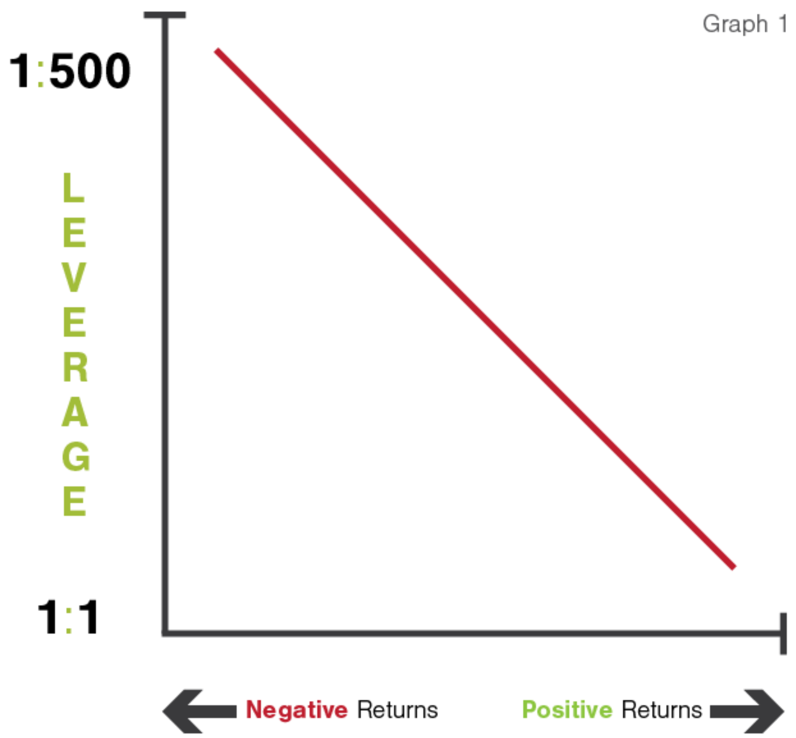
The best Friends and single worst
Enemy in FX Trading

The most common question we get from new traders entering the forex market is how can they become profitable in these very volatile and a lot of times unpredictable markets? My answer is that when it comes to trading, there is no absolute certainty; however what they should try and focus is the long term performance of their accounts. Trying to make a fortune in forex trading in a couple of weeks or months utilizing high levels of leverage is a recipe for disaster and it's almost certain that it will end up with zero equity in the account. In fact being profitable in the long term is much easier than a lot of disappointed traders think, but in order to get into a profitable mode they have to first accept and follow some simple rules.

1. Excessive leverage is your worst enemy

The introduction of forex trading to retail clients in the last decade, has taken the concept of leverage (or margin) to a new level. Unfortunately this new level is not good for the clients. In order to protect the retail clients the US authorities have already moved and limit the leverage on retail accounts to 50:1-which we think, is still too high! Based on our 11 year experience we have identified a clear inverse relationship between leverage and individual account performance. That is, the higher the utilized leverage, the less is the average return (graph 1).



This relationship does not guarantee that if someone uses 1:1 leverage will be certainly profitable, but most importantly it demonstrates that at offerings above 1:100 there is an almost certainty of negative returns. It also shows that at lesser levels of leverage (we strongly suggest 1:20 to our clients) you have much more chances of being profitable. And the reason why this relationship is so strong is in fact simple. And its not because of volatility. The forex traders that complain about volatility should take a look at equity markets. The major currency pairs average daily movement is 1 % per day, whereas in other financial markets average daily movements of 5-10% are not a big surprise. What in fact amplifies the daily currency volatility is the excessive leverage. No trader and no system in the world can always get it right and we all get losing trades. Sometimes it happens because something unexpected comes out or because we simply have a wrong idea.

This is a fact in a traders life and the soonest a trader accepts it, the better are his chances of being profitable in the long run. At leverage of 1:500, a potential small wrong call of a mere 0.2% will wipe out the whole account equity in the blink of an eye. Think about it…

2. And your best FRIENDS are:

Once you got the ugly enemy out of the way, it's good to know that there are some good friends that you can use to guide you into a profitable long term performance. Through our experience we have seen and tried a lot of different complex strategies, techniques, fundamental and technical analysis. What we propose here though, is some simple rules of thumb to apply in your forex trading.

F	—	**Follow the Trend**
R	—	**Rationale**
I	—	**Identify market opportunities**
E	—	**Experience**
N	—	**News**
D	—	**Discipline**
S	—	**Stop loss**

Follow the Trend

Well whatever contrarian traders say, the trend remains our best friend. Being trend followers for a long time, we have tested this theory thoroughly and found that, other things being equal, following the trend will produce positive results. The trick here is being able to identify a trend or a reversal of a trend. Technical analysis is very clear and simple in defining a trend (2 consecutive higher/lower highs/lows) and trend reversal patterns (head and shoulders, double/triple tops/ bottoms etc.), while some important moving averages are also quite helpful. Keep in mind that trying to identify reversals before they happen can get very painful and most of the times will result in a considerable loss of equity.

Rationale

There should always be a reason why you decide to go long or short. Whether this is for a fundamental or a technical (we prefer using both) consideration, it is good enough as long as there is a reason. Many times traders are entering a position because of boredom or just to feel the excitement of being long or short. This is also a recipe for disaster! You should always buy or sell any pair on a reason that makes sense to you.

You should remember that what creates trends, reversals or ranges is an underlying story and focus on news on that story that are going to enforce the story or change it. For example in 2010 we had 3 major stories. First was the Greek debt crisis which took EURUSD from 1.5100 down to 1.1900, then QE2 took EURUSD back up to 1.4300 and lately the Irish crisis that has crashed the pair back to 1.2900 in less than a month. Try to avoid trading if you don’t have a view on the market.

Identify market opportunities

Market opportunities are there almost every day and being able to identify those opportunities can yield very good returns. Once again we stress that markets most of the times follow a major story. Whether that is a major crisis, more QE or expected increases/decreases in interest rates it does not really matter as long as you know where to concentrate. However, you should also realize that markets never move in a straight line and corrections can happen any time. These corrections happen either because of market positioning (overbought or oversold) or because news of lesser importance come out and cause an opposite movement in the underlying trend. Being able to identify those market occurrences and trade on them should be very profitable in the long term.

Experience

Most of the new traders entering the market are eager to prove themselves in the short term. They have the illusion that they can become profitable and make a fortune in the next month, but soon enough they end up with a bad psychology which at the end accelerates their losing pattern. Because forex is by its nature a very dynamic market, building on your experience and learning from your mistakes and success is crucial.

Experience will help you identify market opportunities and learn how to react to unexpected market movements before is too late. Experience will teach you to view the market in probabilities and realize that when it comes to trading there is no absolute certainty. Experience will help you handle your trading emotions and learn that a situation is never black or white but is more or less grey. Through experience you will learn to focus on the long term and avoid extreme mental states such as euphoria, anger and disappointment that can be very detrimental on your trading performance.

News

We always advise our clients to gain a basic understanding of the Forex market and what influences the prices of different currency pairs before they start trading. Market news is a major influence along with technical analysis. Therefore, it is very important to keep track of the market news as well as upcoming news that can influence the prices ahead of the actual data release. Checking the weekly calendar of upcoming events and the market expectations is very helpful. Also choosing a provider that has a good and reliable news package will definitely help in enhancing your trading performance. Try to focus on the main market story and developments that affect that story.

Discipline

The most successful forex traders I know are persons recognized for their humility and discipline. In order to acquire the necessary discipline one should devise a trading plan or strategy and stick to it. This plan should be very specific on what instruments you trade, why you buy or sell, what is your trading objective (rationale), when and how often you trade and what is your stop loss. Most importantly your trading plan should include a good money management policy. To do that, you need to determine how much equity you have to fund your account and then determine how much risk you are willing to take on each trade. A very common mistake among inexperienced traders is that they take their profits early while letting their losses run in the hope that the market will come back. To avoid this, your risk/reward ratio (percentage of average profit per trade compared to your average loss per trade) should ideally always be positive. Lastly, discipline requires having an adequate record of your past trading and results in order to recognize past mistakes or deviations from your plan and avoid them in the future.

Stop loss

How can losing money be your friend? As awkward as it sounds, the stop loss is probably your best friend in forex trading. Nobody likes losing money, but losing $5,000 is much better than losing $10,000. Actually one of the biggest advantages of the forex market is that you can have an almost guaranteed stop loss.

To define your stop loss policy we propose a more educated approach. In fact this is the professional approach that we use in our treasury. First your stop loss levels should be a function of your net equity and NOT of your open position. You should then start from the long term and move towards more short term periods i.e. stop loss for the year, for the month and for the day.

For example, someone that starts trading with $50,000 equity should first decide what is the worst case scenario willing to accept for his yearly trading performance. If we suppose that he can accept losing 30%, then it’s easy to define the monthly and daily stop losses as well. Following on that example, a 30%, 10%, 3% yearly, monthly, daily stop loss will result in a $15,000, $5,000, $1,500 acceptable loss for the respective periods. Once you have defined your stop loss levels THEN your open position should be a function of your stop loss.

This is very important and it is again a common mistake among new traders.

Most new traders think of their stop loss as a function of their open position (ex. they are willing to lose 100 pips on each trade). This is wrong and you should avoid it. Instead you should adjust your open position accordingly, based on your daily/monthly/yearly stop loss levels. All those levels should be strictly followed in order to attain a long term profitable performance. Moreover, placing your stop loss at the time you open a trade is essential, in that it will help you create discipline and learn that sometimes you will be wrong.

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