Successful Trading Strategy

with correct Stop Losses

No investor can effectively trade in the FX markets without understanding the basic use of Take Profit and Stop Loss orders. But it's the added knowledge of knowing how to place these key triggers to work in your benefit that will define the profitable from the non-profitable traders. The following article will explain a beneficial use of the Stop Loss trigger than can give an extra edge to traders.

Unfortunately traders much like all people are governed by their human emotions that can cause even a successfully placed position to yield negative profits. The trick is to follow one of the most important rules of Money management, "Plan your work, and work your plan".

This quote is often misunderstood as some traders will only follow their plan until a first disappointment and then most likely leave their losses run in hope of a return to profits. The term "Take Profit" by definition may cause eager traders to impatiently close a position before their target is met, a pattern that is very common among many inexperienced investors. What most new traders fail to fully understand is the benefit of the Stop Loss, which unfortunately is only associated in almost all traders' minds as a failed position with a loss.

The next paragraphs will discuss the basic steps that, in our view, a trader should consider creating, a successful investment strategy in the forex market.

First, a trader should carefully study (technically, fundamentally or both) the currency pair he/she is thinking of taking a position in. If that specific currency pair under scope does not make you feel as comfortable as it should then find another subject. There are numerous currency pairs to choose from and there are even more opportunities that will arise. Do not be afraid to miss a few, there will be new opportunities right along. Act only when you are as comfortable with your decision as possible.

After the investor has decided how the currency price will likely behave, then he should establish the maximum and minimum targets in which the anticipated movement will occur. This is a very important and hard part of the strategy which is where most traders tend to fail even after correctly predicting the price movement. For this step there are numerous sources a trader can use, from support resistances to Fibonacci retracements to Oscillators and so on.

Since the trader has now created an overall estimate of the price movement including maximum and minimum expectations then his aim is to enter the market at or close to the best price he estimated. One simple way of entering such a position is, if the entry point is close to the market price you proceed by opening half of your position now and place a Limit order for the rest of the desired position with Take Profit and Stop Loss orders set at all times.

Another more complicated way is to cut the maximum and minimum range you have created in layers according to possible supports and resistances in between, and set limit orders on each level. In any case, you are always trading according to your view about the estimated price action but the second strategy can result in a totally missed opportunity if the market starts moving before testing the support or resistance.

This finally brings us to the key issue of discussion, the Stop Losses. The stop loss should be placed according to each traders individual time frame but always have a risk/reward ratio that is more than 1:1. That means that if your anticipated move is 100 pips in your benefit, then your stop loss should not be more than 100 pips. When the market goes close to the stop loss, most traders tend to modify their stop loss to higher losses in hopes that the position will return, but in reality if the trader is clear about his stop loss it means that the next possible resistance or support will be some distance away. The price movement will have no reason to stop before reaching the next resistance since it managed to break through a good resistance already.

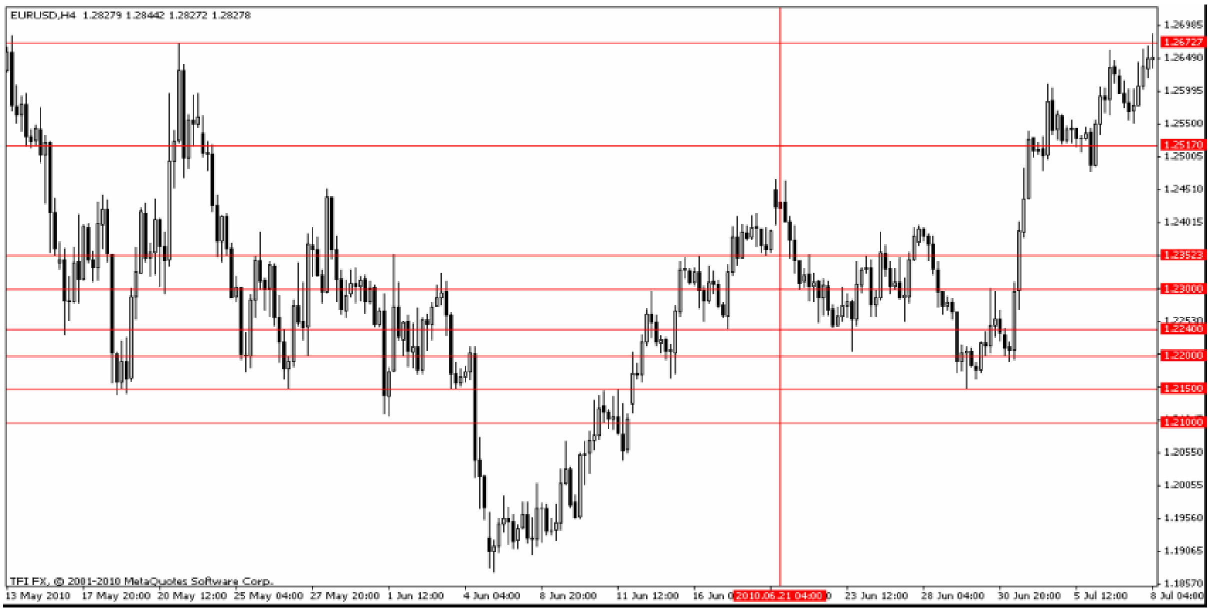
Our experience has shown that is better to avoid modifying our stop loss but rather let the position hit the stop loss and wait for a better entry point from a better price. New entry points will be right before the next support or resistance followed with the same take profit targets and a new Stop loss slightly above the resistance or slightly below the support.

If your position then follows your view as you predicted, then your profit will exceed the initial profit target since it will cover the loss you sustained and add the distance from the old stop loss to the new opening price. The alternative would have been to simply keep your position with a modified Stop loss that would only give you the initial target.

Finally and importantly re-opening your position should of course only take place if your initial belief about the future direction has still not changed. If that view has changed given the new price movement then you should not re-enter the market and you should accept that your initial plan was wrong. In other words, if you have a plan built on rules which have not been proven wrong then stick to it and let your position hit a stop loss, reopening at a better price will always give more profits even with the loss of the previous position included.

If your plan was proven wrong then sticking to your initial Stop loss will once again be the best case scenario. Stop Losses are not always losses; they are new opportunities for more profits or less loss.

Below is a detailed example of how one could utilise this information based on the graph of the EURUSD from the 21st of June 2010



An example that incorporates all strategies explained above can be seen in this graph of the EURUSD 4 hour chart from the 21st of June 2010onwards. At that point a trader should have established that a new uptrend is at play and only a fall below the validated support of 1.2150 or 1.2100 can challenge this. Once again we stress that is very important to go with the trend. Strong supports and resistances lie almost every fifty points each visible by a red support line on the graph.

The supports are at 1.2352, 1.2300, 1.2240, 1.2200, 1.2150 and the ultimate stop loss is at 1.2100. Each of these supports can be used as buy limits just 10-15 points above with respective stop loss orders of just 15-25 points below the supports. The take profit target should be at the previous low of 1.2517 or the high of 1.2673.

An initial buy limit could be set at 1.2365, just 12 points above the 1.2352 support with an additional buy limit at 1.2310 and a stop of 1.2280. The stop loss in this case will eventually take us out sustaining a loss of 85 points on the first position and another 30 on the second.

Another buy limit can then be set at 1.2250 and 1.2210 with a stop at 1.2180. While this position will show some profits, it will eventually as seen in the graph, return and hit a stop loss once again with a new loss of 70 and 30 points. We are now up to a total of 215 points loss since our initial trade.

Since the market price is still above our ultimate 1.2150 – 1.2100 trend changing support, then we still set more buy limits at each remaining support. At this point we are left with a buy limit at 1.2160 and another at 1.2115 with a stop at 1.2085. After two failed positions, we now end up with an open position that covers both our targets and ends up covering all the losses and yields more profit to each position every time. In other words we have reached a profit of a minimum of 330 points if our target was 1.2490.

Adding some more analysis, our target would only be 1.2490 in the case where a correction of the advance was not seen and thus an overbought scenario would linger resulting in shorter take profit targets such as the 1.2490. If the price falls close to the ultimate stop loss level though, we would be able to target larger levels since the trend is now in perfect condition to continue higher. Our new take profit target therefore would be the 1.2650 target, just 20 points lower than the previous strong resistance at 1.2673. The profit at this point would sum up to 490 points.

Also very important in our strategy is to have a positive risk/reward ratio. In both scenarios the risk/reward ratio is 1:1.03 for the 1.2490 target and 1:1.53 with a target of 1.2673. The choice of keeping the initial position of 1.2365 with a stop loss of 1.2135 would in the end prove profitable with125 points of profit for the 1.2490 target and 308 points for the 1.2673 target. The risk/reward ratio on the other hand would have yielded larger risks with a ratio of 1:0.54 for the first target and 1:1.34 for the second. To sum up both the total profits and risks would be more beneficial for the trader if he did not keep one open position with one large stop loss.

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