

The Trade Manual II

Practical Trading

“Simple Rules”

Trader-X

Foreword

In this book I am going to attempt to show you how simple it can be to trade what you see and not what you think. The key was really in part one, which, if you have completed you will know the key is in our heads. Trading systems make up very little of what it takes to become a profitable trader. This is what I look for in the markets.

TRADING PATTERNS AND TECHNICAL INDICATORS

For experienced equities and futures traders, the good news is that nearly everything you already know about technical analysis can be applied to the forex market. Forex charts contain familiar patterns like the head and Shoulders double tops and double bottoms, and symmetrical and asymmetrical triangles.

Forex traders use moving averages, Bollinger bands, moving average convergence/divergence (MACD)—all of the same indicators that equity and futures traders use. There are breakouts and pullbacks, retracements and consolidations, ranges and trends. For example, this shows a pattern that is familiar to traders who use technical analysis—a double top formation in the euro/USD (euro/U.S. dollar) currency pair.





4.2 A massive head-and-shoulders formation in the USD/JPY currency pair.

Experienced traders of stocks and commodities will see many familiar formations and patterns in the charts of currency pairs. For example, take a look at the massive head-and-shoulders pattern that formed over a three-year period in the USD/JPY (U.S. dollar/Japanese yen) currency pair.

Forex traders use support and resistance levels to determine the best location for entry and stop orders, just like equity and futures traders. In Figure 4.3, the USD/CAD (U.S. dollar/Canadian dollar) currency pair finds support repeatedly at the 1.2000 level. Traders who are familiar with candlestick charting patterns will note the series of hammers, dojis, spinning tops and other reversal candles at the support level.

Strategies involving trend lines and channels are also popular in the forex markets. For example, in the daily chart of the USD/CHF (U.S.dollar/Swiss franc) currency pair, we can see two distinct and separate channels, one moving higher and one moving lower. Note that when the first channel fails, the uptrend dissolves into a double top, which is then followed by a downtrend (see Figure 4.4).



FIGURE 4.3 USD/CAD finds support repeatedly near the vicinity of 1.2000.

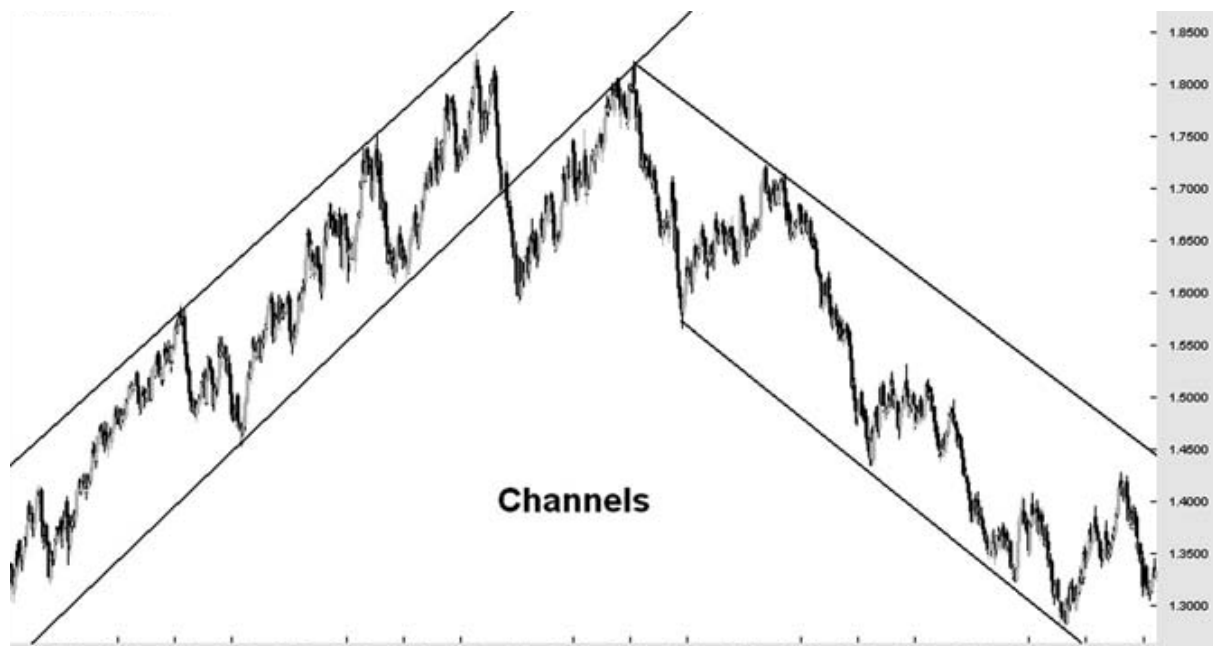


FIGURE 4.4 Two distinct channels form in the USD/CHF currency pair.



FIGURE 4.5 A massive cup-and-handle formation in the AUD/USD pair.

It's important to remember that underlying fundamentals create the technical picture we see when we look at a chart. When we trade forex, we are not trading companies, but entire economies. The fundamentals of an individual country's economy change much more slowly than the fundamentals of an individual company. If the stock of an individual company is weak, there are a variety of actions that can be taken. For example, we can replace the CEO, restructure the company, add new members to the board of directors, and so on, and turn the company around quickly. Turning around the fortunes of an entire country is a much more complicated and time-consuming process. For this reason, the repetition of the technical patterns we seek is much more likely to occur on the chart of a currency pair than on a stock chart. It's also the reason why trends tend to continue for months and even years in the forex market.

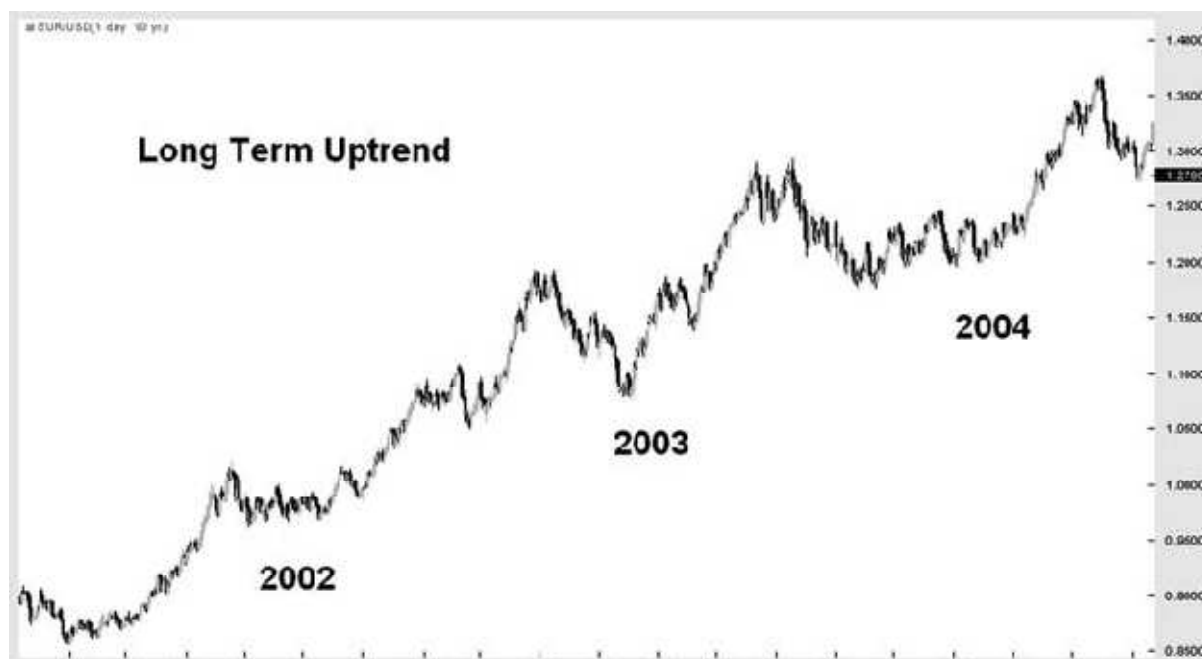


FIGURE 4.6 A long-term uptrend in the EUR/USD currency pair.

TRENDS

Currency pairs have a tendency to form strong, persistent trends. The forex market is famous for these trends, and they are the main reason why trend following traders are drawn to this market.

For example, the euro trended consistently higher against the U.S. dollar over a three-year period. This uptrend occurred during a period of U.S. economic weakness (see Figure 4.6).

FIBONACCI TECHNIQUES

No overview of forex technical analysis would be complete without a discussion of Fibonacci techniques. As you may know, Fibonacci was a famous Italian mathematician, who is credited with several major innovations, including the discovery of a numeric sequence that is found throughout all of nature. Fibonacci ratios are found in everything from architecture to music to geometry. They can be seen in the number of petals growing on a flower, or the manner in which leaves grow on a tree.

The Fibonacci ratio of 61.8 percent, along with its inversion of 38.2 percent ($100 - 61.8 = 38.2$) and the point halfway between 61.8 and 38.2 (50 percent) are considered important support and resistance levels. Traders who use Fibonacci believe that after a significant directional move, the exchange rate will retrace in an amount equal to a Fibonacci ratio, most commonly 38.2 percent, 50 percent, or 61.8 percent. While this type of technique is less popular in equities and commodities trading, it is part of the forex culture and is widely used by banks, institutional traders, and hedge funds, as well as individual currency traders. Because of its wide acceptance in forex trading, Fibonacci techniques create a kind of self-fulfilling prophecy.

In Figure 4.8, the USD/CAD currency pair is locked in a steep downtrend. The pair then rises until it encounters resistance at the 38.2 percent retracement of the downtrend.



FIGURE 4.8 USD/CAD downtrend retraces 38.2 percent to Fibonacci resistance, then falls.



FIGURE 4.9 GBP/USD uptrend retraces 38.2 percent to Fibonacci support, and then bounces.

Is this a coincidence? Please understand that I am a sceptic by nature, but the fact is, since I began trading forex and using Fibonacci, I've found it to be uncannily accurate for predicting major support and resistance levels in currency pairs.

Here's another example: The GBP/USD (Great Britain pound/U.S. dollar) currency pair climbs 2,000 pips before reaching its peak. The pair then retraces exactly 38.2 percent before encountering support, and then bounces higher by more than 400 pips over the next three sessions (see Figure 4.9).

THE “TRIPLE THREAT” TRADER

In the world of forex, the trader who masters technical analysis and trading strategies can locate profitable entry and exit points. The individual who masters fundamental analysis can anticipate turning points in the markets when economies shift. The trader who understands solid risk management can protect and defend the account against loss in any trading environment. The trader who masters all three—technical analysis, fundamental analysis, and risk management—is truly a “triple threat” trader.

It’s my sincere wish to help you become the best trader that you possibly can. You can accomplish this by mastering the three most important aspects of trading. First, learn real techniques, in detail, that can be used to successfully trade this market. That is the purpose of this book. Learn to identify the current market situation, apply the appropriate trading strategies, and adapt to changes in the market.

Then, learn all that you can about the fundamental aspects of forex. Do not be intimidated by fundamental analysis! A solid understanding of fundamentals is often what separates the good traders from the great ones. The third ingredient is risk management, which is the one element that all successful traders share. Good risk management will keep you out of trouble and allow you to survive the tough times and gain valuable experience.

GAINING EXPERIENCE

Which driver is more likely to get into an accident—an experienced driver who has “seen it all” or a teenager who isn’t quite sure which pedal is the accelerator and which is the brake?

Of course, the answer is the latter. A new driver is an accident waiting to happen, while an experienced driver can anticipate problems before they occur. In driving and in trading, there is no substitute for experience.

A good trading education can teach you many things, but it can’t give you experience. Luckily, anyone can gain experience trading the forex market without risking hard-earned money, by using a practice or “demo” account. Most forex market makers offer these accounts, which often include real-time charts, price quotes, and news feeds. I wish we’d them back when I got started! In the “old days,” traders had to learn—and make mistakes—with real money. One of the offices where I worked had an early version of a practice account called a “trading simulator,” but it wasn’t comparable to the demo programs that are available today.

Demo trading is a great way for potential forex traders to familiarize themselves with this market. I highly recommend that every trader use a demo account for *at least* several months before making an attempt at live trading. If you are already trading with real money, don’t be afraid to revert to a demo account if you hit a rough patch.

“Mini” accounts are also available, so that forex neophytes can place live trades with minimal risk. These mini accounts can be opened with as little as a few hundred dollars, creating one of the lowest barriers to entry for any trading market. Trade a demo account successfully for at least several months before advancing to a mini account. Successful trading is not the same as luck; if you turn a profit in the demo, but incur excessive risk in the process, that would not be sufficient to graduate to live trading. Once you’ve gained experience, traded successfully, and entered your “comfort zone,” try opening a mini account. If you can trade successfully in the mini account for several months, without taking outsized risks, you might consider opening a full-sized account.

Don’t rush this process; if you’re uncomfortable at any point along the way, you’re not ready to graduate to the next step. Take your time; the market will still be there when you’re ready. Remember, until you gain sufficient experience, you’re just like that kid behind the wheel of his dad’s car—an accident waiting to happen.

WHICH PAIR TO TRADE?

When you first begin to trade forex, you should start with just one currency pair. The best way to begin is with a pair that has a narrow spread, such as the EUR/USD pair. The spread is the difference between the buy price and the sell price for the currency pair. The spread is a formidable opponent, and pairs that have wide spreads are suited only to long-term trading. Once you have overcome the spread, you have reached the “break-even” point of the trade. This is easier to achieve when the spread is narrow.

Start with EUR/USD (in a demo account, of course), and when you feel comfortable with the way the pair moves, then branch out and try GBP/USD. You’ll find that this pair trades in a similar fashion to EUR/USD, but with greater volatility. Some traders enjoy this added volatility, while others can’t stand it.

Since no two traders are exactly alike, it's up to you to decide which pair's suit your personal style. Any time that you are testing a new currency pair or trading technique, be sure to do so in a demo account. Figuring out which currency pairs are the best for your personality is part of the learning process of becoming a forex trader. Once you grow used to the movements in these two pairs, give USD/JPY and USD/CAD a try. You'll see that these two currency pairs move in a completely different manner from EUR/USD and GBP/USD. The Japanese yen pairs have their own "personalities" and are more likely to find support/resistance at round numbers. If you enjoy trading the USD/JPY currency pair, try EUR/JPY. This pair is similar to USD/JPY, but the moves tend to be quicker, with greater volatility.

COMMODITY CURRENCIES

Next, see if USD/CAD is a pair that you enjoy trading. This has been one of my favourites because of its persistent long-term trend. The relationship between this currency pair and the price of oil is strong, as the Canadian dollar often gains ground as energy prices rise, and falls when energy prices weaken. Currencies that share a strong relationship with the price of a commodity, such as oil, are called "commodity currencies" (see Figure 5.1).



FIGURE 5.1 This wicked intraday reversal on the five-minute chart of USD/CAD coincided with the weekly release of the U.S. Department of Energy's inventory report. The report ignited volatility in the price of oil, which was reflected in the USD/CAD pair.



FIGURE 5.2 On the weekly chart, the CAD/JPY pair rallies and then consolidates along with the price of oil in 2005–2006.

If you want to trade a currency pair that has an even stronger relationship to the price of oil, then try Canadian dollar/Japanese yen (CAD/JPY). Canada and Japan are at opposite ends of the spectrum regarding the production and consumption of oil, and this is reflected in the CAD/JPY exchange rate (see Figure 5.2).

Canada is a major producer and exporter of oil, so the Canadian dollar benefits from higher energy costs. This is in sharp contrast with Japan, which imports nearly all of the oil it consumes. Because of this, the yen is hit hard by rising energy prices. Another pair that enjoys a strong relationship with a commodity is AUD/USD. The Australian dollar often rises and falls along with the price of gold. This correlation can be extremely valuable to currency traders, who frequently see situations where the price of gold appears to lead the Australian dollar (see Figure 5.3).



FIGURE 5.3 AUD/USD rallies along with the price of gold in the spring of 2006. After reaching a near simultaneous peak, both gold and AUD/USD pull back in tandem.

If this works for your style of trading, that's fine, but consider that not every currency pair is always setting up for a good trade. Every pair goes through phases when it has a clear direction and is relatively easy to trade, and other times when trading that pair is considerably more difficult. When you consider this fact, it really doesn't make sense to limit yourself to one pair.

Trading Strategies for Trending Markets

This market is a force of nature. It forms massive, powerful trends that can continue on for years. It creates patterns that are as persistent as waves crashing on a beach. How do currency traders use these trends and patterns to make money in the forex market?



TRADING CONDITIONS

There are three basic types of trading conditions:

1. *Trending* currency pairs have a definite direction (Figure 6.1).
2. *Range-bound* currency pairs bounce between support and resistance levels (Figure 6.2).
3. *Consolidating* currency pairs are trapped in a narrow, tightening area (Figure 6.3).



FIGURE 6.1 EUR/USD currency pair in a downtrend on the daily chart.



FIGURE 6.2 AUD/CAD is trapped in a range on an intraday chart.



FIGURE 6.3 USD/JPY consolidates into an ascending triangle on the daily chart

Traders must approach each situation with the proper technique. Trending techniques are inappropriate during range-bound or consolidating markets, and range-bound styles will not work during trending or consolidation periods. Here is the one thing that you must realize: *markets change*. A currency pair that is trending now will eventually begin trading in a range or move into a consolidation phase. Traders have to be nimble and adapt to this changing environment by using the right strategy at the right time.

THE IMPORTANCE OF MAINTAINING OBJECTIVITY

When you first begin using new trading techniques, you may be fortunate enough to experience success right from the start. Perhaps you just happened to use the right technique at the right time, and you were blessed with immediate gratification. Some new traders even become euphoric, because they feel that they have “mastered the market.” The unfortunate side effect of this initial success is that the trader then might continue to use that same trading technique, even when the market has clearly changed and the technique is no longer appropriate. Traders refer to this situation as “falling in love” with a technique, and the effects can be devastating.



FIGURE 6.4 USD/CHF in a downtrend, 2002–2003.

If this should happen to you, I would encourage you to try to remain objective and realize that while short-term success is not uncommon, it is not the ultimate goal. Anyone can get lucky, but luck does not always last. For example, during the years 2002 and 2003, the U.S. dollar was falling hard against most major currencies. This created a fairly easy trading environment, as trend-following techniques worked extremely well during this time (see Figure 6.4). Many of my students at the time were new traders who had no previous exposure to trend-following techniques. Almost immediately these “newbie’s” racked up huge gains by applying trend-following techniques at the appropriate time, during a trending market.

While I was happy to see my students doing well, I was concerned that they now had developed unrealistic expectations about the forex market and about trading in general. “It’s not always going to be this easy,” I told them. “Learn other techniques so that when the market changes, you’ll be ready.” Some listened, and some did not.

Sure enough, in early 2004 the U.S. dollar regained its footing, and the trend began to unravel (see Figure 6.5). Traders who realized that the trend wouldn’t last forever were prepared for this change, and adjusted their tactics accordingly. Unfortunately, others had “fallen in love” with trending techniques, and continued to use them even though the situation had changed. Their results suffered as the market conditions changed. As a trader, you don’t have the luxury of falling in love with a technique, or an indicator, or a currency pair. Understand that markets are not static, and it is up to the trader to identify and adapt to these changes.



FIGURE 6.5 During the year 2004, the USD/CHF pair ceased trending. Note the consolidation triangle on the right of the chart

BEGIN WITH A TENDENCY

Almost every good trading strategy has at its heart a market tendency. If we observe markets for long enough, we begin to notice these tendencies; for example, the forex market tends to form long, strong trends.

Another example would be a market's tendency to find support or resistance at large round numbers, which is a psychological tendency that can occur in any trading market (see Figure 6.6). Yet another example would be the tendency for a strong breakout to occur immediately following a tight consolidation (see Figure 6.7). Any of these tendencies could be used as the basis from which to create a strategy.

A true tendency will be backed by reason; for example, round number support and resistance occur because people often locate their entries, stops, and exits right at round numbers. Why do people behave in this manner?

The fact is, not every trader consults a chart before placing a trade, and some traders have very general ideas about where they wish to place their orders. These traders often place entry, exit, and stop orders at round numbers, and their orders congregate at these levels. Because of this, round numbers often coincide with key support and resistance levels in the equity and futures markets, as well as in the forex markets.

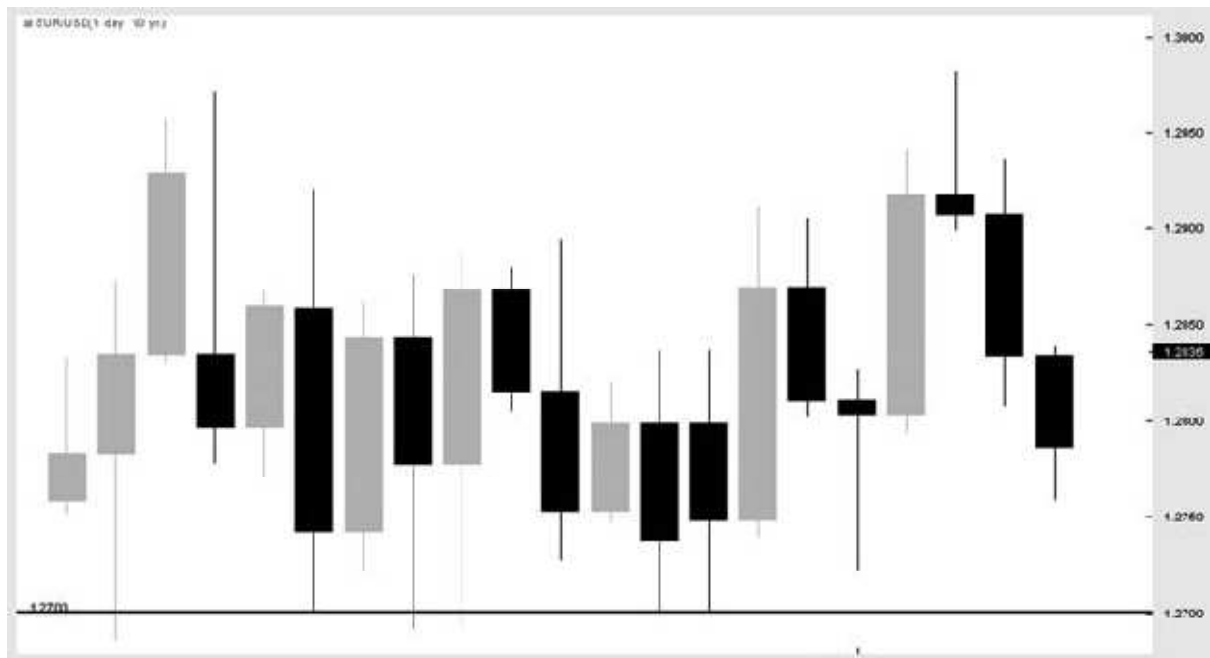


FIGURE 6.6 EUR/USD finds support repeatedly at the round number 1.2700.



FIGURE 6.7 GBP/USD rockets out of a tight consolidation during the spring of 2006.

PUTTING THE TREND TO WORK

Let's take a look at an example of how traders can use trends to their advantage. Consider that when a market is trending, it has chosen a clear direction. We want to assume that this trend will continue, because history tells us that in the forex market, trends can last for years. If we can get on the "right side" of the trend (long in an uptrend, or short in a downtrend), we might have an opportunity to enjoy a substantial gain. You may have heard the phrase, "Let your winners run." This is good trading advice, as many of us have a tendency to get out of our winning trades too soon and hold on to our losing trades for too long.

It's much easier (and more profitable) to allow your winning trades to run in a trending market, because the exchange rate has a clear direction. As long as the currency pair is moving in that direction, our protective stop is less likely to be triggered. Contrast this with a sideways or range-bound currency pair. Since this pair has no real direction, the price has a tendency to "come back" toward the entry point. This makes it more difficult for traders to hold on to their positions, and forces them to be nimble regarding exits. Sideways markets are tradable too, but this situation calls for different techniques than when the market is trending.

SELF-FULFILLING PROPHECY

Not all trends are created equal. The best trends are the ones that jump right off of the chart—one glance and you can see it and identify it immediately. Like many aspects of technical analysis, trends that are obvious tend to work well because many traders can see and identify them. If enough traders then place orders that reflect their belief that the currency pair is trending, this provides additional fuel for the trend.

This is an example of the "self-fulfilling prophecy," a prediction that, in being made, actually causes itself to become true. In other words, if traders believe that a currency pair is in an uptrend, many of them will go long in an attempt to take advantage of the trend. The resulting buying pressure drives the pair higher, reinforcing the trend. The self-fulfilling prophecy is a recurring theme in technical analysis and in forex trading.

HOW TO DETERMINE IF THE MARKET IS TRENDING

There are several common techniques used to determine if a trend is in effect. One popular method involves the use of moving averages and is often referred to as the *proper order* of moving averages, which was discussed in an earlier chapter. Another way to determine if a currency pair is trending is by using the average directional index (ADX) indicator. The ADX indicator, created by the prolific J. Welles Wilder, indicates the strength of the trend without regard to the direction of the trend (upward or downward). High readings indicate strong trends; for example, the ADX indicator's giving a reading above 35 and rising would be an indication of a strongly trending market (see Figure 6.8).

Yet another way to determine if the market is trending is through the use of trend lines. A trend line is simply a line that is drawn beneath an uptrend, or above a downtrend, and indicates the general direction of a currency pair (see Figure 6.9). Be careful when it comes to using trend lines to determine exact points of support and resistance, because they are subjective in nature.



FIGURE 6.8 ADX indicator gives a reading above 35 and rising, indicating a strong trend.



FIGURE 6.9 Trend line indicates EUR/JPY is in a persistent uptrend, summer of 2006.

Perhaps you have heard the saying, “The trend is your friend.” This is one of the oldest sayings on Wall Street, and there is good reason for its popularity. Trading with the trend is one of the most profitable and time-honoured methods used to trade any market, but it is particularly effective when trading the forex market. This is because the forex market has a tendency to form strong trends that can last for weeks, months, or even years. Why are forex trends so much stronger and longer lasting than trends in other markets? Consider the differences between trends in the equity market versus trends in the forex market.

In the equity market, if a stock is performing poorly, there is a certain set of actions that can be taken to remedy the situation. For example, the company can be restructured, or the chief executive officer can be replaced.

These actions can cause a rapid change in the fundamental outlook of the company, which will sooner or later be reflected in the price of the stock. This process can happen quickly, sometimes in just a couple of months.

Forex Multiple Time Frame Strategy

Keep in mind what we talked about earlier strategy development:

Every strategy begins with a tendency. One of the most dependable features of the forex market is its tendency to form trends in a variety of time frames. Forex trends can continue for weeks, months, or even years, and traders who align themselves with these trends improve their chances of success. Let's look at some specific techniques to capitalize on this well-known forex market tendency. Frequently when we trade, we may look at currency pair's chart and receive contradictory signals from various indicators. Which signals should we follow, and which ones should we ignore? When we are in doubt, it's helpful to look at the big picture, by moving to a longer time frame. Let's assume for our example that we are placing trades based on the hourly chart:

First, look to the longer-term chart, which is the daily chart in this example, to see if the currency pair is trending. There are several ways to do this; simply draw a trend line, or use an indicator that is designed to determine market trend. For instance, the average directional index (ADX) indicator could be used to determine if the market is trending. Or we could look to moving averages to determine if they're in the "proper order" formation. Often, the trend will be obvious without the use of any trend lines or indicators. The best trends are the ones that are obvious, because other traders can see the trend and act on it, creating a "self-fulfilling prophecy." If the currency pair is trending higher, trade from the long side only. If it is trending lower, trade from the short side only. If there is no discernible trend, then don't attempt to place a trade using this technique, as it is specifically designed for use in trending markets. First, we'll determine the direction in which we want to trade from the long-term chart; then, we'll look to the short-term chart to locate our entry point, stop, and exits. If we have determined that we are in an uptrend on the daily chart, we can go long if the price falls to a level of support on the hourly chart. Or we can go long if an oscillator, such as relative strength index (RSI), indicates that the pair is oversold on the hourly chart. Enter long with your stop below the area of support. In the case of a downtrend on the daily chart, we will seek to sell at resistance on the hourly chart, or if oscillators indicate that the pair is overbought on the hourly chart. Remember, if the daily chart is in an uptrend, we can only go long. If the daily chart is in a downtrend, we can only sell short. If we cannot tell if the market is trending, then we cannot use trending techniques such as this one. As you will see, there are many variations on this theme. Essentially, I'm going to use everything at my disposal to locate good entry points and put my trade in harmony with the daily trend.

WHY DOES IT WORK?

This system allows us to trade only in the direction of the overall trend, and it requires that trades can be placed only after the price has pulled back to a favourable entry point. In other words, it will not allow the trader to enter

long at the highs or enter short at the lows. The technique can also be used in shorter time frames; for example, an active day trader can use a four-hour chart as the longer-term chart and a 15-minute chart as the shorter-term chart. Take a look at this long-term trend in the U.S. dollar/Canadian dollar currency pair in Figure 8.1. As you can see, the exchange rate had been falling steadily for years, from above 1.60 in 2002 to below 1.10 in 2006. During these years, the prices of commodities like gold and oil made spectacular gains. Canada, a major producer and exporter of energy products and metals, benefited from the increasing flow of capital that it received in payment for these goods. This is why the loonie is often referred to as a "commodity currency."



FIGURE 8.7 RSI dips from overbought to neutral, creating a short entry.

THE ENTRY SIGNAL

As the exchange rate slides and the RSI descends from overbought levels, we prepare to enter our short trade. When the exchange rate drops, we enter short in the vicinity of 1.1225, the point at which the RSI is no longer giving an overbought reading (see Figure 8.7).

PLACING THE STOP

We must immediately enter a stop order to protect against any adverse movement. We have several options for doing this, and the first option will be to place the stop above the recent high of 1.1245. What is the rationale for locating the stop at this point? Consider the possibility that, after our entry, the exchange rate could rally further. Do we really want to hold on to this currency pair if it changes direction and reaches a new, higher high? No, if the pair trades above 1.1245, we don't want to hold on to it, as it could be breaking out to the upside. So, we'll place our stop in a location that will take us out of the trade if a new high is reached.

Don't forget that we also have the Fibonacci resistance point at 1.1250. Since this might give our stop added security, we want our stop to be located above 1.1250. This also satisfies our requirement that the stop should be located above the recent high of 1.1245. If we place the stop at 1.1260, the stop will be located above the recent high *and* above the Fibonacci level, giving our trade additional protection (see Figure 8.8).

The entry point of 1.1225, along with the stop at 1.1260, creates risk of 35 pips per lot. If this is an unacceptable degree of risk, the trade cannot be placed.



FIGURE 8.8 The stop is placed above the recent high and above the 38.2 percent Fibonacci retracement

GETTING OUT

Next, we'll need to locate our exit points in order to take profit. I usually don't exit my trades all at once; instead, I like to exit my trades in portions. So, if I have entered two lots, I'll close 50 percent of the trade at each exit. If I've entered three lots, I'll exit 33 percent per exit, and so on. The number of lots entered is a function of risk management, as we'll see when we progress further. In this trade we will sell short three lots, so we'll need three exits to close the trade. We'll create our first exit by measuring the risk of the trade, which we have already determined to be 35 pips per lot. If our trade reaches the point at which we are profitable by the amount of pips that are risked (per lot), we can then exit a portion of the trade. We need the exchange rate to fall to 1.1190 in order to generate a 35-pip profit, so 1.1190 will be our first exit point (see Figure 8.9).



FIGURE 8.9 The initial exit of 1.1190 represents a 1:1 risk-reward ratio.



FIGURE 8.10 Prior support at the round number of 1.1100 can be used as a secondary exit.

Next, we'll look for areas of prior support (meaning areas that the exchange rate had difficulty penetrating on earlier attempts, due to buyers stepping in at those levels). Looking back, we can see that the price bounced repeatedly from 1.1100, which is also a round number (round numbers often act as support or resistance). Let's use 1.1100 for our second exit (see Figure 8.10).



FIGURE 8.11 Prior support at 1.0975, a multidecade low at that time.

WELCOME TO THE REAL WORLD

Let's take a closer look at those last two exits and think about how they can be improved. When we are trading in the real world, does the exchange rate always fall to the exact level of support, or are markets slightly more random than this? If you've been trading in the real world, you know that the exchange rate or price rarely falls repeatedly to the exact same level of support or consistently rises to an exact level of resistance. Sometimes the price falls below the anticipated support level, and sometimes it doesn't quite make it all the way down. This is why we say that support and resistance are "areas," not exact price points, and we need to use "soft targets" instead of assuming markets will perform to precise expectations.

TWEAKING THE EXITS

When we consider the true nature of trading and acknowledge that there is a certain degree of randomness to any trading market, it becomes necessary to adjust our exits. Instead of expecting the exchange rate to cooperate and reach the “bottom” of support at exactly 1.1100, let’s tweak this exit to improve our chances of success. According to the daily chart, major resistance is located at 1.1250, based on the 38.2 percent Fibonacci retracement that we discussed earlier. Since a support level is located at 1.1100, this would constitute a 150-pip range from support to resistance ($1.1250 - 1.1100 = 150$). Let’s raise our exit by an amount equivalent to 10% of that range, which would be 15 pips (10% of 150 pips). This pushes our second exit higher, from 1.1100 to 1.1115. (see Figure 8.12).



FIGURE 8.12 The second exit of 1.1100 is raised to 1.1115.

This has the dual effect of placing our exit in a location where it is more likely to be reached, above the very bottom of support, and it also allows us to exit ahead of the round number of 1.1100. Round numbers often act as psychological support or resistance levels, because orders tend to accumulate at these points. There is still the matter of our final exit, currently located at 1.0975. If we apply the same technique to improving this exit, we would first measure the distance from support to resistance, which is approximately 275 pips ($1.1250 - 1.0975 = 275$).

Ten percent of 275 is equal to 27.5 pips (we’ll round it up to 28), so let’s raise this exit by 28 pips, to 1.1003. Again, this will raise the exit to an area that is more likely to be reached, since it’s in the middle of the support area instead of at the very bottom of support. It also raises our stop above a huge psychological support level, the round number of 1.1000 (see Figure 8.13).

Because the first exit at 1.1190 is not based on support or resistance, but instead is a function of the amount of risk taken on the trade, this exit will remain unchanged.



FIGURE 8.13 Third exit is raised above round number support of 1.1000.

EXECUTING THE PLAN

If the exchange rate moves in our favour and reaches 1.1190, we'll exit a portion of the trade (in this case one lot, or one-third of the trade) and lower our stop to the entry point. In other words, when the exchange rate reaches

1.1190, the plan is to cover one lot and move the stop on the remaining two lots to 1.1225.

This will have the dual effect of locking in a small profit and eliminating the remaining risk from the trade.

Remember, amateurs are concerned with how much they can make, while professionals are concerned with how much they can lose. Let's trade like professionals and keep risk at the forefront of our concerns.

Once our stop has been lowered to the break-even point, our worst-case scenario consists of a 35-pip gain on the first lot and breaking even on the second and third lot. Now we have assured ourselves of at least a small gain, with the possibility of additional gains, all while having eliminated the risk (see Figure 8.14)



FIGURE 8.14 The first exit is reached; take a partial profit and lower the stop to 1.1225

SECOND-GUESSING

At this point, it would not be unusual if the exchange rate were to rise and reach our stop, leaving the trader with a small gain. If this were to happen, would it mean that something had been done incorrectly or that this was a “bad trade”? What if the price rises, takes out the stop, and then begins falling? Does that mean that there is something wrong with this technique? These thoughts are a type of second-guessing that is natural when things don’t go exactly according to plan. When confronted with these thoughts, it’s important to learn to trust our trading plan and refrain from this type of behaviour.

We can’t control the outcome of any individual trade, and markets do not always cooperate as we wish they would. It is possible to execute a plan perfectly and still lose money on a trade. However, if we create good plans and execute them properly on a consistent basis, we will be miles ahead of most traders.

BRINGING IT HOME

Fortunately, in this case, the massive downtrend kicks in, and a sharp move lower ensues. Now the exchange rate has reached our second exit, and it’s time to cover another lot, this time at 1.1115. We’ll “celebrate” by lowering

our stop again, from its current location of 1.1225 to the former location of the first exit, at 1.1190 (see Figure 8.15).

Since we are more concerned with losses than gains, we will once again consider our worst-case scenario. We have now locked in a profit of 35 pips on the first lot and 110 pips on the second lot. At worst, the exchange rate will rise to 1.1190, taking us out of our third lot for a 35-pip profit. Not bad for a worst-case scenario! After drifting sideways for a while, the trading gods smile upon us as the exchange rate finally dives to reach our last exit point at 1.1003 (see Figure 8.16). The trade concludes with a profit of 35 pips on the first lot, a profit of 110 pips on the second lot, and a profit of 222 pips on the third lot. Good things happen when we trade with the trend!



FIGURE 8.15 The second exit is reached; the stop is lowered to the former location of the first exit, 1.1190.



FIGURE 8.16 The USD/CAD exchange rate plummets to the third exit

WHEN TO STAY OUT

Since the pair is rising up from support, should we enter a long trade and try to profit from a possible bounce? The answer is no. If you recall, the original plan was to trade only in the direction of the trend and to reject trades that go against the trend.



FIGURE 8.17 USD/CAD bounces up from 1.0975, a major support area.

The Ultimate Indicator

People often ask, what is the best indicator to use in forex trading? Is it the relative strength index (RSI), or exponential moving averages (EMAs), or perhaps Bollinger bands? Or is it something more esoteric? New indicators are being created every day, as market technicians attempt to leave their mark on the trading world. What is the ultimate forex indicator?

Well, there is one indicator that stands above the rest, and that indicator is the price. The price has been and always will be the ultimate indicator. Most indicators are simply an equation or formula that is applied to the price.

THE PRICE IS THE KEY

A moving average is a good example, as it consists of the average, or mean, price of a trading vehicle over a designated period of time. Oscillators such as stochastic or RSI (see Figure 10.1) measure the difference between the current price and recent prices, to determine if a currency pair (or stock, or commodity) is overbought or oversold. Eventually, every indicator boils down to the price.

Technically speaking, in the forex market we do not have a price per se. Instead, we have an exchange rate, which allows us to compare two currencies in one equation. Many times throughout the course of this book, you will notice references to the “price.” In currency trading, the word *price* is

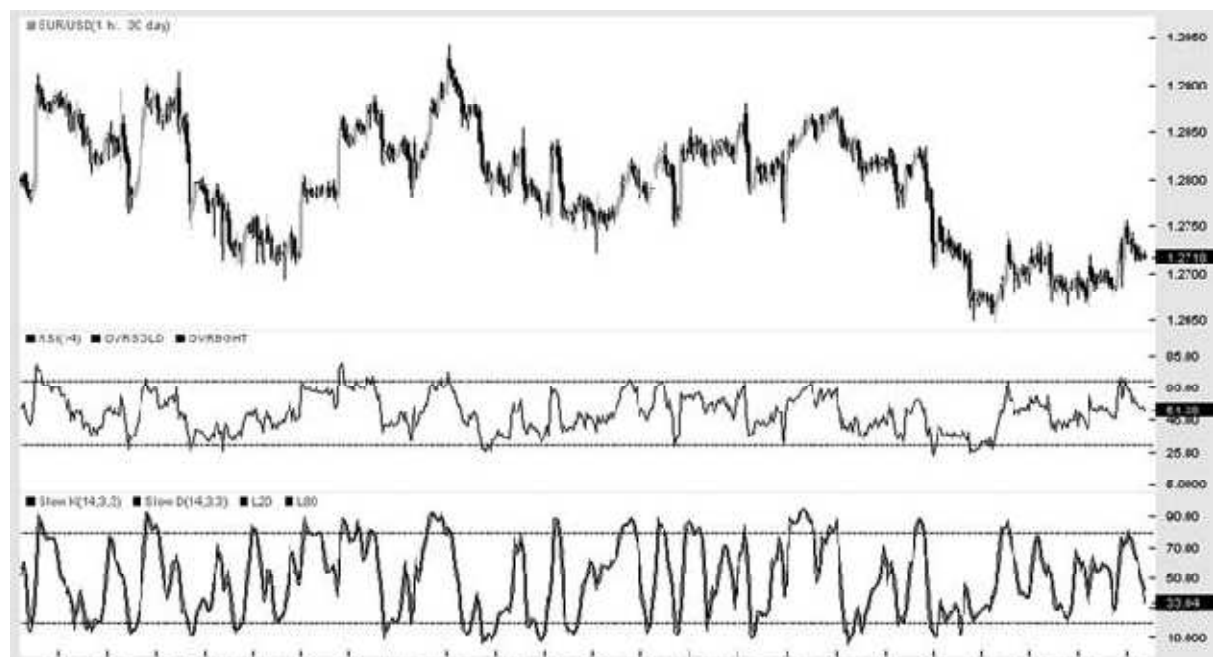


FIGURE 10.1 Oscillators such as RSI and stochastic measure the difference between current and recent prices.

simply slang for “exchange rate.” This is especially true for those of us who formerly traded stocks, and are in the habit of referring to the numbers that we see on the chart as the “price.” When buyers repeatedly step in at a particular price, this is referred to as support. Think of support as the floor beneath you. If you drop a rubber ball to the floor, it bounces back up to you. The price bounces up from support in a similar fashion. When sellers repeatedly step in at a particular price, this is referred to as resistance. Think of resistance as the ceiling above you. If you throw a ball at the ceiling, it then falls back down to you. The price falls from resistance in a likewise manner.

Why is this information valuable? Unlike most indicators, support and resistance levels tell us where the buyers and sellers have set up camp. Remember, many of the large players, the hedge funds and the money-centre banks, do not enter trades in the same manner that individual traders do. While many individual traders enter and exit positions all at once, institutional traders usually enter and exit positions gradually. This is necessary

due to the large size of the orders being placed. Big traders are concerned that their orders might move the market, by creating too much buying or selling pressure at one time. In the case of a large buyer, this can drive the exchange rate higher, making additional purchases more expensive. So, instead of chasing the price higher, the institutional trader waits for the price to come back to the desired entry point, and then increases the size of the position. The result is a currency pair that bounces back up when it falls to a particular price level (see Figure 10.2).

Conversely, a large seller can inadvertently smash the exchange rate lower, creating an inferior price at which to continue selling. For this reason, the institutional traders will sell at a particular level, wait for the price to rise back up to that level, and then resume selling. The result is a currency pair that tends to stop rising when it reaches a particular price level (see Figure 10.3).

As individual traders, we can use this phenomenon to our advantage. We can enter long trades at the levels where the big traders are buying, and we can sell short at levels where the big traders are selling. We can also exit long trades at points where there is evidence of institutional selling, and exit short trades at points where there is evidence of institutional buying. It's important that we think of support and resistance as *areas*. In a perfect world, the exchange rate would always rise and fall to the same exact price points, over and over again. The world of trading is far from perfect, and prices rarely rise and fall to the exact same spot.

In the real world, the exchange rate will often overshoot or undershoot the mark (see Figure 10.4). That's why traders using support and resistance should use a "soft target." For example, instead of referring to support as "1.2847," we would consider this to mean that there is support in the area of 1.2850. This is a much more realistic approach to trading support and resistance levels.



FIGURE 10.2 Support is tested repeatedly in the USD/CAD pair.

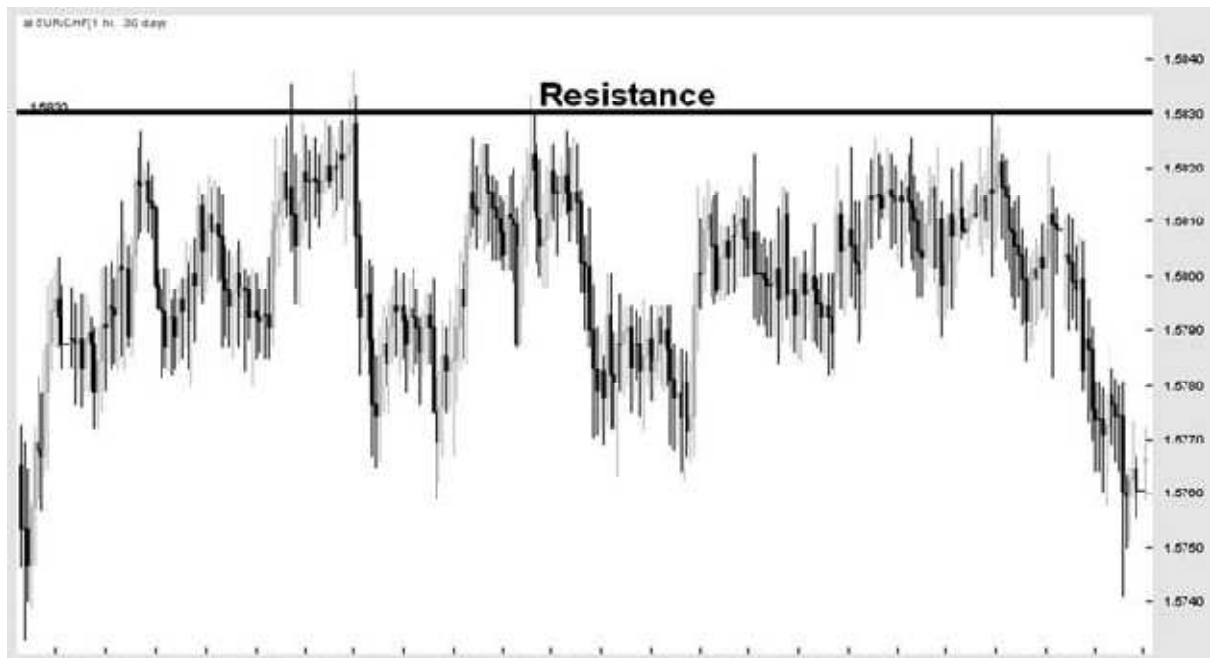


FIGURE 10.3 Resistance forms in the EUR/CHF currency pair.



FIGURE 10.4 The EUR/USD exchange rate overshoots and undershoots resistance.

WHY SUPPORT BECOMES RESISTANCE

If support and resistance held forever, then trading would be easy indeed. We could simply enter and exit as the price ping-pongs up and down between support and resistance levels. Of course, the idea that trading could be so simple is wishful thinking. Let's consider the process that occurs when support breaks. Imagine that a support level exists that has withstood numerous tests; in other words, the exchange rate has repeatedly fallen to a price area, only to bounce back up every time. The reason why the price bounces back is that buyers are stepping in at that level on repeated occasions. These buyers could be institutional traders, individual traders, or a combination of the two.

Every time that these traders have entered long positions at the support level, the market has rewarded them; we could say that they've been conditioned by the market to enter at the area of support. One day, the level is tested again, and traders either initiate or add to their long positions. Only this time the price breaks through, and now traders who entered long at support find that their positions are "under water." Many of these traders will

be taken out of their positions by protective stops, which are generally located beneath support for those who are entering long in the area of support. However, since we know that not all traders use stops, some of these individuals will now begin to experience some serious anxiety.

There is a wonderful thing that we can do as we analyze any trading situation: We can try to understand how the situation feels to those who are directly involved. Perhaps at some point in the past, before learning the importance of risk management, we may have been ensnared in a similar predicament as the current market participants described above.

THE PLEASURE PRINCIPLE AND TRADING

You may be familiar with the *pleasure principle*, a psychoanalytical term coined by Gustav Theodor Fechner, a predecessor of Sigmund Freud. Quite simply, the pleasure principle drives one to seek pleasure and to avoid pain. If you can understand this simple concept, and apply it to how you think about trading, it will allow you to understand the reactions of other traders in the market (and you thought Psych 101 was a waste of time!).

The reason for considering the emotions of those involved in the trade is this: Although time passes and traders may come and go, human nature remains essentially unchanged. Fear and greed have always ruled the markets, and they probably always will. Now imagine how it must feel for those traders who are holding on to their losing positions after support breaks; what are their predominant emotions? Fear and anxiety immediately come to mind. If these traders are not using good risk management, they are afraid of what might happen next (and they should be afraid!). They are afraid that they may have a big losing trade on their hands, and they are hoping and wishing for the exchange rate to rise.

If the price then rises up near to the entry point (the former support level), many of these traders are going to bail out of their losing trades, so that they can experience a different emotion—a feeling of relief. These traders have but one wish—to get out at or near the breakeven point. Always remember, if at any point during a trade you find yourself hoping or wishing instead of following a predetermined course of action, you should close the trade and re-evaluate your trading method. If enough selling occurs as the price nears the former support level, the exchange rate will reverse and begin to fall. Now, the former area of support has become an area of resistance (see Figure 10.5). The reverse is also true—a former area of resistance, now broken, can become an area of support for the same reasons (see Figure 10.6).



FIGURE 10.5 Former support becomes resistance in the NZD/USD currency pair.



FIGURE 10.6 Former resistance becomes support in the USD/CAD currency pair.

PRICE ACTION

Traders are not only concerned with the ability (or lack thereof) of the price to break through support or resistance, but are also concerned with the behaviour of the price when it reaches these key levels. They want to know not only *if* support or resistance is holding, but also *how* it is holding. For example, did the price make a half-hearted attempt at breaching support, and then drift away, or did it fail repeatedly in its persistent attempts to break out to the other side? How is the price moving? Is it rushing headlong toward support or resistance, indicating a strong commitment on the part of traders? Or is it meandering aimlessly, as if traders were afraid of encountering a key level?

The “attitude” of the price at key support and resistance levels can betray the next directional move. I never want to enter a trade based on support or resistance unless I can first observe the price action. For example, if a pair repeatedly fails after numerous attempts to breach resistance, it reveals the presence of a large seller in the vicinity.

Keys to Intraday Breakouts

When trading intraday breakouts, or when engaging in any type of trading, for that matter, it is important for the trader to use every type of advantage possible. We want to search for situations in which the odds are in our favour, and then take action. In all forms of trading, no matter if the vehicle is in the equity, futures, or forex market, there are many instances of false breakouts. A false breakout occurs when the price appears to break below support or above resistance, only to rise back above support or fall back below resistance. In order to reduce the negative effects of these false breakouts, and to improve our chances of success, let's take a closer look at intraday breakouts and how to trade them.

ASCENDING AND DESCENDING TRIANGLES

Ascending and descending triangles create excellent intraday breakout opportunities, because the pattern itself establishes a directional bias for the currency pair. An ascending triangle is formed by a combination of diagonal support and horizontal resistance (Figure 11.1), while a descending triangle is formed by a combination of diagonal resistance and horizontal support (Figure 11.2).

In the case of an ascending triangle, the bulls are gaining strength and buying at higher and higher levels, while the bears are merely trying to defend an established level of resistance. Since the bulls are more aggressive than the bears, they are more likely to prevail in this battle. The odds favour a breakout to the upside. In the case of a descending triangle, the bears are gaining strength and selling at lower and lower levels, while the bulls are merely trying to defend an established level of support. The bears are the more aggressive party in this case, so the odds favour a breakout to the downside.



FIGURE 11.1 Ascending triangle forms in the NZD/USD currency pair.



FIGURE 11.2 Descending triangle forms in the EUR/GBP currency pair.

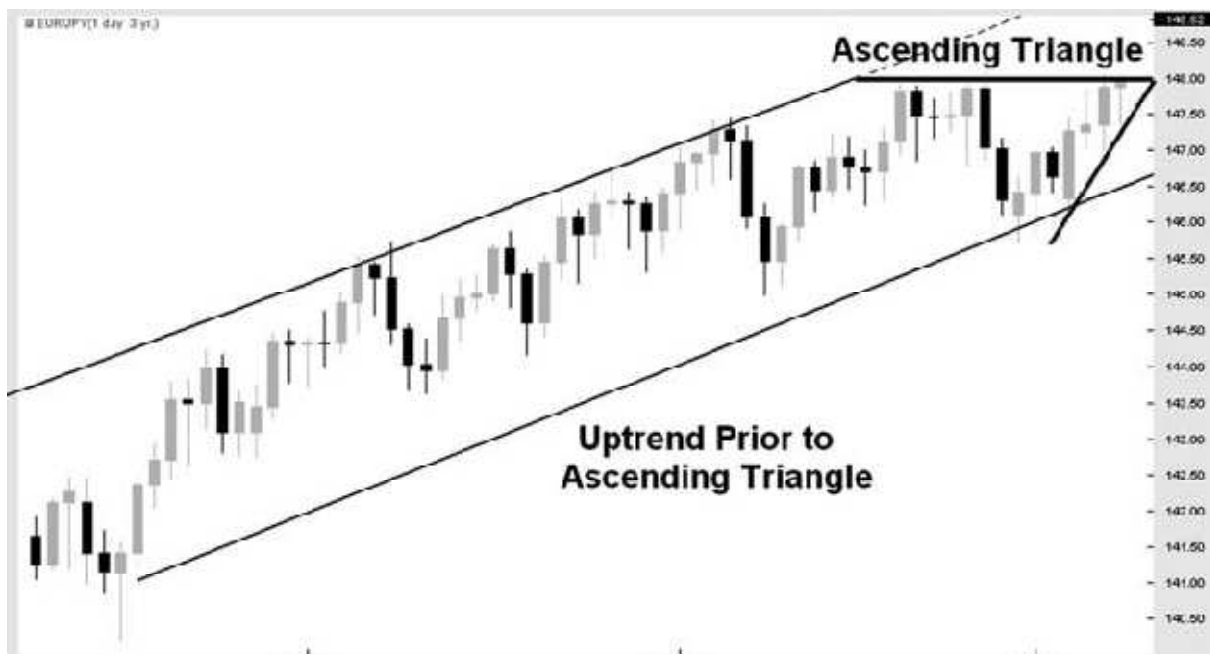


FIGURE 11.4 Prior to the formation of the ascending triangle, the pair was in an uptrend.

SUMMARY

There are steps that we can take to alleviate the problem of false breakouts. By using triangles, the prior direction of the trend, and the time of day, we can improve our chances of success and avoid being “suckered” into a false breakout. These are just a few of the subtle nuances that traders can use to gain an edge.

Flags and Pennants

Imagine that you must climb 10 flights of stairs as quickly as possible. You dash up the first five flights of stairs, and then stop to catch your breath. After this short pause, you resume bounding up the staircase toward the tenth floor. Are we preparing for the Olympics or a triathlon? No, this type of behaviour actually relates to a trading phenomenon. It's not unusual for the exchange rate of a currency pair to race higher, then pause, and then continue to climb. Similarly, we often see the price fall rapidly, then consolidate, and then continue its descent. This period of "rest" is called a consolidation. We say that a currency pair (or stock, or commodity) consolidates its gains (or losses) before moving on. A consolidation that indicates that the exchange rate will resume moving in its previous direction is called a continuation pattern. Flags and pennants are short-term continuation patterns; after the formation of one of these patterns, the exchange rate has a tendency to continue moving in the same direction as it was prior to the consolidation.

These patterns are generally found on short-term or intraday charts. In the case of a flag or a pennant, the initial move is a sudden, sharp directional thrust. It doesn't matter if the move is an advance or a decline, what matters is the velocity of the move. This sharp burst creates a long candle or a series of long candles on our short-term chart, and is referred to as a *flagpole*. If the movement is not sharp or sudden, the reliability of the pattern is called into question. The sharp movement, either higher or lower, is what gives the formation its meaning.

PENNANTS

Figure 12.1 shows an example of a pennant formation in the euro/U.S. dollar currency pair. A sharp thrust higher creates the flagpole, and then the exchange rate begins to consolidate into a symmetrical triangle. This is the pause before the potential breakout. As the price clears the top of the pennant, the signal for a long entry is given. Let's take a look at the specific details of this formation and a technique for using it to place winning trades. Pennants involve two parts: a nearly vertical flagpole and a triangular consolidation. The consolidation is very much like a symmetrical triangle, but shorter in duration. The symmetrical triangle implies that traders feel comfortable with the current exchange rate. However, the pennant is a continuation pattern, meaning that any sense of comfort or a "truce" between the bulls and the bears is likely to be short lived. The first step to trading the formation is to measure the flagpole (see Figure 12.2). In this case, the flagpole is a single long candle, and has a range of 100 pips from low to high (the low of the candle is 1.2727, the high is 1.2827).

Next, as the exchange rate consolidates into a triangle, we'll determine the entry point for our prospective trade. In order to do this, we'll calculate an amount equal to 10 percent of the height of the flagpole. In this case, 10 percent would be equal to 10 pips (the height of the flagpole = 100 pips; 10 percent of 100 pips = 10 pips).

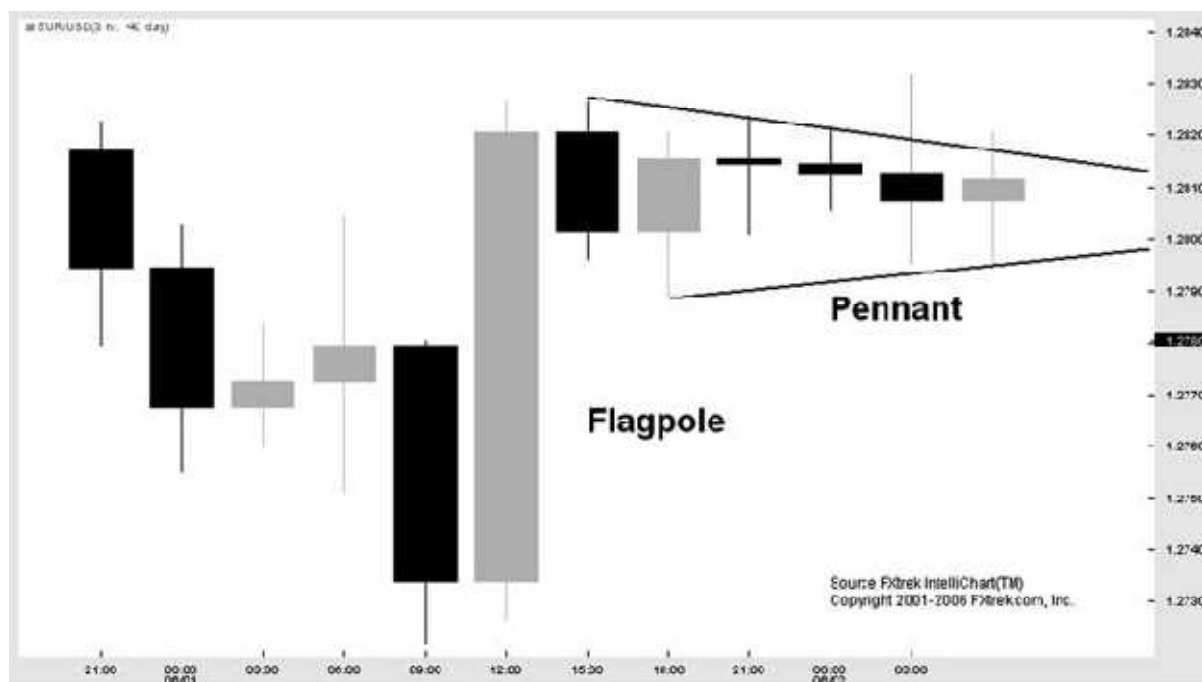


FIGURE 12.1 A pennant formation in the EUR/USD currency pair.

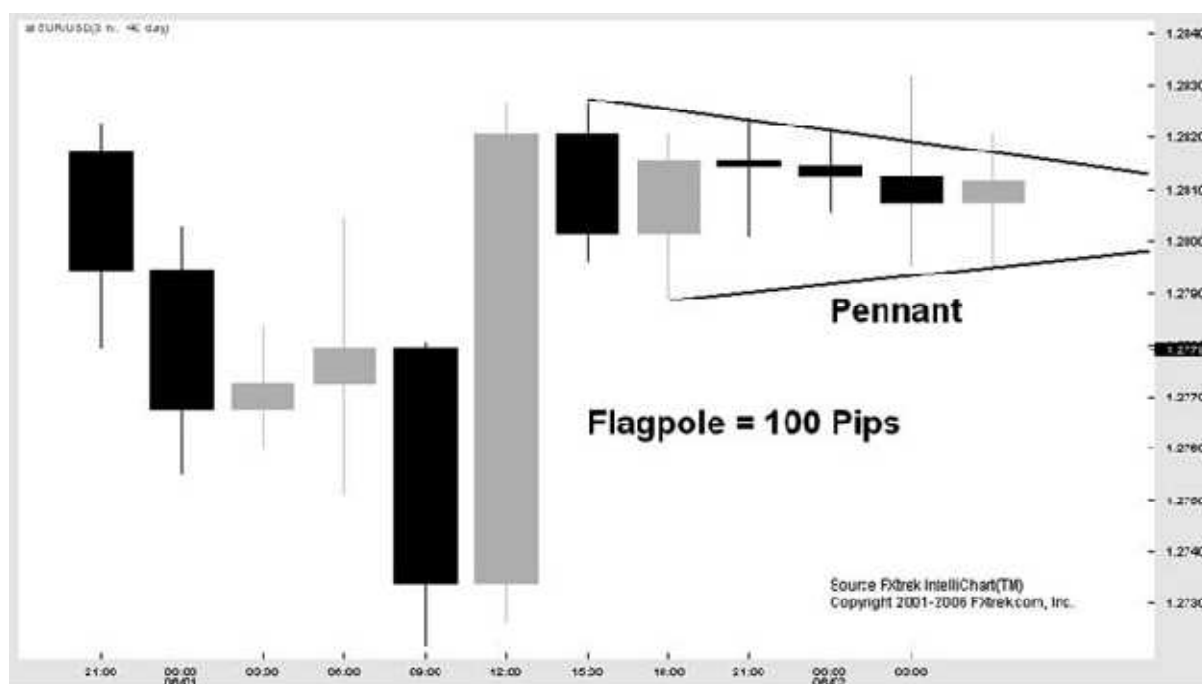
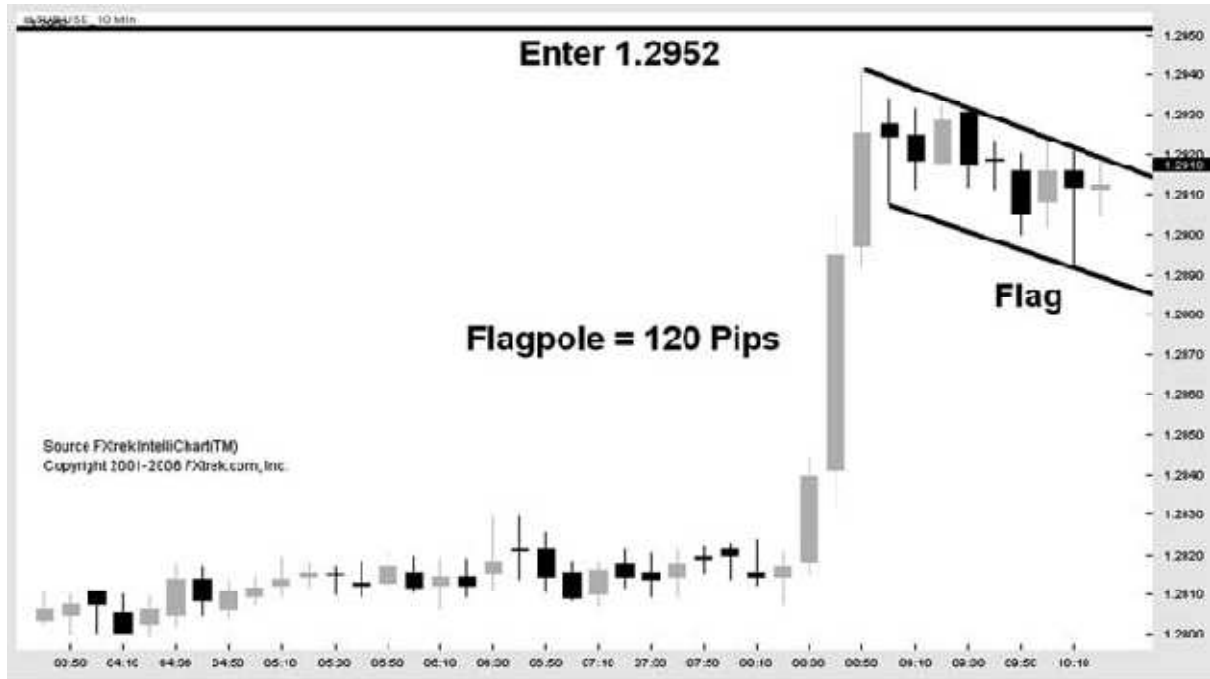


FIGURE 12.2 The flagpole is measured to calculate the entry and stop.

Since the high point of the flagpole is 1.2827, we'll simply add 10 percent (in this case, 10 pips) to the top of the flagpole, giving us an entry point of 1.2837. Of course, if we do enter a trade, we'll need to place a stop. The stop is calculated by using a number of pips that is equivalent to 25 percent of the flagpole. So, since the height of the flagpole is 100 pips, the stop will be placed 25 pips below the entry point.

Please note that the stop is 25 pips beneath the entry point, not 25 pips below the top of the flagpole. Since the entry point is 1.2837, we'll subtract 25 pips from 1.2837, which places our stop at 1.2812. Finally, we will need to create exits for our trade. Our first target will be equal to the amount of pips (per lot) that we are risking on the trade. So, since our risk per lot is 25 pips, we can exit half of the position when we are profitable by 25 pips. This will place our first exit at 1.2862 (1.2837 plus 25 pips = 1.2862).



BREAKING DOWN YOUR GOALS

The way to achieve great results is to take an ambitious goal and break it down into small, achievable pieces. When I give a seminar or address a group of traders, I sometimes ask the following question: “How many people in the room feel that a goal of a 100 percent annual return is an aggressive goal?” Many people in the room will raise their hands at this point, because a 100 percent annual return does seem to be an ambitious target. Then, I’ll follow up with this question: “How many people in the room feel that a goal of a *consistent* 6 percent monthly return is too aggressive?” The hands go down, as almost nobody in the room feels that this is an aggressive target. The punch line is that the goals are one and the same. If a trader can increase the value of the account by just 6 percent per month on a consistent basis, he or she will achieve an annual gain of about 100 percent.

I know what some of you are thinking. “Wait a minute—6 percent per month multiplied by 12 months per year equals a 72 percent return, not a 100 percent return! Ed has surely lost his mind—from all that loud music, no doubt!” Perhaps, but don’t fit me for a straitjacket just yet. Whip out a calculator and perform the following exercise: Starting with a base number of 100 (the “account”), multiply by 1.06 (a 6 percent gain) to calculate your first month’s result (106). Then multiply *that* result by 1.06, and keep doing this until you have calculated an entire year’s worth of results (12 months). You should end up with the following (*note that some numbers are rounded, but this has no material effect on the results*):

Month 1: $100 \times 1.06 = 106.00$

Month 2: $106 \times 1.06 = 112.36$

Month 3: $112.36 \times 1.06 = 119.102$

Month 4: $119.102 \times 1.06 = 126.248$

Month 5: $126.248 \times 1.06 = 133.822$

Month 6: $133.822 \times 1.06 = 141.852$

Month 7: $141.852 \times 1.06 = 150.363$

Month 8: $150.363 \times 1.06 = 159.385$

Month 9: $159.385 \times 1.06 = 168.948$

Month 10: $168.948 \times 1.06 = 179.084$

Month 11: $179.084 \times 1.06 = 189.830$

Month 12: $189.830 \times 1.06 = 201.219$

The account has climbed from a base of 100 to over 200 in one year, an annual gain of just over 100 percent. In order to replicate the results for different-sized trading accounts, add zeros to the base as necessary. In other words, if the base were 1,000, or 10,000, or 100,000, the percentage gains would remain the same. Because the gains are a *consistent* 6 percent, we are building off of a higher base every month. This is similar to the power of compounding.

CONSISTENCY IS THE KEY

This is not to suggest that a monthly gain of 6 percent is easy to achieve, but it does demonstrate the power of breaking our goals down into manageable targets. Consistency is the key; it is not that difficult to achieve a 6 percent return in any given month, but it is considerably harder to achieve a minimum 6 percent return *every* month.

We said at the outset that we’d start with a relatively easy target, and gradually work our way to the next plateau. Instead of starting out with a monthly goal of 6%, why not begin with a monthly goal of just 1 percent or 2 percent? A goal like this is unlikely to put much pressure on a trader, which is good—trading can be stressful enough without any additional pressure. Achieving a goal of just 1 percent per month would put you well ahead of most traders, since the majority of traders lose money. While a goal of 2 percent per month may not sound awe inspiring, if we can achieve it consistently, the annual gain will be just shy of 27 percent—and you’ll have outperformed most mutual funds and hedge funds.

If you have successfully achieved your modest goal for three months in a row, raise the goal to the next plateau—from a 1 percent monthly goal to 2 percent, or from 2 percent to 3 percent, and so on. Don’t rush through this process; remember, as you gain experience and confidence, you will be a better trader in the future than you are now, and you’ll be better suited to more aggressive goals. Here is the breakdown of monthly goals and their annual equivalents (again, please note that some numbers are rounded, but this has no material effect on the results):

1 percent every month = 13 percent annual return
2 percent every month = 27 percent annual return
3 percent every month = 42 percent annual return
4 percent every month = 60 percent annual return
5 percent every month = 79 percent annual return
6 percent every month = 100 percent annual return
7 percent every month = 125 percent annual return
8 percent every month = 151 percent annual return
9 percent every month = 181 percent annual return
10 percent every month = 214 percent annual return

By the time you work your way up to consistent monthly returns of 3 percent and then 4 percent, you'll be putting up respectable numbers, and you'll have gained the benefit of months of experience. At this point, you'll no longer be like that teenage driver with a learner's permit; instead, you'll be more like a driver who is comfortable and confident behind the wheel, in complete control of your vehicle, with the ability to anticipate trouble before it happens. You will have progressed to a higher plateau.

Of course, there will still be goals for which to strive. If you can achieve consistent monthly gains of 5 percent or 6 percent, you will have truly joined the elite. At this point, you can continue to increase your goals, or perhaps you will have found your "comfort zone." Remember, you don't have to continually increase your goals if you don't feel that you're ready to do so—or if you just don't want to. Your personal comfort with your goal should also be a consideration.

WHAT HAPPENS WHEN I REACH MY GOAL?

Once you've achieved your goal, you don't have to stop trading, but you can take precautions to safeguard your gains. In trading, we use a stop on every trade to limit losses and protect gains. Why not use that same philosophy to protect your monthly returns?

For instance, assume that a trader's goal is a consistent monthly profit of 5 percent. After reaching this goal, she continues trading, and her gain for the month climbs to 10 percent. The trader now calculates a "stop" for the entire account, at the point where the gain was equal to 5 percent. If the monthly gain falls back from 10 percent to 5 percent, she stops trading for the month, and has still achieved her monthly goal. She can continue trading in a demo account for the remainder of the month. What if you encounter problems and can't meet your objective? If you are consistently failing to meet your goals, they may be too aggressive. Try for an easier target. If things get really tough, cease live trading and switch to a demo account until you regain your footing. Some traders feel that demo trading is beneath them, but sometimes you have to sacrifice your ego if you're serious about making money as a trader. Don't allow foolish pride to stand in the way of your long-term success.

What You Don't Know Can Hurt You

Here's a little section of the book that will ruffle a few feathers. If you ever hear that I've gone missing under mysterious circumstances, it'll probably be due to the contents of this chapter. These next few pages aren't intended to scare you, but to educate you to some of the realities of the trading business. I want you to know about the pitfalls that are lurking out there, waiting for the unsuspecting and the uninitiated. If I can keep you on the right path and prevent you from being drawn into these traps, your chances of success will increase dramatically.

To be forewarned is to be forearmed.

You will often hear of spectacular returns. You will hear salespeople bragging about 90 percent winning trades, 95 percent winning trades, and so on. You will hear claims that it is possible to win many consecutive trades on a consistent basis. And what could be wrong with winning? It feels good to win, right? Well, the salesperson who is trying to sell you a product or service that promises such a high percentage of winning trades (or in some cases promises a ridiculous number of consecutive winners) is counting on your desire to win to short-circuit your thought process. It is easy to obtain 90 percent winning trades and still lose money.

Conversely, there are many successful traders who place more losing trades than winning trades. The percentage of winning trades has nothing to do with the ultimate success of the trader. Most references to a percentage of winning trades are merely a sales tactic, which is intended to appeal to the trader's desire to "win."

SARCASM ALERT!

Do you want to know how to create a high percentage of winning trades?

Why not simply trade without stops (breaking every rule of risk management, which will surely lead to losses) and take profits quickly? That way, we can hold on to every trade until it either turns profitable or creates a margin call. If this sounds ridiculous, that's because it is, but the point must be made. It saddens me to tell you that this is exactly how many people try to trade. They'll get lucky for a while, putting up some nice returns at first, and then they will blow a hole in the account with one big loss. Their percentage of winners versus losers will still be impressive, but their account equity will be severely damaged. People actually teach so-called trading techniques that promise many consecutive winning trades. I have heard promises of 20 consecutive winners, 50 consecutive winners, and more. This would be similar to flipping a coin 50 times with the expectation that the coin will land with the "head" facing upward every single time. Not only is this trader almost guaranteed to lose money in the long run, but to add insult to injury, he or she actually paid someone to learn techniques that are sure to result in losses.

KNOW WHEN TO RETREAT

Fixation on the percentage of winning trades versus losing trades is like a sickness, and I'm determined to cure this rampant disease within our lifetimes. I want you to think of yourself as a general, fighting a war. Your most important assets are your soldiers. You want to use them judiciously. When it is time to attack, you send them off to battle but if the battle is lost, you must retreat. Otherwise, you will needlessly sacrifice the lives of your troops and weaken your overall forces. Your goal is not to win every battle, but to win the war instead. Trading is much the same way. In order to win the war, you have to be willing to lose a few battles along the way. Or, more precisely, you have to be willing to deal with small losses to prevent the creation of a large loss.

Most major trading disasters have their genesis in the unwillingness to take a loss, from Nick Leeson's destruction of Barings Bank to the Long-Term Capital Management hedge fund fiasco. There are countless other examples of major trading disasters that begin with the failure to take a strategic loss.

THE “95 PERCENT WINNERS STRATEGY”

To bolster my point, I opened a demo account and proceeded to place trades using a “strategy” of holding on to losses until the trade turned positive, and then taking very small gains I placed a total of 20 trades, with 19 “winners” and 1 loss, resulting in a success rate of 95 percent. One might think that a success rate of 95 percent would certainly lead to a nice profit, but as you can see, this is not necessarily the case.

Because this trader was too quick to take profits and too willing to hold losses, this so-called strategy resulted in a loss, despite the lofty winning percentage. Unfortunately, this scenario is all too common. Hopefully, this little exercise will cure all of us once and for all of our tendency to be impressed by sales tactics that present an abnormally skewed ratio of winners versus losers. If we allow salespeople to cloud our vision with unrealistic or impossible dreams, it will only delay our ultimate goal of trading successfully in the real world.

BEWARE THE BACK TESTER

There is nothing wrong with back testing a strategy per se; in fact, back testing can be a valuable tool in strategy development when it is used properly. However, some unscrupulous operators have appropriated this strategy development tool and turned it into a weapon for use against an unsuspecting trading public.

Back testing is the process of optimizing a trading strategy using historical data. Traders back test strategies to determine how well they have worked in the past, with the assumption that what has worked in the past will continue to work in the future. Since markets are not static, and are constantly evolving and changing, back testing is not a panacea. The past does not equal the future. As markets change, good traders adapt, and the best traders are the ones who adapt quickly.

Because we know what has occurred in the past, it is easy to create strategies that would have been highly successful in the past. Since we can’t turn back the clock and trade in the past, these strategies are limited in their usefulness. This hasn’t stopped some individuals from marketing these over optimized, back-tested strategies as current and viable moneymaking opportunities. One individual allegedly solicited funds from unsuspecting investors by misrepresenting back tested returns as actual returns. This person is currently the subject of a Commodity Futures Trading Commission complaint, for allegedly having “engaged in the fraudulent solicitation of customers by misrepresenting his past performance.”

A GOOD TRADE IS NOT THE SAME THING AS A WINNING TRADE

Always remember that, in trading, the ends do not justify the means. Or to be more precise, the outcome of your trade does not necessarily justify the method used to achieve that outcome. Some traders take the attitude that as long as the trade is a winner, there is justification no matter what rules were broken along the way.

But the fact is that a winning trade is not always a good trade, and a good trade is not always a winning trade. It’s possible to do everything wrong and still achieve a winning result on a particular trade, just as it’s possible to do everything correctly and still lose on any given trade. Would you rather be a good trader or a lucky trader? Strive to be a good trader, because anyone can be a lucky trader—for a while. Don’t judge you’re trading on any particular result, but on whether you are following proper procedure. Did you follow a predetermined plan? Did you place the stop correctly and sensibly? Do you have an exit strategy?

If you are doing all of these things correctly, and still are not trading successfully, at least you will then be able to determine that the problem lies not with your execution but with the plan. Plans can be modified.

Now it’s time for you to turn words into work.

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