with a lot of rotten products if he doesn't act. That will mean taking a loss, but if he doesn't act now, the loss gets bigger. Sometimes the market forces you to discard trades before they are completely rotten.

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 spend some time talking about trading goals. What sort of profits are you expecting to make? Do you want to live off the money you make from trading or is it going into a savings account for when you retire? The answer to these questions will also affect the way you run your personal trading business, including the nitty-gritty of daily operations.

The questionnaire I sent you contains several questions regarding your financial status, including whether your funds are discretionary funds (money you can afford to lose). By this I don't necessarily mean spare cash lying around. I am just trying to establish whether the money you will be trading with, if you do lose it, won't mean your financial ruin. A person whose livelihood is at stake faces different pressures. This is an important question apparently unrelated to trading itself, which is 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. Now let's take a moment to look at the different types of goals you need to consider.

A "time" goal

Three years. I don't think you can properly immerse yourself in all the challenges of trading without being in it for two to three years because you need to face different market conditions. I am talking about three years of live trading, with money, not demo accounts. I am not saying this is how long it will take you to become proficient. Some of you will pick it up quickly, and in three years time you will have been trading confidently for a while already, but you have to face different market conditions before you can have achieved your time goal. The truth is that everyone makes money in a bull market, and that is not the test. It's facing the adverse times that make a meaningful time goal. So, what we are saying is you have to allow enough time, probably about two to three years, to really sink your teeth in this venture. I am not suggesting for one moment that you are going to take three years to become confidently proficient at what you do. That might happen in weeks from now and then just grow and grow. By three years from now you might be a super star performer, but you can rest assured **you will have big lessons to learn until you have basically experienced several interrelationships between the market and the outcome of your trading.**

Over a period of time like two to three years the market conditions will fluctuate between three basic scenarios. It will go UP at times. It will go SIDEWAYS. It will go DOWN.

This is how I see it schematically:

- “UP” in this scenario means “positive and good for your account balance”.
- “SIDEWAYS” in this scenario means “ranging for a long period in a relatively narrow price range”.
- “DOWN” in this scenario means “negative and not good for your account balance”

The above assumes that we are long the market which is why UP is good for us. You need to know and understand the correlation between the market and your account. ”Strong / fast / UP” market conditions will translate into a “strong/fast/up” account balance. DOWN will show down in your account.

	Market: strong / fast UP	Market: SIDEWAYS High / low volatility	Market: strong / fast DOWN	Market very: volatile Fast / slow	Market very: docile trending / sideways
Your account condition	UP	UP	DOWN	UP	UP
	DOWN	DOWN	FLAT	FLAT	FLAT
	FLAT	FLAT	UP	DOWN	DOWN

These different relationships between the market and your account balance can be psychologically taxing. That is why many losing traders jump from system to system. They want to ease the pain. The fact is that many of you reading this book have probably only had a few trades and your time horizon has been weeks, not years, and based on this you are wanting to make a final judgment on a trading system.

You need time in the market during which you follow one approach. That approach should be robust enough to allow you to weather all the basic market conditions even though your account might not always go in the desired direction (profits).

Once you have a mature, long-term view of this whole endeavour you should subdivide it into a “mainly learning phase” and an “early trading phase”. If you already trade and the description below sounds like you, you will also have to allow for an initial “**period of unlearning**” many things. In fact **you should be ready for a paradigm shift.** This is an explanation someone gave me recently about how he was trading pre-BWILC.

My present strategy - summary

General

- *Use no more than 2% of my account on any one trade*
- *Daily Target of 20 Pips*
- *Stop at 30/35 Pips*

- *High Impact News times DON'T TRADE –*
- *Trading Times GMT + 1 Hour - 8 to 11 & 2 to 4*
- *Get the TREND by looking at the 20 bar MA in the Daily (longer trend) & the 60 (medium trend)*

Entry Strategy

- *Trade mainly off 5 min*
- *Only take trades with the trend*
- *Signal to have closed above/below the 20BMA & 5/10 MA have crossed or breakout of support/resistance*
- *Is the Tick volume[2] higher than average?*
- *What are the buying/selling bars telling me?*
- *Is there enough distance for a possible profit using Sup/Res & Fib76.*
- *Enter with two positions*

EXIT Strategy

- *Exit half the position at 10 pip profit - move stop to 20*
- *If close above/below the 20 pip scalp target move stop to breakeven - free trade*
- *If tucked up well above/below the MA's can stay with the trade & lock in profits by moving my stop to - low/high of the last 3 bars*

There is a lot to be unlearned in this scenario, which is pretty representative of how most "serious" loser traders trade. Do you recognise yourself? Do you recognise a few highly touted trading systems?

A financial goal

There are two important aspects here.

- Firstly what you want to achieve as a financial return over this initial "learning & early trading period". Forget about wealth. If you say to me you are aiming for something like profits equal to your initial investment (training, service fees, etc) then I would say that is a good financial goal. The less realistic your goals, the smaller your chances of success. Wouldn't it be a tragedy if you failed at your business not because you couldn't trade but because you couldn't set realistic goals?

  This goal also needs to consider demo or live trading, even with a small account. **There is simply no way that you can simulate the real psychological test of trading with demo money.** But there are solutions. Even a micro lot (1,000 units, to the value of 1/10th of a pip per pip) account is an option. If you have the money and can comfortably afford to fund a trading account with $50,000 or more you can think of starting with an account of about 1/5th of your initial account value. You can

[2] I have only recent read about this potential volume indicator in the forex market but you can rest assured that in the retail forex space even if it is available it is useless.

then step this up over time as you begin to feel more comfortable. As your capital survives over time and you manage your account through different difficult market conditions, your confidence will grow.

- Secondly, trading over the long term. What are one's goals here? This is a question many of you ask because it touches on the desire many of you have to quit your job and trade for a living..

  Do the obvious first. Work out how much you need to live off, after tax and remember that you will get taxed on your trading income. And know this: making a monthly return, under pressure, is tricky. I've done it. I know. You often have to smooth it out, over months, if you have had one good month followed by a bad month. This will happen. There are no more monthly salary payments landing in your bank account. You've exchanged those days for these days.

  I got a thank you note from a client in the US who is making around 10% per month and life is great. But that can't last all the time. You have to make your money when it's going well, so that you have something for the lean months. This means taking risks and risks cause pressure and stress in your life. But the more comfortable you become with what you are doing the better you will understand your risk profile. The better you understand your risk profile the more you can **calibrate your risk taking and risk acceptance** under different market conditions.

I want to say something quickly about different market conditions. Losers think it less of a factor generally because they trade more like robots and cannot discern between different market conditions. They get hit by a new market condition that doesn't fit their formulas and they crash out. The market wins, not their formulas. But if you know that you may have to adapt to a sudden change when the market moves against you, even drastically against you, you also know that you can step it up when the market is going your way

But you can't just arrive there, you have to work your way there, and starting with low expectations is a good beginning. Find out early what your risk tolerance levels are, and you will be surprised, usually on the upside. This is a personal and individual matter, but rather be the tortoise than the hare.

Full-time or part-time?

To trade full-time or part-time is another burning question one cannot really answer properly until one has traded for a while. And often it is an academic question because many of you don't have the choice and can only trade part-time. So let me first try to answer the question is it possible to do this part-time?

The answer I think is yes, and I would go so far as to say that with some of my clients, because of their make-up, it is in fact desirable for them to trade part-time. People tend to over-trade by spending too much time watching screens. Information overload leading to poor decisions is a real danger. However, let me be clear what I mean by part-time. I do not mean that you can set a side X number of hours which you dedicate to trading. A lot of people think or hope this is how part-time forex trading will work. You get home, and from 5 to 7 you trade. From 5 to 7 the market may be doing nothing. So part time-trading following the BWILC approach means being alive to trading and opportunities all of the time, just not being involved all of the time.

For most people the real question is if they can trade optimally while they continue with a normal other job. This obviously can depend on different factors like the demands of the job you have, time availability to do something else and your ability to "multi task". How much effort can you put into something totally unrelated to your main income producing processes in addition to your other personal commitments to family, friends and self?

The short answer is that you can trade part-time following the BWILC trading approach without it being problematic for your trading. In fact I believe, and so do many of my clients, that having too much time on your hands to trade affects your trading negatively. You tend to over-trade. You want to do too much.If your view of trading means there are certain hours of the day for "trading" and that you must sit all that time in front of your computer and "trade", i.e watch price graphs for entry and exit signals, then you must change that view if you want to follow the road and pointers I give.

The premise of that way of trading contains several flaws, the most important however is that you slice and dice the market and then want to find signals for a trading system that is based on a continuum of trading, 24 hours a day, 5 days a week all around the globe. You will just be cherry-picking some feel good confirmations of what essentially would be no better than a coin toss, also because with your limited time at the screen you want to have a trade decision, entry and exit all done and dusted in a very short time. This forces you to very short term, sub-hour interval trading and we have already established that that is a dead loss.

A proper perspective on the market will allow you to see the market and trade in a multi-day perspective and will allow you to spend the necessary time when it is available to do your trades, which at any given time will mostly be only one side of a position, either to open a position or to close a position. I think there is also merit in the "set and forget" approach. Trading software allows you to put conditional trades in the market, in other words, say, at 7:00 in the morning before you go to work you can open a trade at the market price and then put an order in the market to take a profit at a certain level. Another way to do this would be to put orders in the market for both the opening and closing of a trade at specified levels. If your time doesn't allow any more than this, then this is what you will need to incorporate in your trading and this is one of the main benefits of the 24-hours characteristic of the market. Even offline you can still make money.

If you are the sort of BWILC trader I hope to help you become, you will be something like this:

- You will have a clear concept of what is dear and what is cheap in the specific currency pair or pairs you will be trading.
- You will have a view of the possible price range your currency is likely to traverse over the next few weeks, not overly concerned about shorter random up and down movements within that range.
- You will not have too many surprises, you will know what to do at what price levels, and you will do it. In short, you will have this mapped and hours of analysis will not be required.
- You are constantly aware of the underlying drivers affecting the market and in terms of analysis you will have a limited number of sources to check. This will go hand in hand with your attunement to "market dynamics", i.e. the correlations that are likely between different markets (stocks, bonds, commodities, forex) as well as the way that the forex market discounts information – the so-called "buy the rumour, sell the fact" dynamic.
- You will have a fixed framework you use to place trades based on the potential size or range of price moves in reaction to market information. Because of this you will be able to classify an upcoming trading period (say the rest of the day, at 07:00 in the morning) as potentially an active day or quiet day, you can set trades accordingly either setting them, or doing nothing (doing nothing is good sometimes).

You will either know how to do this already, or you will need guidance to become proficient.

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.

I hope I have convinced you that your first trading edges do not start with the market. They start with you. Consider the sequence of how edges unfold. First you, no market, options are broad. Then you enter a position. Now the market, and less of you, and your options are suddenly limited. The point is you do not want to approach the market with your options already unnecessarily limited So every advantage you can maximise, every event over which you have maximum control, use it, because it is an edge in your favour and the first of these edges as I have set out above, are your goals. The type of goals you set will determine the type of trading you need to do. Remember, you can set your goals without haste, pressure, with time to reflect, to change your mind, to give you an edge.

Pressure accumulates with uncertainty and increases with expectations, particularly short-term expectations. Let's take a trader who has not used his pre-trading edges and has set unrealistic short-term goals. It's Friday morning and the week's goal is still not reached. He needs 100 pips. He enters a position, confident it is a "good trade". His style is to open trades with 20:1 leverage and place a close "trailing stop" 20 pips away in order to break even if the market fluctuates even slightly.His plan is to take a 50 pip profit, closing half his position, and leave the other half for another 50 pips, again with a 20 pip trailing stop.

The first major uncertainty our Friday morning trader has is whether the stop will be hit. The second one is whether he will clear the breakeven level, i.e. no net loss. The third stress factor is whether he will reach the initial 50 pip goal without the price coming back to take out the stop. Let's say he made it all the way to the first 50 pip target. One half of the position is booked as a profit. Now the stress starts again. Will it dip back to the trailing stop? Will it reach the target? Should he allow it to run all the way to the profit target. Should he take an early profit? At this point the market can dip back to his entry level and he will return 20 pips on the remaining half if the trailing stop is reached. In potentially a very short time space he has had apparent success (reached 50 pip target) and then agonizingly he had a big disappointment and didn't reach his weekly goal. This might have been Friday morning. For the rest of the day he will grapple with some more uncertainties: should he even look for further great trades that day and go through the whole process again, risking the new initial possible loss of 20 pips (trailing stop). Assume price action was favourable but he didn't take a new trade. The uncertainty of direct outcomes and more distant goals are a continuous strain for these "one big trade, several small losses" trading style.

For as long as you are new to a specific trading system based on signals and a certain risk:reward ratio you will have the uncertainty about the validity of the system to reach any long-term goals. You will have certainty for your losses but all those lost profits will gnaw at you. But forex brokers understand trading psychology. They are not stupid. They know that people are wired to want to rather know their losses up front in exchange for future but uncertain profits. Few people can change their thinking on this and it is one of the main reasons so few people succeed in the forex game.

The kind of pressure I have described above, where you don't have any control or manoeuvrability is extremely hard to handle. This is why I suggest that your business plan, your whole trading framework must be designed to give you flexibility in decision-making. Limit arbitrary deadlines. Don't set daily and weekly goals. The second aspect of this is not to run at full throttle the whole time. Trading is not a sprint, it is a balance between middle and long distance running. You need to be able to kick when the time is right, but it is more important for you to be in the bunch, and comfortable, than running out in front. It is no good having Usain Bolt's speed, and using it up on the first hundred meters. In other words if you define your risk tolerance as something like "only risk 2%" of your account and you think it is good to use 10:1 or 20:1 leverage per trade you are running the hundred meters at under nine seconds, which is fine, if you don't have a 10 000m steeple chase to follow..

Apart from this constant nagging issue of "my stops being hit" the uncertainty about "will I really be able to do this high adrenaline stuff for years and years" will wear you down in the long run (in this case probably not much more than a few months to a year).

It doesn't matter what you do, you are not going to eliminate pressure fully from trading, but you should try to make it easier on yourself.

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 have a sceptical nature. It helps me in my trading. Even now, 12 years later, when I enter a trade or even close a trade (but more when I enter trades, something I find much harder than closing trades) my last thought is always "you're making a mistake". That thought keeps me from over-trading. As long as I don't over-trade, "mistakes" can be rectified and managed to become profits.

I will encourage you to be sceptical of your system as you develop 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.[3]

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 you to learn. I encourage you to read, to form your own opinions, to hold different views, to hold views different from mine. 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.

[3] To read more about this you don't have to look further than The Black Swan – the Impact of The Highly Improbable by Nassim Taleb.

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." [4]

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?

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

[4] Roger Lowenstein, When Genius Failed

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, their heads, and their clients' money.

During the second half of 2008 the currency market displayed its own fat tail. It was making moves in weeks that usually took years of steady trending, and then reversing them. Being wrong didn't mean what it usually meant, a question of patience, timing being out, the usual stuff we don't worry about. It meant survival, it meant that only the most vigilant traders with the most robust trading approaches could absorb this kind of shock. Systems that expected the unexpected.

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."[5]

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 you.

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

I don't want you to trust your system, at least not at first. At this stage you probably don't know enough and you are actually just 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 representative of anything, especially not effortless future "success". 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[6]. 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.

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

[6] The credit crunch saw the high profile failure of one of the oldest and most revered Wall Street investment banks ever, Lehman Brothers. I found the account by former vice president of Lehman, Lawrence MacDonald, "A Colossal Failure of common sense", riveting. It is a very recent explanation of the same "Wall Street" meets "Main Street" story which is an education for any trader. I recommend it.

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.

Your 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. 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*

You 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, you will test your system, modify it and improve on it. And then a state of what I can only describe as 'sceptical optimism' will have developed between you and your system. To be able to trust anything in this market is priceless. Like many traders developing a system you will be tempted after a few bad trades to chop and change. I will encourage you to resist this. One of the reasons you will want to do this is because of the exaggerated effect 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*[7], 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…

'….. [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

[7] The one trading book you should read if you haven't yet.

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 non-noise…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.'[8]

You can't handle too many negative responses. Knowing this in advance, minimising the amount of negatives you will have to cope with in your personal trading business, 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.
You will learn that you need a system that allows you 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 you must be able to watch

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

this, from a distance, and get in when you feel comfortable buying (assuming your 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 makes 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 as personal trading business owner – a key individual in your business. 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.'*[9]

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 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 you are probably coming to the realisation that your business plan or system is a guide not a gospel. That you are going to have to exercise good judgement. You probably have 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 (by getting the edges) in your favour, and then giving them time to make you money.

UNDERSTANDING RANDOMNESS

I've touched on randomness before. Now it is time for you 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.

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

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 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 their 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 or fifteen 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. The implication of this is that even while things are going "according to plan" there may be long periods of heavy uncertainty, and pressure, stress and emotional deficits. Trading is not easy. If it was everyone would have been doing it profitably for years.

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. See, no rocket science there.

The shorter the time frame you choose to work with the greater the randomness you have 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, in the "randomness vortex", 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 five 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.

(See Appendix A for a trade-by-trade example, including relational analysis notes, how I have leveraged my advantage and edges over a 12 month period, June 2007 to May 2008.)

THINKING IN PROBABILITIES

"Fate laughs at probabilities"

- *Edward Bulwar-Lytton, author*

Being able to think in probabilities is one of the biggest assets you can acquire for your trading business. 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[10]. 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 you may struggle with. You are being asked to think both fluidly and flexibly on the one hand, and rigidly or statically on the other. Most of us want either a fixed point or predictable volatility, not both. Unfortunately you 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.

You will be required therefore to think on a small picture level and on a big picture level and you will be asked to do this simultaneously! It is not easy, but with practice you will become proficient. You 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 you to understand that the market will require you to think in this manner and you 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

[10] Refer to Appendix A "12 months of trading". One of the observations from this is that if I enter a trade there is a high probability that it will add up to a 60 pip contribution as part of a longer-term plan.

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 you to think about trading, using a system that maximises all possible advantages. I want you to think like the casino, not the gambler at the casino. I want you to make all the 'house' rules that are within your power to make, rules such as when to trade, how much to trade, when not to trade, what goals to set. I want you to have understand that these are advantages that are *available* to you, 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.

CORRECTLY EVALUATE YOUR PERFORMANCE

I have already made mention of the importance of evaluating your progress in terms of a longer-term goal and plan. This is something different. Considering that you are looking for a way to trade that will set you apart from the losers, I want to offer you something quite subtle, but important by way of an illustration.

You have a funded live trading account of $50,000. The first two months go badly. You are down 20% on your equity to $40,000. Then the tide turns and you make rapid gains with the developing trend during the next month. You are up to $55,000. What was your performance?

Was it a gain of 10% or a gain of 37.5%? The correct answer is that it was both. It all depends on how you look at it. Looking at your net trading performance as if it is a track record presented to investors is not what is called for if you are in the learning phase of your trading career or business. What is called for is an honest appraisal of what you have done. In the situation described above is that what you did was that during a prolonged difficult period, against the trend, you managed to limit losses to only 20% and had the emotional stamina when the tide turned, to recover the losses and return 37.5% in a short period. Add to this that you were, as part of your strategy, **prepared** for prolonged periods of difficulty during one of the three main market conditions (UP, DOWN, SIDEWAYS) and that you expected (again as part of your strategy) to make money under two of three main market conditions. How did you perform from this perspective? You have performed as planned and according to general expectations. You can trust your trading system, you can have confidence in what you are doing because you are doing fine.

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.**
7. **Evaluating your performance, especially in the beginning, may be trickier than you think. One needs to look at the extent to which you have succeeded in containing the things you can't control and to what extent you have followed a predetermined process rather than putting too much emphasis on the hard returns of you investment.**

Chapter 11

General 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, a myriad of technical indicators or expensive software; it was pretty ordinary[11]. Yet, though I was clearly doing something right I hadn't thought too

[11] People seem to forget that many great traders made money before technology came along. They had none of the benefits of today's fancy tools. When I started I had to make a phone call to get the spot price, get some contextual information about the market and usually make a decision to trade or not before putting the phone down!

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 personally 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 I could directly benefit from their trading. If you want to know why I wrote BWILC, then that is one of the main reasons. If you make money, I make money, through IB (introducing broker) fees. The longer you trade successfully, the more money I make. This is my challenge, to get you to be successful because data shows that most retail forex trading accounts bomb out after a few months. That's no good for me. You've lost all your money and I've lost an income stream. To make it more difficult, since 2003 a lot of regulatory changes have taken place.

The cornerstone of a personal trading business is the concept of *real time*. I will say more about this later but you must fix this in your mind. The business of a trader is a real-time business. Real time is where here and now takes yesterday and tomorrow into account. It's a fluid, dynamic and complicated concept but one you must master. In a sense all business operate on real time. A customer enters a store. He is there because he saw an advert yesterday. He is there because he wants to buy something now. And he must come back tomorrow so that you can grow your repeat business. But the crucial thing is that you have to act now to make the sale. You have to use real-time analysis in real time. Is your customer a giggling teenager, a serious accountant, a housewife, or perhaps a tourist. How does the person look, is he a browser that should be left alone to make his own choice, or do you need to press the sale. Is action or patience required.?

The main function of the owner of a personal trading business is to do real-time analysis. If people ask you what a trader is you could just as easily reply a "professional real-time" analyst. The currency prices you receive don't come in a vacuum. They come packaged, wrapped in layers of information. Real-time analysis is about unwrapping the package, dissecting the value in the price, tagging it and doing something with it, even if that something is nothing.

Real-time analysis is not only about the market out there. It is also about your business in here. You must constantly analyse the state of your business finances. You might find a valuable price, but can you afford to buy that currency at that price (which might be reasonably fleeting – you might not have the luxury to think the rest of the morning about it before acting) considering the "state of your books". Perhaps you are already deep in overdraft (draw down)? Perhaps you are "fully" invested, perhaps you are contemplating another opportunity in another currency pair, perhaps you are waiting for some more related information to determine the real value of your existing positions.

Finally your real-time analysis is about what is going on in your head, your evaluation of your own emotional and psychological make up at the time you make decisions about the market.

The personal psychological well-being of your personal trading business' most valuable asset (you) is paramount as this directly impacts on your trading decisions. Have you put yourself under pressure to reach some arbitrary short-term goal? Maybe it is just out of reach unless you take some additional risk (add a position or two). The pressure now impacts on your decision-making. It is part of the real-time analysis you need to apply to the totality of your business.

Real-time decision-making

Making decisions and acting on them is a vital part of real-time analysis. It is part of real-time analysis to use different analysis tools (discussed below) to analyse the market to distinguish between high and low, cheap or dear. Once the analysis has been done a trading decision must be made – usually also in real-time. Again, the decision may be to do nothing, to decide that the best decision is not to trade, or not to take that profit now or not to take that loss now. This is probably one of the most exhausting and challenging aspects of trading. Whatever you decide there is a consequence caused by the continuous micro price fluctuations in the very short term and short term.

These continuous price fluctuations are also the reason why yesterday's real-time analysis expired yesterday. You have to start again, and it is this starting over and over that is exhausting. The real time nature of trading causes pressure. I am teaching you to design a trading system that is not only robust enough to deal with an unpredictable market but comforting enough to deal with your own unpredictable changes to that market. You system has to be rough and tough, while at the same time being gentle on you, a port in a storm.

So real-time analysis consists of analysing the market, analysing your business finances and analysing your personal emotional state. These three elements are intertwined and one needs to think about the relationships between them. It should be pretty clear to you that if you are going to neglect everything except analysing the market you may run in big trouble with your business. Isn't this exactly what happens to so many traders. There problem is that they are so focused on learning and applying technical analysis to find exact entry and exit points in the market that they completely ignore equally important aspects of trading like real-time analysis.

Since this is your personal business and you are the boss I believe your first responsibility is always to ask yourself whether you should work today – are you up to trading. Real-time analysis begins with yourself. Your frame of mind, your emotional state. This you must sort out first, and only then comes the market. And always remember:

Limit the greed and the fear will cure itself!

ANALYSIS TOOLS: TECHNICAL ANALYSIS

Get your facts first, and then you can distort them as much as you please.

- Mark Twain, American author

One of the all time successes of the marketing wizards was the way in which they have succeeded in creating a need for technical analysis (TA), making it seem indispensable, and placing it at the centre of the retail forex trader's universe. It is simply astounding to what extent "trading forex" and "doing technical analysis" has become one in the minds of many traders.

Let me just quickly repeat how this happened. Your typical retail forex broker probably grew up during the dotcom boom, in other words, with technology coming out of his ears. One of the things they did was disseminate streaming tradable prices to forex traders. Then came the dot com crash and with it the implosion of online stock day trading. This created the necessary gap for these forex trading companies to step in, and tout the advantages of online forex trading (no commissions, 100:1 leverage, free prices and free charts with technical tools). They packaged the illusion of certainty that technology gives and sold it to retail traders, not by charging them for the use of their charts, but by taking their money. You cannot fall for this illusion and survive.

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 out of you.

Consider this. At the Euromoney Forex Forum 2004, probably the major international forex market event that is frequented by all the major players in the forex market such as banks, funds, and governments, the guyswho really move the market, these players were asked what their analysis tool of choice was. Here is their answer:

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

Just stop and think about that for a second. 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.

TECHNICAL ANALYSIS EDGE, UNDERSTANDING ITS LIMITATIONS

"Statistics are no substitute for judgment."

- Henry Clay, American statesman

The first trading edge you need 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 Lefĕvre 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 or live trading rooms and webinars, 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 information 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 information 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 recently there was a relatively big sell-off on the euro during the day. Nothing unusual for this market but see how the market commentators reacted. Some said there was a rumour of an imminent bank failure in the US. Others said there was an imminent bank failure in Europe. Others again linked it to a fall in the Chinese stock market or as profit taking at the end of the holiday season. Everyone was looking for a reason *on the day*. Something someone said, or some correlation or some dynamic. But to what extent can any historical price based indicator, usually an average of an average combined with some other average of an average or some pattern visible on hourly charts, but not on daily charts really predict such an outside move? To the extent that it is hindsight.

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, we have the added problems of crooks in suits massaging the books, giving asick patient rosy cheeks. The most famous examples, the Enrons, Worldcoms and Parmalats, or special investment vehicles created by banks on tropical islands to keep the majority of their liabilities off their balance sheets, 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 $3+ 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.[12]

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 the BUY / SELL button now.

TA: THE FUN AND THE FLAWS

The idea of this section is not to debunk technical analysis in general. The idea is to divest your from the fallacy that the only option to run a personal forex trading business profitably is by application of technical analysis to intraday price data. It is this very idea that causes 90% forex day traders to fail.

I recently came across an article written by three intellectuals, Luc Bauwens, Winfried Pohlmeier and David Veredas, with the title "High Frequency Financial Econometrics - Recent Developments", in which they discuss intraday technical patterns on five minute data using the EURUSD. The following abstract says it all:

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

We investigate the existence of chart patterns in the euro/dollar intra daily foreign exchange market. We use two identification methods of the different chart patterns: one built on 5-min close prices only, and one based on both 5-min low and high prices. We look for twelve types of chart patterns and we study the detected patterns through two criteria: predictability and profitability. We run a Monte Carlo simulation to compute the statistical significance of the obtained results. We find an apparent existence of some chart patterns in the currency market. More than one half of detected charts present a significant predictability. Nevertheless, only two chart patterns imply a significant profitability which is however too small to cover the transaction costs.

Translation: After we have really churned that data and tried every conceivable chart pattern we came to the conclusion that even though our computers could make some pattern predictions we can't use intraday price patterns to make money in the forex market.

Amen.

You should consider the following. Any data series of the kind provided by sequential currency prices can be analysed mathematically with moving averages and moving averages of moving averages. If you torture the data long enough you are going to find some evidence of repetitive price behaviour. The question is if it is useful or predictive. To the extent that it may mirror herd behaviour it might be predictive, but, and this an all important but, can it really provide insight into herd behaviour as a predictive tool in a globally diversified market like the foreign exchange market on an intraday level? In other words, is it really a significant indicator of market psychology to such an extent that one can bank on repetition based on market psychology? The answer is probably not. All you are really betting on is a statistical oddity of some observed formation / price sequence's chance to of ocouring again with some frequency. But is it tradable? It seems as if many are trying it but few are succeeding. The evidence for this is clearly to be seen in the innumerable forex AP's and EA's (automated programs, "expert advisors") that have been programmed by thousands of programmers on all time intervals and using all known technical indicators. Instead of producing something definitive we only have the wreckage of failed systems. Never before has so much research by so many sharp brains resulted in so little positive outcome.

So, here it is in a nutshell. I make no use of any indicators. In short I divide TA into the useful (support, resistance, trends) the pretty but useless (most "pattern type" indicators) and the ugly and wasteful (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 under any circumstances". It's just that I can't figure out how to make them work even in the bigger scheme of things where some other professional chartists seem to have enough success that they get paid for what they do. Since I can't make sense of them or have a need for them I really don't care. To be honest I do follow some of the technicians that are explaining their trade on the financial channels. It contributes to the reading of the market's mind, because usually this type of analysis includes a summary of expected market composition and behaviour. In these longer timeframes the technicals can indeed be representative of some types of market behaviour. There is a strong feeling in the market that something like a 200 day moving average has some significance. So when prices come close to a 200 day / week moving average it usually means we had some strong lasting trend which is now reversing and a price break through the moving average may indicate continuation of the (new) trend (the reversal of the original big one). The operative word is "may". And the latter point is where intraday technical analysis really breaks down conclusively. A 200 day 15 minute series moving average being crossed by a price doesn't make for a "trend" reversal.

I think the reason the "proper" technical analysis schemas don't work for me and why they probably won't work for you (any newcomer to this market trying to establish a personal trading business) 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 an 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. To go back to the 200 day moving average example above: If you have a proper relational analysis understanding (price-event-time relationship) of the period covered by that moving average you will understand the drivers that caused the original trend, are causing the reversal and will have a healthy view of the odds of continuation based on different price-event-time development scenarios. The point is that there are not thousands of drivers that cause those quite noticeable trends and interim reversals or full reversals. You must not doubt your ability to recognise them.

Based on a false belief that the fundamental drivers are too opaque to be useful in a short-term trading strategy people think they should rather pick up a textbook that describes one of these indicators, read it, and then mechanically apply it profitably. Yet, like many others you will be going out into a rainstorm without a raincoat. It's akin to watching Tiger Woods playing golf, reading his book on how to do what he does, and then signing up for the pro tour. Why would it be different in a trading scenario where the winners are also professional?

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 you 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. Are you a bad trader? No. But these false signals have induced you to enter the market only to watch the 'cross' now 'uncross'. The pressure to anticipate a 'cross' mounts. You are now entering trades because you think your indicator is going to do something in the future. In effect you have doubly distanced yourself from the markets. You are not even trying to guess what the prices are going to do next, you are trying to guess what the indicator, based on the prices, is going to do next. 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 BWILC in 2004 I had a look at the daily MA200 (simple) of EURUSD. As luck would have it, the MA 200 was all the buzz. At that time 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. 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.

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 FUNDAMENTAL TREND, YOUR LONG-TERM EDGE

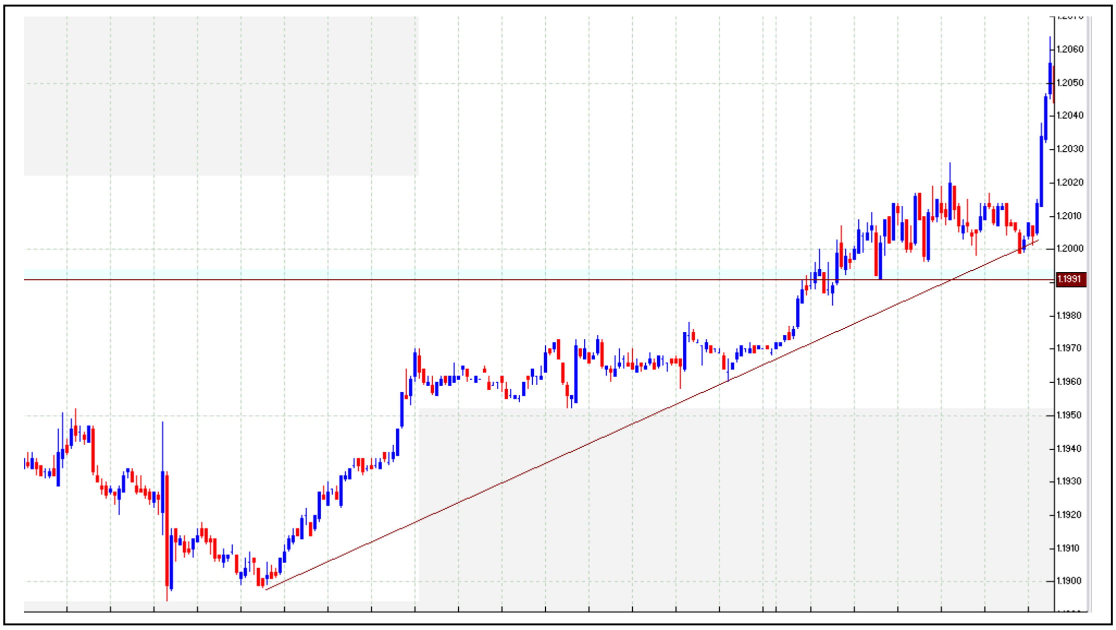
"Never forget that only dead fish swim with the stream"
– Malcolm Muggeridge - writer

This is a big edge, one of the building blocks of our trading system. You may wonder why, if I am so sceptical about “everything”, 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 direction of its move, 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 you 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 4.11.2)

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 4.11.3

Picture 4.11.3

You should 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 short term 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
- Very short term is intra day and intra week – generally the realm we operate in.

If you want to identify a trend look at a properly zoomed out chart, with daily or weekly intervals. (See picture 4.11.4) 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 – for weeks if not months - and then continues. Get a time frame, a reference point and your own perspective on what's going on.

Picture 4.11.4

This trend covering more than two years, crossed a 200 day moving average several times. 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.’

But keep this in mind, while a technical trend may be identified by looking at longer term charts, the understanding of the fundamental drivers behind that trend and how they develop dynamically is the real differentiating factor that will put you in a position to make trends work for you.

SUPPORT AND RESISTANCE – “BRACKETING” THE MARKET

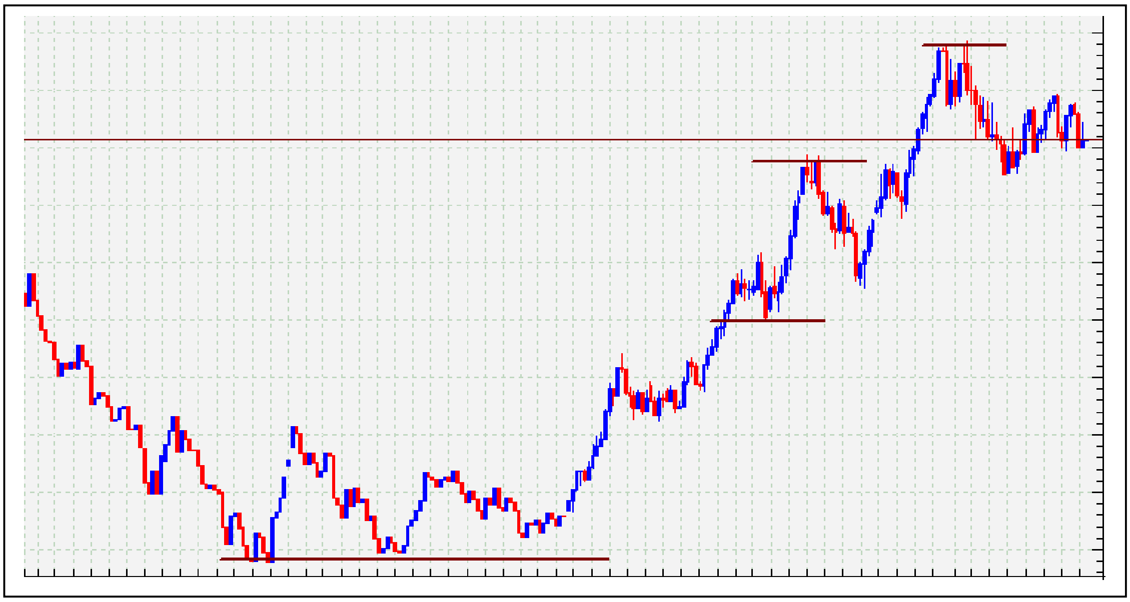
“When everyone is bearish , a market must go up because there are no sellers left; conversely, when everyone is bullish , a market must go down because there are no buyers left.”

- *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**

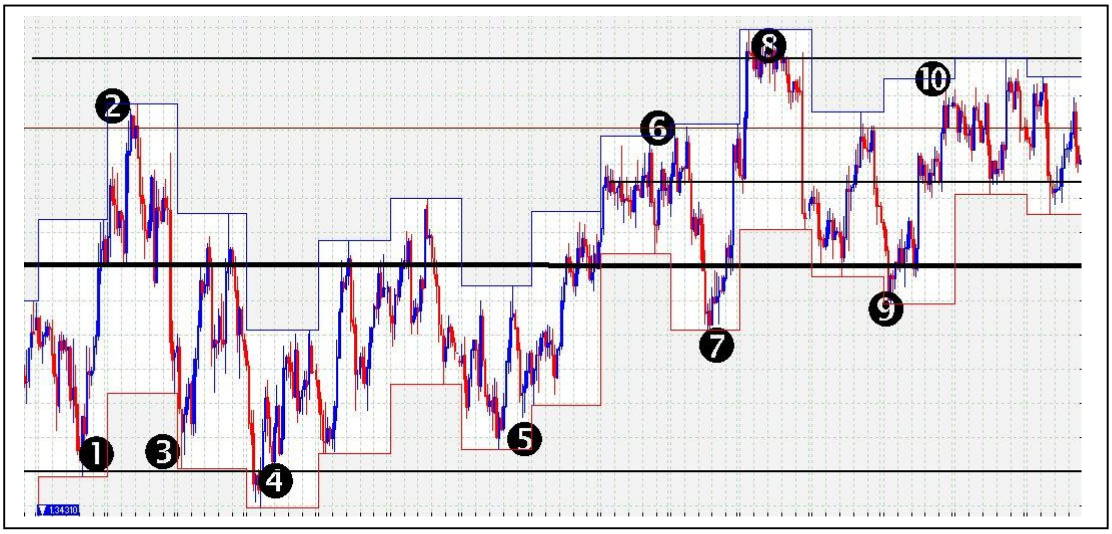


Why is this an edge? Prices bounce off the support or resistance, testing it and reinforcing the fact that it is a support or resistance level. A very important thing you should know is that prices will seldom test a level more than three times before either definitively breaking through it or definitively retracing back from that level. Also, support and resistance levels are not clean straight lines, but price levels with a variance of up to 50 or even 100 pips depending on your perspective. 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 imagine 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 I am now betting that before long the trend will re-establish itself. Said differently, the market is oversold and buying will start again. I buy because I think 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. I have done no more than identified a trend, waited for a dip, bought it, and I am now waiting for the trend to continue. It's not the timing that counts, but the wait.

Overbought and oversold in a median grid



ANALYSIS TOOLS: FUNDAMENTAL ANALYSIS

Economic data releases

There is a difference between understanding the role of economic data releases and trading them (so-called "news trading"), and for a while trading them became the latest forex fad. You cannot unfortunately build a forex trading system around economic releases. But this didn't stop the forex marketing wizards and many brokers started selling the potential of data release trading to their clients as a way of making money. Something like the US jobs report will cause considerable volatility in the market. But the impact lasts for no more than 90 minutes, hardly a trend, of which the greatest volatility occours in the first few minutes. This is a hardly a good foundation on which to build a forex trading system.

More importantly, it can't be characterised as trading the fundamentals. Take a look at the picture below and the reaction of the forex market (EURUSD; USDJPY) to the jobs report for August 2009, released early in September 2009. The picture shows the volatility impact clearly, but it also shows vastly different reactions in the USDJPY and EURUSD market (the two mostly traded and most liquid currency pairs). The interesting thing is that the one important aspect of the jobs report, the nominal number of job losses or gains, was basically as expected, while the second important number, the jobless percentage, was a bit weaker than expected. On the nominal number you would anticipate a subdued reaction. It is the most keenly watched. You would expect the US dollar to drop in value (bad economic statistic, should be bad for the currency), but what happened? In EURUSD the USD **strengthened** initially, way below the earlier lows of the day, just to later begin to give back those gains and end the day and week (before a long weekend, which also played a role) weaker than the "release price".

EURUSD, jobs report 4 September 2009

But, have a look at the USDJPY which made an incredible 100 pip move in the first ten minutes after this release, and after thirty minutes (when EURUSD was at its low) the USDJPY basically returned to the pre-release price range.

The antics of highly leveraged retail forex traders around important data releases soon became a predicament for online retail traders and it's affect on brokers and traders is worth recounting.

A forex broker makes money by getting people to trade. The more trades, the more money. The broker makes money from the spread and arbitrage between intra day retail traders' positions and longer term (but not long term) market prices. News trading started when a relatively insignificant group of retail traders started placing a relatively significant amount of money on or about data releases by taking positions in the market with huge leverage. The leverage had been offered them by the brokers, and it was coming back to bite these very same brokers. Here is how it looks to a broker. The US jobs report is at 8:30. At 8:28 the whole financial world is holding its breath waiting for the report, both big traders and tiny traders like you and me. Money-for-jam Brokers is watching its order desk. An entry order for EURUSD 2,000,000 comes in. This is, remember, a smallish order highly leveraged. Money-for-jam is ok. It can handle this order.

But then, suddenly, in the next few seconds 15 similar orders come in. Now, just two minutes before the jobs report Money-for-jam has an exposure of EUR 15 million, long 10 pips from the price and EUR 15 million short 10 pips from the spot price (let's just say half the order were long and half were short). They know the volatility that's coming and 10 pips either side will get taken out for sure A 30 million EURUSD exposure is not what they signed up for. Their first reaction would be to hedge these positions in the market, i.e. go short against the long orders at one clearinghouse and long the short orders at another clearinghouse. But, you try to trade EURUSD 30 million one minute before the jobs report. So suddenly retail forex brokers had a big problem – surviving the jobs report. These crazy retail forex traders had taken them up on their offer of high leverage. Luckily for them, retail forex was largely unregulated until recently, and the brokers could simply manipulate the prices they offered the traders. They also simply cancelled trades with the excuse that there weren't tradable prices for them in the market. This caused a huge outcry. Forex forums were abuzz and complaints were laid at the US regulator. Actually, these traders are irresponsible and I have very little sympathy for them. They place not only their own money but of others at risk-if the broker collapses everyone loses their money. So the brokers came up with a new plan. When you join them now you sign an agreement that stipulates that the broker cannot guarantee execution of stop and limit orders during abnormal markets (any economic data release of their choice can constitute and abnormal market), no placement of entry orders in 30 or 45 minutes before some data releases (these are not announced, your platform simply refuses to take orders), and the best of all, no fixed spreads during abnormal market conditions...

The traders' response was a chorus of whining and jumping from broker to broker who promised fixed spreads until one day these brokers also got nailed by the rogue news traders. Newcomers to this industry like to look at broker reviews, but you have to consider news trading when you read broker reviews. As a matter of fact you can bet your bottom dollar that most negative reviews had to do with some attempt of a trader to misuse some aspect of the brokers' service – either intra minute scalping or news trading, or some funny scheme that isn't conducive to a proper broker client relationship and in this the forex broker has all my sympathy (not something I easily give brokers).

But brokers, always alive to business opportunities, knew there was a desire for trading the news and if they could manage their risk with their new agreements, why not fleece the trader. So they started marketing news trading as trading the fundamentals and suddenly every retail forex broker began to provide calendars of economic data releases from New Zealand to Newfoundland. They realized it could be a very important trade trigger for thousands of traders.

These days you can visit many a "forex calendar" and some marketing wizard's "economist" has listed 50 economic data releases for the next week and colour coded them for you according to his interpretation of importance or impact. Data releases that have never been of interest in professional trading rooms suddenly became all the rage in the retail forex world. All that forex brokers wanted to do was create more trading opportunities, and this is what they accomplished. And so they began to punt news trading under the banner of "incorporating fundamentals in your trading".

And these brokers are ruthless. Here is a guide to news trading by one of these brokers:

- Do it regularly
- Do it with high leverage
- Place close stops ('it will be suicide to use high leverage without close stops')

Now if such a strategy was touted by an individual he would look a fool. But put forward as it is by brokers it appears legitimate and savvy.

I downloaded a free report some two years ago from a company. The report gave statistical evidence regarding very short-term price behaviour and supports my contention that it is basically random and that there is no edge to be derived from searching for repetitive linear patterns in these very short time frames. This company has now changed its view on the randomness of short-term price behaviour. Needless to say they now push news trading. Unlike some outfits who ask subscription fees for their services (guessing which way the market will go after data releases) everything is free, but you must open a trading account to use their automated news trading service.

It is pretty clear who sits behind the current popularisation of news trading. The beneficiaries of regular highly-leveraged-tight-stop trading strategies are the market makers and their marketing agents who promote the viability of this kind of hare-brained trading.

I want to point out that while professionals may even play along and have a punt on some data releases it will never be a consistent feature of their professional strategy to expose themselves to any great degree. Yet this is what you are encouraged do: take all your trading capital, gear it up like crazy and take a punt on what is essentially an event with a 50 / 50 probability of satisfying your highly leveraged bet. The placement of a close stop practically ensures that in every instance you do not make money, the market maker gets a nice pay-out in addition to whatever he made on the spread.

And that is why I say you can bet your bottom dollar that most fools who try news trading will lose and this has absolutely nothing to do with forex fundamentals. Different game, but the same people are selling it.

A fundamental analysis framework for forex

Long before technical analysis of financial instruments, mainly stocks and bonds, became all the rage, fundamental analysis revolved mainly around the modelling of future income streams from purchasing a stock or a bond. In other words, by determining the value of a stock today, i.e. is it cheap or expensive, the analyst will try to determine the income stream (dividends) from buying the stock and then discount it to find a present value of such an income stream. In forex it doesn't work like this. There is no inherent income stream to determine the present value of.

In stead there are a myriad of factors impacting on currency valuations and for traders it makes sense to begin their fundamental analysis by distinguishing between "economist fundamentals" and "trader fundamentals".

Economist fundamentals are really long term measures of currencies like purchasing price parity. In terms of traders' long-term and medium-term perspectives these principles simply make no contribution to trading decisions.

"Trader fundamentals" are a function of perspective or "time frames" and can be categorized as follows: Long-term, medium-term and short-term fundamentals. To be exact all fundamentals co-exist simultaneously through these time frames but depending on the traders perspective he will attach more value to certain fundamentals. This explains why such apparent contradicting fundamental drivers exist at the same time.   Its importance isn't evenly distributed so to speak. At any one moment, the US dollar can be subject to massive trade deficits (negative for the USD), a rising interest rate differential versus a specific currency (positive for the USD) and say, increasing positive consumer sentiment (generally positive for the economy, neutral to positive for the USD) and in this context on one specific day a negative durable goods number (with its intra day impact).

Let's see what the different trading perspectives are:

The long-term trader:

This is a New Jersey- based portfolio manager with risk funds under management making global equity investments and local (US) equity and bond investments. Due to the widening US trade deficit and growing budget deficits he may want to allocate a larger portion of investments to global investment centres which will impact on the dollar because he is going to sell US dollars in order to buy these global investments. Since he has this long-term outlook it isn't that important for him if the dollar trades at 1.3000 to the euro or 1.3500 or 1.4000. The point is that at levels he feels he is getting value he will exchange dollar for other currencies. Part of his consideration will be the economic fundamentals of the countries and investments he will make. His bias could be supported by a dollar anywhere in the range from 1.20 to 1.60 versus the euro (or a dollar index at 90 and 75). These are very long-term fundamental drivers that do not change quickly.

Long-term fundamental drivers can thus incorporate a very wide range of prices. The US trade and budget deficits were seen to be a driver of US dollar weakness at levels of parity vs the euro as well as all time highs at 1.29/30, a recovery to 1.16/17, new all time highs at 1.36/7, recovery to 1.24/5, new all time highs at 1.40, 1.50 and 1.60 but also at 1.40, 1.30 and 1.25. All of these price levels accommodated his view, a view that is weighted mainly towards dollar selling.

A pension fund manager in Tokyo also makes long-term global investments. This progressive manager doesn't see foreign exchange just as a mechanism to exchange yen for other currencies but looks at foreign exchange as an asset class. He believes the Japanese yen, because of Japan's dependence on importing its raw materials for industry, has a structural tendency to be weak, and in addition there is strong political will to keep it weak in order to promote exports of goods made with those imported raw materials and improve the export prospects of global Japanese corporations like Sony, Honda, Yamaha and Toyota. He looks to invest in bonds in safe but high yielding countries and straight currency carry trades in major currencies which all pay a small premium for holding long positions vs the JPY. He may cover some of his risks of JPY appreciation with options strategies that only cost a fraction of the total revenue from his strategies if they work out as expected.

The medium-term trader:

This trader may be a global macro hedge fund manager registered in the Caribbean but operating from Miami, Florida. One of the things that contributes to his medium term outlook is the convention that hedge funds usually report quarterly to their investors and they also share in profits on a quarterly or at the most, annual basis. He actively invests in currencies for profit and his strategy is mainly based on interest rate differentials as a driver of currency momentum. He believes a currency with increasing interest rate differentials will strengthen against other currencies. In addition to this he will also look for cyclical economic trends in the relevant countries, especially the situation with inflation and the propensity of the central banks to adjust interest rates upward to combat inflation. He will be very aware of end of rate hike cycles and other economies' moves towards increasing rates and decreasing the differentials he is betting on. While interest rate trends can last for the long-term the potpourri of different countries, currencies, economic cycles and other relevant factors will cause him to make adjustments in terms of months rather than years, catching some overshoots in currency values or buying some deep dips where a currency got oversold due to lagging economic and interest rate factors. He will be much more inclined to act in expectation of a rate announcement or in reaction to an interest rate adjustment than the long-term trader. While he will be aware of the "deficit issue" his main drivers are at a different level and this will determine his action in the spot market.

The short-term trader:

A short-term fundamental trader will be a lot more sensitive to market dynamics than the other two traders already mentioned. While he will be very aware of medium-term fundamentals the market dynamics associated with interim highs and lows will be more important to him. Especially the old notion of buy the rumour and sell the news will be a driver he looks for. In other words he focuses more on the actions of other traders in the short term as a driver of his actions than real fundamentals. As I have said before, it is a matter of perspective and the time frame in which he chooses to operate is encompassed by most traditional fundamental drivers. He can be long, short and long again without any of the major fundamental drivers for the medium or long term trader having changed much at all.

Another extremely important element to consider in this regard is how traders with different time frames use portfolio diversification differently. While the fundamental drivers are the same for all traders the way they impact on the market by trading and the market reflexively impact on their portfolios is determined by their diversification strategies. A short term trader focusing on forex and in particular based on fundamentals on probably only a handful of correlating pairs will tend to act with a much larger part of his portfolio in response to some fundamental driver. In fact many times the short term trader will act with a multiple of his portfolio value based on his view of one current short term driver, because of the leverage he employs. If he is correct he makes a handsome return. The longer term trader will diversify by scaling only part of his portfolio at any one time into a specific investment where the currency market drivers play a role.

FUNDAMENTAL ANALYSIS: CORRELATIONS

One of the reasons why you shouldn't shy away from using fundamental analysis rather than the no-win game of the intraday technical analysis the marketing wizards want you to play is because fundamentals are way easier to identify and interpret than you might think. One of the aspects that proves this is how markets correlate with each other when considered from the point of view of the fundamental drivers.

Before we consider some subtleties of correlations I want to just state the obvious.

All markets can only go up or down or sideways and thus in the very short term, i.e. looking on a specific day at a correlation doesn't mean anything. Irrespective of what drivers are in place two different markets are also driven by distinct and market specific drivers that in the short and very short-term may be totally dominant, without changing the longer term correlations at all. The reason is the correlations exist in the medium and long term based on the shared medium and long-term drivers.

The role of correlations is to distil the real fundamental drivers that lie behind real-time price changes in the medium and long term perspectives. In other words by considering fundamental drivers and price action in real-time in different markets one can identify which drivers are dominating the market's mind at any given time.

Intermarket Correlations

In our world, where real-time dissemination of information takes place on a global scale all financial markets are inter-related even in the very short term as traders at different centres across the globe try to interpret information to gain an edge in order to improve their profitability. This forms the basis for all markets reacting to any incoming news and opens the door for the potential of correlation or non-correlation. By correlation we mean markets react / act in the same way and non-correlation mean they react differently.

Let's consider the main markets from a currency trading perspective where correlation may help us to make better currency trading decisions.

- Major stock markets, especially the New York Stock Exchange but also other major currency markets like the Japanese, the German, the London Stock Exchange and as a group, emerging markets for instance the BRIC countries' stock markets (Brazil, Russia, India, China).
- Interest rate markets. Here we look primarily at the long-term debt markets, i.e., the bond or treasury markets.
- Major commodity markets. The most important markets are the gold and oil markets but also indices that include other major commodities like grains and metals like copper, silver, platinum.

It is important to consider the underlying dynamic why these markets are important and why correlations may give clues to future currency market direction. The answer lies with the huge amounts of global investment money flows.

Global investment managers from institutional pension funds, sovereign wealth funds, asset managers and global investment funds (equities or commodity specific or bond specific) and global macro hedge funds are continuously looking for "alpha" (yield, return on investment) in different markets. We have already considered how their time horizons are generally medium to long term and investment decisions are mostly made based on fundamental factors.

The point we have also made in the introductory paragraph above is that different markets (asset classes) on a global or large regional level all share the same major underlying drivers.

As a rule of thumb these drivers have to do with the direct factors affecting "yield" in different global regions as well as virtual investment asset classes like "emerging market equities" or "commodity country equities" or "the gold market".

What are these main drivers? It is not complicated.

When asset markets are expanding, i.e., asset prices go up in general in all markets it will be because economic conditions are generally good. People are investing in many different markets and they believe opportunities may be better (in addition to the advantage of diversification into different global markets and regions) with global investments. Again as a rule of thumb, what will the flow of investment money be? Will there be a huge globally relevant flow of money from Rwana or Peru? No. The largest capital pools are in the largest economies and that is the United States, Europe and Japan. Here is one major rule of thumb: during good times money will flow from these major economies to other regions or between them which will affect currency values directly. One of the reasons why there are so much information and news flying around in the financial markets is because investors are continuously evaluating the factors that influence these global economies and how and why to adjust their own portfolios. Because these opinions differ so much we have very active and liquid global markets where supply and demand is in constant flux.

Correlations are very linked to market sentiment. As many of the most trusted sources of market information are shared by thousands of financial and investment firms (in the same way thousands of retail traders share some of the forex analysis services) market sentiment tend to converge around themes which since the crash and recession of 2008 have been distilled to two concepts: “risk on” and “risk off”.

The most important drivers originating from the United States have to do with the United States economic recovery which should lead to the US consumers’ increased demand for imported goods and thus stimulating economic development and growth in the predominantly export nations. But this will also have a direct impact on the currently very low interest rates in the US and since the US is the leading economy and the Fed the globally most important central bank, their interest rate decisions affect market sentiment everywhere.

Making sense of correlations is thus a case of identifying the major current global investment themes affecting all investment behaviour and also those affecting specific behaviour like in this or that country’s stock market or bond market or this or that commodity market, and, especially from a currency perspective, the dominant gold and oil markets.

From a currency market perspective correlations between the US dollar vs commodity currencies, high or low interest rate currencies and the euro (as anti-dollar) when global market sentiment adjust, are the correlations we are interested in.

I hope you can now understand why I said first of all that correlations in the short and very short term are not useful simply because all markets can on a day-to-day or week-to-week basis only be perceived to go either UP or DOWN and if global markets today and tomorrow both go up it doesn’t necessarily mean anything.

People tend to especially note exceptions in the very short term on long run correlations and then want to extrapolate from that something significant.

Unfortunately the problem of which market leads which market and is thus the driver for correlation is in most cases unanswerable. Oftenthe US stock market pundits would say the stock market is doing this or that on the day, just following the US dollar. On the same day the currency pundits will say the US dollar is doing this and that because global stock markets and US stock futures were leading, due to the lack of “new information” or “conviction” in the currency market.

As you can see, correlations are definitely not a silver bullet for successful very short term and short term currency trading, primarily because traders tend to find correlations on charts, which as we know is history and trading is real-time with a bias for anticipating the future.

To make sense of inter-market correlations one needs to identify global drivers, how these drivers in theory should affect investment decisions and sentiment and how global money managers’ investment decisions have been affected in the past and will be affected in the future.

Therefore this is not something one can describe in a handbook. However on a programme like my mentoring programme where we live on a day-to-day basis with these correlations it is quite possible to share insights about these drivers and the resulting inter-market correlations and their likely impact on the markets.

What makes this even more effective in a private community is that the “group wisdom” is focused on incorporating these insights in trading decisions broadly based on the same approach to currency trading. In other words all the members in the community have an overlapping communal framework in which that can integrate insights from inter-market correlations to make their own trading decisions.

Forex Market Correlations

I said earlier that one of the reasons why so many people lose in the forex market is because of developments around the “how to trade stocks” industry. People simply do not account for the fundamental ground level differences between stocks and currencies.

First of all currencies are an indicator of a whole country’s economy and sentiment surrounding that country in a global context while a stock is simply an indicator of one company amongst thousands listed on stock markets. Secondly and more importantly in a very real sense stocks are totally independent from each other. Although stocks in the same economic sector (health, financial services, information technology etc) might from time to time correlate with each other it isn’t intrinsic to stocks to analyse company A in order to determine an investment in company B. It doesn’t help you one little bit because Apple has great prospects to buy Dell without isolating Dell and investigating and analysing it on its own. Not so in currencies. In fact in currencies you can probably not get very far down the road by analysing only the US dollar.

The main reason currency correlation is important is because currencies are valued in relation to each other. No currency has “a price” on its own. All currencies only have a price in terms of another currency and since all prices adjust dynamically currency price correlations and non-correlations happen all the time. Since the US dollar is the world’s reserve currency the relations and changing correlations between currencies are dominated by their value in terms of US dollars.

This is how it works:

Lets examine the correlations between the US dollar, the euro and the British pound (EURUSD; GBPUSD; EURGBP):

First of all, if you own an equal amount of all three these currencies the changes amongst them will not affect your wealth at all. (Compare this now with owning five IT stocks, changes amongst them will definitely affect your wealth). That has big implications. Currencies are perpetually in equilibrium. This means if one of the currency pairs changes in value this will reflect to some extent in the other pairs. Say for instance the US Fed make an interest rate announcement that causes the US dollar to weaken. The EURUSD and GBPUSD will correlate in the sense that both of them (euro and pound) will strengthen to some extent vs the US dollar and this will reflect in the adjustment in the pairs EURUSD / GBPUSD. But, as we have said, the three are in equilibrium, thus EURGBP will adjust to account for any difference in the EURUSD and GBPUSD changes.

Say EURUSD strengthens more than GBPUSD, then EURGBP will strengthen to account for the difference between the EURUSD and GBPUSD adjustment.

This dynamic dominates intra currency market correlations. This same Fed announcement will also affect, say, AUDUSD. AUD will probably also strengthen and that will then impact on EURAUD and GBPAUD to the same extent that EURGBP adjusts. If EURGBP adjusts UP then EURAUD will adjust euro positive vs the GBPAUD. (I say “euro” positive, because if AUD strengthens against both it will strengthen less vs EUR than vs GBP but if EUR strengthens against AUD, AUD will weaken less against GBP than against EUR.

I hope you can see how this dynamic constantly contributes to the intra-day and sub-hour randomness in the currency market and why there simply is no justification or foundation for most of the analysis that is touted as the surefire way to make high probability entries and exits at any time. On the intra-day and sub-hour level this “butterfly effect” causes most of the volatility.

But currency correlations, exactly because of the above dynamic, are “true” and once you have an understanding for currency market drivers, especially the drivers that cause the USD to move up or down you can use correlations and differentiations between currency prices to benefit in the very short term, without spending one iota of energy to time any trade entry or exit.

Other currency market correlations work principally like the potential correlations in stock market sectors with this important difference: because they are currencies they are intrinsically linked. For instance, interest rate changes in the US may affect commodity currencies in a certain way. All commodity currencies will generally be affected in the same way, but there will be differences in the extent to which they will be affected (because each currency has many different drivers at any given time).

If you combine knowledge of correlations between currencies with the principle that currencies trend and then reverse you have a very strong basis for making money from currency price changes that have absolutely nothing to do with traditional technical analysis trade identification principles.

I leave you with this thought as we now move on to an exposition of the Bird Watching in Lion Country forex trading approach. I call it my 4x1 strategy that I combine with my median trading methodology.

It is important to understand that this is not just another system amongst thousands of others that is based on the same old parameters, that “loser’s formula” (technical analysis is all you need, precise high probability entry, exit, close stop, 2% money management).

Part 5

Applying your edges

"Money frees you from doing things you dislike. Since I dislike doing nearly everything, money is handy."

- Groucho Marx, Actor

Contents

Chapter 12

The Market in Perspective

Historically people refer to technical and fundamental analysis as the main tools for the personal trading business owner and we can identify with this as important for our purposes. We are very critical of most attempts to apply technical analysis on a very short term (intraday) basis, with the illusion that it provides clues to excellent entry and exit points with pinpoint timing allowing for relatively large positions (highly leveraged). We are critical of closely placed "risk/reward ratio" stops. We are also critical about attempts to equate fundamental analysis with trading economic data releases. Both these schemes are propagated by forex brokers in order to provoke more trading and bigger trades from traders. More trading and bigger trades are increased revenue for the brokers and not for traders. For us, traders, it means higher costs and the higher your costs to trade as a percentage of your capital the better you must trade to make a profit. We have explained that economic data releases are clearly volatility triggers but we are convinced that it is not possible for even the most experienced and adept traders in professional trading environments to consistently make a profits trading economic data releases.

We are not saying that we don't use technical or fundamental information. We are saying that we use it in a proper context combined with a proper perspective of the market. We stand back from the highway of death on the hillside in order to have a clear view of what is happening in the market place.

What does that mean in practice? How do we go about creating a workable perspective to manage randomness and manage a trading business to profitability?

A BIRDSEYE VIEW

Every one of us has at some point experienced a situation where we were totally out of our depth. If you think back this was invariably because you were involved in something completely new to you. The fact is that you didn't understand the full context of that specific scenario. You may have joined a new job, maybe your first job with some theoretical college knowledge. It took a while to understand the environment you were in, both the physical environment (new town, or a new part of town, new building, new shops) and the psychological environment, (new people, new demands, new challenges, new processes). How did you cope with this? If you were smart you got a birds eye view as soon as possible: Of the company corporate structure, of the environment, of your colleagues, your boss, of anything "big picture" that could help you. Without perspective most endeavours are a partly blind groping about in the dark.

A good example of this perspective problem might be found on primary school sports fields.

Think of games like soccer, hockey and rugby where everyone's playing area is not clearly demarcated. Can you see in your mind's eye how the small kids all bunch up around the hockey ball or soccer ball, sticks and boots flying?

When you compare this with adults or older kids playing you find that everybody is spread out to cover strategic positions in attack and defence and midfield. They utilize the full pitch in playing the game. That is what perspective is all about. It is about having a bird's eye view of what you are doing. This is absolutely critical in forex trading. Not only must you understand the market place and the market, but you need a clear perspective and view of your "surroundings". The soccer player needs a perspective of where the goal boxes, the touchlines, the offside lines and his own attacking and the other team's defending players are. A golf player needs to know the distance to the green / pin, the shape and slope of the fairway, where bunkers and water hazards are, what the wind direction is, the angle to the pin. Without this proper perspective playing par (golf) and scoring goals (soccer, hockey) will be very difficult to impossible.

If you don't have the right perspective in trading making profits will also be very hard and virtually impossible. The very first thing you need to do is to get perspective. I have spoken about this before, at the outset of the book. I don't mind repeating myself.

The things you need to put in perspective in your trading business are a bit more intangible but just as vitally important as in any other area of life.

You need perspective on mainly three things:

- Prices relative to other prices, i.e. which prices are high and which prices are low relatively speaking.
- Prices relative to time, i.e. when were prices high / low relative to the current time
- Perspective of "events", the driving forces that impacted on prices through current time-price relationships.

Then there is a fourth element. You have to relate these relations in a coherent whole with what's going on in your trading account. Ultimately it is your trading account (your personal trading business) that funds the purchase of that "low priced currency" and it is your trading account that receives the booked profits when you "sell a high priced currency".

I hope you have caught on to what I am saying here about the fourth relational aspect. It implies the following: what is high and what is low out there in the market is not normative. The most important is what is high and what is low **for you!** Determining that and acting in a disciplined and rational manner to benefit from that knowledge is what will put you in the small profitable group. Losers don't do this. They don't even think for one second that it is important. For them all that counts is finding that price entry, exit and placing that stop order.

These three, elements, price, event and time are the building blocks of relational analysis but before we go into the details I want to show you how to really get perspective of the forex market in order to execute your trading strategy.

I want to give you a proper context within which to consider, execute and evaluate your trading decisions.

I hope you have caught on to what I am saying here about evaluating your trading decisions. Think about how the losers trade, how you may have traded once as a loser. Was evaluating your trade part of the “system”? No. Once that all important signal was received and the pieces of the puzzle fell in place, your entry, your exit, your stop, your position size, everything was determined. All you had to do was to emotionlessly watch the spectacle, run the profits, cut the losses without interfering and tinkering with the ‘proven system’. I am telling you now that it is a critical part of trading success to continuously evaluate the impact of your trading decisions on your business. Let me put it like this: your books must be kept up-to-date and your management accounts must be done on a daily basis.

THE G-FORCE OF THE FOREX MARKET

We previously referred to the overshooting characteristic of currencies. Over the very long run currencies follow a reasonably smooth trend and within this trend there are pockets of overshooting and retracements.

The principle is that currencies revert back to where they came from. This is clearly different from stocks. In the long run stocks either rise indefinitely in price or they fall to zero. For instance the share price of Berkshire Hathaway, Warren Buffett’s company has risen from around $15 in 1962 to a high of $149,200 in December 2007. One of the reasons the price is so high is that they have never split stocks to keep the price low in order to improve scarcity and limit liquidity. Many other stock prices of blue chip companies have also increased phenomenally over the years but due to several stock splits the prices have remained lower.

The tendency of currencies to revert to the mean or median price is what I call the G-Force of the currency market. Over the medium and long term there are relatively large currency trends from time to time, but due to natural supply and demand factors and because currencies are always measured in relation to other currencies with their own supply and demand factors, currencies tend to, more than most other tradable instruments, to display mean reversion characteristics. In the short and short-medium term (few days to few months) these mean reversion characteristics are also dominant in price behaviour.

I try to base my trading 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.

For a proper perspective of the market it is necessary to consider the mean reversion characteristics in the short and medium term. Once you have a good perspective of this and you can begin to relate the monetary value of positions as they gyrate through and around these price areas, reverting after a while to the mean, you will understand something very important about currency trading.

THE MEDIAN GRID

As already stated, the forex market moves in three ways only. Up, down and sideways. After a strong up / down move there is usually a retracement (pull back from an extreme), followed by a further surge, or alternatively a prolonged sideways movement. The thing is that these transitions are not easy to spot and it takes weeks before they crystallise and one can say with any certainty what type of market you are in. But with a proper perspective it becomes easier, to spot these transitions, and benefit from them. The phrase ‘pull back from the extremes’ 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 short term traders, to plot it, and trade it.**

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. You need to understand very clearly what the median grid is: it is a **context creator** rather than a price forecaster.

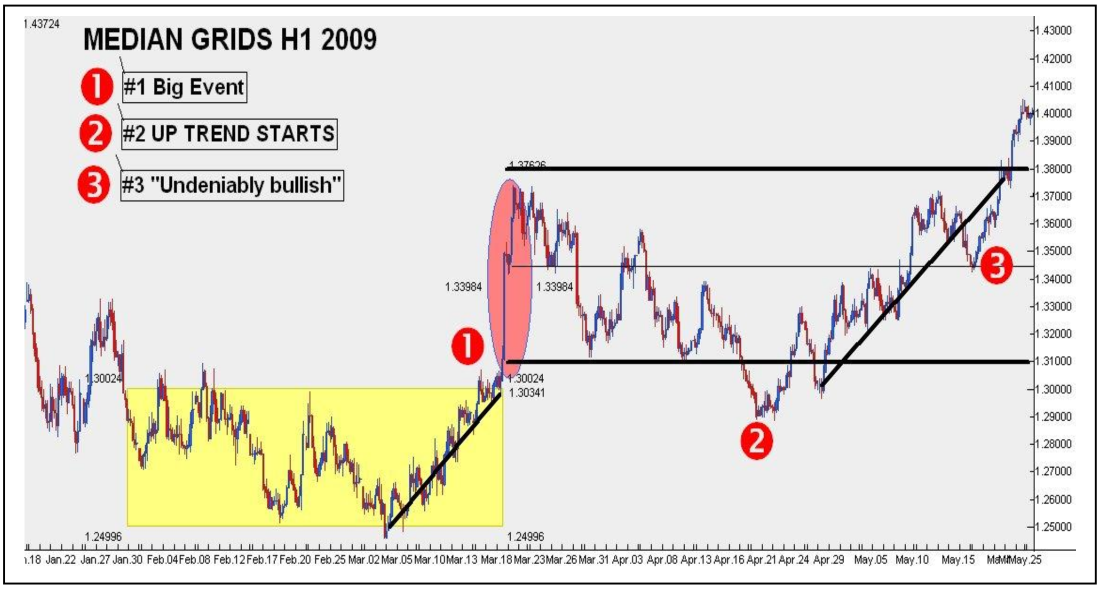
In order to learn to make sense of this insight you have to **view the market in terms of price ranges.** A price range is a demarcated price area where the price goes up and down more or less ‘randomly’ over a clearly discernible period of time before it exits the price area on either side. This is not rocket science, it is rule-of-thumb, but in trading rule-of-thumb works while precision and perfection does not.

Because the market ranges a lot of the time you can identify price ranging areas. Obviously prices move out of these areas after ranging within them for a while. If you have an understanding of price drivers it is often possible to anticipate such a break out, and benefit from it.

This ranging area I call the **median grid**.

Let’s have a look at 2009 price action to see how this works in practice. Once we have done that we can look at the **median grid** in more detail.

Median Grid Chart 1



This first chart is a candle stick chart of EURUSD, covering the period January to early June 2009. I have chosen 4-hour intervals because I want to begin with a wider perspective. I want you to ignore everything prior to mid March (the yellow background) when we suddenly had a very sharp movement that took us from 1.3000 to 1.3500. Most of this happened in 10 minutes following an announcement by Fed president Bernanke. This is clearly marked on the chart as **"#1 - Big Event**".

It should be clear to you, if you consider the price action from the beginning of February, that leading up to that "Big Event" you basically had a price range below 1.3000 with modest price action in the 1.3000 – 1.3100 price area. The majority of this price action was between 1.2500 and 1.3000, specifically in the second half of February and the first half of March. This was a median grid with a low price extreme of 1.25/4 and a high price extreme of 1.30/1.

The "Big Event", just as the price began to establish a foothold outside the median grid following a two-and-a-half week UP trend ***inside the median grid,*** caused a complete adjustment to a new range. This large adjustment took place in a few hours after a massive initial spike within a minute or two. There is no time to sleep on the job with median trading.

In order to establish a new median grid you have to be **forward looking.** This is one of the reasons why I chose this example, it happened so suddenly. You can't just look back and say the new grid is 1.3000 (old resistance becomes new support) to 1.3500 (the new high). The principles of price adjustment are that you have long sideways ranging periods followed by quick trending periods, back to ranging and so on. So in this case, with price already at 1.3500 and on the day no indication of a quick turnaround you have to allow for more upside, because you want to capture a price area where you don't have to adjust the grid the whole time.

To give you the real-time feel of how this played out I am going to take you to my daily briefing just after the 'Big Event'.

> *It doesn't make sense to work with a grid that doesn't contain current prices and doesn't leave room for continuation of the immediate trend. The immediate Fed spike was from 1.3100 to 1.3350. One must assume that if prices get with any sort of momentum back to 1.3350 it can just as easily fall to 1.3100 because there obviously were no volume there.*
>
> *This morning there was a fake attempt to new highs but that is now beaten back somewhat as I write, euro at 1.3670 is about the level where the quick move originated.*
>
> *It will be way too early to assume this is a top of this move just because there is a pause, but I would suggest that if we end today like below 1.3600* ***we might get away with a grid 1.31 - 1.38.*** *Otherwise we will have to look at 1.3300 - 1.4000.*
>
> *Because my advice is to rather stay on the sidelines to see how this unfolds for another day or two this decision can also wait a bit.*

This is a good example of the virtue of the median grid perspective. If you look at the chart you will see that that 1.3760 was indeed the high and that the projected 1.3800 → 1.3100 range held for the next month.

Next we want to focus on the uptrend that basically started when we reached, and then broke, below the 1.3100 grid lower extreme. For roughly a month price action was again contained in our 1.31 – 1.38 grid. With hindsight we now know it was the first half of a trend that continued all the way to 1.42/3, well beyond initial expectations. But for a long period we only had to evaluate one thing: how strong were the current drivers and will they drive price to a new price area?

On May 19th I commented in my Daily Briefing:

> *We are back to upper levels of the current grid without a visit to the lower levels and this on the back of improving sentiment and a view that the worse of the economic downturn in terms of GDP is behind us. (And still all the credit crunch risks are exactly the same.) There just seems to be loads of money ready to bet on better times, not wanting to miss the boat. I am pretty sure there are much more where this comes from thus while there may be set backs, you can bet your bottom dollar dip-buying may be the order the day across all markets.*
>
> *For the euro this is good because the euro is the anti-dollar and the dollar will have only some temporary strength on a serious spell of US based investment flows on the recovery theme and probably the Fed will lead the interest rate hike charge initially - that would also be USD positive. But those aren't things that will happen soon.*
>
> ***The bias is undeniably bullish at this stage.*** *If we can settle in a range where the risks referred to above by UBS will limit risk taking while euro is high and the levels where dips will be bought and euro is low then we will have it made for now.*

So while we were working with a grid we had established two months earlier our view had changed from "selling tops" to "buying dips" and at the extreme of this grid we were bullish.

As you can see from the chart we had a price move outside the grid as we had expected and therefore it was easy to adjust the grid again to make room for a new ranging area once this uptrend had worked itself out.

Let’s take a real-time look again through the spectacles of my Daily Briefing:

> *The big moves in H2 and especially the EURUSD spike in December 2008 make it impossible to find natural resistance levels at this time. For me the fact that we came back in one day from 1.47/8 to 1.41 and the next day to 1.39 during that spike (Dec. 2008) makes this a resistance level.*
> *I think it was on this basis that I have earlier moved my toe-in position to 1.4100 profit take level, which I thought might be on the higher end of a first "test" of levels above 1.40.*
> *On this basis the grid high to be in 1.41/2 area. The low I'll pull up to 1.35/34 which is basically the level from which the last few day’s multiple day rally originated.*
> *That was the 18/19th May and interestingly it was when we were amazed by the markets ability to change colours and I was a bit philosophical about the speed of change and what’s different in markets. I‘ve said: If you snooze you lose.*
> *The narrowing range may prove to be 1.3600 and higher (if the idea is valid). But it is a bit difficult to find resistance levels. I can remember coming down from the above 1.50s on the risk aversion and carry unwinding theme (2008 H2) we found support here at the early 1.40s for a time, but I don't know how real that is in terms of current positioning. While at that stage people had to adjust views to accommodate extreme down moves we are now essentially accommodating more sedate deep fundamental reasons to shake-off H2 08 short term "fears" and re-establish the positions based on main drivers.*
> *There will be a tussle between economic growth drivers and these deep fundamental drivers and the higher we go on deep fundamentals the more out of whack the euro's level will seem to be, looked at from the economic growth comparisons with US. This should at some point overcome the up surge, (if the economic growth story stays weak).*
> *There is only one certainty now and that is that you are going to feel pretty edgy every time you are long dollar, thus the bias is long euro and definitely so in the buying areas of our current grid.*
> *Grid adjustment bias = UP (to probably 1.45)*

As you can see, we think in terms of grids. Now that we had left the old grid (high extreme1.37) where would we find a new high? To express the fact that we believed there were strong drivers behind this move I also added a “**grid adjustment bias**”. We believed the trend would continue, therefore, while we first worked with a grid 1.36 → 1.41/2, it could also “*with the current set of drivers*” go “*as far as 1.45*”. As you can see from the chart we made it all the way to 1.4050 in the first phase of the move.

Here is a rule of thumb I use when considering a grid adjustment. Often price finds resistance about ½ a grid outside the existing grid. Therefore in a trending scenario your typical adjustment would be a quick ½ a grid (300 pips) with a bias to adjust another half (300 pips) (assuming approximate grid size based on volatility and current ranges is 600 pips).

Median Grid Chart 2

This chart covers the period from May 20 to the end of the "summer holidays". As you can see for this whole period we traded in the projected area, the grid with 1.41/2 high, plus bias to adjust to 1.45 (if we breached the initial high, which indeed happened quickly, and caused a new grid of 1.37/8 low and 1.44/5 high).

Part of relational analysis is to relate the current dominating drivers in the short, medium and long term to the median grid and potential adjustments that need to be made as a result.

You must not get "lost" in a median grid. Be aware that this is always a danger due to our short-term trading style. It is also possible to trade with a longer perspective which will prevent you from the dangers of over-trading in the grid by losing perspective of the bigger picture.

Let's now take a more systematic look at setting up a median grid.

SETTING UP A MEDIAN GRID

Keep in mind there is **no place for rigid thinking** in this trading strategy. This market is quicksilver – impossible to pin down and hard to categorize. The purpose of the median grid is to provide some context for you to be able to apply your trading strategy in comfort because regular pinpoint accuracy is out of the question. It is therefore not a predictive tool or even a technical analysis study. But it is a very important tool. As we said earlier it is a context creator that gives us perspective.

The first step is to get your charts up and to see where you are in the bigger picture. For this purpose you would like to see a multi year view and then zoom closer to the last year, half-year and finally the last few months.

In order to illustrate how illuminating this process can be I have set up four different EURUSD charts in order to place a grid at the time of writing (early September 2009). Each chart is followed by some comments.

This multi year view (January 2006 to September 2009) is dominated by an uptrend for EURUSD of more than two years, ranging at the top for about 5 months and then a spectacular drop giving back almost all the gains, a vicious one month UP and then two months DOWN spike back to the lows at 1.25. Since March 2009 we were in quite a strong UP trend again, from 1.25 back to almost 1.45 (at time of writing the trend has exited the range and reached 1.5050.

This one year view indicates that the big drop occoured during a three month period, August to October 2008. It remained at these lows for almost a month-and-half. A spectacular spike of 2,200 pips occoured in Dec 2008. This was quickly reversed by the end of January 2009 and then almost two months of ranging took place in the same sub 1.3000 low area before a spike up, a retrace and then definitive fast uptrend to 1.43 early in June 2009. Since then price has ranged for three-and-a-half months with a slight upwards drift, but the dominant move is sideways.

During March / April price left the low 1.30s behind with a strong upward trend to 1.4350, reversed to 1.37/8, back to above 1.40, ranging between 1.39 low and 1.4450 high, back to 1.41 and ending the period around 1.43.

Since the early peak of a trend that started in the low 1.30s during March / April at 1.43, which can be interpreted as an initial overshoot, price see-sawed to sub 1.40, 1.42, sub 1.40

(1.38), 1.42, sub 1.40 (1.39), 1.43, and 1.40. Up to this stage, at end of July 2009, the high was around 1.43 which could have been a grid high for several months. A break of this high to 1.4450 indicated more potential upside and in order to accommodate this a grid covering this whole period may have been in order:1.37/8 – 1.44/5.

Consider the following pointers to set up 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 with the EURUSD pair 500 – 600 pips would be effective since markets began to stabilize after the instability of the credit crunch period during which historical ranges were exceeded with large margins in double quick time.
    - To calculate rule of thumb percentage changes you need to consider that when currencies are related 1:1, i.e. one euro = one USD or one AUD = one USD, then a 100 pip change is a one percentage change.
    - At 1 = 1 we say ranges of about 400 pips work well. With GBPUSD at 1.60 – 1.80 you are dealing with more pips: 400 * 1.6 to (1.8) at least. Thus for the same volatility environment GBPUSD might need about 700 – 800 pips.
    - EURUSD at 1.30 – 1.50 will work well as we have indicated above with 500 – 600 pips.
- Identify relevant support and resistance levels that can roughly be aligned with the typical grid size and which would probably accommodate a lot of ranging price action if the market ranges during the next few weeks. These support and resistance levels will be the extremes / borders of the median grid.
- If the fundamental trend (the trend based on longer term fundamental drivers) is UP (DOWN) and the recent price action was UP (DOWN), or the intermediate trend (based on medium term fundamental drivers) was UP (DOWN) your median grid should allow for continuous breakouts UP (DOWN).
    - In order to accommodate this you should have a grid adjustment bias. That is, you should answer the question: if it brakes and establishes a new level, where will the first stop be?
    - You won’t go too far wrong if in this case you adjust the upside median grid extreme in increments of ½ of whatever your current grid size is.

- If there is a counter fundamental trend move (the intermediate term drivers dominate, while the longer term drivers still hold true), as a rally fizzles out, your lower median extreme / border will be under constant attack and it is prudent to allow, if the lower extreme is breached, for a grid adjustment. In other words you will need patience for it to establish a new low about half a current grid size below the lower extreme.
    - I repeat there are no hard and fast rules and price action around grid extremes are difficult to manage, especially if it breaches the extreme but not decisively.
    - 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. 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.
    - Adhere strictly to median trading principles in order to exploit volatility.
    - It is really not possible to place grids effectively without a proper view on the long and intermediate term drivers behind those trends.
    - Real-time, relational analysis is a vital part of trading with confidence and using a median grid as comfort zone.
- 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
    - 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.
- Also consider that a median grid is a very personal tool. It is not a technical study of the market, but simply your view of a price area you feel comfortable in so that you can apply the 4x1 trading strategy.

Chapter 13

The 4x1 Strategy – Piling up the edges

ONE CURRENCY, ONE LOT, ONE DIRECTION, ONE PERCENT

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

- *Albert Einstein*

If you ask me to summarise my trading approach in a few words I would say, ***"think big, trade small"***. If you think about most trading approaches out there (think 90% losers) I would, following the logic behind this, categorise them **as "think small, trade big"**. There is a huge difference between the two approaches on a very fundamental level. A term you have probably heard many times before **is "high probability trades"**. In trading systems out there traders try to identify high probability trades. If you think about it, the ability to do this is their edge, their competitive advantage. We, on the other hand, believe that whole approach is fundamentally flawed. In the type of random environment we live in, the forex world, your one and only edge simply can't be your so-called ability to identify many moments of non-randomness based on your skills of applying historical price patterns to real-time prices. The whole point of this type of randomness is that it makes a mockery of repetitive patterns. If the type of randomness exists in this market, and a few simple tests of logic can show you that it does (a coin-toss experiment), then you would be fooling yourself to think in terms of a few high probability trades amongst the thousands and thousands of trades that are being done on a daily, weekly and monthly basis.

If we assume that a large percentage of all traders have well thought out trading systems, identifying high probability trades and yet on a permanent basis there are traders long and short the market, buying and selling the same currency at almost every pip increment, isn't this saying something about the complete an utter unreliability of "high probability trades"? It is nothing more than 50 / 50 probability trades. What I propose goes exactly against the idea that you can indeed identify special trading opportunities with pinpoint accuracy in a system that works like clockwork and can thus be complemented with things like risk reward ratios where the ratio provides confidence to bet the house on any "high probability setup".

Instead of spending all your energy in finding a supposedly high probability trade, you should be doing the opposite. **Don't be choosy about the entry, but once in, focus your energy on turning a profit.**

In the "think small trade big" systems you divide your 'skill sets' into two distinct categories. First your 'search skills' – you look for the (illusionary) high probability trades and then you add a second skill set called "risk management" with stop-losses, risk reward ratios, and not risking more than x percentage of capital(usually 2%).

In the 4x1 strategy, this distinction between finding trades and managing risk doesn't feature so prominently. Managing risk is inherent in the 4x1 strategy. The 4x1 strategy acknowledges for instance the problems associated with random price behaviour, the potential havoc that can result from information overload, the underestimated risk of trying to pick tops and bottoms and the psychological problems associated with fundamentally flawed trading systems. It's funny, the "think small trade big" crowd always tell you "don't try to pick tops or bottoms", but that's exactly what they do. Everything in their trading world is based on picking a top or a bottom usually on a miniscule scale.

Let me explain this clearly.

Why do I say this? Well, because in almost all cases they work with a concept that after a trade has been identified a stop loss must be positioned – not risking more than 1% to 2% of capital. In practice this means the stop loss is always close to the market and the market is expected to move away from that stop loss. In effect, you must enter very close to some turning point (bottom or top) in order for that to happen.

Ok, now I am going to discuss the guts of the 4x1 strategy, the most important edges, its fundamental building blocks.

ONE CURRENCY EDGE

These days you can trade a multitude of currency pairs. This is not good. You may wonder why I say this. Those who disagree are of the view that not only is it better to have more choice, but it is **obviously** better. I'll attempt to give one reason. If you really think about it, what is a history of currency prices used in testing trading systems and risk : reward ratios and the like in order to get to the point where you can implement a rigid mechanical trading system? **It is just a data series.** If you remove the tags from all the currency pairs, all that remains are a lot of data series that are to some extent related. It seems to be natural if you have found some magic formula on one of these data series, to also try it on similar data series. After all, it is just data. What works in this series may just as well work on that series goes the argument. Bring the tags back, call the one data series EURUSD and the other USDJPY and the other EURJPY and this whole argument about "just data series" crashes because there are real-time fundamental drivers or real world currencies behind those "just data series".

The question you have to ask yourself is if you as a rank beginner can really operate like an emotionless machine utilizing these "just data" series to make or lose significant amounts of money for you? If you are in any doubt let me tell you. YOU CAN'T. Now, because of a glitch in your system, you change currency pairs, try new timeframes, try new chart studies and indicators and parameters for indicators. And suddenly the choices become overwhelming.

Too much choice

In his excellent book, *The Paradox of Choice, Why More is Less – How the Culture of Abundance Robs us of Satisfaction,* psychologist Barry Schwartz explains the problem of too much choice. It creates paralysis and robs you of satisfaction. In the forex market too much choice can rob you of more than satisfaction. It can diminish your capital. Schwartz explains how too much choice can be bad for a person's emotional and psychological well-being.

Now transpose that on to the forex market. The extraordinarily taxing effect of randomness on your mind of just one currency is challenge enough. How on earth are you going to cope with a scenario where you now have to consider the miniscule ups and downs on an intraday level of the following closely related currency pairs: EURUSD; USDJPY, EURJPY; GBPUSD; EURGBP; GBPJPY; AUDUSD; GBPAUD; EURAUD; AUDJPY? If the EUR suddenly strengthens versus the AUD, and GBP and AUD strengthen versus USD, what pops out in GBPUSD? If this strengthening was just a 30 minute burst for 50 pips and it then reverses almost all the way versus the AUD, but just 30% versus GBP, what happens with your GBPUSD "mechanical system"?

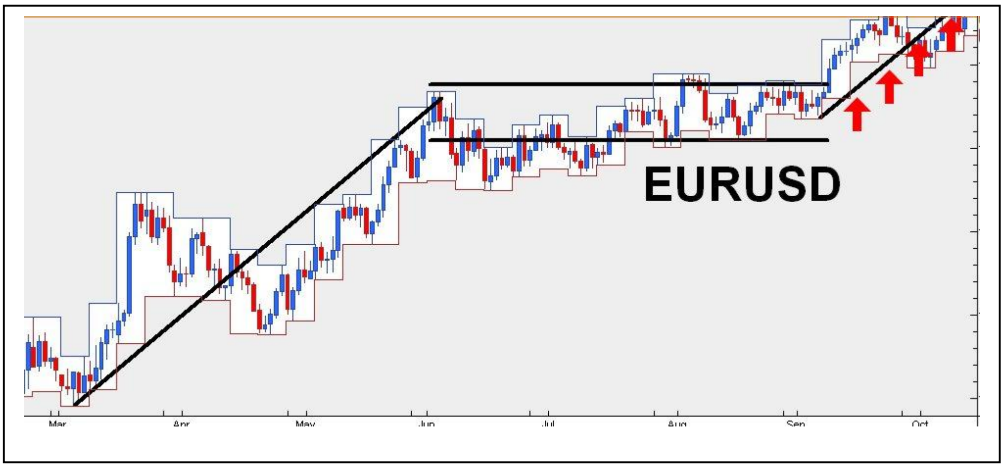
There is a view that trading several currency pairs simultaneously is a risk diversification principle and that is a good reason to trade more currencies. This may be true under some circumstances, but under others it is not. Unfortunately, many of the mechanical, "think small trade big" systems, when they do apply diversification, apply it incorrectly. This is because they don't understand correlation between currency pairs. Many currency pairs like the EUR crosses or USD crosses correlate reasonably well. (Remember correlations only hold over longer time frames and they can break down, often dramatically, on a day-to-day basis). And keep in mind, mechanical systems give buy signals based on a single currency, not a correlated relationship between currencies. So instead of diversifying risk you pile on more risk – just an increased bet size on one specific trade.

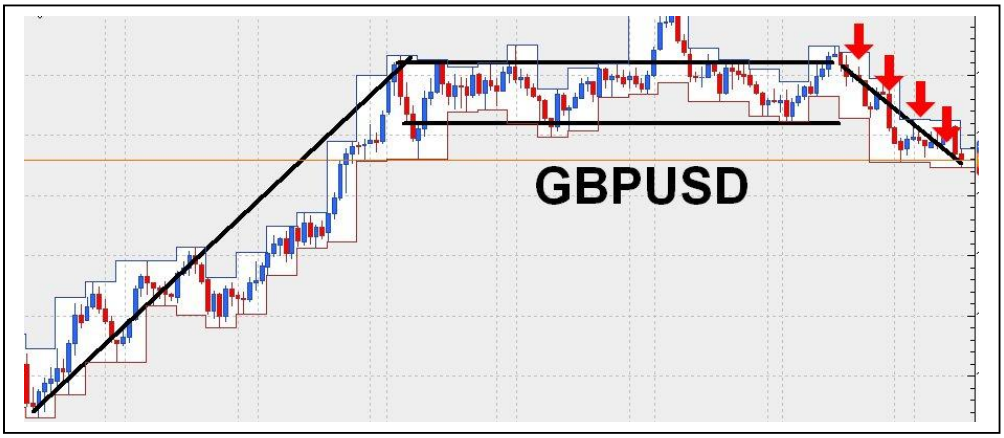
The currency market is in perpetual equilibrium. This means what one currency gains / loses in one relationship it will lose / gain in another relationship or relationships. Most people don't even know this and as such it doesn't feature in their "back tested" mechanical systems.

Keep it simple

Choice causes complexity. Randomness causes complexity. Constantly changing correlations causes complexity. Keep things simple and stick to one currency and preferably one currency pair. In the process of getting acquainted with this pair you will gain enough insight to benefit from related opportunities.

In order to master a currency you have to understand its fundamentals, its relationship to other currencies, the various fixed interest rates, bonds and other markets like the oil and 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. You must be alert to both sudden shifts and slight shifts that can cause a currency to change characteristics / correlations. In this regard I want to show you a recent example of how the EUR and GBP were quite similar for a few months and then suddenly the GBP took a different path versus the USD.





The fact is that you are Joe Soap Spot Forex Trading Inc, not Deutsche Bank or Goldman Sachs or HSBC or some macro hedge fund. You don't have thirty analysts specializing in global currency markets and ten economists with twenty assistants studying every aspect of every major country's economy and its relationships with other countries. You don't have five technicians and their ten assistants to fool around with every imaginable technical analysis approach in every major market, providing ideas to traders who will execute their trades based on their interpretation of all this information and their need for a bigger bonus and polishing their ego's. You are just Joe Soap and you must analyse and you must trade and you must run your trading business.

Your ability to cut to the chase, the fact that you don't have the issues that come with having a huge analysis and trading team, those are your edges in a personal trading business. Don't go complicate it now by thinking you have the capabilities of a whole experienced trading team. Stick to what you can handle. One currency.

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, Ozzie, 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.

When it comes to choosing a main currency or currency pair to trade there are a few things to consider. The US dollar as the reserve currency of the world is almost inevitably part of every currency trade. The common denominator is in the fundamentals. The US dollar is tracked via the USD Index. In this index the euro has a weight of about 60%. It is thus inevitable that the EURUSD correlates well with the USD Index. The euro is to that extent known as the anti-dollar and the most macro fundamentals are truly driving this currency pair. This is enough reason for me to see and use the EURUSD as a proxy for almost all analysis and to view the whole market through this "portal". To some extent your one currency should become your analysis currency. You learn to understand the correlations. Due to its dominance in the USD Index the EUR is the preferable currency for this.

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. This introductory sentence in the original BWILC could not have been more prophetic. Look at Wall Street, look at the blow up of revered century old financial institutions. Look at them and don't do what they did. In terms of the "think big trade small" paradigm the one lot edge means to under utilise the leverage available to you. The fact that your broker will allow you to leverage your positions 200:1 doesn't mean 20:1 is low leverage.

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. Leverage impacts on every aspect of your trading. It requires close stops, a bad thing as we have seen. You simply can't afford to high leverage and distant stops. Training programmes and literature that doesn't address the issue of leverage should be dismissed with contempt. This is strong language I know, but I believe anyone writing or teaching in this game is guilty of reckless negligence if they don't explain the dangers of leverage. And I don't mean just one sentence. I mean a proper and thorough exposition of the subject. What it is, how it works, why it is dangerous. Programmes that actually promote high leverage are to my mind criminal.

'Entry' v 'Trade'

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. In fact multiple entries are a critical part of successful trading in a random environment like short-term currency prices.

An average gearing per entry up to 2:1 or 3:1 is acceptable. If things work for you with this leverage you will have periods of abundant income. The other side of this coin is just as relevant. The higher your per entry leverage the more your draw-down will be every time the market goes against you. You must note that I say every time, because it is going to happen a lot. 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 relational 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.

Multiple entries

The 4x1 strategy goes hand in hand with multiple entries. We are not interested in illusionary high probability setups that form part of some elaborate risk – reward system. But if you do use multiple entries you must have defined risk parameters regarding leverage. This will depend on several factors including the state of your account and the state of your mind. It is important to understand the calculation of leverage.

If you are prepared to trade with up to 10:1 leverage in total on your account you will be able to make five entries of 2:1 each.

Assuming you have a $10,000 trading account. Leverage is calculated by dividing your capital into the value of the trade. So, 2:1 leverage will be (approximately) 20,000 units of the base currency. For instance in EURUSD a 20,000 position means the pip value is $2.00 (for each pip the market moves your account goes up or down two dollars). If you have 4 such positions the pip value is $8.00 for all four together. In other words you have to consider the aggregate amount of all your positions together. In higher volatility environments like we had during and after the credit crunch period (September 2008) it makes sense to use even lower leverage 1:1 and 0.5:1 per entry, spreading the entries and thinking twice before adding additional entries.

Practice right

Here is another point.

It doesn't matter if you trade with demo money or real 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. If you will have a small account, do not use a $50,000 demo account. That will be suicide. 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.

Look at the maths

Take for example a trader with a margin of $5,000 trading one $100,000 lot. He is 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 this trader must use close stops, say 30 pips. 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 his 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. He is a strict technical trader trading high probability setups. Fundamentals are for fundamentalists he was told. He enters another trade. Unfortunately for him, he does so just before an interest rate announcement in Australia. 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 too 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. 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 won't 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. And where has this guy's money gone? 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 plus free drinks and a free room. 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.

Our example trader 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 won't make money simply because you gear up. Doing that is nothing other than a blatant attempt to ride your luck. It has nothing to do with a professional approach to a personal trading business.

A recap

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, the highest probability of them all and I am going to up my gearing significantly. Be disciplined.

Can one 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 best define 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.

Scaling down

Also keep in mind that you 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 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 are 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 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 1.4500 and one at 1.4450. 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*

One of the big selling points of the currency market is the fact that it is a two-way market. You can long or short a currency to your heart's content, no questions asked. No up-tick rule, no lending of script, no regulators' anti-shorting rules. It is also true that due to the long ranging periods of the currency market in a well chosen median grid trading from both sides makes sense. I agree. The one directional edge does not exclude any potential you may have to benefit from trading long and short simultaneously. But there is an important nuance you need to understand, and which most failed currency traders never grasp. You must have a bias. And you must stick to your bias. A bias doesn't exclude being either short in a predominantly long market or long in a short market. It means that you have a long term view of either being short or long, but not both. This never changes. There may be times that short-term drivers change. Instead of then just sitting and waiting you have full control over your personal trading business to decide to make a short term excursion against your long term directional view.

The 'one-way-play'

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 by using prudent gearing strategies you will have much less losing transactions, or entries. But still, the question remains, why not trade the retracements (go short)? 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.

The critical word here, again, is "bias". Since we work with multiple entries it is possible to have some entries long and some entries short at the same time (that is if some over-zealous regulator like the CFTC doesn't interfere) and in that way benefit from two-way price moves. The important point is to maintain your bias. This means for instance if you have entered say four long positions EURUSD from low in the grid and for reasons you understand you decide to keep all of them for a rally and bigger profits than normal. But then, just like this market can do, it turns around on some rumour or stock market or commodity market behaviour and you just feel that there might be an opportunity going against your bias and fundamental trend, you should have no issues to take it. But maintain your bias. In this example you will at the maximum go 3 positions short, in order to maintain your long bias with at least one position net long.

Discipline

One direction only trading **teaches you discipline.** If for no other reason than this, have a plan and execute that plan with discipline. In a certain sense frenetic and unstructured two way trading is like playing chess against yourself. It's quite difficult to reach anything but stale mate. **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. The market can change with frightening speed. Since most of us trade part-time you have to accept during some times, rather quickly a day that had potential to go in your direction can conclusively turnaround. This can easily mean that instead of a small profit you suddenly have to deal with a growing out-of-the-money position.

Nothing is going to happen today for the last time. There will always be new opportunities. I want you 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 long-term position in this market. Have a bias, and back that bias, with discipline. 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 forty 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.

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 a short position at the highs to cut when the trend continues in my one direction. 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. At the same time I keep my eyes and ears open for signs of reversals, corrections, (break of trend line, support, median levels).

The **one direction** approach dovetails nicely with the **one currency** approach, different sides of the same coin.

Fifthly, and perhaps the most important reason to maintain a directional bias, is the issue of timing (once again). You have to understand that I can hardly talk to you on my strategy of one directional trading without mentioning timing. It is true that you can't eliminate timing completely but you can reduce the problem of timing significantly by applying a directional bias with low leverage.

THE ONE PERCENT EDGE

"A profit a day keeps the bailiff away."

- *DrForex*

For most traders out there, profit taking is a huge source of frustration instead of what it should be which is a source of profits. I am convinced in no other place is the loser's system so exposed as here.

Firstly, all their effort goes into entering trades, opening positions, or stopping them out to prevent losses. Profit taking seems like an afterthought.

It is generally good advice not to borrow short term to lend long term, or use your credit card to pay your mortgage bond. It is no different in your personal trading business. Let me explain.

Your capital (margin) is your funding source, it's your bank account holding the working capital for your business. When you open a trade (enter a position), you can only do this if you have enough margin. Your margin is thus a source of short-term loans to your business to buy "stock" (euro, dollars, pounds, kroner, yen). You hold this stock to sell it for a profit. All the profits of individual trades (or entries) together is the profit of your business.

Your profits are the active realization of your dreams, plans, and goals. It is what is going to make you happy and successful. It is an investment in your future. In other words your profits (distinct from your existing capital, the margin) are the long-term funding source for success and the realization of your dreams. It is analogous to your mortgage on your house. It's not the mortgage or the house per se that gives you fulfilment but the object being mortgaged that represents your ongoing achievement and fulfilment.

Subconsciously making of profits is critical to your wealth and (trading) mental health. Profits are the building blocks of your future.

Now look at the losers' trading system from this point of view. Cut your losses, run your profits. He will have more losses than profits. He is actively embarking on short-term loan funding for his long-term future. Instead of building that future one small step at a time he wants to make it with a few giant leaps. But in short-term currency trading the environment is simply not right for that and you can't force it with what you want. In this environment the cost of the close stop-loss type short term funding is hopelessly too high to fund your hopes and dreams in the form of big profits on a few trades. Profit taking should be approached from a different angle.

Let's look at it theoretically. If you want to make a 100% return on your money in whatever time frame, you need to book 100 profits and each profit must be equal to 1% of your capital. Or you could book fifty 2% (of your capital) profits, ten 10% profits or book one profit equal to 100% of your capital.

In the losers' paradigm high probability trades are few and far between and need to be uncovered with 'super' technical analysis skills. The natural result of this scarcity of high probability trades together with the 'skilful' uncovering of them is that traders want to make relatively large profits. Built into the system is the high amount of smaller losses which is offset against the larger profits. Built into the approach is a tendency to want to make profits in big leaps.

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.

Pip movements and market realities

An analysis of currency market price movements indicates that optimal pip moves which occour regularly where you have a directional move as well as smaller counter moves are certainly not measured hundreds of pips. This is critical for profit taking rules. Typical and realistic profit targets can be anything from 30 – 60 pips. In the randomness vortex that constitutes the currency market in the very short term you need to remember this: every time you enter a position it is at a market price in the middle of this randomness vortex, where prices move without rhyme or reason UP or DOWN 30 – 60 pips. In other words, the very the idea of high probability directional set-ups is preposterous because of this prevailing very short-term randomness of price action. The reality is that it is just as likely for any position to immediately move 30 – 60 pips UP as it is for it to move DOWN. Most losing traders can't face this uncomfortable fact.

Profit targets should take this important reality into account. Small profit targets are much more easily achieved than giant profit targets. Most high probability set-up systems don't have a good track-record of uncovering a few giants moves to compensate for the short-term randomness that can snuff out that high probability move.

Let's say you have $10,000 on margin. If you gear your entries 3:1, you trade €30,000 EURUSD and one pip move equals $3-00. From this a 33 – 35 pip move equals about $100 or one percent of your capital. Considering the inherent volatile characteristics of the forex market achieving a 35 pip move is high as long as you don't expect it to immediately move in your favour, i.e. placing a stop close to the market.

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.

The last word on profit taking is however that you cannot rely on small profits alone. In this approach you build in that your typical profit will be smaller than your typical loss. But you also build in that you will take many more typical profits than typical losses. In order for that to average out in profits you must, over time, offset these larger losses with larger profits as well. If this works out well your many small profits become your real profits, the realization of your dreams. You realise your dreams one small step at a time, gradually and consistently, and not haphazardly with a few giant leaps.

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.' He then 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 the student 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 14

The Median Trading Methodology – Making the edges count

We have said that one of the greatest challenges we need to overcome is the problem of randomness in the very short term and its implications for the typical trading system built on technical analysis skills (to find pinpoint exact entries with close stops to ensure some risk reward ratio that will guarantee profitability in the long run). This trading approach we said can best be categorized as “think small, trade big”. We said, because traders are very optimistic about their skills, their identified entries and the risk reward ratio they tend to put big bets on their carefully diagnosed high probability trades. So far history has proven that while this whole approach appears to be very rational and logical, it is in fact not. The traders who use it lose money. From my own experience and inquiries into the trading history of my mentoring clients I have gathered that most of my mentoring clients who have traded before use some derivative of this scheme. As an alternative we suggested the 4x1 strategy, summarized as "think big, trade small". Hence we said that perspective of the market place as well as of market price behaviour is critical. We introduced a median grid to help gain this critical perspective and assist us in entering and exiting trades. (A trade, we said, is actually an aggregate of multiple entries).

In the previous chapter we also identified and discussed the four primary edges on which the 4x1 strategy is built. One currency. One direction. One lot. One percent. In this chapter we will examine how you put these edges to work. But I first want to re-introduce the median grid and have a look at the "insides" of the grid in a little more detail to see what exactly is going on there, and how we can best utilise it for our trading success.

TRADING IN A COMFORT ZONE WITH PERSPECTIVE – THE MEDIAN GRID

You may be sitting with a nagging question. If you do not rely on signals for the 'perfect' execution of trades, how do you decide when to enter a trade? This is a fair question.

First of all don't forget that in a random environment like intra day and specifically sub-hour currency price behaviour the whole notion of timing is utterly ridiculous. Timing shouldn't feature as a factor. Thus the question *"**when** to enter a trade"* needs to be rephrased to *"**where** to enter a trade"* and *"**whether** to enter a trade at this time"*.

Instead of seeing the market in terms of timing and timeframes like 15 minute charts and 1 hour charts and 1 day charts you should think about the market in terms of pricing and price frames (price ranges). Pricing is an indication of relative value, i.e., is this price high or low in a specific price range.   Price ranges are very important because if you think about it it is the distance price travels, not the time (though still important) it takes to travel that distance that counts most. (To be fair in the options market time is very important but we are trading the spot market and time really only plays a minute role with regards to rollovers and carry interest.)

Even in the losers paradigm a stop is placed based some distance from the entry. The illusion of precise timing on the intraday and sub-hour level causes the distance to the stop to be very small and thus the time it takes for the price to take out the stop is relatively short. Because typical stops are placed 20 – 30 pips away, and risk reward ratios mean profits are taken at 40 – 60 pips, losers all relate the common experience of having the market go in their direction just after their stops are taken out. This is the random price behaviour in the sub 100 pip range that the loser denies exists. The whole life cycle of these trades takes place in the randomness vortex. Can you see how the combination of timing and high leverage is lethal? That is why I say that the reliance on timeframes and time intervals instead of price ranges is utterly misguided.

Instead of working with timing in an environment of 5 minute, 15 minute and 60 minute timeframes we work with pricing (valuation) in price ranges of relevance, up to 50 or 100 or 200 or 500 pips. It is very subjective. You can use whatever you like. Doing this you are breaking new ground, you can make the rules! A median grid captures a lot of very relevant price ranges.

In the picture above we have a seven week period spanning mid July 2009 to early September 2009. During this period price action was contained in a narrow grid range of 500 points. We have already covered the considerations we take into account when placing a grid and therefore I won't repeat that here. This grid is therefore placed without considering the grid history.

The TOP and BOTTOM grid extremes are placed at support and resistance areas and usually I round it off to the closest BIG FIGURE (1.40; 1.41; 1.42 are big figures).

The MEDIAN is the centre area of the grid. Usually for practical purposes I only use the median line. For illustrative purposes I have coloured the median area. Although it is slightly skewed it is clear that a lot of price action take place around the median area. It is also clear that price action tends to either move from one extreme area through the median to the opposite extreme area and other times it finds support or resistance at the median area. In addition price often does not spend a lot of time at the grid extremes. Obviously none of these are hard and fast rules, it just depends on how you place, and potentially adjust, your grid when price action nears an extreme.

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 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.

On the left hand side I have made reference to four quadrants. This helps to identify additional relative value areas in the grid. Now you can see what is (relatively) high and (relatively) low in the BOTTOM and the TOP halves of the grid. The placement of quadrant lines is also subjective. You can adjust it as price action develops in a grid to identify support and resistance areas, based on intra grid price action, or as I have done in the example you can just dissect the two halves each in two halves.

I have used 2-hour intervals for this grid picture. As a rule I personally use 30 minute or 60 minute time intervals in order to get an even better view of the random up and down moves through the grid.

But consider the following numbers. During this period there were about 480 consecutive 2 hour periods. Sixty-six, or about 15%, or 2 per day, were 60 pips or more between the high and the low. This just indicates how many rather quick profit opportunities there were during this period. Assuming you have just applied a basic principle to buy low in the grid or always lower than recent highs and sell higher in the grid or always higher than recent lows most positions would have been closed profitably given the elapse of time.

From a one directional point of view the only issue that could have developed was towards the end of the period if you had a net short position and now the break-out through the TOP extreme took place. However, if you kept your euro bias based on the fundamentals, in other words you kept a long euro bias, you would probably have had profits all the way and carried some of these profits into the new adjusted grid area. (Not shown here).

I will now look at how one applies the 4x1 strategy within the comfort zone of a median grid.

THE FIFTH 4 X1 STRATEGY - DIVERSIFICATION

The granddaddy of all risk management principles is diversification. *"Don't put all your eggs in one basket"* the age-old saying goes. To apply the 4x1 strategy in a median grid we make use of several tools from the diversification toolbox. We have already covered the topic of multiple currencies and determined that under most conditions simply trading in different currency pairs doesn't mean you diversify or manage risk prudently. This is due to the unique structure of the currency market where everything is related to everything. Instead we use some very common sense diversification techniques that can be applied even under a strict interpretation of the "one currency" principle.

Multiple entries

"Think small, trade big" naturally means that you have a "one trade at a time" approach. Based on

- the false confidence generated by the pinpoint timing attempts,
- the false certainty of the trading system with a false risk reward ratio
- the false risk management principle not to risk more than a small percentage of your account with hard stops,

traders have little trouble in putting on trades with 10:1, 20:1 and even 30:1 leverage. Remember 10:1 leverage means if you have a $10,000 account you do one trade to the value of $100,000. Since these traders don't generally risk more than about 2% of their account they need to place a stop as close as 20 pips away from the entry. Due to the relative quickness of these types of trades and due to the dependence on signals to enter the market in the first place, multiple entries aren't common. One signal. One trade.

Opposed to the above, in the "think big, trade small" world, our world, the whole point of departure is that you have multiple options, multiple positions and multiple entries. **Diversification is what conquers randomness.** Never bet the house. Bet it a room at a time, at different levels, until you are fully invested for that particular trade.

Trading in a median grid requires you to use multiple entries spaced properly throughout the whole grid or covered price area in the grid in order to benefit from the potential price action in the grid as much as possible.

Your starting point is deciding your maximum level of investment. Assume you make several individual entries, buying dips throughout the grid, but you do not take a small profit on every entry. Alternatively, once you take a profit at lower levels in the grid you re-enter again at about the same level. After some time you will have a number of open positions. Added together your multiple entries add up to a larger leveraged TRADE in your one direction.

Lets say for argument's sake you decide that the maximum level you want to be leveraged is 15:1. If you have a $10,000 account, your aggregate position size will be about 100,000 euro ($150,000 almost). This means you will be able to enter 10 1:1 (10,000) sized entries or five 2:1 entries (20,000) or three 3:1 entries (30,000). Multiple entries are about scalability and price diversification and exploiting random price movement in the grid.

To optimise it makes sense to enter larger entries or more entries in the lowest parts of the grid, say Q1. It's those positions you can really use to make bigger wins in order to “prepare” for some bigger losses by for instance entering three positions at the lower level of which you juggle one for 35 – 60 pips, and target one for say 150 pips and one you target for the Q4 area (up to 500 pips).

You can scale into a position and scale out of a position. You lower the risk significantly from entering one large position somewhere in the grid where you have to bring in a close stop in order to prevent significant losses.

Let’s look at our sample graph. Let’s assume you entered in late July at around 1.4250 (1:1), 1.4150 (1:1), 1.4100 (2:1) and 1.4050 (2:1) for a total position size of 60,000 or leverage of about 8:1 with an average price of 1.4116 and covering a price range of 200 pips from the highest to the lowest entry. At the time you made the lowest entry your draw down was 400 pips or 4%. Even if you begin to scale out of this position if prices break the 1.4000 extreme your total loss will easily be limited to less than 8%. Compare this with your “think small, trade big trader” who might have entered at 1.4250 with a 100,000 position. At 1.4210 he would already be down 4% unless he stopped himself out earlier. He might have entered again at 1.4050, short this time, just to write off another $400 (assuming a 40 pip stop). (Keep in mind he doesn’t have the perspective of a median grid. He trades very short-term momentum. UP today. DOWN tomorrow. Broke by the weekend).

Multiple entries afford you the luxury of scalability which can be used to calibrate your risk-taking in the comfort of the median grid. This scalability extends to the profit taking part of the equation as well. You can juggle some positions for the typically useful 35 to 60 pips profits and other positions you can allow to mature for hundreds of pips. Keep in mind that every time you scale out of a position, you can consider re-entering that position on any decent dip, having a second and third bite at the cherry.

Price levels

If you are very used to the principle that a signal from the market triggers your trades, it will take some getting used to an environment where the market doesn’t trigger your trades but you decide when, or rather, where to enter and exit the market. As I have said before, I base my triggers on **price levels.**

The median grid is an excellent tool to help with this. First of all there are the TOP and BOTTOM halves of the grid which generally denote a BUY and SELL area. If your view is that the currency is bullish you BUY in the lower half of the GRID and sell in the TOP half. That will align you with the most important trading principle, buy low and sell high.

A price level is a price range of about the number of pips which if multiplied by your typical leveraged ratio per entry will make 100 (or produce a profit equal to 1% of your capital). This means if you get lucky and pick a bottom or a top you will also be able to close out a small trade without the price really changing its level. In other words you made money for jam. Nothing whatsoever has changed, except that you have made a profit!

Let me put figures to this.

You have a $10,000 account and trade EURUSD using typical 20,000 EURUSD entries which means every pip is worth $2-00. In order to book 1% profit you need a 50 pip move. A price range for you will be in the region of fifty pips.

But also consider that every little bit counts, thus it is also possible to apply this based on two entries of 10,000 each 50 pips apart.

There are other equally valid but completely different ways of looking at price levels as trade triggers. You can use historical data to determine the average intra day price range for the currency of your choice and then use some common sense to divide it into levels of approximately 1/3 of the average daily, or two day range, or three day range. Irrespective, it will come to around 40 – 60 pips depending on the relative value of the currency pair and recent volatility factors.

What constitutes a day in order for us to determine a daily range? For me it is the typical financial market day that starts at around 5 pm New York time.

These price levels, whatever method you use, can be identified in relation to pockets of support and resistance or more subjective levels like a predetermined number of pips below a recent high or above a recent low. One of my clients uses it in relation to Fibonacci levels, others use it in conjunction with pivot points or others just use some "big lion" support and resistance levels as guides.

The important point is that in the randomness vortex we enter and exit trades at the current market price, which is always at that the instant of the transaction the centre of the randomness vortex. A few minutes later it can be 20 or 30 pips away. Thus there is no sense whatsoever in trying to justify why pip 1.4321 is better than pip 1.4305 to go long the second largest currency in the world against the world's reserve currency. Do you follow my logic? In this example, if your analysis is correct that it is OK to be long euro any level around 1.4300 – 1.4350, especially if you decide you are going to take a small profit.

Once you'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 you, it does not invalidate your decision to be long one position the second largest currency in the world. That is crucial to understand. What the market does immediately after you've entered is purely random, it is not predictable, and therefore I don't sweat it, and neither should you.

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.

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 enough to make a small profit without exceeding that most recent high or low.**

When you think about trade triggers, you must consider that the main characteristic of the currency market is its immense intraday volatility relative to what we think a nice profit is, say

35 - 60 points, depending on the volatility environment. 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 intraday 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.

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.

In conclusion let me say that seeing the market as a tapestry of price levels is the ideal substitute for the doomed idea of perfect timing. It allows you to predetermine price levels on which you would like to act, either by entering or exiting the market once it gets to your level. I hope you can also see how this allows for part-time trading even though it is a 24-hour market. If you have your 4x1 ducks in a row, you have identified your price levels you can put in entry orders and go to bed or go to work and let it be. No manner of wishful thinking while staring at price and indicators and pattern and randomness in action will change what is going to happen with the prices.

Cost averaging

The third diversification principle we apply in a manner tailored for short-term forex trading is the age old diversification principle, cost averaging.

By adding multiple entries when the price "dips", you make use of this sound investment principle. 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 one-big-trade-at-a-time 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 turns short at +40 pips. Your trailing stop snuffs the trade out at +30 pips. That 30 pips can't make you happy. 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.

But by applying some cost averaging you can turn this whole scenario around. By now you know we use small entries and therefore we can enter at several price levels throughout our median grid. Our median grid is the price area where we expect prices to hold for at least a while based on fundamental drivers we understand. We also have a directional view, thus we can identify optimal levels where we would like to buy the currency of our choice. By buying at different, "fixed" price levels we average the cost of our entries and thereby the entry level of our trade (the sum of our entries, when we will be fully invested).

Let me put some figures to this:

The current EURUSD price is 1.4300 which is 200 pips below the most recent high and our median grid extreme. I like to make 20K entries with my 10K account and I identify price levels of 1.4300, 1.4200 and 1.4100 to scale into a 60K trade which will average at 1.4200 and which means if I exit it at 1.4400 (still well below the median grid extreme) I will have made 200 pips x $6-00 per pip which is $1,200 and 12% of my capital. I might also decide to not go for such a large target but simply add the positions and take the lowest position for 200 pips, the middle position for 100 pips and the first and highest position for 50 pips. ((Remember what we said about the interference of the regulators in optimal trading. According to new US regulation this won't be possible in one trading account. But we can do this at the brokers of my choice I introduce you to.) This means that without the market making any significant move, within the context of our grid, without focus on timing, with no great technical analysis skills, but a well rounded trading approach and some patience you made a profit in a short period of time most institutional funds will be happy to make in year.

And the best of all? The process can be repeated. Not necessarily every day or every week and sometimes it will not work out optimally and you might have to cut some losses too, but principally you have a robust trading approach that works while you have turned most of the common how-to-trade wisdom on its head.

A case study

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.

Chapter 15

4x1 trading as 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. That indeed is the most important risk management principles for all traders. This is very important for individual traders running a personal trading business. It is also paramount for you to understand the difference between you, running a personal trading business and someone ("a professional") working as a trader in a financial company. Both groups (individual traders and let's call them "trading team members") have to live and die by this principle. If it's you, you have to ask yourself for more money. If you are a trading team member you have to ask your boss. In both instances you have failed.

But the point I want to get to is that it is very different for a "professional" working for a trading organization. He will probably be fired or receive no bonus (and then leave on his own accord) but his career is far from over. In the professional environment he can still, especially during good trading times simply walk right into another trading job with a half decent record and an explanation that what caused his demise was some erratic market action. This luxury of moving from one failure to another causes the trading team member to have a totally different view to risk taking and risk management. He does not as a rule concern himself with the ongoing existence of the organisation he works for. His main concern is "will I be able to get another trading job" if he is in a trade that could blow him out of the water. You will agree that this mindset allows for taking much bigger risks and I believe it is part of the reason why big profits are made by individual traders while their track records are in fact poor. They can afford to think small and trade big. They can go for big killer trades because it is not their money. But the fact is you as a personal trading business owner cannot afford to have this type of mindset especially if you are nearing the end of the road in terms of the capital you are prepared to invest in this venture. For you to survive your risk management must begin long before you run the risk of blowing your business out of existence with the next two or three trades. It begins with your expectations. They must be realistic for your circumstances. They must be realistic in terms of the fact that most personal trading businesses fail miserably in a matter of weeks or months. In this chapter we are however going to look at some of the practical ways you can manage your trading risk.

HOW NOT TO DO IT

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?

In the "loser's paradigm" trading and risk management are usually seen independently. This is clear from the way these concepts are presented. Thousands of articles about risk management have been written independently from the trading decisions that cause the need for the risk management. I am not saying it is impossible to treat risk management independently as a subject but the danger is that these types of helter-skelter risk management ideas (what I call "patch-and-solution" – hole in the tyre; quick, bring the patch and solution) become divested from the total trading business package. An even bigger problem is the thousands of trading systems being promoted that are devoid of any integral risk management principles.

To be a trader is to be a risk manager. Understand that first. Trading is about taking high risks relative to your trading capital. Low risk is putting your money in a savings account at a AAA rated bank. To survive or profit from such a high risk environment like running a personal trading business, you must manage that risk carefully. In the Bird Watching approach risk management is fully integrated into our trading system from the word go. I have already said, right at the beginning, that risk management begins long before the first trade is entered, i.e. long before the “patch-and-solution” stop-loss risk management that is so prevalent in the loser’s paradigm.

The “patch-and-solution” risk management system usually works like this:

- Once you have identified a trade signal you calculate the 2% “risk” point and place a stop-loss order there.
- Do not adjust your stop-loss further away
- Ideally use a trailing stop-loss or manually move your stop to breakeven (zero profit) as soon as possible.

From a proper risk management perspective the critical fault here is primarily the laissez faire approach to the position sizing (leverage) and secondly the placement of the stop right in the randomness vortex due to a hard loss limiting rule (“2% of capital”) which is unconnected to the realities of the market that is full of big moves based on real drivers.

THE MEDIAN GRID AS RISK MANAGEMENT TOOL

First of all the median grid gives you perspective of the bigger picture. By constructing a history of median grids you gain a multi-month or multi-year understanding of bigger picture price action. If you can combine this with an understanding of the price drivers behind these different median grids, you've almost got it made! In other words, the median grid in itself, creating a comfort zone and price area where you are in control of the underlying drivers in the sense that you understand them, is a powerful risk management tool. You can apply your other risk management tools of the 4x1 and diversification tools in that grid area with great confidence. The demarcation of the area, almost like the 'fairway' on a golf hole is in itself a risk management tool. You know, just like the golfer who landed in the 'rough' knows, that special conditions exist for his approach to the green, different to had he been in the middle of the fairway. He has to take greater risks, and different risks. If price moves outside of the median grid you work with special conditions. You have to take some special risk management actions.

So lets look at that first.

By creating a grid using the support and resistance most evident on intra day charts like 60, 120 or 240 minutes at the bottom and top of the screen 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 you 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.

Once prices threaten to leave your median grid you need an action plan to handle this event. Clearly there will be a difference in the risk you have to manage depending on which side of the median grid prices threaten to exit. Since you have a one directional view and your entries are positioned to gain when the market goes in that direction, fine and dandy when they do. But when they don't and threaten to exit at the opposite end, then suddenly things don't look so good and you have quite a different view of the situation.

I have used the following picture, a USDJPY grid between 88.00 and 93.00 during late September 2009 to late November 2009 to illustrate this principle and how you should mange these different scenarios.

Use the following assumptions: Your one directional view is long USDJPY and you have established positions at the lows in late September and early October. You would have taken some profits and re-entered with that long-term bias in mid-October around 90 – 91 levels. Towards the end of October the price reached the top extreme on the one directional side of the grid. So this is positive for you.

First of all the price area around the grid extreme is an uncertainty zone. On this positive side I personally see the “uncertainty zone” outside the current grid. Under ideal conditions one will have more than one position at this time and can close at least one in the uncertainty zone for a profit. In this way if prices retrace you can re-enter that position on a decent dip and have a second bite at the apple. But, more important is the fact that you need to make money when prices move in your one direction. Therefore I will want to keep a small position in the market, just in case this is a real big break-out causing a grid adjustment. It didn’t happen here. As you can see from the symbols in the picture there are two conflicting risk principles here. Being at the edge of the grid there is the danger of prices turning around, therefore some pre-cautions should be taken and what better caution to take than booking a profit?

But, considering it is a move in the direction of your one directional trend it’s also good and for that part of the risk management you stay with the trend, i.e. “run your profits”.

Lets continue with this example. Prices turn around, we’ve taken one profit and have one open position, still believing in our one direction trend, USDJPY long, (going UP). Prices drop rather quickly and we re-establish positions around 90 – 91 and around low 89 – 90 levels. Towards the middle of November we have three positions long USDJPY one at 91, one at 90, one at 89 and price is dipping relentlessly towards the grid extreme. We begin to wonder if our long-term view shouldn’t be postponed a while because the drivers for USDJPY that will drive USDJPY up to 100 seem to be receding rather quickly.

First of all, as you can see in the picture, on this "wrong" side the uncertainty zone straddles the grid extreme. Part of it is inside the grid, part of it outside. This is a real life example. What I have said above really happened, and I began to think there is a chance that a break of the EURUSD well above 1.5000 may lead to a move of USDJPY well below 88, out of the grid, and who knows whereto then? The question you have to answer then is "**can I at this stage, taking everything into account allow these positions just to draw down another 200 or 300 points**". Usually to answer that positively is a bad idea. Here's why:

- If your long-term view is correct (in this case back to 100 which will be a great one-way trade) and your short term view is correct (possible ½ grid break towards 85) then you are going to have opportunities to establish positions for that long term move at bargain basement levels. Holding on to the positions you have will limit your capacity to add these bargain basement positions at, say 86-87, 85-86 levels because you will be looking at draw down and of course greater leverage (more open positions).
- If your short-term view is wrong and the market doesn't really go **all that way** down, THUS, this current low (around 87 / 88 still in the current grid) is THE BIG LOW then **re-establishing** them at these low levels in the grid would be the way to go. If you lose in the process a few pips per position (by first closing positions for a loss "just in case" and then re-opening) it really isn't a big deal.

On the wrong side of the grid you just do the opposite of the actions on the right (TOP) side of the grid. On the "right" side you want to ride the potential breakout. On the wrong side you want to cut the loss short. In BOTH cases you do whatever you do by scaling out of the position, one entry at a time. **NEVER EVER** decide one price is worth closing all your positions, especially when you take losses. If you close all your profits because you are content, that's fine, but not all your out-of-the-money positions because of being discontent. In a real life scenario I have scaled out of a fourth position at low 90s, the third positions at 88.50 and the second position at 87.80 (below the extreme). Because I have used hedges to scale down the risk I have decided to keep the third position for now, since prices are still in the uncertainty zone, close to the grid. EURUSD has made a new high since the credit crunch lows of 1.2400 and is pushing at time of writing the top grid extreme uncertainty zone edge. Considering everything I am happy to hold that position.

THE ROLE OF RELATIONAL ANALYSIS IN RISK MANAGEMENT

I want to continue with the real-life scenario above, because it was unfolding real-time, and it will illustrate the application of relational analysis to these real time events. Nothing, but nothing, is worth more than these sorts of real life examples. Just so you remember:

relational analysis is about making sense of price-price, price-time and price-event relationships which are continuously changing. It goes without saying that if you can relate these things perfectly and do trades optimally based on that analysis you will pretty much have solved the problem of trading. After doing this for 12 years I can tell you it is unlikely to happen, though I can tell you you get better at it. In this instance my relational analysis leads me to make a slight adjustment in my view of USDJPY short-term outlook just before it fell below 89 for the first time in about six weeks. This is how my thoughts have changed:

My long-term view was that the JPY was hopelessly overpriced at these levels considering the fraught position of the Japanese economy, its bad debt position (almost 200% of GDP), the fact that it would probably yield to China at some point as the leading Asian economy, and the status of the Yen vs the Yuan might change long before the USD loses its reserve currency status (if ever).

At this time there was a very strong correlation between “risk on” / “risk off” as a global sentiment expressed in equity market UP and DOWN moves. Every time the US stock markets went DOWN the “risk” was said to be taken off the table and with that the JPY strengthened (i.e. moved down on the graph as above). This whole ‘dance’ was due to the deep imprints on traders’ psyche’s – during both the credit crunch and the disorderly unwinding of the carry trade of ‘06/07 the JPY strengthened tremendously (up to 87.10).

What I picked up was a **slight breaking down of this correlation in the week or so leading up to this point** we’re at now (sub the grid and 88) which seemed to be related to rumours that the US Fed will begin to act on stimulus removal and interest rates. That would be the trigger to cause the dumping of all these yens acquired during “this risk on” / “risk off” dance. But since that has been conclusively postponed to beyond Q1 2010 and because the USD is coming under more and more structural pressure to weaken, and because things really looks like decoupling between emerging markets and the US, and because the EZ area seems to be in better recovery shape, I began to think that in the short term the JPY may strengthen with the other major currencies, even though “risk was on” and stock markets were not going south. Therefore I began early in the grid area to adjust my positioning from four long USDJPY positions to only one long USDJPY position preparing for the potential short term move based on my relational analysis.

> If you consider the above carefully I hope you will realize that I can teach you a lot about currency trading and the 4x1 strategy and risk management and how to take losses and how to take profits in a book like Bird Watching in Lion Country – retail Forex Trading Explained, but I cannot effectively teach you how to do real-time analysis based on relation-analysis. There is only one way to do that namely in real-time, showing how one apply these principles and how one place trades based on your analysis. This I do very effectively in my personal mentoring program.

DIVERSIFICATION AS RISK MANAGEMENT TOOL

Multiple entries - Instead of doing one big trade at one important price you will sub-divide your big trade in a number of smaller trades ("entries") and enter the market at different prices.

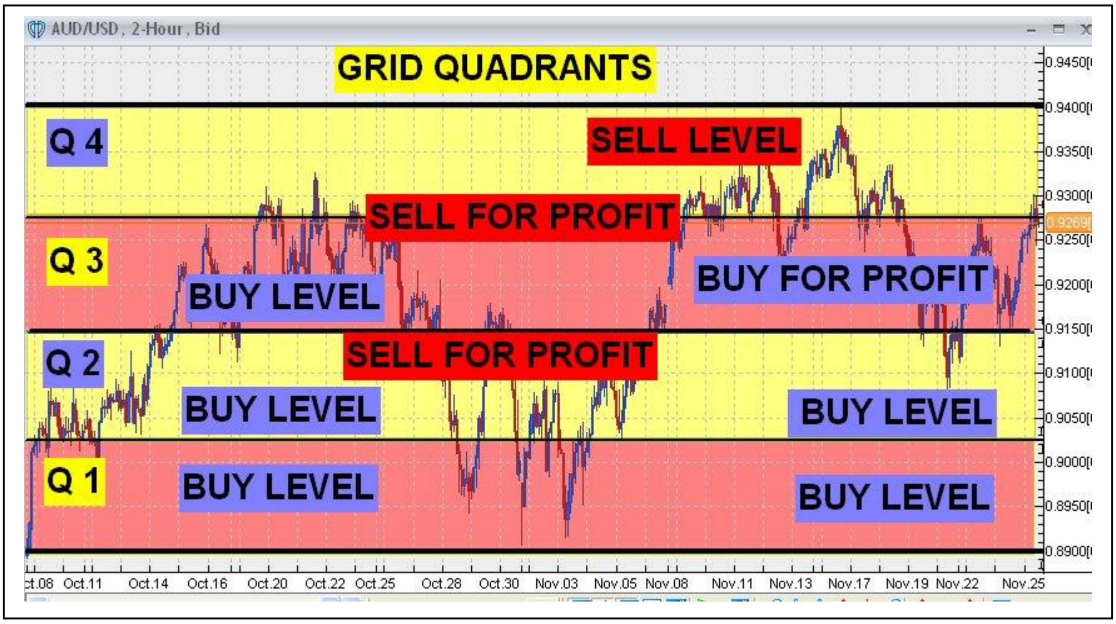
Price levels - We view the market in terms of price levels or price areas / ranges in your median grid where it makes sense to make multiple entries. One risk management concept around price levels would be not to make more than an optimal number of trades at any one price level of 40 – 100 pips, depending on volatility factors and your typical profit parameters.

Cost averaging - This is one of the most prudent investing principles ever developed. 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.** The way to phase your multiple entries into the market is by using cost averaging at different price levels in the median grid.

The basic structure of the median grid already split it into two equal halves around the median towards which, and across which, prices will tend to move in the grid. Combine this with your one directional view and every grid has a buying zone where you will find better prices relative to your one directional view or the long-term trend and a selling zone where you can with greater confidence enter positions (short term) against your one directional view. Let's be clear about one thing here. If your one directional view means you BUY then if you SELL to take profit it is also a move against your one directional view. In addition to this you can enter a totally new position short, which one can categorise as a "contra trade / entry".

For the above shot the following assumptions hold. Our directional view is long AUDUSD. The first risk management principle is simply to divide the grid into a general BUYING and SELLING zone. On the assumption that prices will remain for a time in a certain median grid you will automatically consider the lower levels of this grid (UP trend is UP on the chart) as better buying levels and the higher levels as better selling levels. Selling levels either to take profits on positions carried from below the median area or to enter new short positions back to the median and lower.

Quadrants



You should further subdivide your grid into quadrants, four levels (400 / 500 pips divided by 4 quadrants equals 100 / 125 pips per quadrant). This will give you greater focus and allow you to apply the diversification techniques better. The bottom two quadrants will be your prime buying areas (Q1 and Q2 with several "BUY LEVEL" tags). You will also trade up and away from the median in Q3, just above the median, (See BUY LEVEL tags) but by now you should know enough to show caution in Q4 (the top quadrant) (In the example no BUY LEVEL tags, but SELL for PROFIT and SELL LEVEL tags.) 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.

Pyramiding – 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 1.4500, keep it and buy two lots at 1.4600, keep it and buy three lots at 1.4700, keep it and buy four lots at 1.4800 and so on. You can see an obvious flaw. Even a small retracement at the higher end will write off most of your profits.

Here's the calculation. Assume one lot is 20,000 units and thus $2.00 per pip. At price 1.4600 you have made $200.00 and add 40,000 units and thus make $6.00 per pip. Adding three lots (60,000 units) at 1.4700 to your $800 profits makes the total 100,000 units for $10.00 per pip and grows it to $1800 profits at 1.4800 and so on. The problem is that if price turns around well short of 1.4800, and revisits 1.4600 instead you have made the 100 pips between 1.4600 and 1.4700 at $6.00 per pip but will be down $10.00 per pip at 1.4600 with only a "buffer" of $200, i.e. 20 pips to 1.4880 before you will go into negative territory. In the long run if you repeat this kind of setup you will definitely end up down.

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 400 / 500 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. Here is a schematic example of proper risk management with multiple entries and cost averaging via pyramiding.

Profit taking - 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. In other words we make use of diversification of profit targets and should be very flexible as circumstances change. Below is a schematic illustration of risk management with profit targets in the median grid.

Here is an important tip: instead of adding a further position with a small profit target consider just stretching the profit target of one of the existing positions with the same number of pips.

MANAGING LOSING POSITIONS

I think you will agree by just quickly examining the different examples of median grids (EURUSD; USDJPY; AUDUSD) in illustrations in this chapter that the scope for losing positions due to a directional bias and the application of cost averaging through a median grid is vast. To be clear, not any just-out-of-the-money position can be classified as a losing position. In our definition out-of-the-money positions in the randomness vortex are not necessarily losing positions. In fact they are winning positions that are just a little slow out of the blocks! In the same vein a position entered relatively high on a specific level will not be a losing position if you plan to enter another position low on that same level, for example if you see Q1 as the "basement bargain level" and buy high in Q1 (assuming prices dip from Q2) with the idea to add in low Q1. The first position will not be a "losing position" at the time you enter the second position.

It's very important that you accept this concept of flexibility around your entry prices. Fretting about out-of-the-money positions in the median grid around levels you have identified as levels to add positions for purposes of cost averaging is pointless and counter-productive.

The reason why it doesn't make sense to take a loss in the randomness vortex is because the odds are very good that the first time it moves 20, 30, 40, 50 or even more pips in one direction immediately after you have entered it will not last and it will turn around and move in the opposite direction.

You just have to accept it and any negative thoughts, emotional upheavals, psychological implosions and throwing of objects at the screen should be saved for more serious matters like poor sports refereeing denying your national team a chance to play in the soccer world cup! (Sympathies to my Irish readers.)

Drawdown

In the "one big trade at one big signal" trading paradigm drawdown is defined as the difference between your highest gross account value and your current gross account value (assuming it is below the highest level). The reason for this is that negative trades are quickly being snuffed out by close stop-loss orders. Here is an example.

Trader "A" has a $10,000 account and makes 100,000 unit ('standard lot trades').

Over a period of time he has made the following trades:

- Wins 100 pips
- Loses 40 pips
- Loses 40 pips
- Wins 100 pips
- Loses 40 pips
- Loses 40 pips

His next trade is a loser of 40 pips. Each trade is discrete and complete. Especially losing trades are completed quickly due to the close stop losses. His highest equity was $10,000 + $1,000 - $400 - $400 + $1000 = $11,200. After his last trade in the series his account balance was $10,400 ($11,200 - $400 - $400). His drawdown is $800 or 8%. His net profit is $400 or 4%.

When you use multiple small entries and cost averaging to enter trades the concept of drawdown changes. You are not focused so much on the end result after you have booked trades (closed them for a loss or a profit). Instead you are focused on the net value of your account, i.e. all booked trades plus the net value of all open positions. This is a key factor in your risk management. How to understand and then manage drawdown or "down side". Here is an example:

Over a period of time a BWILC trader with a $10,000 account has made the following entries in chronological order and is now taking stock: Assumptions, EURUSD direction BUY, GRID 1.4100 – 1.4600.

The trade begin with prices in low Q4 at 1.4500.

- #1 Open 10K @ 1.4500
- #2 Open 10K @ 1.4450 = drawdown 50 pips, $50, 0.5%
- #3 Open 10K @ 1.4350 = drawdown 250 pips, $250, 2.5%
- #4 Open 10K @ 1.4300 = drawdown 400 pips, $400, 4.0%
- #5 Close 10K @ 1.4200 = drawdown 800 pips, $800, 8.0%
- #6 Open 10K @ 1.4200 = drawdown 800 pips, $800, 8.0%
- #7 Close 10K @ 1.4100 = drawdown 1100 pips, $1100, 11%
- #8 Close 10K @ 1.4100 = drawdown 1100 pips, $1100, 11%
- #9 Open 10K @ 1.4200 = drawdown 900 pips, $900, 9.0%

I think you will agree that in this scenario things went really wrong, but the result at the worst point is only a drawdown of 11%. His account balance, or gross value changed from $10,000 - $300 (closed #1) - $100 (closed #4) - $200 (closed #3) to $9,300. His net value at the low point was $8,900.

But note how in this scenario he has managed the speed of the drawdown at different price levels by closing some positions (#4 & #3). Instead of going negative at $4.00 per pip from 1.4100 he closed the latest entered positions to limit the speed of drawdown outside the grid (in the uncertainty zone) to $2.00 per pip. This has the further advantage that he has created room to re-enter these two positions, possibly at better levels.

Lets add insult to injury and examine what happens if the market turns around after his last long entry at 1.4200. Speed of drawdown is $3.00 per pip.

This time I want to introduce hedging. Instead of closing at 1.4100 (drawdown 1,200 pips) he hedges one position at 1.40 (drawdown 1,400 pips) and the market turns at 1.3900 (drawdown 1,500 pips).

His trades looked like this by the time the market found a bottom:

Open #10 10K @ 1.4100 short = net profit 200 pips

Open #11 10K @ 1.4000 short = net profit 100 pips

He now closes both these at 1.400 for a net profit of 100 pips. His account balance increases to $9,400.

He enters #12 20K @ 1.4050 and #13 20K @ 1.4100. He also has #2, drawdown 350 pips, #6 drawdown 100 pips, #9 drawdown 100 pips; #12 is positive 2 X 50 pips = 100 pips.

The point of this is to explain drawdown and loss management. I am not just going to assume we are through the problem period and the BWILC trader has more trades at 1.4300 and 1.4400 but he takes no profits, then closes everything at 1.4500, the price at which the trade began when everything went wrong.

Taking stock at this point:, after closing all positions:

- #2 @ 1.4450 = 50 pips, $50, 0.5%
- #6 @ 1.4200 = 300 pips, $300, 3%
- #9 @ 1.4200 = 300 pips, $300, 3%
- #10 @ 1.4100 short, closed at 1.400 = 100 pips, $100, 1%
- #12 20K @ 1.4050 = 450 x 2 = 900 pips, $900, 9%
- #13 20K @ 1.4100 = 400 x 2 = 800 pips, $800, 8%

At the original price of 1.4500 the gross value has increased from the lowest gross value of $9300 with $100 + $50 + $300 + $300 + $900 + $800 to $11, 750 with 17.5%.
I concede that the return to profitability will in a practical scenario be different with several smaller profits and several new entries. Even with this variable the net result will be better than 4% up AND the original uptrend has now kicked in. By the time the EURUSD made it all the way to 1.5000 this account could be up 30% or more.

Managing drawdown

As you can see from the example with multiple simultaneous, cost averaged entries drawdown is a given. It is necessary to identify an aggregate level of drawdown per trade (consisting of several entries at different levels cost averaged through the grid) which will trigger your **drawdown management steps**.
Drawdown management steps are focused on limiting the speed of drawdown (measured by the value per pip). By doing this you can accept a further move against you with the fewer remaining positions. This creates room to re-enter at better levels and recover the drawdown and eventually profit from the cost averaging in such a manner that your net value and gross value meet up as the market moves in your chosen one direction.
It is a fact of this style of trading that most of the time you have drawdown, because of the cost averaging approach and the fact that you take many small quick profits.
Not only does hedging limit the speed of drawdown but it also presents opportunities to make profits while under the stress of relatively large drawdown.
The decision about an aggregate level of drawdown is quite important. One needs to prepare for “low scenarios” and “a worse case scenario”. Preparing for these means to mentally accept 10%, 20%, 30%, 40% drawdown but then put drawdown management steps in place to prevent you from reaching those levels.
The tools you need as you can see from the example are

- the size of entries,
- the number of simultaneous entries,
- the pip value per entry,
- the aggregate pip value,
- and a decision about closing positions or hedging positions.

The golden rule: scale in, scale out, never rely on one big trade and one “important” price.

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 1.4800 and there is strong support at 1.4720/40, place your stop below 1.4720, even below 1.4700. **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.

It should be clear to you by now that it is not possible to think in traditional terms about stop-losses and almost everything said about stop-losses is irrelevant if you have your ducks in a row with your total risk management strategy as set out above.

In the multiple small entry, cost averaging paradigm stop-losses play a role on the “trade” level. Keep in mind a trade is compiled of a series of multiple entries at different price levels, backing one direction, within a median grid.

If your trade seems to go completely wrong and underlying fundamentals and relational analysis begins to point to a change in the drivers, then the idea of a traditional stop-loss begins to play a role.

You may define a price level at which you abort the whole “trade”. This price level may be just as a grid is broken on the wrong end or maybe after a half a grid adjustment. This can still happen as we have described by scaling out of positions and hedging positions up to a predetermined point when you will either leave the market square (no positions) or, if you use hedging, trade in the opposite direction to your original bias. Say you have started doubting things with 5 entries all long and you have closed and hedged some to eventually be square with two long entries and two short hedged entries. You can basically stop the whole original trade by beginning to add additional short positions, i.e. your net position changes to “short” from “long”.

A second way to approach aborting your “trade” in a stop-loss fashion would be to consider the level of drawdown. You may set a principle like, cutting a position to square at between 8% and 10% or at 15% drawdown from your account balance. What this is will depend on things like your typical position size, number of positions and drawdown positions relative to price levels in a median grid. It might not be the best idea to completely abandon relational analysis as well as the structure of the grid, which in many cases offers very strong support or resistance at the extremes.

Nevertheless, whatever your stop-loss decisions at the trade level, the golden rule should stay in place: scale in, scale out, never rely on one big trade and one “important” price.

Summary

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.

Summary:
We use our 4X1 strategy to bring together all the edges we have identified. We ply our trade in the median grid. We live with randomness. We don't pretend the grid has great predictive value. It is a context creator, a snapshot of chaos, but it gives us context and perspective and we can profit from this. We believe in the principle of diversification and for us it means multiple entries rather than multiple currencies. In keeping with our flexible approach we scale into trades, at multiple levels, and we cost average. We never do big trades, closing or opening everything at once. It is not how we think. Our risk management strategy is simple. It is part of our 4X1 trading strategy. Just as we scaled in, we scale out. We NEVER EVER choose a random price to close all our entries. In this way our trading is also consistent and fluid and an extension of one whole and integrated philosophy: we 'trade' our drawdown just the same way we trade our 'drawup'. We have the unique approach where we live constantly and comfortably with drawdown, because our equity is increasing and the drawdown in our account is a staggered, diversified, cost-averaged "investment" waiting to bear lots of little fruits.

Chapter 16

Relational Analysis – combining your edges

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.. 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 and how they play out in your trading account: 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. In this sense events in your head have a lot to do with the status of your account (your trading business' books).

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 $30,000 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 in my comfort zone and specific price frames 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.

We have emphasized the importance of perspective. Relational analysis, seeking the relevant price-event-time relationships is the toolbox to gain that perspective in a practical trading sense.

The following relationships need to be investigated in order to get the trading perspective needed to make optimal trading decisions within the fundamental analysis framework and the 4x1 strategy applied in a median grid.

Price – Time relationships

Sometimes prices move a lot in a short period of time. An example is the second half of 2008 when prices made huge directional moves leading to mainly JPY and USD strength against other currencies. Then there are periods that prices are relatively muted and move in rather narrow price ranges. Price time relationships can be applied in the medium term and short term. It can even be useful on an intraweek and intraday level.

When you consider price-time relationships the one underlying question is about the "speed" of the market. Are we in a fast-moving market? If it is a fast moving market then in the bigger perspective it is either trending UP or trending DOWN.

From a multiple entry and scaling in / scaling out perspective you will want to use that opportunity to either scale in or out of a position. There are risks, assuming you scale into a trade (multiple entries) while prices are dipping away from your direction, you might find that you scale in way too early in a fast moving market. It makes sense to consider the following: what lies behind this fast move and check your potential scaling in against price-event relationships at that time.

There is a saying "don't catch falling knives" referring to buying in fast moving ("falling") markets. My advice is that you temper scaling in during a fast moving market by being slow to pull the trigger repetitively during the initial stages of such a move. On an intraday basis it is unlikely that a very short fast move will cause a substantial change in price-levels that it implies the addition of multiple entries (of your typical entry size) in a short period of time (intraday).

A second important price-time relationship is the time that has elapsed between price moving from, and then returning to, original price levels. If prices move substantially away from a specific price level and return back to that level very quickly, then repeating your previous trading action at that specific price level as soon as prices reach it, may not be the best idea. What I am saying is: "beware of price spikes and retracements". Again this can be on the short-medium term as well as short term and intraday levels. In these scenarios you usually have a miniature "price bubble" caused by some trigger ("driver") which is shorter term than the predominant drivers in slightly bigger perspectives.

Price – event relationships

Now I will only refer to "external" events, i.e. "events' in terms of fundamental drivers. This is one of the more practical PET relationships because you are trying to answer the question "what is the relation between the price(s) I consider and specific market "events". ("Event" in this sense can be described as "a recognisable price driver".)

Practically relational analysis means considering and balancing certain important events (remember "recognisable or discernable price drivers") and the price levels at which they occurred and the price changes they sparked. In the macro perspective a solid understanding of price event relationships can be very rewarding.

I think you can see where we are aiming. We are not satisfied with the dictum that the price contains all relevant information. In fact I don't find this very helpful. What does it really mean, practically, for a trader? Sure we use support and resistance levels, but I want more, and that's why I look around. Relational analysis is a sophisticated type of "looking around".

On the macro scale this helps a lot to make decisions about bias in your trading. It also helps you make optimal use of cost averaging opportunities. In most cases significant events that cause multiple big figure price changes and start medium term trends are interpreted differently by traders / investors with different time horizons. Often a large part of the initial price change is due to traders with shorter term horizons and short-term speculators entering and exiting the market in the first reaction to such an event. When they exit the market, happy with their profits, they cause selling pressure (vs the buying pressure triggered by the event) and prices cascade back towards the initial price level. Traders and investors with a deep understanding of the fundamental drivers and deep pockets to drive the market will use this as a "dip buying opportunity" and this Event-Price relationship becomes very meaningful in order to maintain a support level for an ensuing trend and potential future retracements, or counter trends.

A recent example of this was the US Fed's quantitative easing announcement in mid March 2009 (we referred to it earlier in Part 4). This not only marked 1.31/2 EURUSD as a significant level, but it also triggered many other markets to rally into the end of 2009 following that announcement. Recognizing important events is crucial to good relational analysis. Unfortunately it only comes with practice and practice takes time. It definitely helps to be guided by someone with experience in this regard.

On an intraday basis there is scope for micro price-event relationships regarding economic data releases and other market-moving news.

Experience helps a lot to be able to recognise price-event opportunities. One should look to benefit from event driven price spikes, especially to take profits on existing positions.

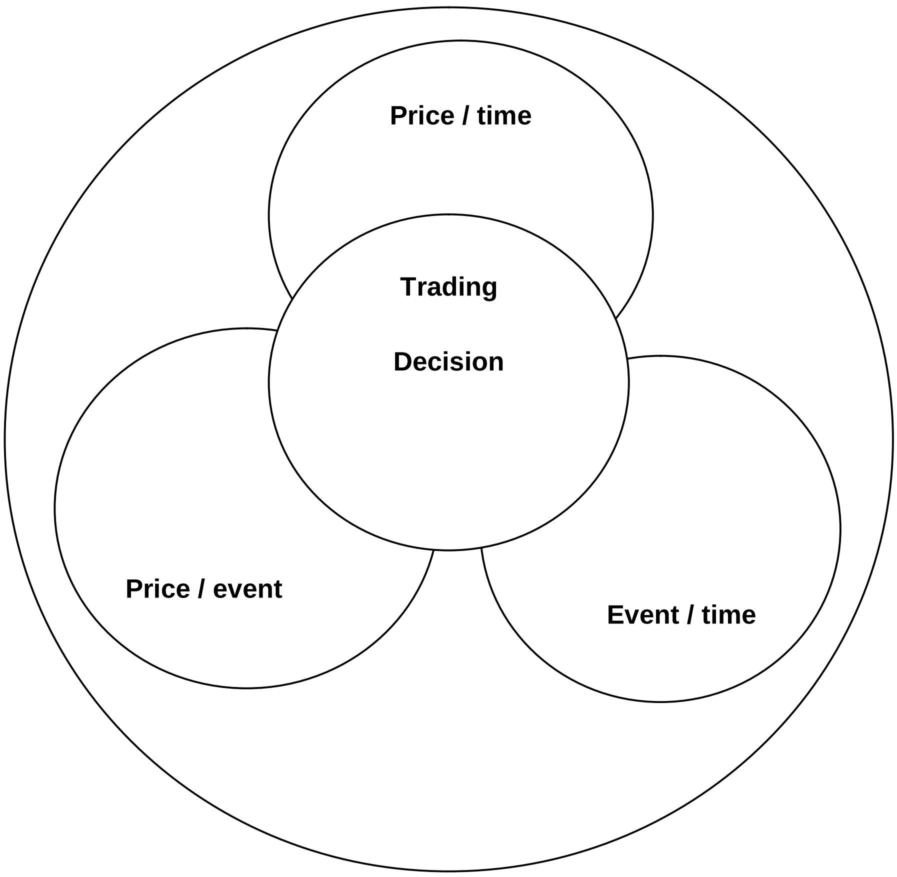
Event - time relationships

This is really where "buying the rumour selling the fact ("event") comes into the relational analysis picture.

In short, the market discounts future events, which means price changes anticipate what's likely to happen, giving birth to the saying: "buy the rumour, sell the news". As traders incorporate the expectations of certain events into their thinking and trading, prices change more and more as that "event" is being incorporated in the price, exactly like a future value is discounted to get a present value (the time value of money). Past events and sometimes even future events are thus said to be “priced in” or “fully priced” in. That means it is not useful to consider the event anymore as a driver. Obviously all these things aren’t clear cut in a real-time scenario.

Practically it makes sense on a monthly basis to be aware of the important central bank meetings about interest rates and the market rumours about them, i.e. what is expected. On a weekly basis you should take note of the potential market influencing economic data releases (there are not many) and monitor how the market factors these expectations in.

On an intraday basis it is important to know that most economic data releases of importance don’t seem to have a major influence beyond about 90 minutes.



MARKET DYNAMICS

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.

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.

Here is how it works.

The trading day(s)

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 won't.

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.

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.

Understand the trader's routine

You need to be very practical in your thinking about this. At each one of these forex centres traders follow a specific routine. Like everybody else they have a basic daily routine of waking up, going to work, working, closing down for the day, going out / home, sleep.

What happens when a trader arrives at his desk? Again, there is a specific routine. This routine generally has to do with information gathering and then information distillation. Traders need up to date (real-time) information. Today there are many sources of real-time information, professional, commercial services geared towards providing real-time financial markets information.

Business television and the Internet are great equalisers in this regard. This gives the personal trading business owner a very good chance to gain access to critical information. At any time of the day he can gauge what the real-time drivers are.

A relativity Polaroid

Consider this: I see the market exactly as I have described it above, but like a snap shot, a Polaroid of relativity. I see it in price frames, in other words I have an idea, if I get a real-time price, like on the ticker on business television, if that price in the relative price frame (median grid, or section of median grid) is relatively high or relatively low. I see it in terms of PET relationships.

This is just natural and normal. There isn't too much thinking, or analysis going into this. It's just a snap. If there wasn't a really noticeable difference between the last price I have in my head, to which I have anchored my whole view, my whole understanding of the market and the first price I see once I return to the market (this can be at any time of my day) then presumably "nothing has happened". This then means I only have to spend time on the next question "what may be happening" "soon".

A typical routine

Let's take a morning routine. My information gathering routine is very basic. I have been doing this since the very early days of my bond trading when I had no access to real-time prices or information. I phoned my mentor and we would have a short chat. We would go through news highlights and important prices of different local and global markets. Next we considered any known events like economic data releases for the day, implications of some of the market closing price levels and maybe some technicals, reduced to "prices are a little high or little low or slow". Finally we would take a view on whether the market was flat, bullish or bearish. That was it.

Today I go through this process usually by watching the headlines and price ticker on business television (mostly CNBC). I always have a reference price in mind and if the new price triggers any "excitement" I will make some effort to find out more. This usually means opening my trading platform or my preferred charting platform and I use 30 minute charts to determine what happened in terms of price. But I keep the concept of price levels through a median grid in mind. Since I have the price and since I have a good idea where I have entries or exits or plans to enter or exit some of my positions, I use this basically to see "how did we get where we are"? "What was the price dynamic the last few hours"? For me in the morning this includes the “post New York close” and “Asian” trading session. I immediately get a feeling for how the financial markets are digesting all the action of the previous day, including how Asian traders now assess what they did and thought the previous day, and how they respond to the European / UK session and the cumulative impact of the US session (and their interpretations of the previous day’s Asian and European sessions).

Since I only focus on a specific “analysis framework” dominated by the US dollar through a EURUSD “lens” everything quickly falls into place and I can determine at that moment if I “am leaning towards buying / selling / doing nothing”. This will be determined by which of my positions are either close to profit-taking levels or if prices are close to trade “entering” levels.

In this way I automatically and quickly relate prices to what’s going on in my account, in other words “closing” the relational analysis “loop”, relating market prices to my business, my account.

Sometimes things are not clear at all or I may decide to “see how Asia closes and / or early London trading unfolds”.

I can’t really give more detail because your situation will depend on where you live and to some extent which currency you predominantly use to determine your general views (your version of my “USD through a EURUSD lens”).

To what extent the forex market has grown and taken centre stage on business television is clearly seen in the frequent references to currency prices and short snippets of currency market interpretation.

Because I am experienced at what I do and because I have the unique structures to understand the market, structures I have described in detail in this book, I tend to use this abundance of non-intrusive information to identify “themes” rather than to get “interpretation” help.

Obviously, any beginner will have to spend some more time gathering and evaluating the interpretations including conflicting interpretations. But I think there are really easier ways to come up to speed with this than listening to business television trying to get a hold on market dynamics and trying to piece all these snippets together in one coherent whole. Business television doesn’t do it and is mainly there to fill the 24 hour day for people on the move who want to access mostly the headlines and some supposed expert’s interpretations of all the markets.

However, there are regulars on business television and if you have access to it, it is useful to follow some of these regulars, listen to their arguments, listen to the themes they present and the development of these themes over time. This can greatly contribute to your relational analysis, your understanding of the relevant themes and the different scenarios that can play out, both in the long, medium and short term.

One of the things I like about business television is the fact that in the forward looking contributions for a week or a day you get a proper view on what "events" are on the radar screens of traders in different markets. Applying this to your own business is part of the relational analysis you need to do.

But it is important that you have your own reference framework which includes the full market day perspective. It is laughable how often business television attributes price changes retrospectively to events early in the day which are patently wrong. The majority of the price changes occoured long before the event.

In summary, develop an information filtering system including looking at the following:

- US stock markets, primarily DOW at NY close
- What day - and time - important economic data releases (limited to US releases) take place
- Major currency price levels and previous daily range. Current level relative to previous days close.
- Gold price and range like the major currencies. Gold / commodity themes.
- Oil price and any significant oil related themes
- Any outstanding economic data events, any other headlines, central banker speak etc.
- Are stock markets and indices going up, down or nowhere on the day and in relation to the previous day? Currently the "risk on" / "risk off" theme is dominant for major currency directions and stock markets are the main indicator of risk
- I regularly look at the US stock futures prices

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.

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 and their expectations
- central bank policy adaptations
- macro investment themes
- special financial market conditions
- bond / treasury market investments
- gold, oil and other commodity market investments

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.

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 time of writing (end of 2009) the story line is "recovery from recession: who is first and when will the US normalise interest rates". Within this storyline there are multiple flavours: Japanese yen strength; Spectacular AUD performance in 2009. Inter market correlations. Gold on a break-away. Weekly and daily flavours depend a lot on the expected known events.

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.

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.

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.

A proper relational analysis framework will assist you in putting the nitty-gritty of important data releases and the fluctuating flavours of the day and week in "price perspective". Many technical traders do not trade data days. It's kind of hard finding "non-data" days. Every bit of information is splashed on to our screens. I rather think of it this way: data releases are integral to the market. They are necessary volatility generators and are idea "agents" that cause prices to adjust from one level to another adjacent level in a median grid.

Data releases are therefore not to be avoided but to be observed in order to utilize opportunities. In many cases the data release volatility is just enough to make a decent profit on at least one of your multiple entries, sometimes more. On other occasions they cause a "dip" which can either be instantly bought or brings you closer to that cost averaging opportunity you have planned.

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.

Relational 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. **Relational 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.

RELATIONAL ANALYSIS CASE STUDY: WEEK OF NOVEMBER 23 – 27, 2009

I have already written about the limitations of books as trading courses and at no point is a book's shortcomings more exposed than when trying to convey the essence of relational analysis. Not only how to explain price-event-time interactions but also how to explain its integration with the management of your personal trading business, the business of opening and closing multiple entries, subtly adjusting your exposure to current market themes, their storylines and the flavours of the day and the week.

In an effort to indicate to you some of the intricacies involved I will use the most recent trading week at time of writing to explain to you the practical application of relational analysis and how it works.

I hope this will also give you a feel for what my personal mentoring program will be like as a guide as you start up your own successful personal forex trading business.

Background : The big picture

In this case study I will focus on the **EURUSD and the USDJPY** because on Friday 20th November 2009 going into this week of 23 – 27 November 2009 I had open "trades" consisting of multiple positions in these two pairs.
To begin with I include the real big picture graphs up to Friday November 20th. This represents the background knowledge in my head regarding these two currency pairs.

As my preferred "one currency" I use the EURUSD as "analysis currency pair". This means I see everything in terms of EURUSD and different correlations and themes are seen through a EURUSD "lens". Naturally I have a very good feeling for how EURUSD has made macro moves and what were price-event highlights.

The numbers #1 represent price levels 1.2500 – 1.3000. During the second half of 2006 it ranged for a long time on this price level before it broke up due to changes in the US and ECB interest rate policies. At the height of the credit crunch (Q4 2008 to Q1 2009) it represented the final support level and the top end of the range 1.3000 was final support after a significant event in that the Fed announced a massive quantitative easing programme. This marked the "end of the credit crunch" in the sense that it was clear that the future will focus on resolving the issues created by the credit crunch and not on preventing any further deepening crisis of further financial market implosion.

The numbers #2 represent a new ranging period after a fast run up from the 1.3000 break two years apart. For practical purposes the range just below 1.5000 caused major resistance at the end of 2007 and also this year up to this point for almost 10 weeks.

The numbers #3 represent the price ranges prior to and during the credit crunch and its aftermath. First EURUSD was stuck for 5 months in a range at its all time highs. It crashed to the old 1.25/30 range with a little pause around 1.40 – 45. During December 2008 it spiked up to the current range and back to the 1.25 – 30 range to finally leave it after the March 2009 quantitative easing announcement of the Fed. It moved all the way back up after a short struggle during the traditionally slow summer months to clear 1.45 to the current range 1.45 – 1.50, the same level it spent 5 months at during the 2007/8 transition before convincingly clearing 1.5000 for the first time.

From a relational analysis big figure perspective it seems therefore as if the sub 1.40 – 1.45 levels were very closely linked to the "credit crunch" and nothing else. On the way up during 2009 it got all the way back to this 1.40 – 45 range rather quickly but was contained there during the traditionally slow summer months. Once the summer doldrums were over it quickly broke this level and established a new range attacking 1.5000 and beyond.

During strong trending periods I usually ask the question: "what drivers are around which might cause this strong trend to reverse completely", as opposed to just causing a decent dip from high in the median grid to low in the median grid.

Strong trends always elicit commentary from pundits, mostly chatter. The trend is overcooked, it is a crowded trade, a trend reversal is imminent, and so they earn their money, jabbering away. In itself this talk is not enough to constitute the type of psychological driver that can cause a trend reversal. It is actually a medium-term horizon view and doesn't have the punch to move the currency against the more fundamental drivers. Such medium term psychological drivers, from a grid perspective, rarely have the legs to cause price to move through a complete grid against the prevailing trend. Based on this understanding of price behaviour during strong trends I had a EURUSD long bias and the closer we got to 1.45/6 from the highs of just above 1.5000 the stronger this bias, i.e. the view was BUY the DIP at the lows in the grid, 1.45/6 – 1.50/1.

However, going into this new "high" level my initial view was to sell the highs since I thought that the December 2008 spike highs may give enough resistance to keep us above 1.40 but below 1.50. This view began to change because: (i) the stock earnings season for Q3 in the US panned out to be very good; (ii) the staying power of the "risk on" trade (i.e. major currencies strengthening vs the USD) increased and my bullishness with it. Going into this week a grid break and gird adjustment above the 1.5100 extreme became a real possibility. The backdrop to all of this was thus relatively strong global economic data, strong European data, the gold price was making new all time highs every week, oil was back at the 80 level (after dropping to 35 during the credit crunch) and the US Fed has indicated that it will be keeping US rates very low as long as possible and it will not move on rates if it does not have to in order to keep inflation in check.

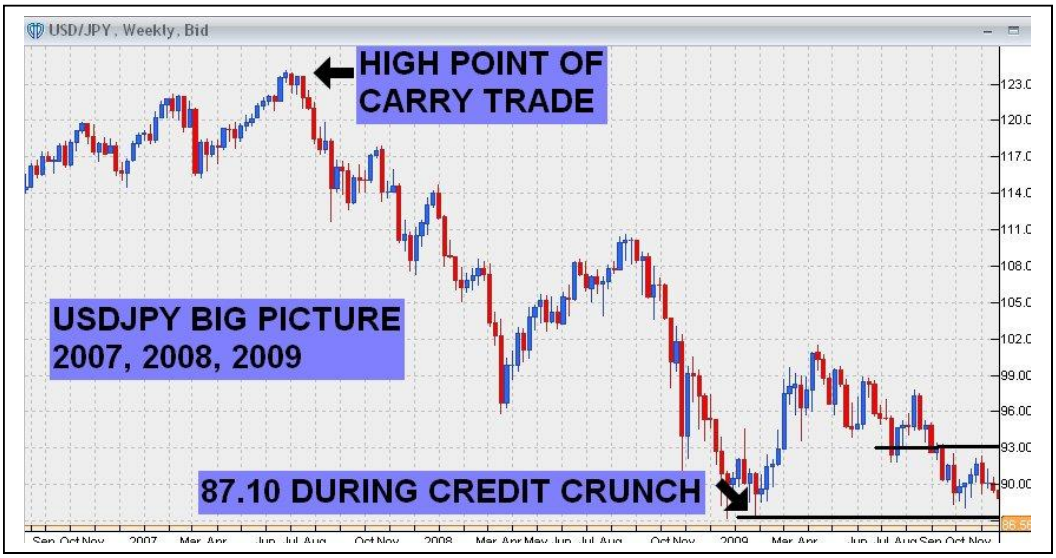
The zoomed in picture for the period preceding and leading up to our case study week looks like this:

This is the current median grid. **At #1** we adjusted the 1.47/8 to 1.50/1 high. **At #2** in the week under discussion the 1.51 was breached but we didn't adjust the grid due to the fast drop, in other words because enough time wasn't spent there before we could adjust, due to the "Dubai default" news. Due to the lots of price action between 1.47 and 1.50 my position in the EURUSD contained a few hedged entries, i.e. I had both long and short positions. The shorts were first established as we moved towards and beyond the initial grid high 1.47/8. The longs were established a bit later to "hedge" the shorts and to get to a net long position just in case we break above the 1.5000 level conclusively. In real-time this is not "obvious".

One of the arguments to maintain some short positions was because some of the big banks in their analysis didn't foresee a move as high as beyond 1.5000. For me the strongest argument going into this last trading week of November was the fact that globally many financial trading companies had November as the financial year end and the date used to calculate bonuses. Individual traders and trading teams thus have a "profit protection" mindset going into end of November. And because this was a good period with stock markets making new highs, currencies in a strong trend and commodities pretty strong (because the "risk was on") profit-taking could be on the cards. As a trader myself I know that if you are generally in profit-taking mode spikes in the direction of your trade increasing your profits are the times you use to “cash in”.

This played an important role in this final week in our analysis as we were already aware of this and it was already mentioned in my analysis (Daily Briefings) early in November.

USDJPY



USDJPY: Since mid 2007 the JPY has strengthened against the USD from 123 to 95 in March 2008. The USD then recovered to 111 in mid 2008, about the time the EURUSD was at its all time highs around 1.55 – 1.60. During the credit crunch the JPY strengthened to a intra week low of 87.10 but generally didn’t spend much time below 90. The BOJ (Bank of Japan) indicated some intervention action in the market during the height of the credit crunch. USDJPY made it back to touch 100 by May 2009, then weakened again to remain mainly at levels above 93, mostly 95. In August 2009 Japan elected a new government and the new government orally withdrew traditional support for a weaker JPY. Japan needs a weak currency in order to improve its export prospects, being a very large export economy. JPY quickly broke 93 and 90 but has remained in the 88 – 93 median grid from mid-September.

Price action in USDJPY from the credit crunch lows in February and early March 2009 (sub 93) up to May when it hit above 100 was very much in line with analysis that the JPY drastically overshot during the credit crunch. Thus, even while USD which also overshot was losing ground against other major currencies it made ground against the JPY. (Because of the correlation concepts explained earlier, the USDJPY rebalanced in favour of the USD.)

Since then the JPY has distinctly bamboozled analysts and traders including myself by strengthening on every “risk off” theme. JPY has thus been driven by short-term factors back to very long-term resistance levels.

When analysts turn negative on the USD and discuss the JPY and assume the JPY will strengthen like other currencies vs the USD they tend to extrapolate the USDJPY to levels as low as 80. This was the view even before the yen dropped below its lows of 95 before the credit crunch.

But if you assume that a primary driver of the JPY is active policy, culminating in intervention in the currency market at times, to limit JPY strength it is not far-fetched to assume that the JPY will under-perform other currencies vs the USD during periods of general USD weakness, and because of this the 87-89 level was a significant resistance level for the JPY.

Thus, while the EURUSD has strengthened since March / April 2009 from 1.25/30 to 1.45/50 the USDJPY has remained above the 87/88 lows. While we were trading just above these levels my view was that the long-term view on the JPY was definitely USDJPY UP, and the trigger needed for this would be when the rumours begin to surface that the US Fed will end quantitative easing sooner rather than expected as well as increase short term interest rates.

Following the picture of the median grid September to 20 November 2009.

During a period of “risk off” in late September and early October the USDJPY weakened to the 88 level but then bounced up again through October as the Q3 earnings results were positive and stock markets and all “risk on” indicators rallied – as expected. But then things changed and the USDJPY began to weaken in line with USD vs other “risk on” currencies.

This change didn't escape yours truly and while I believed the long-term path is still USDJPY UP I began to accept that if the risk rally continues into year end, then the USDJPY might correlate with that and JPY may even dip below the 88 lows in the short term.

There were two reasons for this:

The one I have already mentioned, profit-taking at November year end for many traders. The point here is that there probably are no profits to be taken and no inclination to buy USDJPY for the long-term trend before sometime next year because every month the Fed fails to indicate that they will not keep rates low for "as long as necessary". Thus what will undoubtedly be a trigger for JPY weakness will not be a trigger now, and the lack of demand against the global "risk on" trade also keeps the USDJPY on the back foot.

Secondly there was an important but little known factor for anyone that doesn't have deep insights in the currency market and "risk" drivers. This had to do with the fact that in the very short term, the US interest rates actually fell below the Japanese rates. I believe this is a temporary phenomenon but in practice it caused USD selling versus the JPY for the practical reason that it is now possible to do slightly more profitable carry trade transactions in USD rather than JPY as the "funding currency". Because of this I have incorporated in my long-term USDJPY view the potential for an additional short period of JPY strength which may cause even better long-term levels. My way to treat this was to hold on to my long-term USDJPY long positions but add entry orders to hedge these positions if we dipped close to and below the 88 grid extreme. Then I could sit out with a smaller net long position to wait for what I believed would ultimately be great USDJPY buy levels.

What follows is an exposition of relational analysis through my Daily Briefings as well as some comments from traders in my mentor program forums.

My Daily Briefing is a daily email & community forum message (long ago it was a live chat room message) containing my real-time analysis. It includes a review of the previous day, analysis, plan, reference prices, "big bank analysis" and reference to my positions and any changes I have made or plan to make. I target to complete the message around 9:00 AM GMT, i.e. I can incorporate up-to-the-minute price action and news headlines for early London trading.

(Please note: my Daily Briefing, or DB, is also written in real time! I give it to you here as it was written with all the mistakes, spelling and otherwise, but I think it gives you a flavour of the exciting real time cauldron of currency trading and analysis).

Daily Briefing Monday 23

"Review

Broadly speaking I have maintained the same position over the last two weeks:

Slightly long EURUSD although the idea that profit-taking into the end of November could do the USD some favours was part of the argument. Therefore I am probably not net long with more positions than the one on Friday.

As the end of the month is nearing one must also consider the "real-timeliness" of this.

I have also **maintained the long USDJPY** position and considering that there may be some additional risk to this position if the euro crosses 1.50 substantially I haven't bought a dip now more than 100 pips below where I have dropped one long position for a loss. Still hedge orders just below the current price and just below 88.00.

Since I have indicated that I wouldn't like to go on holiday with an uncovered JPY position I am just going to leave the hedge entries there and let be what will be.

The JPY analysis is correct. It simply won't stay at these levels through the natural interest rate gyrations and one must just be vigilant to not allow it from running away without being on the bus. Timing is probably not a big issue since the US will need some improved data (retail sales, spending, production and jobs) and bad data (inflation higher) before US interest rate change rumours will begin to drive the currencies.

I suppose that's already some analysis.

Analysis

It is Thanksgiving week in America, confusing issues about end of the month closure, profit-taking etc.

Looking back what happened in the past at this time, last year must be ignored as we were in the midst of the credit crisis and the last thing on traders' minds was subtle profit-taking to protect big bonuses.

So far 2009 looks a lot like 2007. After the summer ranging a break to new highs, a peak in this current week and the next followed by a little dip / ranging into January and then a resumption of the big trend (it was in early 2008).

2006 is also not totally different ... the range break actually was a new all-time high of 1.30+ in October, followed by a little dip and resumption in 2007 Q1 of the big trend.

Fundamental drivers might be set up for something of the same order, except that we might see a currency charge in December (possibly on the back of gold which is making big strides again this morning with 1165 all time highs ...)

Currencies are bullish so are US stock futures and EZ stocks.

Some ISM data earlier today in Europe was the best in two years or something like that.

US data sees also GDP Q3 revision (seems like it is rumoured to be revised downward) that should make stocks unhappy but these days stocks seems to be happy as long as rate rises stay far out on the horizon, irrespective of economic situation.

It is a reasonably busy data week, but not single big releases and with the Thursday / Friday long weekend in the US (Thanksgiving) one shouldn't read too much in data release volatility.

But expect good German IFO and other EZ data to be supportive of the euro.

PLAN

I don't think I am going to make changes now but if I do I lean towards rather increasing my long bias and also positions, but I'll leave it to see if a big break of 1.50 is possibly happening.

PRICES

(BWILC 2010: These are reference price at the time of concluding the Briefing with the range for the day with Asian session and early Europe /London trading in brackets)

EUR 1.4980 (4988/4937)
GBP 1.6600 (6477/6600)
JPY 88.90 (89.00 / 88.60) (Japanese holiday)
AUD 0.9225 (up from 0.9115)
GOLD 1165
OIL 78.
US DOW FUTURES +85
(BWILC 2010: This is a strong “risk on” indicator, especially if there is a low chance for early US data releases changing the mode negatively).

From some Big bank analysis:

EUR: ECB President Trichet announced that the ECB will very slightly tighten the eligibility criteria of ABS collateral it will accept at liquidity tenders. The tighter standards will be phased in over the next 14 months, clearly indicating no sense of urgency on the ECB's part. Friday's unexpected announcement coupled with Trichet's remarks suggest that the path is being paved for exit next year and, since, this is progressing more rapidly than at other major central banks, **we see this as being broadly euro-supportive**.

JPY: Later this week, CPI inflation for October is expected to fall to -2.4% y/y from -2.2% y/y in September. **If realised, this would be the lowest level reached since records began in 1971**, and should pile further pressure on JGB yields.

(BWILC 2010 – this is very supportive of the analysis that the JPY is hopelessly overvalued in the long term.)”

Daily Briefing Tuesday 24

“Review

Up to late morning in New York yesterday everything (for currencies) was pretty rosy and Gold made it to 1173 but then it turned south. Maybe it was on a good housing number from the US.

Even though the US stock market ended well UP today profit taking is apparently on the cards and the US futures also point down. Typical risk on / risk off scenario as currencies are weaker in line with the risk off. Asian markets are down and so are EZ markets in the early hours, but it is hardly a rout.

Analysis

The euro dipped briefly below 1.49 early morning but recovered and after a good IFO number just now it is back to 1.4930s.

Make a note of the "good IFO number". There are many good numbers from the EZ on important counts.

The JPY flirted with mid 88.50s just shy of my stop so far, but I suspect in the currencies rally today on all sorts of US data the JPY may just strengthen with them (there are still room to go to that 87 lows.)

The are four US data releases today:

08:30 Q3 GDP revision 1 - expected to be revised lower
9:00 Case Schiller house price index - expected to show a drop
10:00 Consumer confidence - expected to show a drop
14:00 Fed minutes - expected to show they are expecting a long period of no good economy

I am not sure what will happen if this proves to be right. I get the idea the fact that we are going down so far today may have to do with positioning based on these expectations and also that end of the month of **November position squaring which will due to Thanksgiving probably be concluded this week.**
Yesterday saw good housing numbers and housing is at the root of the trouble so good numbers cause some optimism. But it is just good in relation to probably beaten down expectations. What’s the real number like some would say?

A lower revision of GDP may not be good news for the stock market, unless the argument is "we buy stocks" because we need yield which we don't get anywhere else and as long as interest rates and inflation isn't on the horizon this is as good as it gets (buying stocks).

The Fed will probably be a non-event. Who cares if they sounded a bit more optimistic than the guesses of the analysts?

What one can't be sure about is if bad data will be ignored and the risk rally just continues today and tomorrow like normal?

What about if the data is good? What will we have then?

I think I am just going to watch with a view that we are probably going to see some "profit-taking" irrespective. Everybody will be able to find a reason to take some money off the table before the weekend (and square their books to lock in whatever bonus money will be available.

JPY back to 88.56.

I got this bad idea this morning that maybe the Japanese also think their economy is generally in better shape relative to the depths of the crash of 2008 than the US economy thus they may be more adventurous before the Fed on interest rates and stimulus withdrawal. This may cause a real short term reason for JPYUSD strength.

(Tellyman saying Japanese banks have to up their capital adequacy ratios - that is the type of actions that count towards generally improving economic conditions)

<u>PLAN</u>

No change except that since we are at the other end of the range now, buying a decent dip becomes an opportunity.

I maintain my rather bullish stance and think odds are good that if everything just continues slightly risk positive that the currencies will strengthen into the year end.
Conversely I don't think there will be a big correction in the US stock market to cause a real big currency dip, say to below the current grid lows.

So the plan is to keep my bread buttered on both sides!

<u>Positions</u>

Still euro + 1, a bit over-weight mid 1.49s long and shorts well lower.
USDJPY +3, with 2 hedge entries just below the market and just below 88
(BWILC 2010: +1 means one “one lot” entry net long EURUSD (but at this point I also have a few hedged positions))

(BWILC 2010: +3 USDJPY means three “one lot” net long USDJPY, while I have two “one lot” hedge entry orders, for in case we go lower in the short term for all the reasons explained).

<u>Prices</u>

EUR 1.4935
GBP 1.6525
JPY 88.65
AUD 0.9180
GOLD 1168
DOW FUTURES -27
OIL 77”

Daily Briefing Wednesday 25

"From some Big bank analysis

A potential source of year-end risk aversion is profit-taking and associated repatriation flows. With investors keen to realise profits, especially in the well-performing, high-growth currencies and asset classes, our equity flow monitor and data from external sources point to liquidation of risk trades. Investors' stronger overseas bias is a vote of no confidence in dollar assets and the US economy, while debasement fears continue to loom and force funds offshore. However, even though flows since mid-October have been positive and firm, EURUSD has stalled since the rally to 1.50 and continues to struggle. **This implies that some form of offsetting flows have countered the new greenback selling .**

(BWILC 2010: – What they are saying is that this November profit-taking has countered the EURUSD move above 1.5000.)

The dollar was relatively unchanged amid mixed economic data and dollar-related commentary in the latest Fed minutes. EURUSD traded 1.4889-1.4990 and USDJPY 89.08-88.36.

(BWILC 2010 – confirming the view we had that the Fed Minutes would not have much of an impact.)

I believe this dynamic explained in the first paragraph is all about the fund yearend now, end of November. The interesting thing is that this might be a temporary boost for USD demand and if this is correct by next week this additional demand (squaring of equities in emerging markets) may fall away and that might give currencies a boost since this demand is due to equity profit repatriation, not inflows to buy US equities necessarily.

It is quite possible that this process gets reversed early next year if emerging equities and bonds still seem to be the best bet say up to Q3 (if the Fed stay for long on the low rates high stimulus wagon.

I am not going to write DBs over Thanksgiving weekend. I'll post Big Bank + maybe comments.

Review

The data was mixed and after an initial "rather safe than sorry" dip, stocks and currencies are displaying "risk is on" characteristics yet again.

Wasn't that cool of me to detect / suspect a slight change in the USDJPY for now. It cleared the 88.50 and are we now trading low 88s. With EUR through 1.50 in the last hour or so I think **USDJPY will grind slowly lower if euro moves well up**, through the 1.50 resistance.

Analysis

I have posted on the forum that what we might see is currencies being held back due to the end of financial year profit taking by mainly stock traders they referred to. Once this is over we might see the handbrake dropped and euro may surpass our current grid extreme taking all majors with it to some extent.

Euro fundamentals are setting up for that. Dec 3 ECB meeting they think will contain a path to normalization of stimulus. I think sentimentally that will be as big as the March Fed QE programme announcement was. The latter I interpreted at the time as the announcement that "we have the crisis under wraps, the heavens will not fall on our heads". The markets agreed. All of them.

Such a timetable to phase stimulus in the ECB area out will basically have the same kind of impact. While the economy are not great we are so far out of crisis mode that we can normalize the credit infrastructure that drives the economy. Even if it takes 12 months or whatever its setting the scene for completely ignoring the idea that a banking crisis can hit Europe or that the EZ will fall apart due the economic synchronization difficulties. You must absolutely not underestimate the long term value of that kind of thinking. As I have said many times before. Just think in terms of you being a manager with final decision making of $50 billion. What are you going to do with it? Buy dollars?

GBP

This currency is beginning to test any theory that currencies are unpredictable in the short term. Don't you think I have explained a while ago exactly how the GBP has acted since then? Why am I not trading this thing?

JPY

Let me just repeat here: While I believe this is shaping up to be the best one way play once the idea that the US will begin to move on rates sooner rather than later (long USDJPY) for now the counter counter argument is that JPY may bask in the glory of a structurally strong currency rally, lead by the euro rather than the high yielding commodity driven AUD.
There is thus a chance that we may even go sub 87 to about 85, but not much lower since that will be the levels of a lifetime bargain to be taken before it flashes away, is a fact many will act on.

PLAN

No change around the long weekend. The bias is up, my euro positioning is up, first profit target is 1.5100, which is also grid extreme range. Will we get there my view would be to stay toe-in, in line with the adjustment bias, i.e. to add on the dip without chasing new highs but be ready for a grid adjustment deeper into the 1.50s.

PRICES

EUR 1.5015
GBP 1.6720
AUD 0.9270
JPY 88.10
GOLD NEW ALL TIME HIGH 1176/7 (high 1179)
STOCKS UP looking back & UP looking forward.

Friday is known as Black Friday in the US due to a huge shopping day inaugurating the festive / shopping season. Back Friday because on that day the stores' books change from red to black!

There is going to be some headlines and a talking-head frenzy about how much the US consumers spent on this day and what it says for the rest of the shopping season. If its optimistic "risk will be on" and this will contribute to the idea of a equity and currency rally into year end."

Daily Briefing Thursday 26

“Happy Thanksgiving to all the US readers ... and a great day also to everyone else!

My comments about JPY going even below 87 came true in double quick time. The low was 86.30 bouncing back to 86.90

I have booked the two shorts I had, one from 88.50 to 87.50 and one from 87.80 to 86.70. (I initially had an order for 87.30 but took it live at 87.70 after the first low of 86.54)

I have also placed another short to open if the 87.10 low falls but wanted to put it outside of the "stops" range and did so at 86.70. That is open now and my net is +2 USDJPY.
Just after the DB yesterday I got the idea that a fast rally was imminent and I decided to punt +1 long GBP and +1 long AUD at levels well below day and recent trend highs. The GBP didn't act properly so I placed a stop at breakeven, which was taken out and GBP promptly dropped 150 pips from there!

AUD (+1 @ 0.9283) I decided is a more long term play, so no stop although in the wake of the JPY rally its also down about 100 pips.
My +1 EURUSD long was booked at the 1.5100 level.

PLAN

Looking to re-enter +1 EURUSD. Not ideal to be neutral if trend view stay strong.

Grid adjustment almost on the cards.

PRICES

EUR 1.5090 (5140 high)
GBP 1.6555 (6724 high)
JPY 86.85 (86.30)
AUD 0.9220 (.9321)
Stocks and stock futures down (US stocks closed today)
GOLD 1187 (1195 high)
OIL 77

From some Big bank analysis:

USD: Dollar still vulnerable During the Asian session, the dollar made no serious attempt to recover from yesterday's heavy losses. Although EURUSD was steady between 1.5099 and 1.5142, USDJPY saw a steep drop to 86.30 after earlier trading as high as 87.48. Like yesterday, liquidity remained extremely thin, due to the US holiday. We continue to see EURUSD at 1.45 in 1m.

JPY: USDJPY fell sharply to 86.31 prompting a chorus of rhetoric from government officials. FinMin Fujii said he is watching FX moves very closely, a claim re-iterated by government spokesman Hirona. While USDJPY was still above 87.20, Deputy Finance Minister Noda said "we are not considering intervention right now". Senior Vice Minister for the Economy Furukawa however said that the government would have concerns if the yen rose too rapidly. Deflationary concerns featured prominently in the BoJ minutes, both from the BoJ board and from the MoF representative who attended the meeting. He said the government wanted the BoJ to clarify how it would address the problem of deflation. This morning's fall in USDJPY will simply add to these deflation concerns.

(BWILC 2010: – It is important to note that this BIG BANK analysis is from Thursday morning and still there is only reference to "normal" factors in describing the USDJPY moves into the Thanksgiving weekend. Then on Thanksgiving day, which was also the beginning of an Islamic holiday weekend, an announcement of a debt standstill by Dubai due to problems of a huge Dubai based corporate, Dubai World a global property investor, hit the headlines."

<u>Daily Briefing Friday 27</u>

Well, I suppose I can't leave you with all that has been going on due to this Dubai potential debt default story without saying anything.
"Risk on" is really taking a shot on the chin.

The JPY in early Tokyo trading slashed right through 86 and 85 to touch 84.80/90. On the other JPY crosses we are seeing levels not seen since July.

As far as I can see this is not such a big single issue, as that it is a big wakeup call about being too complacent that all financial troubles are over.

Considering the important end of November year-end of many trading institutions I think the timing of this will change some of the things I have said in this week. I will be amazed if we return to a "risky business as usual" stance next week into year end.

Maybe too early to say, but that is my expectation.

That means we might have seen stock and currency highs for a while and the 1.45/6 may be on the cards indeed.

It seems as if the GBP is specially under pressure due to UK property and UK bank exposure to Dubai debt.

With my naked long USDJPY exposure I am most interested in that pair now and the first thing I saw when I woke up and got up early this morning (very early for no specific reason) was reference to JPY's "perfect storm" and "84". I rushed to the charts and there it was, JPY, which I saw late yesterday the last time at 86.54, was at 85.60/70, up from 84.80.

Just a few hours earlier I had an email conversation with someone about where Dubai may take JPY and I said "hopefully not beyond 85" - but for no moment have I thought I will see 85 before the sun rises!

He asked the question because I said yesterday I have added a short and if this wasn't good buying levels. I agreed but said I don't want to go all the way to 85 +3. Having a short to make the net positions (USDJPY) +2 helps.

It looks like an important bottom, spike and back UP quickly to 86.00. Some Japanese official was complaining loudly about excessive moves. And I have little doubt that the BOJ stand ready to intervene if this doesn't stabilize quickly. Normal bad JPY news was out today - they have deflation and low rates and a way out of whack too strong currency.

No doubt this is now really shaping up to be great buying levels but with +3 already it’s difficult to just step in amidst the crazy thin market. What happens when the US and some other markets in Asia that is closed return? What I did was to buy a Call Option USDJPY at strike 86.15 for a month.

I might continue to do that (buy another Call option or two) if we go again to 85 / 84.

Randomness

I need to say something about this again. You will remember that I say randomness influence us more than just the specific intraday price randomness. How about the fact that I decided for the first time since the credit crunch to punt the “risk on” pairs GBPUSD and AUDUSD and within 48 hours there is a huge "risk off" event?

It is so important that one keeps perspective of these things.

Luckily I dumped the GBP simply because I didn't like the immediate price action after a data release. AUD I tried to keep a stop out of range by placing it just below 90, but that also fell.

Positions

My last JPY short yielded 110 pips and we are 60 pips above the take profit level. So that went well. AUD lost me basically 300 pips, forcing me to consider working it back. But not now before this Dubai story has cleared.

EUR worked out well since I am back to square at 1.5100 after taking that profit and trading sub 1.49.

Conspiracy

My first thought was that it is very convenient to happen on Thanksgiving and when some other markets are also closed (Islam holidays). You know my view is that funny things happen behind closed doors.

Yesterday morning when CHF was clear through 1.000 and JPY through 87.10 and looking at the charts, I really thought ... what's behind this? Something is funny. Why are these safe-haven currencies acting like this at this stage?

This morning I thought, these Big Lions don't get up one morning and then decide "we are going to restructure our debt" and tell the world and then begin to talk to people about it.

Just now reported on the Telly: some sheik said "they made their decision full well knowing how the financial markets will react ..." Bloody hell and shorting the crap out of the risk markets and buying the "risk off" markets (CHF, JPY) before hand... probably they chased gold to 1200 also ....

Big lions ....

(BWILC 2010: – What I am saying here is that the price action before Thursday in GBP, CHF, JPY was indicative of preparation for a big shock to hit the markets over the holiday weekend. One thing that any prospective forex trader (bird watcher) can take to heart from this is that many Big Lions are also excluded from market moving "inside information" (as is clear from the JPY analysis referred to by one of the major investment banks) and that surprising news will be surprising to "everyone". A small trader with a proper perspective, proper trading plan which is robust enough to withstand price shocks can benefit well from these events if you listen clearly to what the market says.

Even though I was and is pretty bullish on USDJPY I began to prepare for some down side and because my view of intraday price action lead me to maintain short positions against my long term bias I could benefit from this market shock.)

PRICES GMT 09:00

EUR 1.4870 (4830 low)
GBP 1.6350 (6270 low)
JPY 86.35 (8490 low)
AUD 0.8970
GOLD 1152 (1138 low)
OIL plunged this morning, now 73+ from 77
FUTURES & STOCKS Asia plunged, EZ isn't looking too bad, US is really looking sick, but DOW up from -300 to -240. (These are big numbers)
But if Europe seem to be stable, (but down) they may improve drastically

From some Big bank analysis:

Developments in Dubai which have shaken global financial markets will continue to dominate the headlines for the next few trading sessions. A combination of systemic risk fears and thin market liquidity due to the US holiday season has proven to be a combustible mix and several currencies or currency blocs are feeling the impact. The wider fallout has simply revealed how fragile both markets and risk appetite still are. There are two sources of pressure on sterling directly attributable to the story. First, the amount of investment in the UK by both private investors and sovereign wealth funds based in the region has been significant over the last few years. There are genuine fears that many of these assets could be liquidated and repatriated should funding problems surface. However, the bigger worry is the amount of exposure UK banks and other institutions have to borrowers based in the region through local subsidiaries. Judging by FX market price action on the Asia open, it appears that markets are already pricing in a worst-case-scenario and risk appetite is taking a tumble. If systemic risk and contagion again become a major problem, the dollar will gain and risk currencies will suffer.

JPY: Fujii threatens "appropriate measures" MoF intervention rhetoric increased several notches overnight, with Reuters later citing market sources saying the BoJ was seen in the market checking rates in USDJPY. USDJPY fell sharply during the Asian session from a high of 86.60 to a low of 84.83 in thin market conditions. The pair eventually recovered but not before Finance Minister Fujii issued his strongest warning yet, saying that "appropriate measures" were now justified given that there was "no doubt the market has moved too far in one direction". He described the current FX moves as "extreme". He hinted that the response could be internationally coordinated and, saying that he will "establish contact" with US and European officials "if necessary". He also said that a flexible approach to issuing G7 and G20 joint statements could be taken. Clearly a hint that an inter-meeting joint statement could be issued. Such an approach was used to good effect on Oct 27th 2008, which led to a 6% appreciation of USDJPY the next day. With USDJPY now off its overnight lows, the intervention risk has receded somewhat allowing the MoF some breathing space to go down the G7/G20 route.

In response to my view that a “risk on” currency rally may now be off the charts one of the guys made a post on the Daily Briefing discussion forum that he doesn’t believe it will impact the currency rally to any important extent. By late Friday November 23rd this view was beginning to be vindicated with currencies back on the rally track and up to 200 pips from the lows on Thanksgiving …”

Epilogue

Quo vadis?

In 2004 internationally renowned financial journalist, James Surowiecki published a book, *The **Wisdom of Crowds** – Why the Many are Smarter than the Few and How Collective Wisdom Shapes Business, Economies, Societies and Nations*.

In this book Surowiecki investigates and explores the idea that large groups of people are smarter than the individually brilliant or elite few. This very contrarian idea has some profound practical implications for how we conduct business and our lives.

One of the examples he gives is how if a large group of people would have to guess the number of marbles in a big jar the average of the group (ie the group wisdom) is generally very close to the correct number whereas individual's random guesses are all over the place.

Applying the principle of the Wisdom of Crowds to forex trading I believe that it explains to a large extent the conundrum why there are, despite so many courses and trading systems available, still this large number of losing traders.

Essentially individuals overestimate their ability to "beat the market" or "become a consistently successful trader", especially if they have made a rational decision to buy some product (like a trading course, or trading robot or trading system) to improve their individual ability. In the same way many traders that follow signals from "experts" eventually find the services unsatisfactory. It is clear that individuals simply overestimate their ability to make wise trading decisions. This overestimation is supported by also overestimating their opinion and decision about what would be proper support or training materials.

The principle of the *Wisdom of Crowds* implies that an individual trader will be better off with some form of group wisdom as a guiding principle. I believe every trader who has made the perfectly rational decision to study Bird Watching in Lion Country can improve his odds of making a success of his personal trading business by joining a select group where the group wisdom is built on the principles in the BWILC book and is managed to benefit all members. By "managing group wisdom" such a niche market group, filters out all the useless information but aggregates all the useful information for successful trading based on these principles.

In the Case Study of the week of 23 – 27 November 2009 I indicated how one of the group members was of the opinion that the new low JPY levels were buying levels. This discussion between the two of us became, through the vehicle of my Daily Briefing, group wisdom and everyone in the group could incorporate the ideas of buying into the extreme low levels but maintaining a long-term bias. I have also mentioned how the group discussion was quick to offer a contrary view to my own that things might take a turn for the worse towards the end of the year.

Sorowiecki makes the point that lively discourses with conflicting opinions generally leads to better group wisdom than one-sided discourses.

When BWILC was first published in 2004 a properly structured niche market group to compliment the reading of BWILC was lacking. I have kept a strict individual relationship with every mentoring member. Since then I have formed a strong mentoring community where the whole structure is aimed at supporting and assisting traders from their first steps as “bird watchers” to maintaining their business through long-term participation in the community discourse.

I invite you to consider the advantages this community and the “managed group wisdom”, built around my personal mentoring program, could have for your personal forex trading business. The program is structured to take you through the most critical first 12 months of your business (doing it the proper BWILC way) and thereafter you have options to stay in the community if you so choose to gain from the group wisdom for much longer.

www.dirkdutoit.com

APPENDIX A: "ONE YEAR OF 4x1 TRADING"

Notes on S-I-T account: D D DU TOIT FX SOL 327448

Background

In about February 2007 I have decided to start trading on a personal account at FX Solutions where my introducing brokerage fees are paid in and as I don't withdraw it always there always seem to be a decent "float" which represents a typical retail trader account. The type of account many of my clients will start trading with.

In May 2007 I embarked on the "Stay-In-Touch" (S-I-T) account and decided to first of all trade reasonably active on the account, sort of put my money where my mouth is and then also report regularly what I have done and how it panned out.

Part of my thinking was to utilize this later on for marketing purposes, but only after at least one year of trading. So, twelve months later I had a good look at what I have accomplished and I must say I think it is pretty amazing. I hope you think so too and that you find a way to benefit from this.

Principles

No pressure

One of the big stumbling blocks between individual amateur or semi-professional traders and decent profits is the presence of undue pressure to perform. I want you to understand that I had (have) very little financial pressure linked to this account. Obviously I wouldn't like to throw away my introducing brokerage but even if I had significant losses on this account it wouldn't have been devastating at all.

100% discretionary

I didn't apply a very systematic approach in this account. I have also a very advanced application of my own 4x1 strategy and median trading methodology which beginners simply don't understand. I excuse everyone who didn't do my mentoring programme and looks at this trade record and thinks for instance "how does this relate to "one currency?" But as an example, if you look a bit closer you will see one non-primary aspect of that, namely the USD is one leg of every trade without exception.

I don't think there was one trade that wasn't entered at the market (market order) but exits were a combination of market orders and limit orders and here and there , very limited, trailing stops / stops.

I didn't stick faithfully to a median grid trade matrix, neither in position sizing nor in number of positions nor in mechanical application of trade levels. I think if I had done this the returns would have been even better.

Advanced application of 4x1 strategy

Behind these trades lie concepts like same currency hedging, intra currency correlations, cross currency hedging and what I'll call short term value arbitrage. Due the credit crunch and the unwinding of the large JPY carry trade and carry trades in general I have basically traded short USD most of the time and to some extent due to that clear trend the USD was the "one currency" I primarily traded (short).

Multiple entries and low leverage

These concepts feature very strongly. For instance will you see that every trade bar one was done with one lot, meaning it is with no leverage or 1:1 leverage from the point of view of the base currency. In practice on USDJPY and USDCHF these were strictly technically 1:1 but for EURUSD and GBPUSD it was between 1.33:1 and 2.10:1, while for AUDUSD it was 0.85:1 – 0.95:1.

Gross return

171% for the period 1 June 2007 to 31 May 2008.

For practical reasons this report only contains the gross numbers, i.e. all the settled trades between 1 June 2007 and 31 May 2008. Although I thought I will do some house cleaning before I start on this formal campaign I couldn't get myself to close some of my open positions which were far out of the money.

The other reason is that when one takes a snap shot at any time the need to mark-to-market is actually an accounting thing that makes regulators purr in their sleep but can cause massive problems for traders. On a grand scale the billions and billions of write downs Wall Street banks now have to make is due to regulatory accounting requirements. So if you don't have to do it why do it?

Finally, even if there is a large discrepancy between the gross and net values on a specific date the gross return is more indicative of the long term prospects than the net return because as long as current open positions still fall within the general framework of your trading parameters the probability that they will eventually contribute to the long run shape of the return profile is very high. I.e. next year this time they will in all probability form part of the settled trade structure.

Month by month performance

	Gross pips	% return	# trades
Jun-07	264	2.34	3
Jul-07	1020	9.49	14
Aug-07	2779	25.72	44
Sep-07	2717	26.04	47
Oct-07	1189	11.34	12
Nov-07	1748	16.60	25
Dec-07	471	4.59	8
Jan-08	1158	11.35	18
Feb-08	2963	29.55	41
Mar-08	2313	23.15	34
Apr-08	311	3.11	3
May-08	847	8.30	15
	17780	**171.57**	**264**

Average pips per entry 67
Average leverage per entry 1:1

	# entries
EURUSD	61
USDJPY	73
GBPUSD	64
USDCHF	34
AUDUSD	31
USDCAD	1
	264

Keep in mind the distinction I make between “entries” and “trades”. An “entry” is one position at a specific price level. A “trade” is a combination of multiple entries at different prices levels and the “per trade” leverage can be higher. But not too high!

Net return

The net return excluding the net results of carry interest and open positions on 31May 2008 was still well above 100%. It is not worth the trouble to try to construct the impact of carry for this purpose. It may have brought the net return down closer to 100% because for long periods I carried JPY positions with a negative interest and I also carried especially euro hedged shorts which also cost money. Carry interest is basically a cost of doing business as I see it and there is little reason to change your trading due to the potential of negative carry for an extra day or five.

Number of entries

During this period I have booked (closed) 264 entries.

I don’t have a target number of entries in any period. The most active months had between 30 and 50 entries closed and the most inactive less than 5.

Entries closed for a profit: 259
Entries closed for a loss: 5

The average net profit per closed entry was 67 pips.

This is a vitally important number. I can today enter any trade, without any technical reason whatsoever, as long as that entry falls within the principles and framework of my 4x1 median trading structure and believe that the odds are 98% that I will be able to close it for a decent profit or that it will contribute to a profitable history.

There were three months with pretty low activity and thus low returns.

June 2007 – we moved house.
December 2007 – two weeks vacation and thereafter the Christmas and New Year period.
April 2008 – two weeks vacation and then the passing away of my mother.

Losses

You know I believe it is more important to take regular profits than it is to take regular losses which in most cases are simply the eradication of a potential typical profit. I am surprised myself about the low number of losses and if I think back about the individual instances there is a good discretionary reason for each one of them. The only bad loss was the AUD sell at 0.8723. That was money wasted.

I have highlighted two instances of what I would call a little bit of house cleaning. I had hedges going on and decided to close it and if one looks at those two instances as a composite trade the net result was a positive and can one say I did 259 trades with 3 losses. (Not that it is necessary to try to improve on the 98.06% "success ratio".)

Profits

I have made this interesting remark in one of the initial Daily Briefings commenting on the Stay-in-Touch account concept during May 2007.

So I put in practice my most general profit taking principle:

See it. Like it. Take it.

Another principle I use with taking profits is the "love at first sight" principle. I see it and I love it so much I take it. I have the exact opposite view of losses. I see it, I hate it and I leave it until later. How effective this approach is, is very very clear from the results.

Walking through the trading year

I believe in relational analysis. You must relate prices, times and events, the components financial markets are made of. I also believe in real-time analysis. You must not look in the rearview mirror you must look through the windscreen, look ahead, plan ahead, think ahead.

This year had some big trends and I have dealt with them reasonably well.

The first one was the buy the JPY vs USD trend. The carry trade became totally over extended and the JPY at levels above 120 completely out of whack.

On Tuesday June 19 I said in my briefing:

And I want to talk about JPY.

Looking at a JPY graph even I can see a channel representing a massive up trend since March 5 / 7. That means March, April, May, June. The move isn't that big, 7 to 8 big figures but the initial action and what we saw the last few days in terms of daily ranges stand out.
I am planning to add to my long JPY (short USDJPY) position. I can't say now when it will happen but it will.

Remember what I said before, if a carry trade unwind takes place the USD will initially rally vs. EURand GBP.

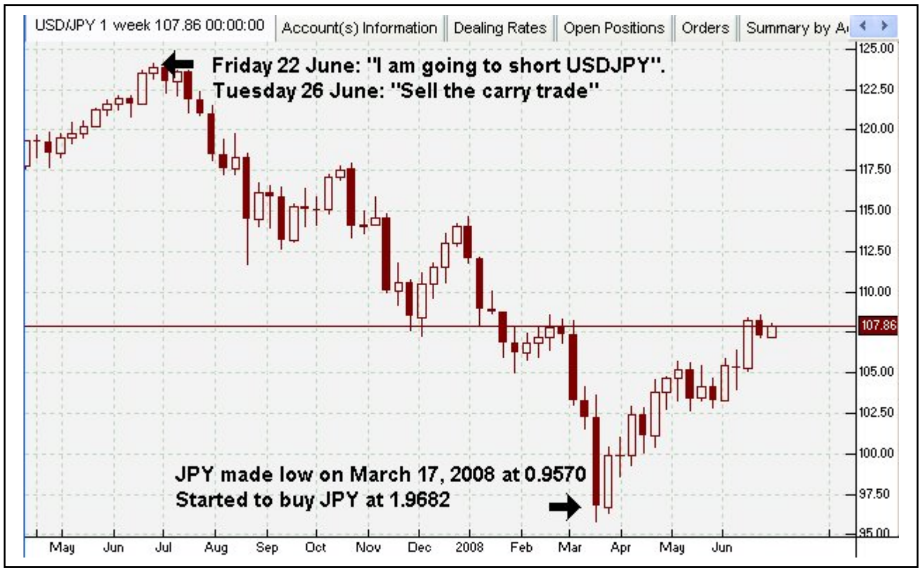
On Friday June 22 I said this in my briefing:

On JPY I am seriously thinking to short the carry trade (i.e. long Yen, contra carry trade).

On 26 June we followed up with:

Well this morning it seems that after the BIS meeting the brigade of bankers and there henchmen were out to reinforce the market's mind and they told us the following:

1. Interest rates can go up globally due to record global economic expansion.
2. Don't make one way bets on the JPY carry trade (this is to counter the effect of reaction to #1 by putting on more carry positions.)



And then came the beginning of credit crunch ….

I repeat this from that June 19th briefing:

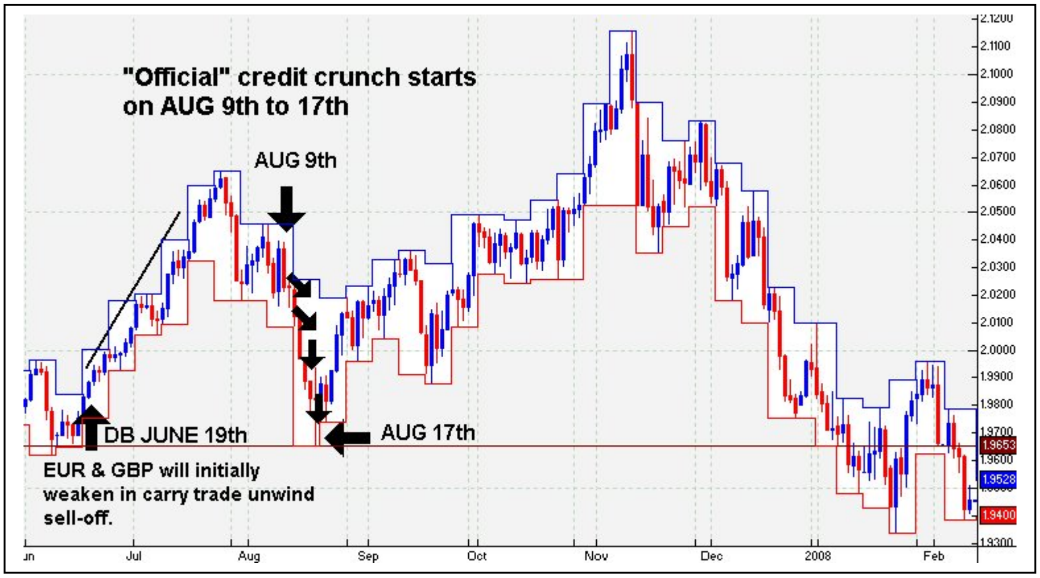
Remember what I said before, if a carry trade unwind takes place the USD will initially rally vs. EUR and GBP.

Between the uttering of this plan on June 19th and August 9th I have bought GBPUSD 8 times, closing all of them for profits, the last bought on August 6th, closing it on August the 9th for a very small 21 pip profit.

The formal appearance of the credit crunch was 9 August 2008 when the big French bank BNP Paribas suspended three of its investment funds worth 2 billion euros because they couldn't value these funds, "because the market has disappeared." This began a hectic week which ended on August 17th with the Fed cutting the discount rate with ½ a point. During these 8 days the EURUSD dropped from 1.3815 to 1.3360 and the GBPUSD from 2.0390 to 1.9650. The JPY strengthened from 119.75 to 111.60. The detailed report shows how I have made merry during those days selling USD vs JPY, but buying USD vs EUR & GBP

USD/JPY	1	**S**	08/09/2007 16:21	118.20	08/10/2007 08:29	117.67	53
EUR/USD	1	**S**	08/09/2007 16:21	1.3674	08/14/2007 03:56	1.3570	104
EUR/USD	1	**S**	08/14/2007 04:39	1.3578	08/14/2007 19:42	1.3533	45
GBP/USD	1	**S**	08/14/2007 04:38	2.0000	08/14/2007 19:43	1.9954	46
USD/JPY	1	**S**	08/06/2007 03:13	117.71	08/15/2007 17:39	116.33	138
EUR/USD	1	**S**	08/15/2007 03:15	1.3492	08/15/2007 17:47	1.3423	69
GBP/USD	1	**S**	08/15/2007 04:35	1.9884	08/16/2007 04:32	1.9846	38
USD/JPY	1	**S**	12/08/2006 09:21	115.00	08/16/2007 06:37	114.24	76
USD/JPY	1	**B**	08/16/2007 06:36	113.94	08/16/2007 06:53	114.46	52
GBP/USD	1	**S**	08/15/2007 03:15	1.9878	08/16/2007 06:53	1.9824	54
USD/JPY	1	**S**	08/16/2007 08:32	114.46	08/16/2007 12:11	113.49	97
USD/JPY	1	**S**	08/16/2007 12:13	113.37	08/16/2007 12:42	112.72	65
USD/JPY	1	**B**	08/16/2007 12:58	112.08	08/16/2007 18:40	114.21	213
USD/JPY	1	**S**	08/16/2007 06:42	114.29	08/16/2007 19:08	113.67	62
USD/JPY	1	**S**	08/16/2007 16:12	114.10	08/16/2007 19:08	113.67	43
USD/JPY	1	**S**	08/16/2007 19:11	113.53	08/17/2007 00:24	112.55	98
GBP/USD	1	**S**	08/16/2007 08:36	1.9850	08/17/2007 03:43	1.9719	131
USD/JPY	1	**B**	08/17/2007 00:13	112.70	08/17/2007 05:00	113.85	115
GBP/USD	1	**B**	08/17/2007 04:03	1.9734	08/17/2007 06:28	1.9768	34
USD/JPY	1	**S**	08/17/2007 08:44	114.36	08/17/2007 10:00	113.75	61

On a price chart it looks like this:



While we are busy with the GBP and have the chart above let me mention that from Aug 17th (BUY GBPUSD @ 1.9734) I have only closed GBPUSD BUYS (I have held SELLS open until January 2008 before closing them for a profit) until Nov 7th, (on the chart the second highest blue candle) when I have started with a majority of sell GBPUSD positions, closing them all for profits.

<u>BUYING CHF vs USD</u>

I saw the CHF basically as a secondary carry unwind trade, although it didn't act exactly like that during the big credit crunch week. Otherwise I felt CHF was undervalued in relation to EUR and with EUR making all time highs every second day trading CHF in correlation with EUR vs USD seemed like a good idea. Altogether I didn't capitalize enough on a move that I did foresee.

On <u>Wednesday Sept 19th</u> I have said the following:

CHF: I have referred to the fact that it is closing the rate differential due to the SNB hiking rates and for all practical purposes no professional will at this stage consider the CHF as a funding carry trade currency. This means it should recover a lot of lost ground against everything it was lagging against, including the euro. When euro was at 1.36+ at the end of 2005 CHF was at 1.13. Looking at CHF it is also clear that every now and again (notwithstanding its weak rate differentials) it makes big moves in a short time. This might be one of them.

The CHF was at 1.18+ and I have already sold it twice in preceding days at 1.1860/7.

Two months later the CHF bottomed temporarily on Nov 23rd around 1.09, 15 positive sell USDCHF trades later. I missed the subsequent bounce and only caught CHF below 1.10 again.

Trading AUDUSD

AUD took a real beating during the carry trade unwind and after its fast recovery from those lows and based on the increased interest rate differentials and commodity rally the Ozzie became a potential one way play. We caught this positive AUDUSD play around 0.9000 late in October.

October 24th:

Ozzie Core CPI above their target rate thus rate hike expectations for Nov 7th.
I think I am going to stick a toe in Ozzie with that inflation news and back to below 0.90 vs USD.

October 25th:

I said a while ago that AUDUSD is shaping up to become a one way play. That is the kind of thing that should interest us (one-way-play's over the long term).

We also say we have to minimize the impact of timing as a rule. Always. We don't believe in special trades. We believe the market dispenses many equal opportunities and that we will do better to maximize many of these than by trying to find those few elusive big score trades.

But a big decision like this forces your hand. I think this would be the first time I would have bought AUD ever. It is a big decision and if you like it or not, timing is a factor.

So I have posted the DB yesterday with AUD at 0.8980 with the idea to buy below 90 on the day. Immediately thereafter AUD moved up rapidly. I decided to "chase" it. The first price I could get was 0.9015. With a bit of tick watching I got 0.9009.

From then on we have steadily banked profits on the Ozzie, sometimes sitting through rather deep dips but believing the interest rate differential and high commodity prices will keep Ozzie going up.

Feb – Mar 2008

This was the most profitable part of this 12 month period with returns slightly better (52%) vs Aug – Sep 2007 (51%). With hindsight one can say this was credit crunch round two as the currencies peaked around the Bear Sterns collapse and the Fed led buyout by JP Morgan in mid March.

However it was other things that kept us on the right side of this price action.

1. We never bought the story that the USD will rally in 2008 just because it was supposedly oversold.
2. We expected the EUR to go to above 1.50 and thereafter if the US recession seems to be short lived, and if the rest of the world also have economic troubles, to fall back in a moderate fashion.
3. We specifically said that we don't see at all a massive USD rally because we simply cannot see why people with any money left will actually throw that money at the Wall Street people who robbed them big time with the credit derivatives.

With the EURUSD in a multi month range below 1.5000 trading can be very choppy but we have succeeded not to sell EURUSD willy-nilly on down moves but to buy the dips in stead, patiently waiting and considering the setup for a break out above 1.50.

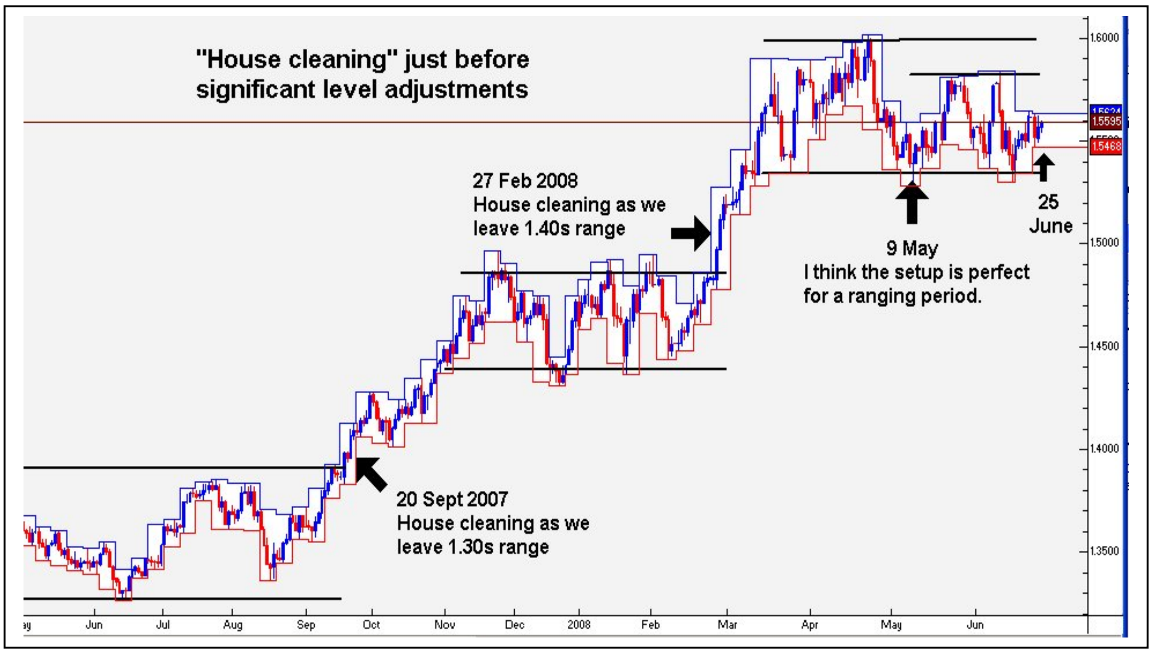
Thursday Feb 7th:

This also supports my view that we will stay for some time while there simply are no good trending choices to be made basically, most of the time in this current grid, effectively middle to higher 1.40s. Based on the above view I will look to buy euro in the low 1.45s

In the accompanying records you can see the EURUSD buys on the day at 1.4496 and 1.4529. This was the final lows of the long range trading period and EURUSD launched to 1.5900 basically non-stop.

P/L	B08167135	EUR/USD	2	**S**	02/05/2008	1.4644	**02/07/2008**	1.4620	24
P/L	A08334055	GBP/USD	1	S	01/14/2008	1.9557	02/07/2008	1.9451	106
P/L	B08203670	EUR/USD	1	**B**	**02/07/2008**	1.4496	02/07/2008	1.4533	37
P/L	B08214166	USD/JPY	1	S	02/07/2008	107.43	02/11/2008	107.16	27
P/L	B08202651	EUR/USD	1	**B**	**02/07/2008**	1.4529	02/13/2008	1.4569	40
P/L	B08200033	EUR/USD	1	**B**	**02/07/2008**	1.4566	02/14/2008	1.4636	70

On a price chart is looks like this:



During February we have identified the Bernanke testimony before congress as the potential catalyst to send the currencies soaring vs USD. This testimony was on 28 and 29 February.

EURUSD: Feb 22nd:

The 1.44 - 1.49 grid has done well. If we smooth out our initial preparation for move above 1.50 we see it basically contained price action for three months. That is a long time and amazingly so considering the very high levels.
Many times in the past stalemate was broken by Fed presidents Greenspan and Bernanke also (specifically the mid 2006 1.25 turnaround when they stopped hiking rates).
It is not unreasonable if everything lines up to Bernanke's testimony that the same can happen again.

EURUSD: On 27 February we said:

What about the euro and our old view that 1.51 / 52 and then a decent correction probably to the lows of the current grid (mid 1.40s)? It is in tact. I personally think there is a chance that we see a major adjustment and we might see an adjustment to above 1.50, i.e. the range adjust from 1.40 - 1.50 to 1.45 - 1.55 on the low end, if not 1.50 - 1.60.

USDJPY: February 22nd:

I am looking at JPY closely. It is hitting a ceiling here in the low 108 areas. And it sometimes behave strange. We got used to ... US stocks down, JPY stronger, US stocks UP JPY weaker, but a few times now this wasn't the case. And in the mean time deep down I think there is a consensus building that the JPY is going to strengthen a lot, together with other Asian currencies. Maybe this only happens when the US seems to be bottoming and it becomes clear that their (Asian) exports won't suffer too much due to US economic slowdown. In the mean time however there is a medium to longer term building up of long JPY positions. In the short run I think a break to 109+ is going to be a good buying level. I believe there is a majority of longer term positions here looking for a 5 - 10% JPY move and they will add at better levels (109, 110, 111 doubt we will see the latter).

On Monday March 17th when the Fed bailed out Bear Sterns over the weekend we said:

What this means is where the banks consistently had the problem that they couldn't borrow from another bank because the other one didn't want to lend to them they can now resolve the problem by going to the discount window of the Fed, who will borrow from them. Structurally that big issue is now resolved. OK all confidence isn't back yet but the big problem is solved.

For us that means the potential for credit crunch to cause further level adjustments in the currencies vs the USD is now limited.

What isn't limited is normal currency market factors ... interest rate differentials, good economy bad economy stuff and on this level things don't look rosy for the USD.

Which bring us back to an old theme ... when will there be a ray of hope for the USD and a moderate pull back from credit crunch over extension?

It might be exactly today.

As you can see on the chart above, that was the exact day. Monday March 17th.

How you can benefit from this

The concepts we work with aren't rocket science. However, trading, or, running a personal forex trading business, is not as easy as it seems. After ten years working with aspirant and struggling traders I have come to the conclusion that most traders simply don't make it because they totally overestimate the odds to make money by applying intra day technical analysis to virtually random price action in the currency market and they underestimate the demands of forex trading.

Overestimating the tools of your trade and underestimating the demands of your trade is a recipe for problems.

My personal mentoring program is specifically designed to help new or struggling traders to apply the 4x1 strategy and median trading methodology in their trading.

See: www.dirkdutoit.com

Contact: dayforex@gmail.com

Account Number: FX327448

Customer: Dirk Daniel DuToit

Entry Type	Ticket ID	Currency Pair	Lots	B/S	Open Date Time	Open Rate	Close Date/Time	Close Rate	Pip Count	% on capital
P/L	E07409934	EUR/USD	1	B	05/23/2007 10:34	1.3483	06/05/2007 13:23	1.3523	40	
P/L	E07351080	USD/JPY	1	B	05/18/2007 04:51	121.39	06/15/2007 02:54	123.00	161	
P/L	F07179222	GBP/USD	1	B	06/07/2007 03:44	1.9927	06/22/2007 08:59	1.9990	63	
			3						264	**2.34**
P/L	D07325787	GBP/USD	1	B	04/17/2007 08:44	2.0051	07/02/2007 12:01	2.0158	107	
P/L	G07133894	EUR/USD	1	B	07/03/2007 12:24	1.3619	07/10/2007 08:49	1.3660	41	
P/L	F07294270	USD/JPY	1	S	06/15/2007 04:37	123.39	07/10/2007 09:29	122.46	93	
P/L	G07201232	EUR/USD	1	B	07/10/2007 09:24	1.3689	07/10/2007 10:36	1.3729	40	
P/L	G07149604	GBP/USD	1	B	07/05/2007 07:25	2.0199	07/10/2007 10:40	2.0240	41	
P/L	G07203030	USD/JPY	1	S	07/10/2007 09:57	122.35	07/11/2007 02:00	121.30	105	
P/L	G07206611	GBP/USD	1	B	07/10/2007 11:37	2.0252	07/11/2007 03:39	2.0286	34	
P/L	G07204822	EUR/USD	1	B	07/10/2007 10:45	1.3730	07/11/2007 10:41	1.3777	47	
P/L	G07232480	GBP/USD	1	B	07/11/2007 12:51	2.0335	07/16/2007 06:42	2.0383	48	
P/L	G07240572	EUR/USD	1	B	07/12/2007 03:42	1.3777	07/18/2007 11:04	1.3815	38	
P/L	G07308108	GBP/USD	1	B	07/18/2007 08:31	2.0496	07/18/2007 12:06	2.0533	37	
P/L	G07335935	GBP/USD	1	B	07/20/2007 05:24	2.0528	07/24/2007 01:23	2.0634	106	
P/L	G07425559	GBP/USD	1	B	07/26/2007 08:40	2.0450	07/26/2007 10:01	2.0481	31	
P/L	G07219347	USD/JPY	1	S	07/11/2007 02:10	121.32	07/26/2007 11:39	119.10	222	
P/L	G07460286	GBP/USD	1	B	07/27/2007 08:32	2.0313	07/31/2007 14:33	2.0343	30	
			14						1020	**9.49**
P/L	G07515867	GBP/USD	1	S	07/31/2007 17:45	2.0290	08/01/2007 06:06	2.0251	39	
P/L	G07515872	USD/JPY	1	S	07/31/2007 17:46	118.46	08/01/2007 07:30	118.46	0	
P/L	H07134748	EUR/USD	1	B	08/02/2007 10:03	1.3664	08/03/2007 08:38	1.3718	54	
P/L	H07103510	EUR/USD	1	S	08/01/2007 02:20	1.3649	08/03/2007 08:39	1.3719	**-70**	
P/L	G07512976	EUR/USD	1	B	07/31/2007 14:34	1.3688	08/03/2007 08:39	1.3714	26	
P/L	G07514951	GBP/USD	1	B	07/31/2007 16:53	2.0316	08/03/2007 08:39	2.0369	53	
P/L	H07148315	EUR/USD	1	B	08/03/2007 08:38	1.3719	08/03/2007 10:30	1.3773	54	
P/L	H07149485	GBP/USD	1	B	08/03/2007 09:02	2.0369	08/03/2007 15:54	2.0404	35	
P/L	H07154538	EUR/USD	1	B	08/03/2007 10:36	1.3770	08/03/2007 16:08	1.3778	8	
P/L	H07115058	USD/JPY	1	S	08/01/2007 10:17	118.80	08/05/2007 16:01	117.80	100	
P/L	H07162859	GBP/USD	1	B	08/05/2007 17:35	2.0403	08/06/2007 01:24	2.0424	21	
P/L	H07160281	EUR/USD	1	B	08/03/2007 15:46	1.3798	08/06/2007 01:24	1.3812	14	
P/L	H07212354	GBP/USD	1	B	08/08/2007 05:34	2.0230	08/08/2007 08:59	2.0345	115	

P/L	H07155239	USD/JPY	1	B	08/03/2007 10:51	118.39	08/09/2007 03:05	119.03	64	
P/L	H07176704	GBP/USD	1	B	08/06/2007 09:09	2.0293	08/09/2007 03:06	2.0314	21	
P/L	H07253540	USD/JPY	1	S	08/09/2007 16:21	118.20	08/10/2007 08:29	117.67	53	
P/L	H07253535	EUR/USD	1	S	08/09/2007 16:21	1.3674	08/14/2007 03:56	1.3570	104	
P/L	H07312959	EUR/USD	1	S	08/14/2007 04:39	1.3578	08/14/2007 19:42	1.3533	45	
P/L	H07312938	GBP/USD	1	S	08/14/2007 04:38	2.0000	08/14/2007 19:43	1.9954	46	
P/L	H07170711	USD/JPY	1	S	08/06/2007 03:13	117.71	08/15/2007 17:39	116.33	138	
P/L	H07338543	EUR/USD	1	S	08/15/2007 03:15	1.3492	08/15/2007 17:47	1.3423	69	
P/L	H07340478	GBP/USD	1	S	08/15/2007 04:35	1.9884	08/16/2007 04:32	1.9846	38	
P/L	L06234968	USD/JPY	1	S	12/08/2006 09:21	115.00	08/16/2007 06:37	114.24	76	
P/L	H07377975	USD/JPY	1	B	08/16/2007 06:36	113.94	08/16/2007 06:53	114.46	52	
P/L	H07338538	GBP/USD	1	S	08/15/2007 03:15	1.9878	08/16/2007 06:53	1.9824	54	
P/L	H07383316	USD/JPY	1	S	08/16/2007 08:32	114.46	08/16/2007 12:11	113.49	97	
P/L	H07392626	USD/JPY	1	S	08/16/2007 12:13	113.37	08/16/2007 12:42	112.72	65	
P/L	H07395463	USD/JPY	1	B	08/16/2007 12:58	112.08	08/16/2007 18:40	114.21	213	
P/L	H07378641	USD/JPY	1	S	08/16/2007 06:42	114.29	08/16/2007 19:08	113.67	62	
P/L	H07403660	USD/JPY	1	S	08/16/2007 16:12	114.10	08/16/2007 19:08	113.67	43	
P/L	H07408599	USD/JPY	1	S	08/16/2007 19:11	113.53	08/17/2007 00:24	112.55	98	
P/L	H07383790	GBP/USD	1	S	08/16/2007 08:36	1.9850	08/17/2007 03:43	1.9719	131	
P/L	H07409356	USD/JPY	1	B	08/17/2007 00:13	112.70	08/17/2007 05:00	113.85	115	
P/L	H07425548	GBP/USD	1	B	08/17/2007 04:03	1.9734	08/17/2007 06:28	1.9768	34	
P/L	H07437206	USD/JPY	1	S	08/17/2007 08:44	114.36	08/17/2007 10:00	113.75	61	
P/L	H07357164	EUR/USD	1	B	08/15/2007 17:13	1.3433	08/17/2007 10:03	1.3492	59	
P/L	H07466036	USD/JPY	1	S	08/20/2007 04:16	115.40	08/20/2007 12:10	114.40	100	
P/L	H07442376	EUR/USD	1	B	08/17/2007 10:05	1.3500	08/22/2007 17:23	1.3548	48	
P/L	H07442337	GBP/USD	1	B	08/17/2007 10:05	1.9900	08/22/2007 17:23	1.9933	33	
P/L	H07312488	GBP/USD	1	B	08/14/2007 04:31	2.0036	08/23/2007 06:06	2.0065	29	
P/L	H07537403	USD/JPY	1	S	08/23/2007 05:32	116.49	08/23/2007 11:55	115.91	58	
P/L	H07526424	EUR/USD	1	B	08/22/2007 18:31	1.3549	08/24/2007 09:27	1.3607	58	
P/L	H07567533	EUR/USD	1	B	08/24/2007 08:27	1.3617	08/24/2007 14:05	1.3671	54	
P/L	H07568890	USD/JPY	1	S	08/24/2007 08:56	116.02	08/28/2007 09:42	115.02	100	
P/L	H07531963	USD/JPY	1	S	08/23/2007 00:45	115.89	08/28/2007 13:11	114.77	112	
			44						2779	**25.72**
P/L	I07113610	EUR/USD	1	B	09/04/2007 03:40	1.3609	09/05/2007 17:59	1.3649	40	
P/L	H07571587	GBP/USD	1	B	08/24/2007 10:08	2.0110	09/05/2007 18:00	2.0197	87	
P/L	I07155757	EUR/USD	1	B	09/06/2007 03:45	1.3650	09/06/2007 11:43	1.3704	54	
P/L	H07525392	USD/JPY	1	S	08/22/2007 17:24	115.34	09/07/2007 08:35	114.38	96	

P/L	H07628889	USD/JPY	1	S	08/29/2007 02:57	114.44	09/07/2007 10:17	113.90	54
P/L	I07185526	USD/JPY	1	S	09/07/2007 10:18	113.92	09/07/2007 10:58	113.48	44
P/L	I07174851	GBP/USD	1	B	09/07/2007 03:57	2.0187	09/07/2007 11:00	2.0250	63
P/L	I07188371	USD/JPY	1	B	09/07/2007 11:24	113.19	09/10/2007 06:53	113.60	41
P/L	H07476036	USD/JPY	1	S	08/20/2007 12:18	114.35	09/10/2007 11:28	113.42	93
P/L	I07185538	GBP/USD	1	B	09/07/2007 10:18	2.0276	09/11/2007 17:25	2.0326	50
P/L	I07179484	EUR/USD	1	B	09/07/2007 08:38	1.3759	09/12/2007 01:25	1.3867	108
P/L	I07240880	EUR/USD	1	S	09/12/2007 01:57	1.3869	09/12/2007 04:06	1.3847	22
P/L	I07240085	EUR/USD	1	B	09/12/2007 01:26	1.3867	09/12/2007 12:12	1.3907	40
P/L	I07227490	USD/CHF	1	S	09/11/2007 08:42	1.1867	09/13/2007 04:08	1.1825	42
P/L	I07160233	GBP/USD	1	B	09/06/2007 07:57	2.0197	09/13/2007 17:22	2.0222	25
P/L	H07600458	GBP/USD	1	S	08/28/2007 01:30	2.0050	09/17/2007 06:24	1.9989	61
P/L	I07251915	EUR/USD	1	B	09/12/2007 12:12	1.3909	09/18/2007 14:18	1.3940	31
P/L	I07288510	GBP/USD	1	B	09/14/2007 07:36	2.0123	09/18/2007 14:55	2.0130	7
P/L	I07266831	USD/CHF	1	S	09/13/2007 09:09	1.1860	09/18/2007 15:17	1.1826	34
P/L	I07335951	USD/JPY	1	S	09/18/2007 14:23	115.75	09/20/2007 03:29	115.39	36
P/L	I07368895	USD/CHF	1	S	09/20/2007 02:14	1.1809	09/20/2007 03:29	1.1748	61
P/L	I07368890	GBP/USD	1	B	09/20/2007 02:14	2.0016	09/20/2007 03:29	2.0070	54
P/L	I07347748	EUR/USD	1	B	09/19/2007 01:23	1.3983	09/20/2007 03:57	1.4042	59
P/L	I07174848	EUR/USD	1	B	09/07/2007 03:57	1.3679	09/20/2007 03:57	1.4041	362
P/L	H07575058	EUR/USD	1	B	08/24/2007 14:05	1.3675	09/20/2007 03:57	1.4040	365
P/L	G07301484	EUR/USD	1	B	07/18/2007 02:06	1.3814	09/20/2007 03:58	1.4040	226
P/L	H07384577	EUR/USD	1	S	08/16/2007 08:53	1.3423	09/20/2007 03:58	1.4042	**-619**
P/L	I07373496	USD/JPY	1	S	09/20/2007 04:39	115.47	09/20/2007 11:04	114.57	90
P/L	I07373451	GBP/USD	1	B	09/20/2007 04:38	2.0100	09/20/2007 11:04	2.0136	36
P/L	I07372252	USD/CHF	1	S	09/20/2007 03:56	1.1747	09/20/2007 11:04	1.1710	37
P/L	I07373333	EUR/USD	1	B	09/20/2007 04:34	1.4050	09/20/2007 12:19	1.4091	41
P/L	I07382567	EUR/USD	1	B	09/20/2007 11:09	1.4085	09/21/2007 02:38	1.4114	29
P/L	I07387795	GBP/USD	1	B	09/20/2007 15:51	2.0096	09/24/2007 02:11	2.0296	200
P/L	I07396531	EUR/USD	1	B	09/21/2007 03:13	1.4083	09/24/2007 02:14	1.4121	38
P/L	I07382564	USD/CHF	1	S	09/20/2007 11:09	1.1706	09/25/2007 10:01	1.1644	62
P/L	I07382674	USD/JPY	1	S	09/20/2007 11:14	114.53	09/25/2007 10:02	114.08	45
P/L	I07437214	GBP/USD	1	B	09/25/2007 08:45	2.0140	09/25/2007 10:06	2.0188	48
P/L	I07413693	EUR/USD	1	B	09/24/2007 02:23	1.4129	09/25/2007 10:23	1.4129	0
P/L	I07439207	EUR/USD	1	S	09/25/2007 10:01	1.4150	09/25/2007 10:24	1.4130	20
P/L	I07458496	EUR/USD	1	B	09/26/2007 09:17	1.4130	09/27/2007 08:07	1.4170	40
P/L	I07461476	USD/JPY	1	S	09/26/2007 12:02	115.65	09/27/2007 08:07	115.23	42

P/L	I07180043	GBP/USD	1	B	09/07/2007 08:43	2.0294	09/28/2007 06:27	2.0316	22	
P/L	I07227451	GBP/USD	1	B	09/11/2007 08:39	2.0313	09/28/2007 08:47	2.0365	52	
P/L	I07245911	GBP/USD	1	B	09/12/2007 07:53	2.0323	09/28/2007 12:11	2.0395	72	
P/L	I07502960	GBP/USD	1	B	09/28/2007 12:12	2.0402	09/28/2007 14:10	2.0440	38	
P/L	I07388613	EUR/USD	1	B	09/20/2007 17:06	1.4070	09/28/2007 14:10	1.4259	189	
P/L	I07413467	USD/CHF	1	S	09/24/2007 02:17	1.1700	09/28/2007 14:11	1.1647	53	
P/L	I07441869	USD/CHF	1	S	09/25/2007 11:01	1.1675	09/28/2007 14:11	1.1648	27	
			47						2717	**26.04**
P/L	J07184596	EUR/USD	1	B	10/05/2007 08:30	1.4071	10/05/2007 14:01	1.4138	67	
P/L	J07141990	USD/JPY	1	S	10/03/2007 03:07	116.18	10/18/2007 08:27	115.48	70	
P/L	J07142151	USD/CHF	1	S	10/03/2007 03:14	1.1744	10/18/2007 08:28	1.1681	63	
P/L	J07379577	USD/JPY	1	S	10/18/2007 08:29	115.47	10/19/2007 01:54	114.95	52	
P/L	J07394563	USD/JPY	1	S	10/19/2007 01:55	114.93	10/21/2007 16:00	114.45	48	
P/L	I07441460	USD/JPY	1	S	09/25/2007 10:46	114.50	10/21/2007 18:04	113.57	93	
P/L	J07476946	AUD/USD	1	B	10/24/2007 02:32	0.9009	10/26/2007 01:21	0.9103	94	
P/L	J07379554	USD/CHF	1	S	10/18/2007 08:29	1.1676	10/26/2007 02:47	1.1634	42	
P/L	H07159789	GBP/USD	1	B	08/03/2007 15:18	2.0447	10/26/2007 04:09	2.0565	118	
P/L	J07525533	GBP/USD	1	B	10/26/2007 04:08	2.0569	10/29/2007 13:13	2.0627	58	
P/L	J07525559	GBP/USD	1	B	10/26/2007 04:09	2.0569	10/30/2007 07:26	2.0669	100	
P/L	J07525521	USD/CHF	1	S	10/26/2007 04:08	1.1641	10/31/2007 14:24	1.1593	48	
P/L	J07480695	AUD/USD	1	B	10/24/2007 04:34	0.8981	10/31/2007 15:03	0.9317	336	
			12						1189	**11.34**
P/L	I07504797	USD/CHF	1	S	09/28/2007 14:12	1.1643	11/02/2007 03:01	1.1543	100	
P/L	K07136704	USD/CHF	1	S	11/02/2007 08:19	1.1521	11/06/2007 05:12	1.1471	50	
P/L	H07357171	USD/JPY	1	B	08/15/2007 17:13	116.55	11/07/2007 00:54	113.85	**-270**	
P/L	J07554716	USD/JPY	1	S	10/29/2007 14:44	114.59	11/07/2007 02:27	113.76	83	
P/L	J07597525	AUD/USD	1	B	10/31/2007 19:03	0.9323	11/07/2007 02:28	0.9362	39	
P/L	K07203935	USD/CHF	1	S	11/07/2007 02:28	1.1373	11/07/2007 04:23	1.1323	50	
P/L	K07139117	EUR/USD	1	B	11/02/2007 08:40	1.4503	11/07/2007 04:23	1.4686	183	
P/L	I07227515	USD/JPY	1	S	09/11/2007 08:43	113.85	11/07/2007 05:14	113.30	55	
P/L	K07206929	USD/CHF	1	S	11/07/2007 04:31	1.1317	11/07/2007 05:15	1.1311	6	
P/L	K07205421	USD/CAD	1	B	11/07/2007 03:52	0.9121	11/07/2007 13:07	0.9184	63	
P/L	K07206823	GBP/USD	1	S	11/07/2007 04:29	2.1014	11/08/2007 02:34	2.1011	3	
P/L	I07212491	USD/JPY	1	S	09/10/2007 11:38	113.41	11/08/2007 10:51	112.67	74	
P/L	H07394774	USD/JPY	1	S	08/16/2007 12:51	112.56	11/09/2007 05:26	111.51	105	
P/L	K07241032	GBP/USD	1	S	11/08/2007 07:00	2.1066	11/09/2007 08:35	2.0956	110	
P/L	K07235767	USD/CHF	1	S	11/08/2007 02:30	1.1318	11/09/2007 10:57	1.1217	101	

P/L	G07374630	GBP/USD	1	B	07/24/2007 03:39	2.0627	11/09/2007 11:01	2.0946	319	
P/L	H07418420	USD/JPY	1	S	08/17/2007 01:20	112.34	11/11/2007 16:18	110.34	200	
P/L	J07592203	GBP/USD	1	S	10/31/2007 14:22	2.0785	11/12/2007 07:06	2.0720	65	
P/L	K07312885	AUD/USD	1	B	11/12/2007 07:35	0.8809	11/13/2007 07:53	0.8952	143	
P/L	K07346144	EUR/USD	1	B	11/13/2007 07:11	1.4600	11/14/2007 06:38	1.4685	85	
P/L	K07267613	USD/CHF	1	S	11/09/2007 05:11	1.1201	11/20/2007 05:20	1.1082	119	
P/L	K07488230	USD/JPY	1	S	11/20/2007 05:14	110.20	11/20/2007 22:31	109.65	55	
P/L	K07509402	USD/JPY	1	S	11/21/2007 00:53	109.19	11/21/2007 05:03	108.50	69	
P/L	K07379207	AUD/USD	1	B	11/14/2007 08:47	0.9040	11/23/2007 01:05	0.8723	**-317**	
P/L	K07518336	AUD/USD	1	B	11/21/2007 05:12	0.8738	11/26/2007 04:18	0.8860	122	
P/L	K07517561	USD/JPY	1	B	11/21/2007 04:59	108.70	11/28/2007 22:23	110.06	136	
			25						1748	**16.60**
P/L	K07488206	EUR/USD	1	S	11/20/2007 05:12	1.4788	12/04/2007 03:50	1.4642	146	
P/L	L07213990	GBP/USD	1	B	12/07/2007 08:33	2.0302	12/10/2007 00:55	2.0318	16	
P/L	L07214038	EUR/USD	1	B	12/07/2007 08:33	1.4625	12/10/2007 00:55	1.4640	15	
P/L	K07268999	USD/JPY	1	B	11/09/2007 05:39	111.11	12/10/2007 00:56	111.72	61	
P/L	L07214084	USD/JPY	1	S	12/07/2007 08:34	111.69	12/12/2007 01:35	111.08	61	
P/L	L07264615	AUD/USD	1	B	12/11/2007 14:36	0.8770	12/12/2007 10:24	0.8863	93	
P/L	L07264397	EUR/USD	1	B	12/11/2007 14:33	1.4677	12/12/2007 23:54	1.4724	47	
P/L	H07537611	GBP/USD	1	S	08/23/2007 05:36	2.0015	12/19/2007 22:49	1.9983	32	
			8						471	**4.59**
P/L	H07425182	GBP/USD	1	S	08/17/2007 03:58	1.9710	01/09/2008 06:59	1.9648	62	
P/L	A08266648	GBP/USD	1	S	01/10/2008 07:09	1.9640	01/10/2008 07:52	1.9585	55	
P/L	L07296056	AUD/USD	1	B	12/12/2007 16:10	0.8830	01/10/2008 09:50	0.8865	35	
P/L	A08163324	AUD/USD	1	B	01/04/2008 08:32	0.8834	01/10/2008 23:48	0.8951	117	
P/L	K07488112	USD/CHF	1	S	11/20/2007 05:09	1.1073	01/10/2008 23:48	1.1015	58	
P/L	A08262808	GBP/USD	1	S	01/10/2008 04:39	1.9574	01/11/2008 02:41	1.9525	49	
P/L	A08313660	GBP/USD	1	S	01/14/2008 01:30	1.9615	01/14/2008 21:18	1.9562	53	
P/L	A08390466	EUR/USD	1	B	01/16/2008 11:13	1.4624	01/16/2008 13:33	1.4664	40	
P/L	A08499749	GBP/USD	1	S	01/22/2008 02:34	1.9379	01/22/2008 02:59	1.9346	33	
P/L	A08500968	AUD/USD	1	B	01/22/2008 03:01	0.8525	01/22/2008 08:25	0.8654	129	
P/L	A08497471	AUD/USD	1	B	01/22/2008 01:06	0.8591	01/22/2008 08:26	0.8650	59	
P/L	A08516120	AUD/USD	1	B	01/22/2008 08:35	0.8660	01/22/2008 23:34	0.8660	0	
P/L	A08499758	USD/JPY	1	S	01/22/2008 02:34	106.00	01/23/2008 09:32	105.32	68	
P/L	A08515014	GBP/USD	1	S	01/22/2008 08:26	1.9547	01/23/2008 09:32	1.9480	67	
P/L	A08504625	USD/JPY	1	B	01/22/2008 04:00	106.45	01/25/2008 01:38	107.46	101	
P/L	A08604723	AUD/USD	1	B	01/25/2008 02:18	0.8848	01/30/2008 14:15	0.8928	80	

P/L	A08689830	USD/JPY	1	S	01/30/2008 14:22	107.08	01/30/2008 15:58	106.37	71	
P/L	A08571639	USD/JPY	1	S	01/23/2008 23:13	106.36	01/31/2008 08:34	105.80	56	
P/L	A08689547	EUR/USD	1	S	01/30/2008 14:20	1.4855	01/31/2008 11:33	1.4830	25	
			18						1158	**11.35**
P/L	A08693704	AUD/USD	1	B	01/30/2008 16:01	0.8959	02/01/2008 07:20	0.9010	51	
P/L	B08100191	USD/JPY	1	S	02/01/2008 00:30	106.35	02/01/2008 08:36	105.84	51	
P/L	B08107267	GBP/USD	1	S	02/01/2008 08:16	1.9851	02/01/2008 09:40	1.9727	124	
P/L	B08106920	AUD/USD	1	B	02/01/2008 08:09	0.9015	02/04/2008 02:38	0.9065	50	
P/L	K07301746	AUD/USD	1	B	11/12/2007 02:42	0.9019	02/04/2008 05:10	0.9069	50	
P/L	B08167135	EUR/USD	2	S	02/05/2008 16:54	1.4644	02/07/2008 00:27	1.4620	24	
P/L	A08334055	GBP/USD	1	S	01/14/2008 21:20	1.9557	02/07/2008 07:52	1.9451	106	
P/L	B08203670	EUR/USD	1	B	02/07/2008 08:56	1.4496	02/07/2008 09:36	1.4533	37	
P/L	B08214166	USD/JPY	1	S	02/07/2008 15:21	107.43	02/11/2008 02:19	107.16	27	
P/L	B08202651	EUR/USD	1	B	02/07/2008 08:40	1.4529	02/13/2008 01:32	1.4569	40	
P/L	B08291776	AUD/USD	1	B	02/13/2008 09:42	0.8965	02/13/2008 23:22	0.9020	55	
P/L	B08200033	EUR/USD	1	B	02/07/2008 07:52	1.4566	02/14/2008 17:53	1.4636	70	
P/L	B08319094	EUR/USD	1	B	02/14/2008 18:12	1.4643	02/15/2008 04:52	1.4683	40	
P/L	B08238415	AUD/USD	1	B	02/11/2008 01:43	0.9028	02/15/2008 04:53	0.9077	49	
P/L	B08291761	USD/JPY	1	S	02/13/2008 09:42	108.20	02/15/2008 08:00	107.60	60	
P/L	B08326932	AUD/USD	1	B	02/15/2008 04:55	0.9077	02/17/2008 23:32	0.9127	50	
P/L	B08345024	AUD/USD	1	B	02/18/2008 00:25	0.9130	02/18/2008 22:04	0.9185	55	
P/L	B08326939	EUR/USD	1	B	02/15/2008 04:55	1.4683	02/19/2008 02:44	1.4733	50	
P/L	B08400212	GBP/USD	1	B	02/20/2008 09:12	1.9383	02/20/2008 21:41	1.9429	46	
P/L	B08410426	GBP/USD	1	B	02/20/2008 21:58	1.9427	02/21/2008 01:26	1.9465	38	
P/L	B08388337	GBP/USD	1	B	02/20/2008 02:04	1.9483	02/21/2008 04:45	1.9539	56	
P/L	B08365361	EUR/USD	1	B	02/19/2008 02:45	1.4735	02/21/2008 11:16	1.4789	54	
P/L	B08427240	USD/CHF	1	S	02/21/2008 11:16	1.0951	02/21/2008 12:53	1.0889	62	
P/L	B08404768	AUD/USD	1	B	02/20/2008 12:32	0.9174	02/22/2008 01:30	0.9214	40	
P/L	B08331923	USD/JPY	1	S	02/15/2008 08:23	107.58	02/22/2008 05:06	107.06	52	
P/L	B08429445	EUR/USD	1	B	02/21/2008 12:41	1.4814	02/22/2008 08:09	1.4854	40	
P/L	B08345071	GBP/USD	1	B	02/18/2008 00:31	1.9635	02/22/2008 10:01	1.9690	55	
P/L	B08429832	USD/CHF	1	S	02/21/2008 13:00	1.0886	02/22/2008 15:35	1.0848	38	
P/L	B08453009	AUD/USD	1	B	02/22/2008 15:03	0.9218	02/25/2008 01:02	0.9254	36	
P/L	K07149229	AUD/USD	1	B	11/02/2007 13:27	0.9222	02/25/2008 18:20	0.9282	60	
P/L	B08322772	GBP/USD	1	B	02/15/2008 01:42	1.9718	02/26/2008 12:22	1.9798	80	
P/L	B08114247	EUR/USD	1	B	02/01/2008 09:38	1.4832	02/26/2008 15:23	1.4967	135	
P/L	A08334060	EUR/USD	1	B	01/14/2008 21:20	1.4879	02/26/2008 17:19	1.5029	150	

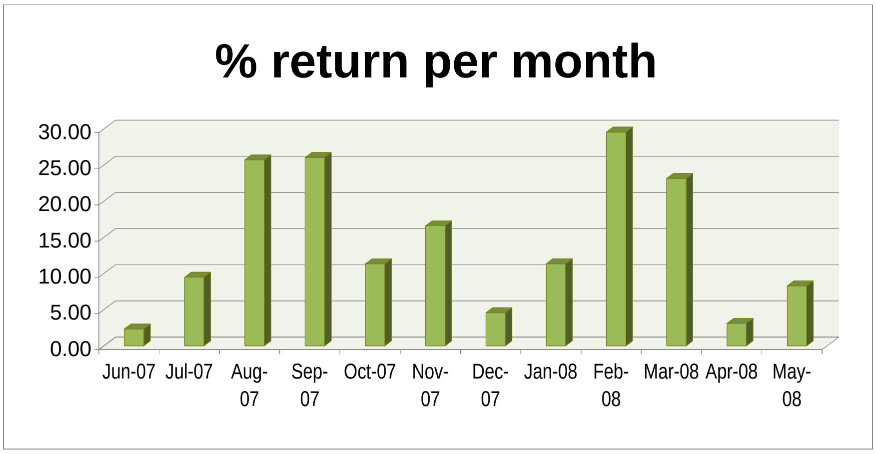
P/L	B08443983	USD/JPY	1	S	02/22/2008 06:26	107.01	02/27/2008 04:15	106.32	69	
P/L	K07241085	AUD/USD	1	B	11/08/2007 07:01	0.9325	02/27/2008 04:15	0.9389	64	
P/L	J07303032	EUR/USD	1	B	10/15/2007 06:40	1.4241	02/27/2008 04:15	1.5071	830	
P/L	I07372394	EUR/USD	1	B	09/20/2007 04:00	1.4040	02/27/2008 04:16	1.5070	1030	
P/L	I07249083	EUR/USD	1	S	09/12/2007 10:12	1.3869	02/27/2008 04:16	1.5073	**-1204**	
P/L	B08524344	AUD/USD	1	B	02/27/2008 10:52	0.9390	02/28/2008 09:32	0.9435	45	
P/L	B08517985	USD/JPY	1	S	02/27/2008 08:03	106.31	02/28/2008 09:33	105.87	44	
P/L	B08546327	AUD/USD	1	B	02/28/2008 09:35	0.9436	02/28/2008 11:14	0.9476	40	
P/L	B08546315	USD/JPY	1	S	02/28/2008 09:35	105.90	02/28/2008 19:51	104.76	114	
			41						2963	**29.55**
P/L	C08110174	USD/JPY	1	B	03/03/2008 01:45	102.71	03/03/2008 04:57	103.15	44	
P/L	C08109110	EUR/USD	1	B	03/03/2008 01:10	1.5216	03/05/2008 10:43	1.5266	50	
P/L	C08231678	EUR/USD	1	S	03/07/2008 08:48	1.5402	03/07/2008 09:44	1.5339	63	
P/L	C08230693	GBP/USD	1	S	03/07/2008 08:40	2.0201	03/07/2008 10:32	2.0151	50	
P/L	C08211007	USD/JPY	1	B	03/06/2008 15:50	102.67	03/11/2008 08:58	103.02	35	
P/L	C08218939	GBP/USD	1	S	03/07/2008 02:06	2.0142	03/11/2008 12:41	2.0064	78	
P/L	C08286385	AUD/USD	1	B	03/11/2008 08:40	0.9269	03/12/2008 20:30	0.9369	100	
P/L	C08347746	USD/JPY	1	B	03/13/2008 04:26	100.05	03/13/2008 08:44	100.72	67	
P/L	C08348540	AUD/USD	1	B	03/13/2008 04:42	0.9352	03/13/2008 10:13	0.9392	40	
P/L	C08359926	AUD/USD	1	B	03/13/2008 10:56	0.9399	03/13/2008 14:39	0.9440	41	
P/L	C08375636	EUR/USD	1	S	03/14/2008 01:36	1.5636	03/14/2008 04:41	1.5575	61	
P/L	C08374518	USD/JPY	1	B	03/14/2008 00:53	100.12	03/14/2008 04:41	100.51	39	
P/L	C08387420	USD/CHF	1	S	03/14/2008 08:50	1.0122	03/14/2008 09:48	1.0068	54	
P/L	C08375533	USD/CHF	1	S	03/14/2008 01:33	1.0061	03/14/2008 10:00	1.0021	40	
P/L	C08375173	USD/JPY	1	S	03/14/2008 01:23	100.00	03/14/2008 10:03	99.60	40	
P/L	C08347629	USD/JPY	1	S	03/13/2008 04:22	100.06	03/14/2008 10:04	99.62	44	
P/L	C08390873	USD/CHF	1	S	03/14/2008 09:51	1.0061	03/14/2008 10:04	1.0005	56	
P/L	C08393720	GBP/USD	1	S	03/14/2008 10:16	2.0375	03/14/2008 13:05	2.0275	100	
P/L	C08394457	USD/JPY	1	S	03/14/2008 10:28	100.00	03/14/2008 15:32	99.38	62	
P/L	C08393398	USD/CHF	1	S	03/14/2008 10:12	1.0021	03/16/2008 17:46	0.9941	80	
P/L	C08391351	EUR/USD	1	B	03/14/2008 09:57	1.5626	03/16/2008 17:46	1.5706	80	
P/L	C08425410	USD/JPY	1	B	03/17/2008 00:03	96.82	03/18/2008 09:12	97.86	104	
P/L	C08484630	USD/JPY	1	B	03/18/2008 14:17	98.00	03/18/2008 14:19	98.60	60	
P/L	C08476280	USD/JPY	1	B	03/18/2008 09:17	97.94	03/18/2008 15:19	99.26	132	
P/L	C08476290	USD/CHF	1	B	03/18/2008 09:17	0.9896	03/18/2008 15:19	0.9963	67	
P/L	C08403992	USD/JPY	1	B	03/16/2008 17:19	98.80	03/18/2008 15:19	99.24	44	
P/L	C08489723	USD/CHF	1	B	03/18/2008 15:26	0.9967	03/18/2008 15:57	1.0013	46	

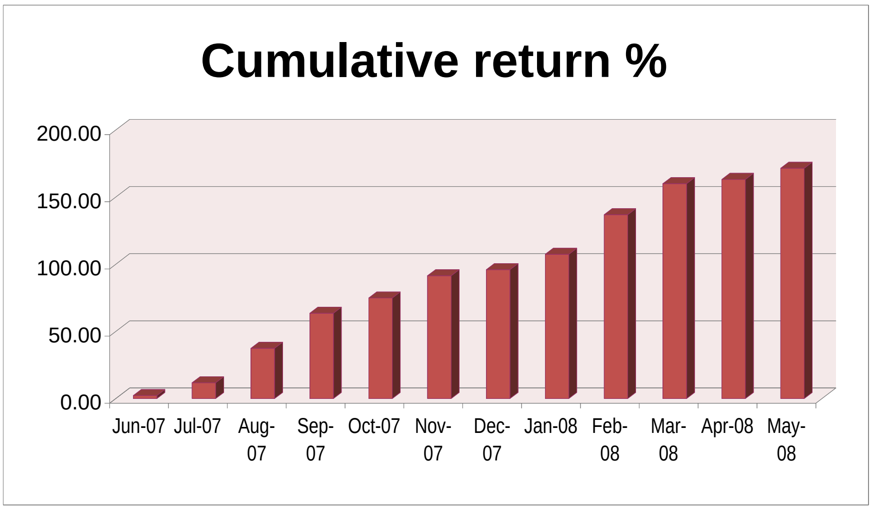
P/L	C08487987	AUD/USD	1	B	03/18/2008 14:58	0.9279	03/18/2008 23:11	0.9318	39	
P/L	C08492236	USD/CHF	1	B	03/18/2008 17:06	1.0026	03/20/2008 05:07	1.0066	40	
P/L	C08392620	EUR/USD	1	S	03/14/2008 10:05	1.5669	03/20/2008 05:28	1.5529	140	
P/L	C08490797	USD/JPY	1	B	03/18/2008 15:56	99.51	03/24/2008 10:17	100.51	100	
P/L	C08394447	USD/JPY	1	B	03/14/2008 10:28	99.99	03/24/2008 11:05	100.71	72	
P/L	C08610375	USD/CHF	1	S	03/25/2008 01:20	1.0126	03/26/2008 05:49	0.9992	134	
P/L	C08645077	USD/CHF	1	S	03/26/2008 05:49	0.9987	03/26/2008 15:04	0.9922	65	
P/L	C08647548	USD/CHF	1	S	03/26/2008 06:51	0.9968	03/26/2008 15:04	0.9922	46	
			34						2313	**23.15**
P/L	C08660649	EUR/USD	1	S	03/26/2008 15:05	1.5809	04/01/2008 10:10	1.5597	212	
P/L	C08660654	EUR/USD	1	B	03/26/2008 15:05	1.5812	04/10/2008 05:02	1.5871	59	
P/L	C08392936	AUD/USD	1	B	03/14/2008 10:08	0.9408	04/22/2008 07:52	0.9448	40	
			3						311	**3.11**
P/L	D08698430	EUR/USD	1	S	04/28/2008 07:38	1.5650	05/01/2008 04:21	1.5532	118	
P/L	E08105730	GBP/USD	1	S	05/01/2008 04:22	1.9872	05/01/2008 09:58	1.9765	107	
P/L	B08566052	USD/JPY	1	B	02/29/2008 03:03	104.44	05/02/2008 08:38	105.56	112	
P/L	E08130360	GBP/USD	1	S	05/02/2008 02:39	1.9781	05/02/2008 08:39	1.9781	0	
P/L	E08140600	EUR/USD	1	B	05/02/2008 08:32	1.5391	05/02/2008 11:06	1.5426	35	
P/L	E08142986	USD/CHF	1	S	05/02/2008 08:40	1.0585	05/05/2008 00:12	1.0535	50	
P/L	E08111036	EUR/USD	1	B	05/01/2008 08:32	1.5505	05/06/2008 09:15	1.5555	50	
P/L	E08115712	USD/CHF	1	S	05/01/2008 10:02	1.0481	05/06/2008 10:15	1.0431	50	
P/L	E08248657	GBP/USD	1	S	05/08/2008 01:19	1.9516	05/09/2008 08:02	1.9473	43	
P/L	E08287558	EUR/USD	1	S	05/09/2008 04:39	1.5470	05/14/2008 03:28	1.5420	50	
P/L	E08498890	USD/CHF	1	S	05/20/2008 03:27	1.0456	05/20/2008 14:11	1.0379	77	
P/L	E08520134	USD/JPY	1	S	05/20/2008 14:19	103.66	05/21/2008 00:39	103.23	43	
P/L	E08530236	USD/CHF	1	S	05/21/2008 03:34	1.0358	05/21/2008 07:08	1.0302	56	
P/L	E08546375	EUR/USD	1	S	05/21/2008 11:07	1.5768	05/21/2008 14:04	1.5755	13	
P/L	E08546373	USD/CHF	1	S	05/21/2008 11:07	1.0286	05/21/2008 20:44	1.0243	43	
			15						847	**8.30**
										171.57

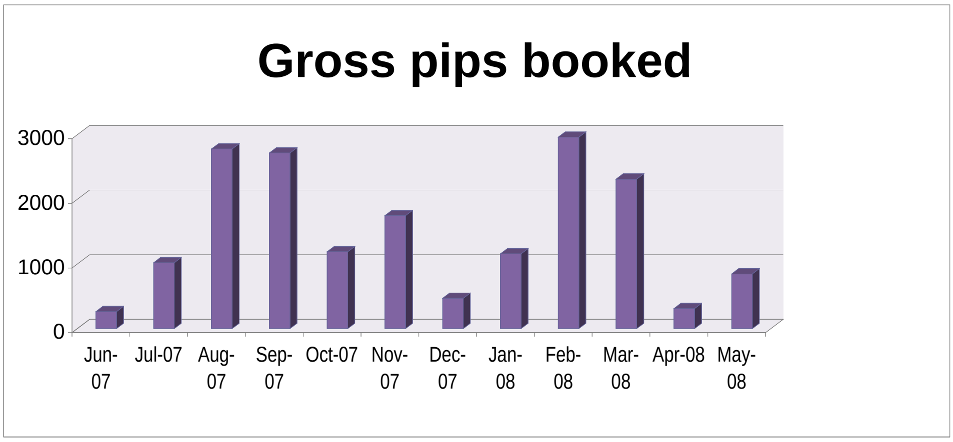
Month	Cumulative return %	# trades per month	% return per month	Gross pips booked
Jun-07	2.34	3	2.34	264
Jul-07	11.83	14	9.49	1020
Aug-07	37.55	44	25.72	2779
Sep-07	63.58	47	26.04	2717
Oct-07	74.93	12	11.34	1189
Nov-07	91.53	25	16.60	1748
Dec-07	96.12	8	4.59	471
Jan-08	107.46	18	11.35	1158
Feb-08	137.01	41	29.55	2963
Mar-08	160.16	34	23.15	2313
Apr-08	163.27	3	3.11	311
May-08	171.57	15	8.30	847
		264	**171.57**	**17780**
		Average	**14.30**	

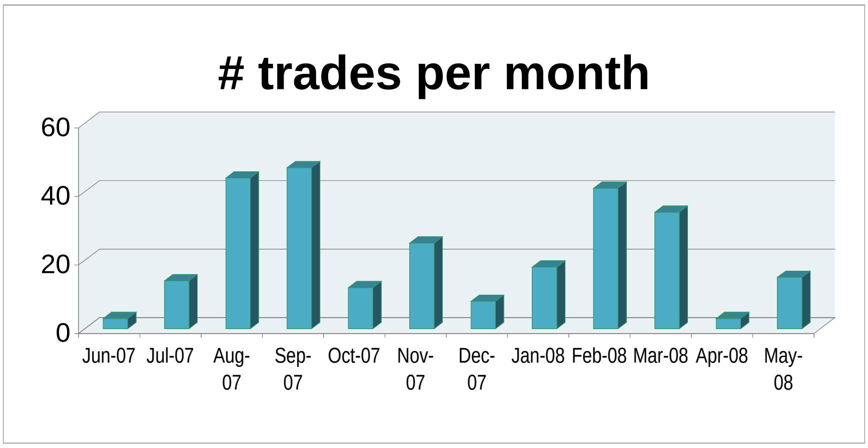
Average pips per trade:	**67**
Average leverage per trade:	**1:1**

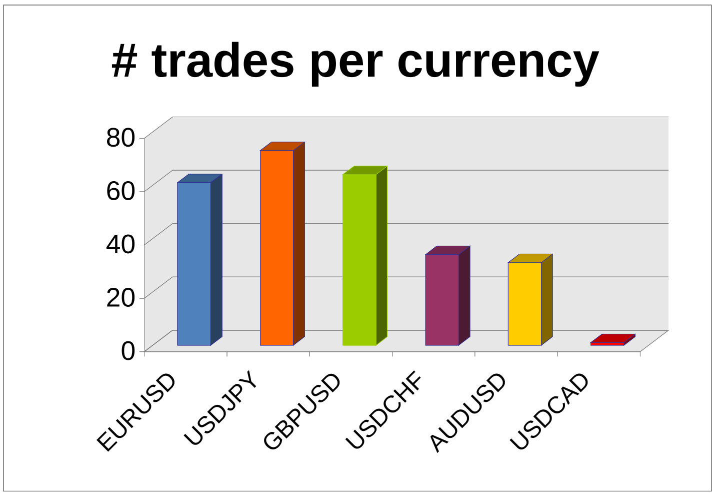
# trades per currency	
EURUSD	61
USDJPY	73
GBPUSD	64
USDCHF	34
AUDUSD	31
USDCAD	1
	264






Gross pips booked
3000
2000
1000
0
Jun-07
Jul-07
Aug-07
Sep-07
Oct-07
Nov-07
Dec-07
Jan-08
Feb-08
Mar-08
Apr-08
May-08


trades per month
60
40
20
0
Jun-07
Jul-07
Aug-07
Sep-07
Oct-07
Nov-07
Dec-07
Jan-08
Feb-08
Mar-08
Apr-08
May-08


trades per currency
80
60
40
20
0
EURUSD
USDJPY
GBPUSD
USDCHF
AUDUSD
USDCAD