PROFITING WITH FOREX:
BONUS REPORT

BIG PROFITS COME FROM LETTING YOUR WINNERS RUN

S. Wade Hansen

Two axioms pervade the investing world—"The trend is your friend," and "Cut your losers short, and let your winners run." And the way I see it, axioms become axioms for a reason so why not follow them? Take some of the stress out of your investing life by betting on the trend while preparing for the turnaround.

The Forex market—because of the global forces that drive it—often trends for extended periods of time. In the years I have been trading the forex market, I have never seen an extended period of time when there weren't at least five or six currency pairs breaking out into major trends. As I discuss in ***Profiting with Forex***, macro-economic forces such as interest rates, oil prices, and the growth of economies like that in China, have the ability to move currency prices for sustained periods of time.

One of the best examples of this during the past five years is the movement of the GBP/JPY pair. This pair has been climbing steadily higher since the turn of the century thanks to the interest-rate discrepancy in the two countries. The Bank of England has kept interest rates in the United Kingdom relatively high during the past half century while the Bank of Japan is just now starting to raise interest rates in Japan from lows of almost zero percent. Because investors have recognized they could borrow money in Japan with virtually no interest-rate burden and invest that money in the United Kingdom for a decent return, many have been selling Japanese yen and buying British pounds. This has caused the GBP/JPY to rise more than 4,500 pips—from 170.00 to 215.00—during the past five years.

Source: Prophet.Net

To put this in perspective, if you had bought one lot of the GBP/JPY at 170.00 in September 2001 and had sold it at 215.00 in mid-July 2006 at a standard leverage rate of 100:1, you would have turned a $1,000 initial margin deposit into approximately $40,500 (assuming a $9 profit per pip). That's not a bad return for a five-year investment.

Of course, you probably would have made multiple trades during that time period, but the concept of trading with the trend to take advantage of large moves is an easy one to appreciate. The key is figuring out how you can profit from large trends like this one on the GBP/JPY without overextending yourself.

THE CONCEPT

I'm going to show you a simple trading system you can implement in just a few minutes every day that will enable you to take advantage of the trends that frequent the forex market. This system I am going to show you provides concise, cut-and-dry entry signals. However, there is some wiggle room on the exits. Let me tell you why.

Every investor I have ever talked to has always talked about the illusive, black-box trading system that will always make you money—the Holy Grail of investing. It tells you when to get in. It tells you when to get out. It tells you how many lots to buy. It will make you rich.

Now, as nice as that all sounds, it simply doesn't exist so you can stop beating your head against your keyboard trying to figure it out. What so many forget when they are trying to put together a trading system is that the market will always be changing, and you still need to leave some room for adjustment. By all means, put together a trading system to tell you when to buy and when to sell, but leave yourself some room to make a few judgment calls. You will be much better off if you do.

There are, of course, investors who will tell you that you aren't really system trading if you are actually using your brain in the middle of a trade, but I say you are. If you have your entries and your exits systematized and leave yourself the option to make an adjustment on that one trade out of ten that just doesn't play out like all of the others, you are trading a system—a dynamic system.

Let me tell you a story of a system I was trading in which I had not given myself permission to make adjustments if they were needed. I received a buy signal on the AUD/JPY pair on 15 November 2005, and I entered the trade at 86.60. I set a profit target according to my system that was 475 pips away, at 91.35, and I sat back and watched the trade unfold. Everything was working out beautifully. The price moved up steadily throughout November, and then took off on the last day of November to bring the price up to 89.50. Just three days later, on 6 December 2005, I was watching the price approach my exit point at 91.35 only to see it come within 3 pips and turn back around and close the day at 90.98.

Source: Prophet.Net

"No problem," I thought. "I'll give it another day or two, and it will certainly climb back up and hit my exit point." Well, as you probably guessed, the price did not turn back around and eventually hit my exit point. Instead, the AUD/JPY retraced its entire bullish rally within a week and a half, dropped past the price at which I had entered the trade, and ended up hitting my stop loss at 86.10.

Source: Prophet.Net

Why did I give up nearly 475 pips on this trade that came within 3 pips of hitting my exit point, you ask? Because I was following my system, and my system hadn't told me to exit the trade. By blindly following a system that told me to stay in a trade that my good senses had told me to get out of on 14 December 2005 when the price dropped to 88.58 and again on 15 December 2005 when the price dropped to 86.94, I not only lost the potential to make a huge profit on a trade that had moved more than 450 pips in my favor but also lost money on the trade as the price dropped to my stop loss.

Source: Prophet.Net

This stinging loss made me reevaluate what I was doing as an investor, and I decided to never fly without a parachute again. That is, I was never going to trade again where I didn't give myself the opportunity to adjust my stop loss.

My stop loss is the dynamic center of my trading strategies. When I talk about leaving yourself room for adjustment, I'm not talking about swapping out the indicators you use to determine you entry and exit signals or adjusting the time periods you use on your indicators in the middle of a trade. Rather, I believe you should give yourself the option to move your stop loss level to protect your profits, or at least break even, when you see your trade floundering. Doing so will allow you to salvage potentially disastrous trades and ride out more comfortably those trades that may be slightly volatile but end up working out in the end.

So with all of that, let's take a look at a dynamic system you can implement today that will give you the flexibility you need to successfully invest in the forex market.

THE STRATEGY

The tools you will need to follow the trend while cutting your losers short and letting your winners run are a simple moving average, a MACD (moving average convergence divergence), and a stop loss. With these three tools, you have everything you need to start making successful, trend-following trades.

Here are the buy and sell entry signals:

Buy Entry Signal—When the MACD crosses up above its zero signal line, if the moving average is also moving higher, or is at least flat, you have a buy entry signal.

Sell Entry Signal—When the MACD crosses down below its zero signal line, if the moving average is also moving lower, or is at least flat, you have a sell entry signal.

Source: Prophet.Net

Here are the buy and sell exit signals:

Buy Exit Signal—If you are short the currency pair, when the MACD crosses back up above its zero signal line or if you hit your price-based stop loss, you have a buy exit signal.

Sell Exit Signal—If you are long the currency pair, when the MACD crosses back down below its zero signal line or if you hit your price-based stop loss, you have a sell exit signal.

The simple moving average should be a short-term moving average that will give you the responsiveness you need to the quick direction changes that are so common in the forex market. I'm going to recommend you begin with a five-period moving average. As I will be discussing this strategy using daily time periods, using a five-period moving average will give you the average of the past week's price movement.

The MACD should also be based on a shorter-term time frame to correspond with your moving average. You should start with an 8-17-9 period MACD. While this calculation of the MACD will still be lagging the price movement of the currency pairs you are analyzing, it will keep you from recklessly jumping in and out of trades. I've found that most investors who are losing money find they are trading too frequently. Rarely is it the other way around.

Lastly, your stop loss will actually be a dual stop loss. Your stop loss can either be activated by the price of the currency pair hitting a certain price level or by the MACD reversing its previous signal by crossing back over the zero signal line. The reason I use this dual stop-loss system is to protect me from the large adverse price movements that are always a risk when trading and to make sure I get out before I give back too many profits when a move is over.

Setting a price-specific stop loss helps me ensure that if the price of the currency pair does suddenly reverse its direction, I don't have to wait until the lagging MACD catches up with it before I cut my losses. For example, if I had sold the USD/CAD at 1.1486 after receiving a sell signal on 24 February 2006 using this system, I would have exited the trade at a small loss at 1.1497 if I had waited for the MACD to cross back up above its signal line on 7 March 2006. If I would have set a price-specific stop loss and moved it down to 1.1407 (the opening price on 27 February 2006) to protect some of my profits after I saw the price close higher and the MACD begin to bottom out on 2 March 2006, however, I would have made a 79 pip profit on the trade.

Source: Prophet.Net

Similarly, having an indicator-based stop loss along with my price-based stop loss prevents me from giving back too many profits on those trades that slowly begin to reverse direction. In early December 2005, the USD/JPY was coming off a nice uptrend and was beginning to consolidate. As it did so, the MACD began to move back down and crossed back below its signal line on 8 December 2005. This would have caused me to exit at 120.33 after having gotten into this trade at 120.63 on 1 December 2005. Because of the relatively flat movement of the currency pair during the previous four days, I probably wouldn't have moved my price-based stop loss up from 119.66 (the low of 30 November 2005), and this indicator-based stop loss would have saved me some money by cutting my losses short.

Source: Prophet.Net

So that's the strategy. It's really quite simple, and that's the way it should be. Trading strategies should be simple. Try not to over-complicate things in your trading.

Some of you may be tempted to add more indicators or requirements to the system. Avoid that impulse. Adding too many indicators to a system actually weakens the effectiveness of the system because the indicators end up fighting with each other. This is called "indicator piling," and it is a trap many fall in to. The rationale that leads investors to pile on additional indicators goes something like this: "If waiting for confirmation from one indicator is good, then waiting for confirmation from two indicators is even better because the price movement has to meet two sets of criteria, not just one. And if waiting for confirmation from two indicators is good, then waiting for confirmation from three indicators must be even better." And so on, and so on.

Unfortunately what "indicators pilers" don't realize is that the trading signals that were confirmed by all three, four, or five indicators would have been confirmed by only one of those indicators while the trading signals they missed because they were only confirmed by one indicator would have most likely been profitable.

To illustrate why simplicity leads to profitability, let's take a look at how you could put my strategy into action.

STRATEGY IN ACTION

I'm going to illustrate this strategy using the past four months on the EUR/USD pair, the indicator settings I mentioned above, and a beginning stop loss of 100 pips. I figure this is a relatively conservative stop-loss number considering the EUR/USD regularly moves 100 pips on any given day.

The first buy entry signal came on 18 April 2006 at 5 pm Eastern (the end of the daily trading period that began on 17 April 2006), and you would have entered at 1.2348. You would have set your initial stop loss at 1.2248—100 pips below your entry signal.

The next two days saw the price of the EUR/USD pair drop to a low of 1.2265, but it never dropped low enough to take you out of the trade. After that initial scare, the currency pair took off, and you didn't receive a sell exit signal until the MACD crossed back below its zero signal line on 16 May 2006. You would have exited at a price of 1.2858 for a profit of 510 pips (1.2858 – 1.2348 = 0.0510 or 510 pips).

Source: Prophet.Net

The next signal was another buy entry signal that came on 29 June 2006. You would have entered at 1.2664 and would have set your price-based stop loss 100 pips below at 1.2564.

Your sell exit signal came two weeks later as the MACD dropped back down below its zero signal line on 13 June 2006. You would have gotten out of the trade at 1.2689 for a 25 pip profit (1.2689 – 1.2664 = 0.0029 or 25 pips).

Source: Prophet.Net

This same sell exit signal that took you out of your previous long trade also doubles as a sell entry signal to get you into your next trade. So as you were exiting the previous trade at 1.2689, you would have been entering a new trade at that same price. Once again you would use a 100-pip stop loss, but this time you would be placing the stop loss above your entry level because you are short the contract. So you would place your stop loss at 1.2789.

As you watch the price action play out, you can see that the price never did reach your price-based stop loss before the MACD crossed back up above the zero signal line giving you your buy exit signal. So you would have exited the trade at 1.2718 on 26 July 2006 for a 29 pip loss (1.2689 – 1.2718 = 0.0029 or 29 pips).

Source: Prophet.Net

All in all, using this system on the EUR/USD pair for the past four months would have netted you 506 pips in profit.

Trade #1: 510-pip profit
Trade #2: 25-pip profit
Trade #3: 29-pip loss

Total Gain: 506 pips

CONCLUSION

In wrapping this up, I want to draw your attention to a few points.

First, you will notice that there wasn't a sell entry signal when the MACD crossed down below its zero signal line in mid-May. That is because the moving average was moving higher at the time the MACD crossed down below. To have a valid signal, both indicators need to be moving in the same direction.

Second, for this article, I left the price-based stop loss levels at their original levels for ease of illustration. You could have moved those price levels higher to trail the price movement of the currency pair if you wanted to. In fact, keeping a tighter stop loss throughout may have given you a larger profit on both the second and third trades. However, it may have also taken you out early from the first trade. So be careful when you're adjusting your stops not to place them too close.

Lastly, the three trades I illustrated are a great example of how this system lets your winners run while cutting off your losers. When you entered the first trade, there was no way to know the currency pair was about to take off on a 500-pip move. There is never a fool-proof way to tell. But I did give myself the chance to take advantage of it if it did take off. The second and third trades also had the potential to take off on major runs, but neither one did, and I ended up getting out of both before I lost too much money. In fact, I even made a small amount on the second trade.

The trick is being in the game when the big moves come and getting out when things aren't going your way. If you can successfully do that, you are on your way to making a lot of money in the forex market.