ATFX | eBook

Trading For Beginners

WHAT IS FINANCIAL MARKETS TRADING?

Financial trading may seem daunting and often intimidating, especially with the use of financial terminology, which you may not be used to. The core concept of financial trading is predicting if the price of something will go up or down. When trading it is important to understand the risks involved, you might gain great rewards but you could lose money.

Before we go into the fundamentals and details revolving around financial trading, you will need to understand the basics. Let's start with looking at what you can trade.

What is being traded?

Financial trading is basically buying and selling financial instruments. It is the same as any other market would work; a two way street of buying and selling goods. There are many different forms of financial instruments that are traded, some of the main categories include:

- **Forex**
- **Commodities**
- **Indices**
- **Shares**

Forex: There are different terms you might come across which refer to Forex, this includes foreign exchange, currency trading, and FX. Forex trading happens via online brokers, banks, market makers, and traders around the world, as there is no centralised exchange, as in stock markets.

Commodities: This is the trading of physical assets such as raw materials or agricultural products. The most popular products to trade amongst retail investors are gold and crude oil.

Shares: This involves the buying and selling of parts of a company. For example, if I think Apple is going to do well in the coming years, I might want to buy a share of the company to trade on the market.

Indices: Indices is the value of a group of companies which are represented by a single number. Examples of indices are the FTSE 100 and Nikkei 225.

Trading could take place because an individual wants to purchase a whole or part of an asset, for themselves or a company. You have probably taken part in trading and not realised. For example, if you were going on holiday to Portugal and travelling from the UK, you will need to convert currency so you can use Euros on holiday. In order for this to be done, you will need to take part in the Forex market.

Most of the time trading takes place because an individual wants to make a profit on the movement of an asset in price. They may not be able to purchase the whole asset so they speculate on the price of either future contracts, or contracts for difference (shares, commodities, and indices). Trading assets can be done quickly as buyers and sellers meet electronically through their online broker.

The financial market is regulated with strict legislation, this helps control fraud and illegal activity. In the UK the financial regulator is the Financial Conduct Authority (FCA).

Who trades?

There are lots of people that trade in the financial markets for various reasons. Here are some examples of the type of people you will see trading:

- Banks can act on behalf of other companies

- Brokers are specialists with experience in trading, who trade on behalf of the clients they have.

- Retail Investors: Retail investors can participate in the markets through investing in funds, buying shares and then also trading through spread bets and CFDs.

- Institutional Investors look at making profits for themselves and their clients by looking after a portfolio. Examples of institutional investors include asset managers and mutual fund providers.

Why do people trade?

Most people trade to use their money to generate value. However, there is a risk of losing money when trading. The money they put into the market has a greater potential to grow compared to the money that is dormant. If you have the right strategies in place, and you trade intelligently then you are more likely to become a successful trader.

There are two forms of trading in the financial markets; one is long-term investing, which involves buying and holding assets for the long run, and the other is active trading which is also known as speculation, this involves focusing on short-term movements in the market.

WHERE DOES TRADING TAKE PLACE?

There are two ways in which you can trade: on an exchange or over-the-counter. Trading on a company depends on if the company is a public company or a private company. If you wanted to trade shares in a private company then you would not find them listed on the stock exchange, you would need to contact the company directly. Private companies are not under any obligation to sell their shares if they do not want to. On the other hand, public companies have more shareholders as they are publically listed. However, they have stricter regulations which include having a board of directors, as well as sharing their financial information to the public at least twice a year. People become shareholders of a company and invest in it because of something called dividends. The company decides to pay the shareholders a dividend when the company makes a profit. This compensates for when the share price of the company isn't moving that much. Also, if a company does well financially, its valuation tends to increase and this causes the company share price to increase and this could be another income stream for the investor.

The stock exchange

The stock exchange trades most major shares.

You probably have a vague conception of stock exchange trading, the idea you have in your head is probably down to representations of trading in movies. You might be thinking of a large hall, full of people shouting and gesturing to each other whilst on the phone to clients, all of them trying to buy and sell at the same time. It just seems like pure havoc.

Traditionally this would have been true as most stock exchanges took place in a physical building. However, as electronic trading has become more of the norm, many stock exchanges have closed their trading floors and instead switched to online platforms.

Here is the process of a stock exchange trade:

The trader will inform their broker on the number of shares they want to purchase, in the market.

The broker will then send the order through to the order department clerk on the exchange.

This is then passed around by the store clerk to a trader, who will then find another trader who is selling the shares the customer wants to buy. Once this has been completed then the two will agree to a price, which the broker relays back to the client.

After everything has been processed, a few days later the customer will receive confirmation in the mail. It sounds very complicated and time-consuming in today's market the whole process only takes up to a few minutes.

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The New York Stock Exchange:
The New York Stock Exchange (NYSE) is located on Wall Street, New York. The NYSE was founded on 17 May 1792, by 24 stockbrokers who signed the Buttonwood Agreement, which created a centralised agreement to exchange securities in the American market. The total market capitalisation recorded in March 2018 amounted to $23.12 trillion, which is equivalent to 40% of the total world stock market value.

NASDAQ:
The National Association of Securities Dealers Automated Quotations (NASDAQ) is also located in New York and was founded in 1971 as the world's first electronic stock market. In March 2018 its total world capitalisation reached $10.93 trillion, which makes it the world's second-largest stock exchange. The top listed companies featured in NASDAQ include Google, Apple and Tesla, amongst others.

Tokyo Stock Exchange:
The Tokyo Stock Exchange is the largest stock exchange in Japan and it was founded in 1878. Its combined market capitalisation recorded in 2018 was over $4 trillion. It is home to globally recognised companies such as Toyota and Honda.

Shanghai Stock Exchange:
The Shanghai Stock Exchange (SSE) is currently the world's fourth-largest stock exchange. The market operates through two classes of stock for every listed company. There are A-shares and B-shares. A-shares are quoted in Yuan and are available to foreign investment through a special qualified program. B-shares are open to foreign investment and is quoted in US dollars.

Hong Kong Stock Exchange:
The Hong Kong Stock Exchange (SEHK) was formed in 1891 by the Association of Stock Brokers. It is one of the three stock exchanges in China. However there is no physical location of this stock exchange, physical trading was closed due to the shift to electronic trading.

London Stock Exchange:
The London Stock Exchange (LSE) was founded in 1801. Currently, it is the largest stock exchange in Europe. In March 2018 the market capitalisation amounted to $4.38 trillion.

Over-the-counter trades

The electronic market matches buyers and sellers together through computer networks. This method is used by banks and institutional traders. Individuals don't have access to the electronic markets, therefore, a broker is used as a middle man. The broker will access the market for you, place an order and then through computer processes, a buyer or seller will be found depending on the order you have placed. The foreign exchange market (Forex) is probably the most famous over-the-counter market as there is no single venue where FX is traded.

Types of Brokers

The main types of broker include:

- **Full-service broker:** This sort of broker works on a high commission basis. They are required by the client to create and execute a trading strategy specifically suited to the client's investment goals.

- **Advisory based broker:** This broker will provide basic advice on and will recommend specific trades to their clients. However they will take a step back when it comes to making the final decision on trades, the client at this point will take over.

- **Execution-only based broker:** This broker has very little influence over the trader's decisions, they simply carry out trading instructions provided by their clients. There is no advice given by an execution-only service.

FOREX SPOT TRADING ACCOUNT

At the start of the century, most online brokers offered Forex only or shares only trading accounts. However, with the launch of the CFD markets in Europe, you could suddenly trade Forex and futures markets via your trading account. New products at the time included the ability to trade gold, crude oil prices, and stock market indices such as the S&P 500 and the FTSE 100.

As clients were used to Forex only accounts, in Europe, a broker would offer both a Forex only and a Forex and CFD account to their clients for a long time for marketing purposes as some clients did not want to include CFDs in their platforms. Also, the platforms at the time had problems showing the price of many financial products. However, in the last ten years, brokers started to offer one account only which included Forex, indices, commodities, and shares to their clients so you will struggle to find a Forex only accounts any more. Upgrades to the trading platforms now allowed people to select which market prices they would like to have, also with the introduction of faster internet speeds across the world, a retail trader can now receive thousands of prices to their home.

In the US where CFDs are not allowed, you can still only find Forex only accounts, but even these will now feature gold and silver prices.

UK traders can now choose to trade Forex via a CFD account or a spread betting account. The latter is preferred by most retail traders as they don't need to pay capital gains on profits if trading is not their main source of income. However, as with all tax situations it is necessary to receive independent tax advice. For the rest of the world, excluding the USA and other countries where CFDs are forbidden, traders can now trade with a CFD account which will include a multitude of asset classes including cryptos.

Spread Betting

Spread betting is when you put up money in hopes of maximising on your return. You can spread bet on everything from horse racing, and sporting events to political decisions. However, it is very common to spread bet in the financial markets on the value of financial assets.

As mentioned before there are various financial instruments including:

- **Shares**
- **Interest rates**
- **Government Bonds**
- **Currencies**
- **Commodities**
- **Stock Indices**
- **Other financial products**

Financial spread betting is predicting whether the market price of these instruments will go up or down. If you think that the price will rise then you will buy, which is also known as going long. If you think that the price of the asset will drop then you would 'short-sell', this is known as going short. If you are right on what you predict then the profit will continue to grow the further the market price also does. On the other hand, if the market price decides to trade against you then so will your losses will carry on increasing as the price movement is greater. You will not have to physically own the underlying asset, but you will gain or lose on price changes as if you did own it.

So what are the benefits of spread betting?

No taxes
When you make money on CFDs or physical trading in the UK, you need to pay capital gains tax on any profits above £11,700 in the 2018-2019 tax year. However, when trading the same markets via a spread betting account you will usually not need to pay taxes as long as your trading profits are not your main source of income. Professionals spread betters and gamblers that live on their trading or gambling income need to pay tax like anyone else. For your exact circumstances, it is best to speak with a tax professional.

No commission or fees
Some brokers may not charge commission or brokerage fees when you open and close trades. There could also

CFD Trading

A contract for difference (CFD) means you are not actually trading a physical asset. You will be exchanging the difference in the value of an asset from the point of when a contract is opened to when it closes.

It is important to note that when you trade leveraged CFDs, the market could potentially move in your favour which will make you money. At the same time if the market moves against you, the more of a loss you can make.

You don't own the physical asset you are trading, allowing you to try to gain profit from both rising and falling prices in the underlying market. This is called going long or short.

CFDs are also known as derivatives because the value of an underlying asset is where a CFD is derived from. On a CFD market offering, there is a two-way price that is quoted.

How to trade CFDs:
If we wanted to trade a CFD on Gold, a provider might be offering a spread of 1563/1569. If you are going to sell (going short) the bid price will be 1563. If you are going to buy (going long) the offer price will be 1569. If you buy or sell depends on which way you think the market price will move. If you think the price of Gold will rise then you buy at the offer price and if you want to sell because you think the price of Gold will drop then you sell at the bid price.

CFDs are traded in standardised contracts and another term for this is lots. Let's use the FTSE 100 index as an example. The exchange on which the FTSE 100 futures index is traded has decided that each point in the FTSE 100 is worth £10. This means that if the FTSE 100 is trading at £7000 then when you buy one contract the total position value will be £70000.

However, most CFD brokers will allow its clients to trade parts of a contract such as one tenth, this is beneficial for investors that do not have the margin to buy a full contract, or just does not want to expose themselves to a £70000 position.

If the FTSE 100 is trading at 7000/7001 and you think the index will rise over the next few days you could buy one lot. A few days later the prices are at 7050/7051. As you bought at the first instance at the 7001 price you now need to close your position via the sell price of 7050, and you made a profit of 49 points. As we know that every point in one contract is worth £10, we know that this trade made a profit of £490. On the exchange, you must buy one contract, however, with your CFD broker you could buy multiples tenths of the contract. As an example, if you bought three tenths (0.3), your profit per point would have been 49 multiplied by 3 = £147.

The ability to trade less than one full contract via a CFD broker is the reason for the rise of CFD brokers as it allows investors with less money to access the markets on similar terms to wealthy investors.

WHAT IS FOREX?

Forex is another word for foreign exchange, however, a commonly used term is currency trading. Currency trading involves the global market and each currency is a participant. The role of the forex market involves establishing the value of a certain currency and then comparing it to a range of other currencies.

In order for international trade and business to run seamlessly, currencies need to be exchanged with each other.

For example, if you lived in the UK and wanted to buy a certain product from China, you or the company you purchased the good from, will have to pay China in the local currency which is the Chinese Yuan. The UK importer will have to pay the equivalent of the GBP in Yuan.

You have probably taken part in forex exchange when travelling to another country and using its relevant currency.

The forex market is immense due to the fact that there is a constant need to exchange currencies, it is the most liquid financial market in the world. According to the Bank for International Statistics (BIS), the reported average traded FX daily value in 2016, was $5.1 trillion.

Trading forex on the financial market enables people to speculate on the market value of currencies. If a currency was relatively high on the market then it means the currency is trading at a higher exchange rate compared to other currencies. If the currency is trading at a higher exchange rate then the price of the currency will also rise. On the other hand, if the currency is weak then it is trading at a lower exchange rate, making the price to drop.

The FX market does not have a central marketplace, trading is done over-the-counter (OTC), which means transactions are completed by traders globally through computer networks.

Spot market

The spot market is the biggest market in which you can trade forex. The other two markets are the forwards and futures markets. The spot market is the 'underlying' real asset that the futures and forwards market is based on.

Since the industry's transition to electronic trading as well as the surge of forex brokers, there has been a rise in activity in the spots market.

It is now quite favourable for both individual and institutional traders.

Companies that hedge their foreign exchange risks to a specific date tend to use forward and futures markets.

The spot market is when currencies are bought and sold for direct delivery, e.g. you buy today and you get the currency the same day. There are many things that can affect the supply and demand of a currency price. This includes current interest rates, reactions to political situations, and economic performance amongst a host of other factors.

Forward and Futures markets

These two markets don't trade actual currencies, instead, they deal in contracts that represent claims to a specific currency amount and specific price in the future. Contracts are bought and sold over the counter (OTC) in the forwards market.

The two parties participating in the exchange will determine the terms of the agreement between themselves, as an example, an importer might enter into a forward agreement with his bank to buy a certain amount of the EURUSD pair for a specific price in the future. The reason for entering into a forward trade is to lock in an exchange rate. As an example, the European importer buys goods for 100,000 Dollars but will pay when he receives the goods three months later. Instead of waiting to see what the EURUSD exchange rate will be in three months and risk his purchase being more expensive, the importer can lock in the exchange rate on the day of purchase. That way the importer can focus on his business instead of speculating on the FX markets.

The futures market differs slightly from futures contracts as they are bought and sold on public commodity exchanges. The exchange acts as a middleman, ensuring that both parties adhere to their part of the agreement. When making a forward agreement you will enter into a contract with your bank, however, if the bank goes bust you won't have the protection of the forward. When making a futures agreement you eliminate some of that risk, but when making a futures contract you won't be able to tailor the contract like you can with forwarding contracts. The reason for this being, futures are dealt in specific volumes and specific dates which might not match with the cash flow of the import/exporter.

Who trades forex?

There are many participants in the forex market. You might have individual spectators trying to turn over a profit in a short space of time. You will also find central banks trying to control currency in circulation. Major international banks are the predominant players of the forex market, this includes Barclays, JP Morgan, Citigroup, and so on.

Central Banks and Governments

Central banks and governments are heavily involved with the forex markets due to monetary policy. Monetary policy revolves around the government or central banks buying or selling foreign currency in exchange for its own domestic currency. The intention behind this to try and influence the exchange rate and manage trade policy.

There are other various reasons as to why both central banks and governments may intervene in the foreign exchange market, mostly it is for economic purposes such as controlling inflation, maintaining competitiveness as well as financial stability.

Commercial and investment banks

The intention behind central and investment banks participating in the currency market is to try and maximise their profits from currency transactions. They may also have a responsibility of managing their client's portfolios as well as trying to minimise risk for themselves from market exposure. Banks have assigned trading desks which will focus on risk management, hedging, and various other strategies to maximise profits and benefits for themselves.

There are approximately 25 banks that are active in the market they include a mixture of big players like Deutsche Bank, UBS, and also smaller players such as ABN Amro.

Businesses and corporations
This is a group of traders that deal with imports and exports. The structure of the business in small and large firms may require them to participate in the forex market

Speculators
Instead of hedging personal foreign exchange risks, speculators will take advantage of the fluctuations in exchange-rate levels. They tend to trade in large volumes which means that their returns are always maximised whether it is a profit or loss. An example of a speculation type is hedge funds, which use advanced strategies in order to trade the markets. You will also find retail traders alongside them trying to capitalise from the political and economic events shaping the markets.

Why trade forex?

There are many benefits to trading the forex market and due to a variety of factors, the FX market remains to be the most traded market in the world currently.

High Liquidity
The volume of buying and selling at any given time in the forex market are high. The market is accessible for all users to buy and sell currencies due to leveraged offered by brokers. The daily turnover for this particular market lies in the trillions, therefore, making it the most liquid market in the world. Due to this traders are allowed to react and respond instantly to the continuous price fluctuations, providing them with an opportunity to make a profit. With high liquidity also comes lower transaction costs and competitive spreads, as financial institutions will compete with each other for the traders business.

Less price manipulation
As the forex market has high liquidity it is said to protect traders from price manipulation. Market manipulation occurs when there has been a deliberate attempt to create artificial appearances within the market, interrupting the free and fair aspect of the market.

Availability
The forex trading market is open 24 hours a day from Sunday afternoon New York time to Friday 5 pm New York time. To meet the continuous demand to trade there are intermediaries globally to service traders needs. Intermediaries include banks, brokers and other financial institutions.

Leverage
Using leverage means the trader borrows money in order to execute trades, this is so they can try and maximise profits. However, it is advised that the trader seeks financial advice from a professional when trading on the margin as it can also lead to amplified losses. If the trader had access to a 200:1 margin it means they can make a £2,000,000 trade with only £10,000 margin. The trader will essentially be putting down 0.5% of the trade down as margin. However, to protect retail investors the Financial Conduct Authority (FCA), has imposed max leverage of 30 times their capital (30:1), that means that you now need to stake up 3.3% of the contract size that you are trading. As an example, if you would like to open a EURUSD position of 10,000 then you would need to have a minimum of €330 on your account. Some say that the restrictions are too high, however, if you would trade with 30 times leverage then a one percent move in the EURUSD would translate to a 30% gain or loss in your account depending if you are long or short, so it is clear that 30 times leverage is sufficient for most traders.

How do you trade forex

For individual investors, they trade FX through a broker. You could also exchange currencies at your high-street bank or post office, but the spreads are extremely wide, and you can't trade with leverage. So, most retail traders trade through an online forex and CFD broker. Some traders may prefer to trade through a bank, but most banks won't offer competitive spreads and tools that brokers are known for. However, they will sometimes offer you a dealer to execute your orders, and that could provide additional help with your trading. You will need to be trading in large amounts to make it worthwhile for the bank.

- **Forex spread betting:** This involves betting on the direction a forex pair price is heading. If the price is moving in your favour the more profit you will receive, however, if the market is moving against you then the more money you will lose.

An advantage of spread betting is that you will not be taxed on the profit you receive. You will also be able to trade with leverage, which means that small changes in the currency pair will be magnified, e.g. if the GBPUSD gains by 1% and you bought the pair with ten times the leverage, then you would have made a 10% return on your account. However, leverage can also act against you and you could have lost 10% of your account if the GBPUSD had declined.

- **Forex CFDs:** With a forex CFD, you open a contract where you agree to exchange the difference in the price of a currency pair. This starts from the moment you open the position to when you close the position. If you open a long position and the price of the forex pair increases, the trade will become profitable. The opposite happens when you open a short position. For the retail trader, there is no major difference between spread betting and CFD trading. However, there is a difference with spread betting most of the time you will not pay profits on gains if trading is not your primary source of income. To make sure that is the case for you, please contact a tax professional. Also with CFDs, there are set lot sizes that you buy or sell, with the smallest one being the micro-lot, which is 1000 units of a currency. In the EURUSD the minimum would be 1000 Euros, while in spread betting you choose how much the pip value will be worth e.g. £0.1 or £1, the exact amount depends on your risk appetite, trade balance, and margin requirements of the market you are trading.

Forex market hours

Even though the forex market is open 24 hours Sunday to Friday this does not mean that it is continuously active throughout the entire day. There are certain times which can be better to trade, and there are periods where the market may not move up or down so there will be limited impact on your profit and loss.

There are four significant forex trading sessions in the forex market: the Sydney session, the Tokyo session, the London session and also the New York session. Below, AFTX has put together a table of the opening and closing times for each forex session.

Local Time	Eastern Daylight Time (EDT)	British Summer Time (BST) (GMT+1)
Sydney 7:00am - 4:00pm	5:00pm - 2:00am	10:00pm - 7:00am
Tokyo 9:00am - 6:00pm	8:00pm - 5:00am	1:00am - 10:00am
London 8:00am - 4:00pm	3:00am - 11:00am	8:00am - 4:00pm
New York 8:00am - 5:00pm	3:00am - 11:00am	1:00pm - 10:00pm

These times are for Spring/Summer US (March/April - October/November)

Local Time	Eastern Daylight Time (EDT)	British Summer Time (BST) (GMT+1)
Sydney 7:00am - 4:00pm	3:00pm - 12:00am	8:00pm - 5:00pm
Tokyo 9:00am - 6:00pm	7:00pm - 4:00am	12:00am - 9:00am
London 8:00am - 4:00pm	3:00am - 11:00am	8:00am - 4:00pm
New York 8:00am - 5:00pm	8:00am - 5:00pm	1:00pm - 10:00pm

These times are for fall/winter US (Oct/Nov - Mar/Apr)

The reason why the open and close times vary during the months of October/November to March/April is that some countries, like the United Kingdom, shift to and from daylight saving time. This can also vary depending on the day of the month the country shifts to daylight saving time. Japan is the only country that does not follow daylight saving time.

Note: In Australia, the seasons are opposite therefore when the US shifts one hour back, Australia would actually be forward by an hour. This is important to remember when trading.

There are also periods where trading sessions will overlap. For example, the Tokyo session and the London session overlap during the summer.

When two sessions are open at the same time there will undoubtedly be more volumes being traded making it the busiest times to trade.

Tokyo session

The Tokyo session is sometimes referred to as the Asian session as Tokyo is the financial capital of Asia.

Japan is the third-largest forex trading center in the world. Approximately 21% of all forex transactions take place in during the Tokyo trading sessions.

Characteristics of the Tokyo trading session:

- Main participants of this session are commercial companies such as exporters and importers, but also central banks. This is because Japan has an economy which is significantly dependent on exports, this also applies to China.

- This market may require a lot of waiting as the liquidity is thin.

- The Asia Pacific currency pairs may have stronger movements than non-Asia Pacific pairs. An example of an Asia Pacific currency pairs is AUD/USD and NZD/USD. The most action is at the start and earlier on in the trading session as this is when most of the economic data is released.

- The Tokyo session could be viewed as a benchmark for what happens later on in the day. In the latter sessions, traders will be examining the Tokyo sessions in order to create and organise strategies for other sessions.

- Chinese demand is relied upon by Australia and Japan, therefore, there is a lot of movement in the AUD and JPY currency pairs.

London session

When the Asian session closes for the day, the European markets begin theirs. In Europe, there are around seven financial hubs, London being the most significant one which traders keep their eye on. Approximately 30% of all forex transactions take place during the London session.

Characteristics of the London session:

- This market has high volumes of trading with many transactions taking place. This means that there are high liquidity and lower transaction costs. For traders, this is beneficial as there are lower pip spreads.

- However, because of the vast amounts of transactions taking place within this session, it also means that there is high volatility.

- Market trends tend to start in the London session and then this is carried on to the New York session.

- There is so much liquidity within this trading session that most currency pairs are suitable for trading.

- Most traders will stick to the major currency pairs which include EUR/USD, GBP/USD, USD/JPY, and USD/CHF.

- These major currency normally have the tightest spreads.

- Economic data which is released during the European session has an influence on the major currency pairs and the way its price moves in the market.

New York session

The U.S session starts at 8:00 am EST time. There is one major session that the traders keep their eyes on and that is the New York trading session.

Characteristics of the New York session:

- In the morning there is high liquidity because it overlaps with the European session.

- According to the International Monetary Fund (IMF) the U.S. dollar contributes to about 65% of the world's official foreign exchange reserves. The dollar is huge when it comes to trading as around 85% of trades involve the dollar.

- U.S economic data has the influence to move the markets.
- Once the European markets close for the day the New York trading session will experience less liquidity and volatility.

Trading any currency pair is an option this is because both the European and the US trading sessions are open at the same time and therefore there will be a lot of liquidity in the trading session.

The busiest overlap of trading sessions are the London and New York sessions. You are likely to see bigger market moves during this overlap, even more so when news reports from the U.S and Canada are released. Late news coming from Europe will also have an influence on the market. The European sessions will start first, therefore, U.S traders will be paying close attention to the European trading sessions and will be ready to establish their positions based on what has happened earlier.

There are also certain days in the week where the markets may indicate more movement. So when are the best and worst times to trade?

- If two of the markets are overlapping this will be one of the best times to trade because of high liquidity.

- Major events seen in the news may shake things up in the market, so paying close attention to this will also be an indicator of when the best time to trade is.

- The middle of the week appears to be the busiest when it comes to trading due to the fact that the pip range widens for most currency pairs.

- As the Asian session tends to see less trends, it is more suitable for range bound trading, while the London session tends to see strong intraday trends and breakouts work better because of the high volatility.

Major currency pairs

The four most popular currency pairs include:

- **EUR/USD**
- **USD/JPY**
- **GBP/USD**
- **USD/CHF**

Sometimes the three major commodity currencies against the US dollar can also be included in the list of major currency pairs. The three commodity currencies are AUD/USD, USD/CAD, and NZD/USD. These currency pairs contribute to an astonishing 80% of worldwide forex trading.

There are also cross pairs which feature key currency pairings that do not include the US dollar, such as EUR/GBP, EUR/CHF, and EUR/JPY.

EUR/USD

This is considered to be the world's most traded forex pair. It is the world's largest economy, the US, against the second-biggest which is the Euro Area. The Euro only started circulating properly back in 2002 therefore this currency pair is fairly new. The volatility seen in this currency pair is influenced by the Federal Reserve System (FED) and the European Central Bank (ECB). Both central banks set the interest rates for respective economies and this has an impact on the currency. If the ECB increases their interest rates then this will make the Euro stronger, making the EUR/USD increase by price. High liquidity can be seen for this currency pair as it is a popular pair to trade, this means that there are always competitive spreads being offered in the market and buyers and sellers are easy to find.

USD/JPY

This currency pair has a unique characteristic and that is its pip value when trading USD/JPY is significantly higher than the other major currency pairs. This is down to the low value of Yen against the U.S dollar. The yen is used for the purpose of the carry trade. A carry trade is when the trader borrows money from a country which has low-interest rates and then invests in a country which has higher interest rates, this is to try and get a higher return. The Yen acts as a funding currency and the U.S dollar is then the asset currency as it has a higher interest rate.

GBP/USD

Another name for this certain currency pair is 'cable'. This is because of the cables under the sea which carried bid and ask quotes across the Atlantic ocean. The sterling used to be the world's reserve currency before the U.S dollar took over. The UK has never been part of the Euro but it is still hugely tied to the European Union, even though it is set to leave the EU. The US dollar will act like the quote currency just like it will with EUR. Both pairs can rise when the dollar is weak and the fall when the dollar is strong. Just like the EUR/USD pair, the central banks will have a major influence on the currency pair, in this case, it is the Bank of England and the Federal Reserve.

USD/CHF

The Swiss Franc is commonly known as a safe haven investment, making it a popular choice for traders at times when the market faces uncertainty or turmoil. The Swiss Franc is seen as a low-risk investment as the economy is stable. The Swiss Franc tends to follow the movements of the Euro when there is little volatility in the market.

Pips Calculation

What does 'pip' mean?

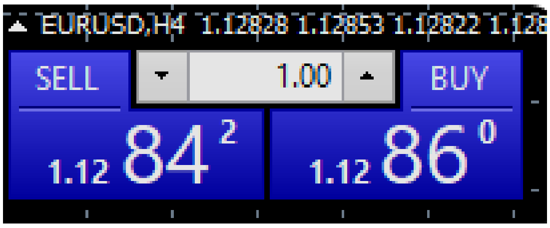
A pip is a term used to express the change in value between two currencies. If the EUR/USD moves from 1.1052 to 1.1054 then the rise in value would be two pips.

Normally the pip is always the last decimal place of a price quote. Most currency pairs except the Japanese Yen go out to four decimal places. The yen goes out to two decimal places. E.g. EUR/USD = 0.0001 and USD/JPY = 0.01.

There is also something called fractional pips and brokers refer to them as ‘pipettes’. This is when brokers quote the currency pairs that go to five decimal places. The yen will only go to three decimal places. In the past, the spread in retail brokers would round up to a full pip and the broker would pocket the profit, but with fractional pips, the brokers can now offer lower spreads. As an example, in the past, the broker would provide a 3 pip spread, but now they can offer a 2.5 pip spread instead of the traditional system where they would have rounded up to the full 3 pips.

How much is a pip worth?

One pipette is equal to a tenth of a pip. Let’s look at an example: If the EUR/USD moves from 1.40501 to 1.40502 then that 0.00001 USD increase is one pipette.



The pipette is the figure which is at the top right corner of the largest digit.

How to calculate pips

Pip value is defined by a one pip movement seen in the spread. You use the term pip value when discussing the loss or gain of a position. Normally the major currency pairs are priced to four decimal places. One pip is equal to the fourth figure after the decimal place. For example, in the currency pair EUR/USD, 0.0001 is one pip.

The pips are very minute in value, therefore, when trading forex you deal with micro lots, mini lots, and lots. These are 1000, 10,000, and 100,000 units of currency. Trading on leverage can influence your position even though the value of a pip is small.

A pip value is influenced by the currency pair being traded, the size of the trade, and the exchange rate of the currency pair.

Here is an example of how to work out the forex pip value: The exchange rate of EUR/USD is 1.20 and we want to trade a mini lot size in this particular currency pair.

Multiply 10,000 by 0.0001 as 1/10,000 is a pip for all forex pairs (except Japanese Yen pairs). 10,000 multiplied by 0.0001 equals 1, which is one dollar as the USD is the counter currency in this pair. This means that if you buy one mini lot of EURUSD and the price trades from 1.1239 to 1.1240 you would have made one dollar. If the market instead trades to 1.1238 you would have lost one dollar.

So what does this mean? Well for every pip movement, your trade would earn or lose 1 dollar.

How to calculate pips profit

Calculating profit and loss for a position is relatively easy. All you need is the position size and how much the price has moved.

Let’s look at an example so we know exactly how P&L is calculated:

Say you have a position open on 10,000 EUR/USD and the position is currently trading at 1.2567. The price then moved to 1.2599, this means that the price has jumped 22 pips. Our calculation would then be 1 0,000 x 0.0022 = $22

However, we still need to know if this is a profit or loss and to determine this we also need to know if the trade is going long or short.

Long position: If the price increases then you would have a profit, likewise if the price moves down then this means you would have a loss.

What is a Forex Lot?

When it comes to currency trading you can't exchange random amounts of currency, you will have to trade in different pre-set sizes. You trade forex in lots and the most common retail lot is 100,000 units of currency and is called a mini lot.

Currency lots come in different sizes, these amount to 100,000, 10,000, 1,000, and 100 units respectively. Depending on the Forex broker some may show the quantity using lots and some may show the actual currency units.

In order to benefit from pip changes which can be a minute change in value, traders tend to trade large amounts of the currency to see significant profit or even loss. As an example, the daily change in the EURUSD from the start of 2019 to August was about 0.68% per day, in money terms that would amount to €6.8 for a micro-lot, and €68 mini-lot.

At the start of the retail forex industry, the standard lot was the norm, that meant that investors had to buy or sell 100,000 units, and trading was primarily for the very rich. However, brokers noticed that they could attract new traders with less by offering the mini-lot, eventually, the micro-lot was introduced. A great benefit of the micro lot is that traders can now tailor their risk better. As an example, according to a report published in December 2018 by Finance Magnates, the average account size was near $4000. Trading with a 10,000 lot would automatically enforce effective leverage of about 2.5 times the account, yet with a forex micro-lot, the trader can now trade with less than their account size e.g. buy one micro lot of 1000 units. As the trader can now trade without leverage they can better tailor their position sizes for the market volatility. In volatile markets, the trader can trade with fewer lots, while when the volatility is low they can trade with more lots.

WHY SHOULD YOU TRADE GOLD?

The gold market offers traders high liquidity as it holds a unique position within the global economy. Gold is not a fiat currency, meaning that it can still hold its purchasing power in periods of inflation. Normally, gold is associated with wealth and power and it has been this way for centuries, it had a major influence over the rise and fall of empires throughout time.

In the past gold was used as a monetary instrument along with other precious metals. Physical units were exchanged between traders and merchants. Then governments chose to use gold and silver as a form of currency, it remained this way for a long time until the decision was made to stop the underpinning of gold to currencies.

Now gold plays a significant role within the financial markets. People trade gold because they consider it to be a 'safe haven' asset. This means it doesn't need backing by banks or governments and it can still hold its value compared to other assets which can't hold its value.

Central banks will also keep gold reserves as a backup currency or a recognised asset which they can use in times of need. There is a high demand for gold as it is used in a number of sectors such as jewellery, finance, and technology.

A lot of people trade gold because of its value. Silver, on the other hand, has more industrial applications and it is a lot easier to find. Gold is impractical compared to the likes of silver and platinum which provides it with premium value. Gold can be seen as a form of an insurance policy for traders as it normally tends to be the product that they go for in times where the market shows uncertainty and volatility.

According to the World Gold Council, the gold market has high liquidity. They estimate that the average trading volumes for gold are significantly higher than other currency pairs excluding the majors which are EURUSD, USDJPY, and GBPUSD. Due to the high volumes of trade, the spreads are bound to be tighter, making gold an accessible and inexpensive commodity to trade.
There are a number of strategies that people can use when looking to trade gold, this includes fundamental factors like examining supply and demand, studying the current positions of gold traders, and technical analysis which is looking at the gold price chart. To trade gold a robust strategy would be using a mixture of the above.

What Drives Gold

There are many factors which drive the price of gold, this includes:

Safe Haven Asset Flows: Gold is not directly influenced by political and economic factors like the FX market. If there is political turmoil such as Brexit or the Trade War then this has a phenomenal effect on the relative currency, its pairs, and the overall price in the market. Therefore, many people turn to gold as it still holds its value through times of uncertainty in the market. It is normally viewed as a long term investment as investors like to include gold in their portfolios so that they can turn to it when the stock market is volatile.

The US dollar: If there is a weakness in the US dollar then this pushes gold prices up. If the US dollar is strong then it has the opposite effect on gold prices. The reason for this is that the falling dollar will increase other countries currency value, when this happens there is also an increase in demand for commodities such as gold, therefore, the price of gold will also increase on the market. However, gold will still remain a safe haven when the US dollar loses its value.

Inflation: For investors, gold can be seen as a hedge against inflation shocks. When inflation levels are high then the value of the currency will drop, losing its value and causing the FX market to fluctuate. Investors and traders may want a product which does not lose its value. This is why inflation has a relationship with gold prices and it can also drive the demand for gold, making it move on the financial markets. Essentially as inflation levels rise so does the demand for gold, this then drives the price of gold up. Instead of saying its inflation that moves the price of gold, it is more realistic to say that it is investor and trader fear that drives gold prices. However, whilst it is treated as a safe haven asset, it is very volatile and will experience very strong price swings during certain years.

Interest Rates: The most common opinion from commodity traders is that interest rates have a bearish effect on gold prices. Other traders believe that there isn't much correlation between gold prices and interest rates. However, if interest rates are increased by central banks then it tends to strengthen the US Dollar and in turn, cause gold prices to turn lower because of the opportunity costs. Also, high-interest rates highlight that an economy is doing well, which is another reason to anticipate gold prices to be suppressed. Interest rates can also be increased to combat spiralling inflation so it is important to understand why interest rates are being increased.

During the 1970s the gold prices were seeing a huge bull market and this led to its all-time high price during the 20th century. Interest rates were high during this period and they kept rising. The reason for the increase in interest rates was because of the high inflation at the time, and as we know from before, gold is considered a hedge against inflation, so it made sense for gold to increase despite interest rates being high.

Supply and Demand: Gold is never consumed, once mined it is still around in some form. Gold is a metal which is impossible to destroy, you can melt it and use it for various other things but it is indestructible. The most demand for gold lies in jewellery and investments. Normally because the supply is constant you would expect the price to go down but for gold, there is always a high demand for the precious metal.

Central Banks: Central Banks are said to hold one of the biggest influences over the market. Sometimes the central bank may want to reduce its gold reserves, this is mostly due to the fact that gold does not generate a return, unlike bonds. The timing of reducing the gold reserves is when the traders and investors have little interest in gold this means the price of gold then falls.

WHAT IS THE SPREAD?

The spread is mostly associated with trading and is the gap between the bid and ask price of a certain asset or security. The term for this is the 'bid-ask spread'.

The bid-ask spread is influenced by a number of things including the supply of the number of financial assets available to trade, and the demand or interest attached to a financial instrument. The bid-ask spread is also used to measure the liquidity of the market and the financial instruments transaction cost. Normally if the current volume of trades is high then the spread gets lower.

The Foreign exchange market is the world's most liquid market, importer and exporters access it in their everyday business, speculators and central banks trade it every day, and shares investors that want to buy overseas shares need to go via the Forex market to invest. It is therefore not surprising that the spreads are very low in forex trading. Trading in an asset that is small and obscure will also have a wider spread as only a few traders will be interested in it. For non-listed shares in private companies, there would not be a sell price, if the investor were to buy shares from a private company then they would have to find a buyer themselves when the time came to sell the non-listed share.

As a trader, you can trade via the two-way pricing. If you were to buy an asset with an ask price of 1.3567 and then immediately sell back the price at the price of 1.3566, you would lose one point per contract. Instead, if you want to break even you would need to allow the price to rise by one point to 1.3567/1.3568. The reason for this is that you buy at the ask-price, and sell at the bid price, then the ask price will always be slightly higher than the bid price. The difference will always be in the spread and it is the most common way in which your broker will make a profit.

In high liquidity markets, like FX markets, there are many people trading, and the competition amongst the brokers is higher which provides a tighter spread. The tighter or smaller a spread the more a trader will be able to profit if the market moves in their favour.

Let's take a look at the spread of a share. If Apple's share is quoted at 201/203 then this means that you could buy at 203 per share, and if you want to sell the share back you could do so immediately at 201. The spread is, therefore, three dollar per share.

Market Orders

What is a market order

When placing a trade you will need to execute an order. Once you execute an order, your broker or trading provider will have the details around your trade allowing them to buy and sell on your behalf, based on the instructions from the trader.

These instructions are recognised as orders and there are various types which enable you to trade instantly, such as market orders, or to trade at a specific time such as limit orders.

Once the order has been placed you will not have to keep watching the market as it does not require your attention.

Orders can automatically open a trade when you decide that the market conditions are just right, it can lock in profits by closing the trade when your target profit has been achieved, it can also limit losses by closing the trade when the market moves against you. This all depends on the type of order you place.

If you want to make a trade immediately then you are most likely to use a market order. If the market is liquid enough then your order will be executed instantly. Once it has been executed it is then called a 'filled order'. There is a chance that market orders can be executed at a worse price than the current quote on the market.

If you want to wait before making a trade then you could place a limit order. This is giving the instruction to trade if the price on the market reaches a specific point that is more favourable than the current price.

For example, the USD/JPY is trading at 1.5166 and the market analyst suggests that the currency pair is bound to fall after it moves up a point to 1.5167. You will most likely want to sell once it reaches 1.5167 but you don't want to sit in front of the computer screen, watching the platform 24/7. Therefore you would place a limit order so that you can execute a short trade once the price hits the point you want to sell at.

Now if the market does reach this level the broker makes the trade you requested and you sell USD/JPY. Then the trade continues like normal if it falls as your analysis predicted then you make a profit and if it continues to rise, you make a loss.

Stop-Loss Orders

What is a Stop Loss Order?
A stop-loss order is a form of a pending order that rests with your broker, and it is an instruction to trade at a specific level if your position moves against you.

Using a stop-loss order means you can close a position which is moving against you, once it reaches the point where you don't want to lose any more the stop loss you have placed will close the position. The purpose of the stop-loss is to give you some sort of protection against losses, so it is used as part of a risk management strategy.

Let's take a look at an example to see how the stop-loss limit order works:

If I owned 50 shares of Apple which I bought at $200 and the share price has declined to $180, what could I do?
If I thought that the price of the company was going to fall even further I could be looking at pulling out at the trade at $179, this is where I would place my stop-loss at.

The price does, in fact, keep declining and reaches $120 but my stop-loss has been triggered and the trade has been closed. I would still have made a loss but it would be significantly lower compared to the loss I would have made if I did not place a stop-loss order.

There is also a term called the stop entry order, this means placing an order to trade at a worse price. Why is this sometimes a good idea? Some analysts could suggest that the market will keep moving in the same direction once it hits a certain level. Using this sort of order allows you to take advantage of this.

Positives and negatives of stop-loss orders:

- No monitoring - When you place a stop-loss order it means you don't have to monitor the market constantly. During the moments where you are busy, you don't have to worry about missing major market movements as you have managed your risk.

- A negative is that the market is also prone to short-term fluctuation this could activate the stop order. If you put a stop-loss order at 5% on a stock which is known for decreasing by more than this then the stop-loss order is not effective. However, if the daily market volatility of the stock is less than 5% then a well-placed stop-loss could help you to maximise profits and minimise losses. The same logic applies to any other financial market.
- Once the price reaches the desired stop price then the order becomes a market order. Therefore if you decide to sell the asset then it might be different from the stop price, and this is what is called slippage. The reason for slippage is that there is not enough volume to close everyone's position at the desired stop-loss price level, so some would be forced to sell at slightly lower prices. As an example, you bought one million EURUSD, and so has your best friend. You both have the stop at 1.2020, however, when the price reaches 1.2020 there is just 1.5 million of buying demand, and if your friend's broker is quicker than yours the might get your friend out at 1.2020 as desired, and that leaves just half a million for you at 1.2020. The rest of your order will be executed at the next best price that could be 1.2019 thus your average exit price will be 1.20195, and you would have incurred a slippage of half a pip.

Trailing Stops

What is a Trailing Stop

A trailing stop is a type of order that will also protect your profits as well as losses. It is attached to a trade that you might open, if the market moves in your favour then the trailing stop mirrors the movement. It acts as a shadow and it keeps its distance from the current price but it creeps up step-by-step until it gets to the most current price and closes your position. This essentially allows it to close your trading position at a better level than your initial stop loss level. Ideally, this is at a level when you are still in profit.

If the market moves against you immediately after opening your trade then the trailing stop doesn't move.

Normally if the trader is going long then they will place a trailing stop limit below the market price, if on the other hand, they are going short then the trailing stop loss order will be placed above the market price. This is normally allocated when the initial trade is placed allowing the trailing stop to mirror the trade taking place.

For example, if a 50 pips trail stop is attached to your trade going long then your position will be closed if the market price declines with 50 pips. However, if the price gains by 10 pips then your stop loss will be reduced by 10 pips. If your position gains by another 10 pips then your stop will be reduced by another 10 pips. You can manage the exact trailing stop limit settings with your broker.

Another example of this would be if you bought the EURUSD pair at 1.2050 with a 50 pips stop at 1.2000. If the price moves to 1.2110 then your floating-gain would be 60 pips, and your stop-loss would now be at 1.2060, this means if the market declines and reaches 1.2060 you would have locked in a profit of 10 pips.

The trailing stop has much more flexibility than a stop-loss order being placed. The reason for this is that it automatically tracks the price direction of the specific asset you are trading so the trailing order does not need to be physically reset.

Traders normally master the trailing stop order by not placing it too tight or wide. If it is placed too tight then it might be triggered by normal market movements, therefore, it will not help make the most out of any market opportunities. If the trader sets it too wide then they are opening themselves for unnecessarily large losses, or even giving up any possible profit.

Take Profit Order

A take profit order (TP) specifies the exact price that the trader needs to close an open position in order to make a profit.

Traders usually create a take profit at the same time they create a stop-loss order, this is to manage the positions that they have open.

If the asset rises to the take profit point then the order is executed and the position will be closed, leaving the trader with their desired profit. However, if the asset price falls to where the stop loss point is and the order is executed, the trader is left with a closed position and a loss. When these two points have been set, the difference between these points and the market price enables the trader to work out the risk-to-reward ratio.

The take profit order means the traders don't have to execute the trade themselves and the order is executed at the specified price, locking the profit. The orders are left resting on the broker's server and the trader can focus on other things.

Traders tend to use technical or statistical analysis to figure out their take profit and stop loss levels, and typically, the take profit orders are placed at resistance levels as they want to lock in the profits before the price starts a correction. Stop-loss orders activated by traders below certain support levels signal for a lower move for prices.

In general, it is good to have an idea where to place stop-loss orders and take profit orders before initiating a new trade, as it will challenge the investors to figure out if the trade is worth the risk. Also, dealing with stop loss and take profit orders when a position is showing a profit or loss will make the trader more prone to take less objective decisions as the floating profit or loss will influence the decision making.

Pending Orders

A pending order is an order to buy and sell an asset which is then executed at some point in the future when the price of the asset reaches that level. When the price eventually reaches that level the order will be executed automatically, meaning that the trader does not have to watch the market around the clock. It is important to note that pending orders are normally executed with slippages.

Pending orders are normally split into stop orders and limit orders. There are multiple types of pending orders but the most basic ones are:

Buy stops: A buy stop order is when you want to buy an asset at a specific price that is higher than the current price e.g. market price is at 102 and you place an order to buy at 110.

Sell stops: Sell stops are the opposite e.g. the price is at 102 and you would like to sell at 98 as you think the will keep on declining.

Buy limit: A buy limit is an order when you are willing to buy at a specific price or better, e.g. the price is at 102 and you would like to buy at 101.

Sell limit: This is the exact opposite of a buy limit order, you are setting a specific price that you are looking to sell, e.g. the price is at 102 and you would like to sell at 104.

The slippage is the difference between the price set by the trader and the price at which the position is executed by your broker. It is important to note that the price may be better or worse than the set one.
Prices will always change in the markets. You may have placed an order to trade at 102 but when your broker receives the order the price might be at 103.

Slippage mostly occurs when you have placed a stop-loss order and it's ready to close the position in case of an adverse market move. The higher the market volatility the higher is the risk of slippage, therefore slippage is higher during periods of market-moving news that produce high market volatility.

THE IMPORTANCE OF A TRADING PLAN

Success in the financial markets, particularly in forex, is highly dependent on the existence of a trading plan. Many retail traders operate without a trading plan and this is one of the reasons that many lose money. Successful businesses first start with a blueprint, known as the business plan, so why would FX trading be any different?

Many of the best trading plans are:

- Have clearly defined objectives and parameters
- Simple

Trading plans should detail:

- A method of entering the market that is statistically proven to be profitable
- When to exit a position in order to preserve profits and limit losses
- How much to risk in the total portfolio
- How much to risk per trade

What should your trading plan consist of?

There are different models and styles of trading plans. Some can be quite encompassing, designed to accommodate other factors that are outside the core trading mandate, while others are more simplistic.

Trading plans should address the following principles:

- Set realistic profit goals for a specific time period: Some traders define their profit targets by assessing how much money could be made in a week or a month. It is normally effective to define monthly profit targets in pips rather than a monetary figure. When the trader sets their target as a monetary figure it could lead to excessive risk.

- Define your trading strategy: Traders use different strategies to achieve their profit goals. Some traders may use price action, while others decide to use indicators. Some even leave it in the hands of forex robots, or could even decide to copy the traders from a social media platform.

- Define your entry strategy: The entry strategy will include the entry price, as well as the type of order you will use to achieve a trade entry at your chosen entry price. Buy or market sell orders should not be the sole trade entry method. Using such orders can result in losses, especially if there is a chance that the market could retrace on your position before it resumes the expected move. In such instances, using a limit or a stop order may be more advantageous. It is key to know when such orders should be used and at what price your entry should be executed.

- Define Your Risk-Reward Ratios: The concept of risk-reward simply defines how much profit (in pips) you are targeting in a trade, versus how much loss you are prepared to accommodate using a stop loss. The bare minimum for an acceptable risk-reward ratio is considered to be a target of 3 pips in profit for every 1 pip, which is then used as a stop loss. This is a risk management strategy aiming to ensure a trading account is not debilitated by a string of losses.

- Define Your Risk Management Levels: Many experienced traders agree that no more than 1.5% of the capital in a trading account should be committed to active trades. You should calculate the financial implications of using various trade sizes which allow you to conform to the 1.5% rule, using your allowable leverage limits as a guide. Margin requirements for clients of regulated UK and EU firms are set at 30:1 and 20:1 for FX majors and FX minors respectively. You should be able to calculate what trade sizes and what capital requirements will keep you within the 1.5% exposure limit.

- Have a Plan On How to Recover From Losses: Losses are expected when trading the financial markets, they happen to the best of traders. What makes the difference between successful and unsuccessful traders is how losses are handled. Some traders use strategies such as the Martingale and grid strategies to recover from losses, which are exceedingly risky. The trader should be able to devise a low-risk methodology of recovering from a string of losses.

This is not a comprehensive forex trading plan, however, we have provided you with a guide that you can use to navigate the financial markets.

Types of Technical Analysis charts

There are numerous technical analysis charts that exist for displaying different types of information in a visual or graphical manner. The most common of these include bar charts, line charts, point and figure charts, and candlestick charts. These four types of charts are used widely by traders, analysts, and investors to display the price movements of tradable instruments, such as currency pairs and stocks.

Line charts

Line charts are some of the simpler charts used by traders to conduct technical analysis. They plot the closing price of a given asset during a specific timeframe. The line chart is created by connecting the closing prices for each time period to form a line. The main drawback of line charts is that they do not reveal the intraday price swings that typically occur during a time period, as they only reflect the closing price for the specific period. Despite this drawback, line charts are popular among investors who regard the closing price of a given instrument as being more important than any price swings recorded within a particular time period.

Barcharts

Bar charts are more detailed than line charts as they reflect the opening and closing prices as well as the highs and lows reached by an instrument during a trading period. Bar charts are made up of horizontal lines with a dash to the left indicating the opening price and a dash to the right indicating the closing price, while the highs and lows are reflected by the bar's height.

Point and Figure Charts

Point and Figure graphs consist of columns of X's and O's which represents an uptrend or downtrend in the price respectively. Each X and O represents a predefined price interval, this is called the box size. The numbers and letters in the chart represent the beginning of a month (1-9, A,B,C). Unlike bar charts and line charts - which are two dimensional, point and figure charts are based on price only, making them one dimensional as they do not take into account time or volume. It is used to identify consolidation periods, as well as set price objectives based on chart formations. Point and figure charts do not plot the volume traded and their purpose is to identify any supply and demand changes, which are known as "breakouts".

Candlestick charts

Candlestick charts are very similar to bar charts as they display similar information with the main difference being a slightly wider rectangle in the middle of the bar representing the opening and closing prices for a given time period. Bar charts that indicate price declines have a different colour to those that indicate a price increase over the plotted period.

Time frames

Most beginner traders typically get stuck trying to choose the perfect time frame, as the typical belief is that each asset has a single time frame on which their trading strategy will work.

This usually results in new traders spending hours and days trying to decide which timeframe they are most comfortable trading.

To correct this misguided belief that usually leaves newbie traders spinning in circles, there is no perfect time frame to trade any asset, or instrument as you can still make both profits and losses, trading on different time frames. The key to choosing a timeframe to trade should be based around your trading personality and how much time you are willing to dedicate to your trading activities. For example, most beginner traders with full-time jobs would benefit from trading on higher time frames such as the 1-hour, 4-hour, and daily chart time frames. Take a look at the examples below:

EURUSD Hourly Chart

EURUSD 4 Hours Chart

EURUSD Daily Chart

On the other hand, if new traders had the means to watch their trading account all day, then they might prefer to make frequent trade on shorter time frames such as the 5-minute and the 15-minute charts.

When choosing a time frame you should pick one based on your trading personality, trading strategy, and the time you can devote to trading the financial markets. For example, there's a huge personality difference between day traders, scalpers, or even position or swing traders regarding how frequently they would like to make trades.

Once you have decided which timeframe you would like to trade, the next step is to find suitable trade setups that minimize your risk exposure, while maximizing your profit potential. We will cover this step in depth at a later time, but the key to successfully trading on any timeframe is to identify the prevailing trends within each time frame. For example, a day trader who focuses on the 15-minute charts would be well-served by identifying the primary trend on a higher timeframe such as the 1-hour chart, and then using the 5-minute chart to determine a suitable entry for their position. The same applies to a swing trader who focuses on the 4-hour charts as they would be best served using the daily and weekly timeframes to identify the long-term trends, then using the 1-hour charts to determine a suitable trade entry position.

Lower time frame charts are considered to have more noise due to intraday random moves that might not have an impact on the overall long-term trends.

The higher time frames carry more weight because they display more data and show more time than a smaller time frame does.

If you compare a 5-minute chart with a 1-hour chart you can see how many more failed signals there are on lower time frames. The reason for that is because there will be a lot more meaningless price movement on a 5-minute chart than on a 1-hour chart. If you were to just look at one price bar on a 1-hour chart, you would not see all the 5-minute bars that created that 1-hour time frame, you would instead see the broad picture of all those 5-minute movements.

You simply are not going to get a very strong directional movement out of a 5 minute or 15-minute chart signal, instead, you will get a lot of little meaningless movements that will not help you identify the trend. Shorter timeframes involve a lot of emotion and it is considered to be mentally exhausting due to fast movements in the market. The GBPUSD chart below highlights many ups and downs, this does not provide the trader with a clear trend.

On the other hand, if you look at the 1-hour chart for the same period you will recognize a clear downtrend move that gives the opportunity for decent gains, and even more out of a 4-hour signal, and even more out of a daily chart signal.

The above examples demonstrate the importance of using different timeframes in your trading as a way to achieve the best possible trade entries and exits. The higher time frames should help you identify the main trend for an instrument and the lower time frames are perfect for identifying the entry positions. The key to trading profitably using different timeframes, is to identify your trading personality and the trading strategy that matches it. Then you can choose the asset and timeframe on which you want to execute your trading plan. Always remember that nothing in the markets is guaranteed and that trading is a game of probabilities, where you want to put all factors that you can control in your favour since the markets never make it easy for you to win.

Barchart

A bar chart is a graphical representation of the price of a tradeable asset such as a currency pair or a stock that illustrates changes in price over time. Barcharts are used by traders, analysts, and investors to examine the price movements of a tradable instrument, they do this to determine when the right time to buy or sell the asset is.

What is the anatomy of a bar chart?
A bar chart typically indicates the opening price of an instrument with a dash to the left and the closing price is represented by a dash to the right. The top of the bar usually represents the highest price at which the instrument traded, whilst the bottom of the bar usually reveals the lowest traded price for that time period. Bar charts are also called "OHLC" charts because they indicate the Open, the Low, the High, and the Close for that particular instrument.

Reading a bar chart
Barcharts are popular among traders and analysts as they usually contain a lot of information about the price movements of an instrument over a given timeframe. The first step to reading a bar chart is to decode its colour scheme, as the bars that represent a price increase will have a different colour to the bars that indicate a price decrease. This makes it easier for a trader to identify whether the price closed higher or lower than when it opened. Barcharts also contain the highest and lowest price achieved in a given time period. Traders can use bar charts to decode an asset's overall price trend by looking at a chart which covers a specific period of time.

Nikkei 225 Bar Chart Example

Bar charts are usually created with the price on the vertical axis and time on the horizontal axis. Each unit on the horizontal axis usually represents a block of time such as five minutes on the 5-minutes chart, or one hour on the hourly chart. A series of bar charts plotted on a graph can be used to tell whether the overall price trend is rising or falling depending on bar colours, as well as opening and closing prices of individual bars.

Bar chart vs histogram

Some beginner traders might want to compare bar charts to histograms, but the two are quite different, and histograms are rarely used in trading. However, the main difference between a bar chart and histogram is that histograms usually do not have spaces between the bars, while bar charts contain spaces. Despite this, it is highly unlikely that you will use a histogram as one of your technical analysis tools when it comes to trading.

Japanese Candlesticks and Patterns

History:

Japanese candlesticks were invented by Japanese rice traders during the 17th century. Rice traders used candlestick charts as a method of technical analysis to help them predict rice prices. A rice trader called Munehisa Homma was the person who invented this charting mechanism. Japanese candlestick charts became popular in western countries after Steve Nison published a book titled Japanese Candlestick Charting Techniques in 1991.

How to read a Japanese candlestick chart:

Japanese charts are also referred to as OHLC charts, which is an acronym that stands for Open, High, Low, and Close charts. These charts typically display the opening and closing prices in the chart's body and the highs and lows as wicks below and above the body.

Bullish bars usually have a closing price that is higher than the opening price, while bearish bars typically have a closing price which is lower than the opening price.

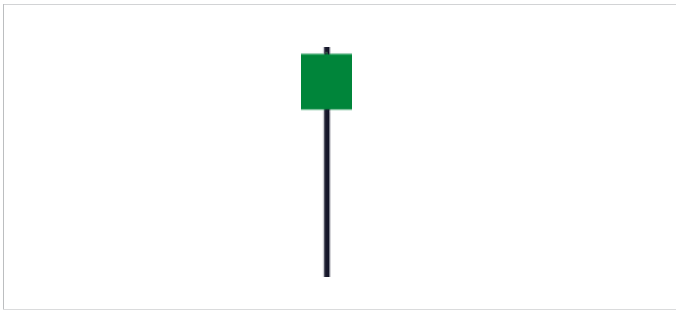
Bullish reversal candlestick patterns:

Bullish reversal patterns usually indicate that the price momentum might be likely to shift in favour of the buyers. Popular bullish reversal candlestick patterns include:

- **Piercing pattern**
- **Bullish engulfing pattern**
- **Morning star**
- **Tweezer bottom**

Hammer:

The hammer is a candlestick that forms when a bearish candle reverses and closes higher resulting in a long bottom wick and a small bullish body. The hammer usually has no upper wick or a very tiny upper wick if it is present. The defining characteristic of the hammer is that the wick is usually about 2 to 3 times bigger than the body, and the body usually makes up about a quarter of the candlestick.



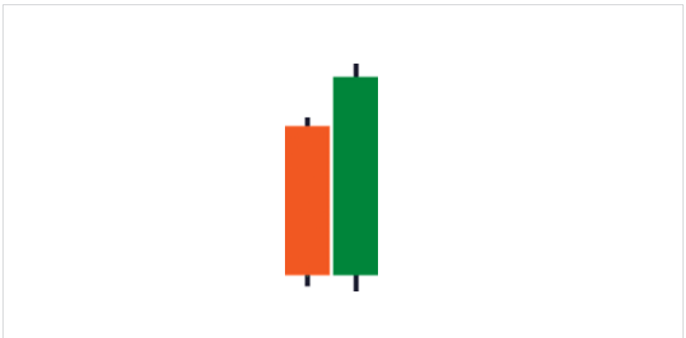
A hammer basically indicates that there has been an intense selling pressure placed on the opening of a session. It indicates that the seller has driven the price lower, but at some point, the buyer took over and driven the price of the asset higher. The buyers kept buying up to the end of the session to ensure the asset closed higher than its opening price.

This is why a hammer is regarded as a bullish reversal candlestick, as it demonstrates that buyers were keen to push the price and higher and may continue to keep the buying momentum going in order to drive the price further.

Bullish engulfing pattern

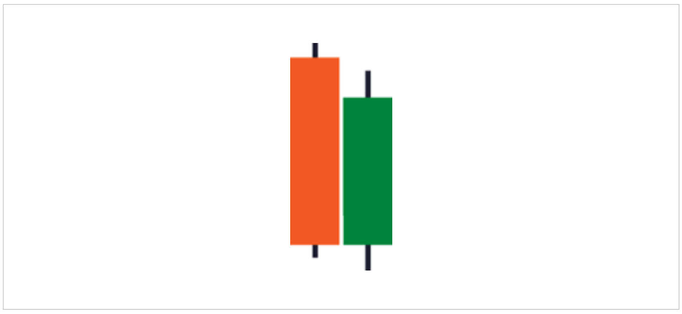
A bullish engulfing pattern is made up of two candles, one bearish and one bullish. A bullish engulfing pattern usually forms after a bearish candle is followed by a bullish candle that closes above the high of the bearish candle.

The bullish engulfing pattern usually indicates that the trend has reversed following a bearish candle, and that buyers were keen to drive the price above the high of the previous bearish candle. This pattern usually indicates that buyers are in control momentarily, however, this does not guarantee that the trend has shifted over to the bullish side.



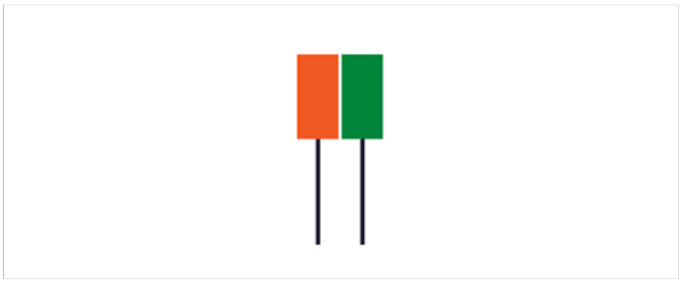
Piercing pattern

A piercing pattern is similar to the bullish engulfing pattern, with the only difference being that the bullish candle closes within the body of the bearish candle that has preceded it. This means that it is not a very strong signal when compared to the bullish engulfing pattern. However, with further confirmation, the piercing pattern can be just as good a signal as the bullish engulfing candle.



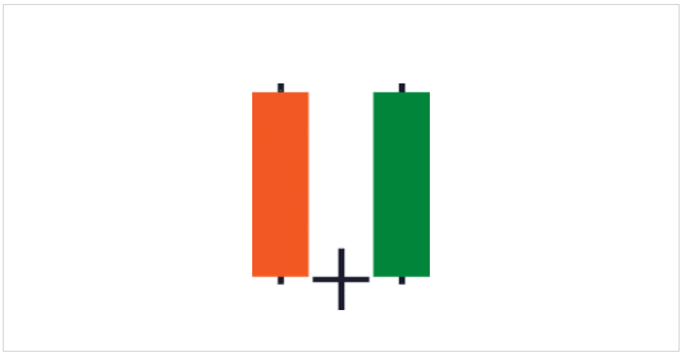
Tweezer bottom

The tweezer bottom is a candlestick pattern that is made up of two similar candlesticks but with the first one being a bearish candle and the second one being a bullish candle. The key to identifying this pattern is that the two candles are usually the same size and they both have lower wicks without the presence of upper wicks.



Morning star

The morning star candlestick pattern is composed of three candlesticks and usually indicates that prices are about to reverse with a bullish bias. The pattern is made up of a bearish candle with small wicks followed by a Doji candle, then a bullish candle with small wicks, completing the pattern. This pattern is a strong indicator that sellers have been overpowered by buyers, and that buyers are currently in control of the instrument's price movement.

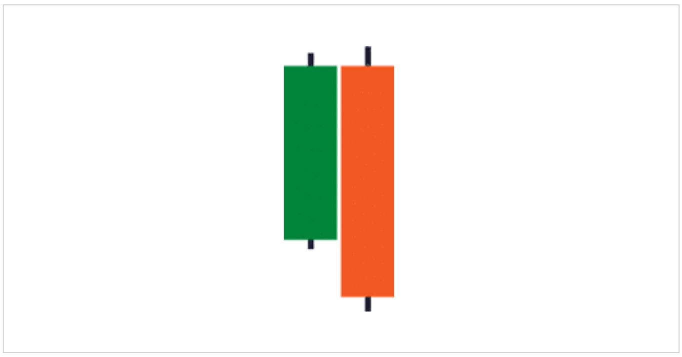


Bearish reversal patterns

Bearish reversal patterns are usually a sign that the price might reverse in favour of the sellers, which could pinpoint optimal locations for placing bearish trades.

Bearish engulfing pattern

The bearish engulfing pattern is made up of two candles with the first one being a bullish candle, which is followed by a much larger bearish candle that covers the entire length of the bullish candle. This pattern indicates that in a tussle between the bulls and the bears over two periods, the bears finally won by retaking all the gains made by the bulls in the first candle. This indicates that a bearish reversal might be in the offing.

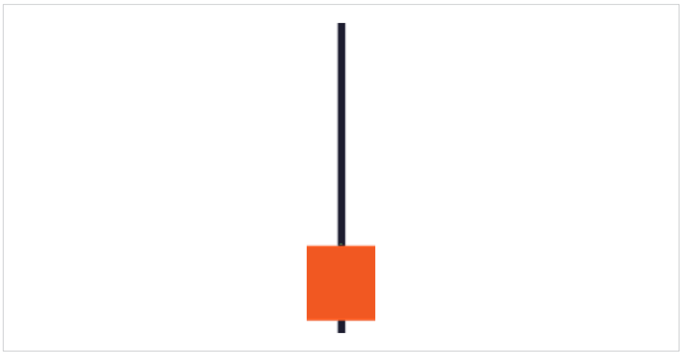


Evening star

The evening star candlestick pattern is the polar opposite of the morning star pattern formed by three candles starting with a bullish candle followed by a Doji candle at the top, then a bearish candle which completes the pattern. The pattern indicates that buyers were in control during the first period but then this was followed by a period of indecision, finally sellers stepped in to drive the pair lower. This is a strong indicator of a market shift driven by selling pressure.

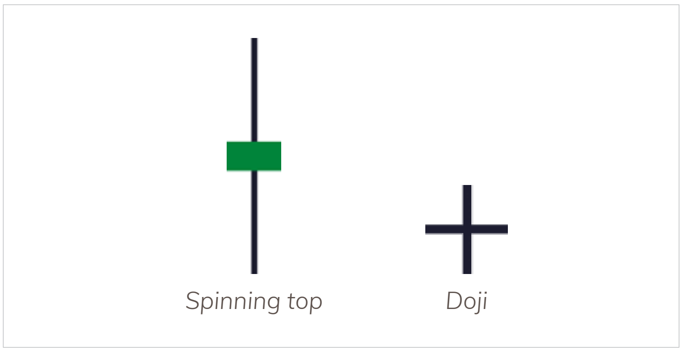
Shooting star

The shooting star consists of a single bearish candlestick that can be easily identified by its long upper wick, its small body and an almost non-existent lower wick. The pattern usually indicates that buyers were in control at the open and pushed the price higher before sellers came in and drove the price lower. This reveals that the selling pressure at the moment is much stronger than the buying pressure, hence a bearish reversal is highly likely.



The spinning top and Doji

The Doji and the spinning top have very similar patterns with the only difference between the two candlesticks being the size of the bodies and the wicks. The Doji is like a cross and has a tiny or non-existent body with short wicks, while the spinning top has a tiny body and very long wicks. The two patterns indicate a state of indecision in the markets as neither buyers or sellers have control of the price direction.



Final comments

Remember that you should not base your trading decisions solely on candlestick patterns as they are not always accurate. You should always combine candlestick trading with key support and resistance levels as well as other indicators to confirm whether the signal has a high chance of success. Always keep in mind that nothing is guaranteed in the markets, which means that you should always limit your risk exposure in each trade. This will help you minimize your losses and increase your chances of becoming a profitable trader.

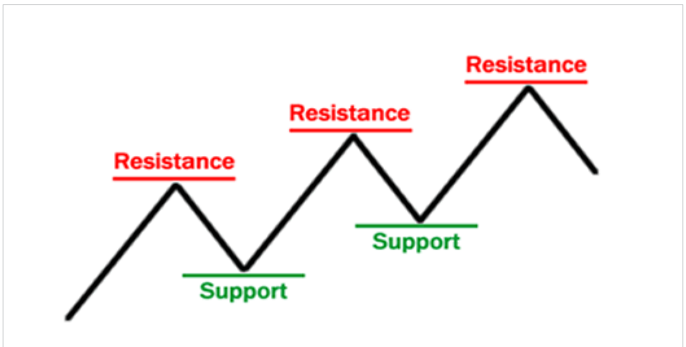
Support and Resistance

For new traders who might not be very familiar with Forex technical analysis, support and resistance levels are regarded as a crucial part of technical analysis. These levels are important to forex traders as they indicate potential areas where the price of a currency pair or other instrument might act in a predictable manner. Given that forex trading is a game of probabilities there are no guarantees in the markets, support and resistance levels are regarded as zones of high probability.

Support zones

A support zone is an area on a price chart where the price shifted from a bearish bias into a bullish bias in the past. This basically means that a support level is a level at which the price of a currency pair stopped falling and turned higher in the past. Technical analysis is based on the assumption that price trends in the market tend to repeat over time, meaning that if the price turned higher at a support level in the past, it is likely to do the same in future.

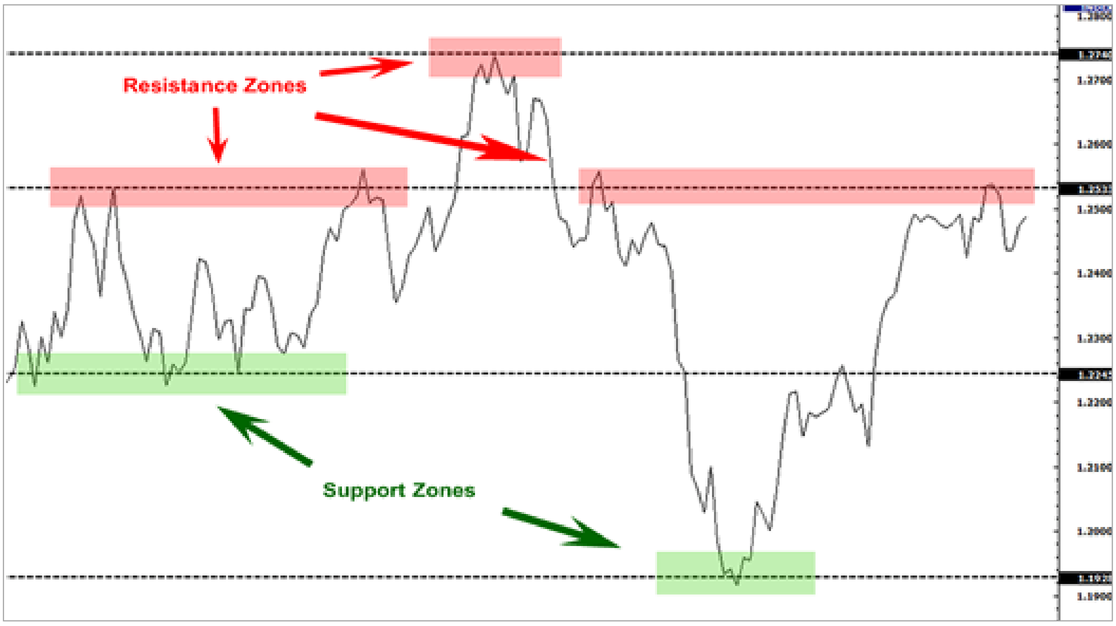
Fig 1: Basic support and resistance levels



Resistance zones

A resistance zone is an area on a price chart where the price of the instrument stopped rising and started falling in the past. This level usually indicates that the price of a currency pair is likely to reverse and head lower once it reaches the identified level. Resistance lines offer a high probability that an asset's price will turn lower to become a suitable level to place bearish trades based on other confirmation signals.

Fig 2: Example of support and resistance levels on a line chart



Drawing support and resistance levels

To draw an accurate representation of support and resistance lines, you should always remember that there is no perfect resistance or support line. What you should be aiming for is to draw a line that touches the most points around a specific level, which should now represent a viable support or resistance level.

S&P 500 Support & Resistance Levels

The best support and resistance levels are usually made up of two lines enclosing a region where the price reversed each time would hit the section. The most accurate support and resistance zones are usually drawn on the chart with hundreds of candlesticks covering a substantial period of time. Such zones are usually more reliable because they indicate that the price respected the chosen level multiple times over a long period of time.

Fig 3: Drawing support and resistance on a zoomed chart

When exactly is a support or resistance level broken?

The simple answer to this question is that a resistance level is broken once the price closes above the resistance region and the second candle opens and closes much higher. The opposite is true of what represents a break of support as this occurs when price closes below the identified support level and the next candle opens and closes much lower.

However, this definition may not hold for all scenarios as sometimes two or three candles may break and close below a support level only for the next candle to reverse and close above support to invalidate the move. This may also happen in cases where a resistance level has appeared to have been broken only for the price to fall back below resistance. Such instances are called false breaks and are quite common within the Forex market.

How to confirm a break of support or resistance

The only way a trader can tell if a support or resistance level has been broken, is to give it time and wait to see how it turns out. You should also consider the time frame you are trading on, the higher the time frame the more accurate a break of support or resistance is. For example, a break of support on the daily chart that is backed up by two or more candles closing in the direction of the break is a reliable signal than a similar break on the 1-hour chart, which is not as significant.

Most experts advise beginner traders to wait for confirmation of a break of support or resistance before opening a trade in the direction of the break. Confirmation usually consists of a pullback to the previous resistance level, which now acts as support before the price continues to rally higher. However, you should remember that a pullback may not occur in all situations and waiting for such a confirmation may lead to missing out on significant profits as the price keeps going in the direction of the break.

Final remarks

Support and resistance zones are a crucial component of Forex technical analysis and they usually provide high probability setups for trades in the direction of the break or reversal. However, beginner traders should wait for confirmation of a break of support or resistance before initiating trades, unlike more experienced traders who may have a deeper understanding of the markets.

WHAT IS FOREX FUNDAMENTAL ANALYSIS?

Fundamental analysis in forex is important whether you want to be a hotshot financial analyst or you simply want to be hands-on with your Forex trading. It involves using either qualitative or quantitative economic and financial factors to determine the intrinsic value of a currency.

Why is fundamental analysis necessary?

Fundamental analysis provides a wider view of all possible elements which could affect the value of a certain currency pair, as well as the overall FX market. This sort of analysis is preferred by some traders as it involves numerous financial elements which ultimately provides an accurate picture of a currency's intrinsic value, this differs from technical analysis which relies on past data.

Examples of forex fundamental analysis tools and data

There are various tools and data that fundamental analysts use, here are a few:

- Economic growth and outlook: One way of determining whether a currency is strong or not, is by looking at the overall economic health of the country. Both positive and negative economic outlooks can have a profound impact on the price of FX pairs.
- Capital flow: This is a measure of the money flowing in and out of a country when people buy and sell capital investments.

- Trade flows and trade balances: Trade balances measure the difference in ratio between exports and imports in a country. Trade deficits are known to push the value of currencies down.

Pros and Cons of fundamental analysis in forex

Pros: There are different reasons why people choose fundamental analysis instead of technical analysis. Firstly, fundamental analysis is based on financial data, which leaves less room for personal bias. This allows investors to use the right information and tools to make informed decisions. Fundamental analysis is a valued option for traders who require a long-term view of the forex market. in and out of a country when people buy and sell capital investments.

Cons: One of the major problems with fundamental analysis is that it is a time-consuming process. It may not be the best option when someone needs to make a quick trading decision.

Conclusion: In summary, forex fundamental analysis is great for people that want an in-depth look into the value of a currency pair. A trader that understands how to read and apply fundamental analysis will make informed decisions once they know the approximate value of an asset class.

WHY IS RISK MANAGEMENT IMPORTANT?

Risk Management in Financial Trading

In all aspects of financial trading, risk management is essential in order to ensure that market risk is mitigated at all times. There are various methods used to try and eliminate a market risk which includes placing contingent market orders, or even through hedging. Hedging is when a trader takes up a position in the market which moves in the opposite direction. For example, a trader buys the FTSE 100 and also buys gold, if stock markets decline the gold would then go up, as it tends to do during times of turmoil.

In all cases, risk management is achieved through planning and examing statistical references. Statistics can show how average-trades perform, it will also highlight how the market moves against the trader, and how it moves in favour of the trader. By looking back at market charts and past trades, the trader is able to figure out some basic risk management rules and principles.

Broadly speaking, most traders follow basic trading psychology strategies. The trading strategies implemented are all about controlling risk and avoiding confirmation bias. This means that all trades are planned in advance, and once placed, the logic for making any further decisions is clear and well thought out. Confirmation bias occurs when you attempt to read indicators whilst having an open position, this could potentially lead to the wrong conclusions.

Fixed vs Dynamic Stops

Fixed stops are placed when the trader opens their position, the fixed stop does not respond to the market and the trader leaves it to run until they have closed their position.

A dynamic stop loss is also known as a moving stop loss, once it has been placed it responds to market conditions. The trader does not move it themselves but rather it moves on its own according to automatic criteria.

There are no absolute rules in trading, however, fixed stops tend to be more suitable for day trading, mechanical trading systems, and for automated trading. Whereas dynamic stops are better suited for swing traders. A swing trader has time to consider more factors, such as previous highs and lows, rather than just a fixed size stop.

Case in point: EURUSD Daily Chart and Risk Management.

Markets tend to trade between trend lines shown in the chart above. When the trendline channel is wide, it makes sense to use tight stops when the price is about to test the boundaries of the channel. This is so the trader can stay protected in case of an adverse breakout. But if you are trading in the middle, between the two boundaries, it makes sense to use larger stops to embrace the day to day volatility. Moreover, these channels differ in width from time to time, so swing traders are better off using dynamic stops and not fixed stops, as they would have time to calculate the stops correctly. Figuring out the exact stop loss level can be tricky. New traders will find it especially difficult if stops are set too close to the market price because it is almost certain that they will be triggered. Often the market will take out these tight stops, only to end up going in the original desired direction.

Once the trader has carefully considered their risk and put in the appropriate actions to manage it, trading stress is controlled. It is also advised that as well as risk the trader also understands the core concepts of money management as it will come in useful when adjusting trade sizes and recording the traders progress. Traders will most likely increase their trade size when their account grows, and they normally decrease trade sizes when they are facing a losing streak, this is the standard strategy when it comes to risk management.

Limiting Risk by Hedging

Hedging could also be considered to be another form of risk management. The idea behind hedging is to have two trades open at the same time in two different markets. A risk factor may suddenly cause the two open trades to react differently. For example, if one trade lost money the other open trade will make enough to limit the loss caused by the first trade.

An example of a hedging pair would be Gold and Crude Oil, most of the time these two markets are loosely positively correlated. Risk management on this pair can be achieved by going long on one open trade and short on the other. The trader can still place stops, but at a more flexible distance. Hedging on this pair would require studying the two markets independently, and also as one. If a risk event occurs, such as the US dollar rallying sharply, both markets will move lower in that day or week.

Time Stops

Another often overlooked method for limiting risk, especially in stock market indices and major forex pairs is elapsed time. You can think of this method as a kind of stop, in the time domain. This is when you place a trade and then wait for a certain period of time. If the market has not moved in your favour by that time, then there is a high probability that your trade will be a losing one. This is considered to be an effective method as the trader will be able to detect trades whilst they are incurring a small loss, or even at the stage where there is no loss at all.

Stops in the time domain are great for limiting risk and keeping your trading psychology in form. The amount of time you need to give each trade depends on the trading style, typically it'd be something between 10 and 30 minutes for day trading. Whereas in the case of swing trading it'd be more like 2-3 days. During forex market opening hours you can test this theory out and study the market, from the 30-minute chart all the way to the daily chart.

You can also analyse the behaviour of other trader's when they are analysing the charts at the same time. An important time to pay attention is when the market takes out an important level, and when a strong move is expected to happen but then the market suddenly goes flat. If you have your trade open and a few days go by where the market has not moved in the expected direction and no stops have been triggered, then the time stop would have been triggered. This would be a good time to close your trade even if the trade only has a small profit.

Conclusion

Risk management trading techniques work, and you can use more than just simple fixed-size stops. You can learn how to inspect statistics closely and gain better risk control methods based on the principles discussed in this article.

How to Set Stop Loss Orders

How to Set Stop Loss Orders Effectively

Financial trading is risky, so limiting that risk as much as possible is essential in order to survive the uncertainty of the financial markets. Classic stop-loss orders can be of fixed size, trailing fixed size, or dynamic. Each type of stop-loss order has advantages and disadvantages, and it is also possible to make use of all three types in a single trading strategy.

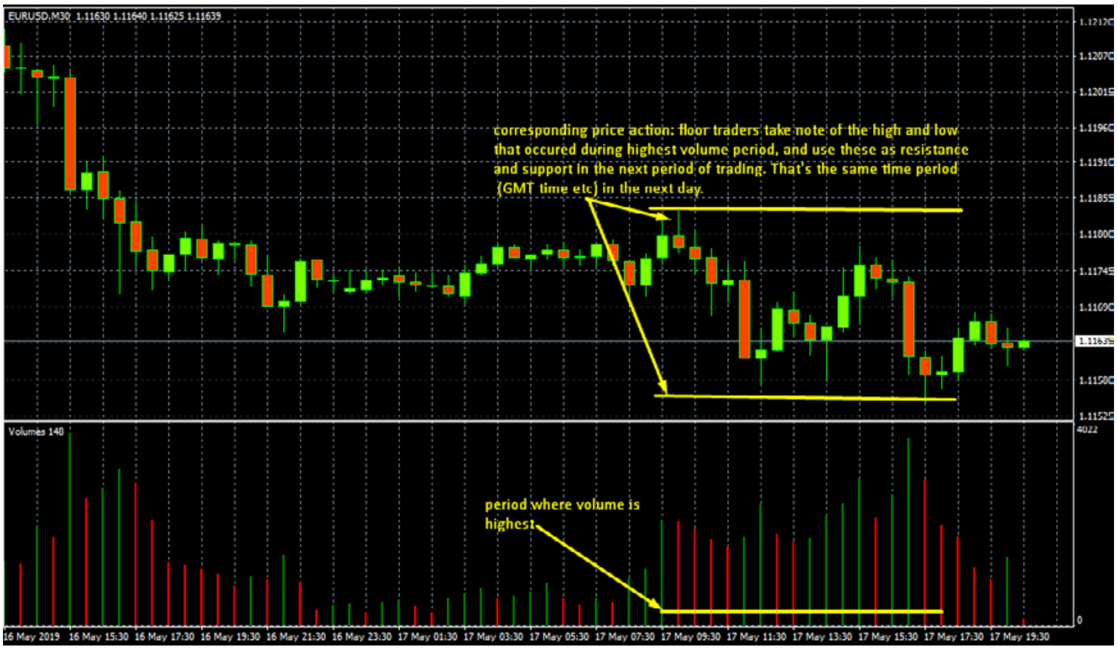
Some traders rely on moving averages, swing trading theory, LSS pivot numbers (also known as pivot points), and gaps and chart patterns. These methods are used as a way of determining when the market is likely to reverse. In reality, none of these methods is perfect, and may not be suitable for all time frames. However, out of all these popular methods for setting stop-loss orders; pivot points and gaps are the most effective ones.

Pivot points are calculated based on the pivot point indicator which takes into account the last hour, yesterday's, last week's, or last month's open, high, low, and close. All charting software packages including MT4, offer tools such as an automatic pivot point calculator. These pivot points are price reaction numbers, where the market price is likely to reverse. Therefore, they make good resistance and support levels.

Markets tend to indicate very strong support and resistance at price gap levels as well. For example, if a market creates a gap as it rallies, that gap indicates support. If the market revisits that gap and fails to fill it, then this support has held and the market will remain strong. In that case, it makes sense to place a stop-loss order right below that gap.

In day trading, floor traders use the concept of value area and calculate it through charting software. This indicates support and resistance, as defined by yesterday's trading session. The best way to explain this concept is to do it with an example.

Case in point: EURUSD Daily Chart and Risk Management.



This is a 30-minute EURUSD chart, the yellow lines highlighted show the price levels that contained the most volume. We can use the lower panel to view when the volume was high. Price is expected to move freely within the range. Stops should be placed right above and below the limits of this range. For example, for a long trade the next day the trader should set a stop-loss order at the lower limit of the value area. As the market goes higher, that stop can be revised at the higher limit, just in case the market goes into the value area again.

Where Not to Place Your Stop Loss Orders

It is not wise to place stop-loss orders right below the previous day's low, or right above the previous day's high. All markets exhibit a strong tendency to revisit and test these price levels, produce false signals, and then move in the reverse direction. So even though it seems logical and convenient to consider these price levels as levels of support and resistance, they do not really work according to me.

It's better to concentrate on highs and lows that occurred days ago, and not the previous day. Even those distant levels are still not so straight forward. Swing trading theory focuses on these methods, and even then it's possible to have false price breakouts.

Previous highs and lows make it convenient for many financial analysts to draw trendlines and perform analysis. And yet most of this analysis is not realistic, it simply makes the analyst look right, regardless of the market moving up or down.

Note that levels from the pivot point indicator are not simple previous highs and lows, they are calculated on the previous day's or previous week's high and low. The actual pivot numbers are very different from the high and low. Moreover, they indicate levels where the market may unleash hidden momentum.

Conclusion

Stop-loss order placement is the subject of heated debates amongst traders, and you will find many popular methods which do not really work. The wrong stop loss method can be very costly, ultimately causing you to lose your trading account. The best way to move forward is to research and figure out what the best stop loss trading strategy is for your system, and you should also consider the time frame you are trading. For more on this read our trading strategy sections.

Position Sizing: How Much to Risk per Trade?

How Traders Decide How Much to Risk per Trade

Good traders know their markets and tend to focus on the few markets they can master well, rather than trading too many different markets. This allows them to implement position sizing strategies, and avoid big risks.

Good traders can still lose trades however, they are able to limit extreme market risk and avoid getting stuck on the wrong side of the market for too long, this is done by using correct position sizing. Using percentage based strategies will determine.

Getting stuck on the wrong side of the market for too long by using the correct position sizing. They tend to use percentage-based strategies to determine how much money they should risk on a trade. However, they also take into account the overall probability of the trade being profitable.

Risk-Reward Ratio Fallacy

The general rule of thumb dictates that you should risk a certain amount of money to make two or three times the risk, with the risk being the difference between your entry and stop loss level, without paying attention to key factors that determine the probability of the actual trade winning or losing. This is known as the risk-reward ratio, and it is a useful parameter, but it can also be highly misleading.

In high-frequency trading, it has been found that the market will give you a poor risk-reward ratio. Sometimes, especially in day trading, you tend to need to risk far than your reward. As an example, risking a 10 pip stop loss on a currency pair, in order to make just 5 pips of profit is typical.

In swing trading, the moves are larger and market noise is lower and allows the trader to achieve better risk-reward ratios, normally two to four times your risk. Choosing your risk-reward ratio should be implemented in your trading strategy. Trying to achieve a large risk-reward ratio when you are day trading, could cause you to lose money unnecessarily due to market noise.

For example, if we assume that a market is trading sideways and a trader expects to produce a profit of 5 pips, then having a stop loss of 5 pips will give you a slightly less than 50% chance of being profitable as you need to pay the spread first, so your position starts closer to your stop than your take profit level.

However, if you apply a wider stop than your expected profit, then the price will naturally be closer to your take profit level and have a higher probability of reaching your target, if we assume that the price is trading sideways.

Determining Levels The Market Is Likely To Retest

One way to reduce losing trades is to pay attention to pivot point price levels, as determined by yesterday's price action (Open, High, Low, Close), and by yesterday's Value Area (high volume trading period). The market can easily retrace these levels before making a new solid move. The market does not care about our trade, our risk-reward ratio, or our risk tolerance. The best we can do is pay attention to those price levels, and expect the market to either go to the levels, test the levels, and either reverse or breakout. Either way, they are pivotal points hinting the market will reach there.

If the market is volatile your stop loss will be wider and you should trade a smaller size, this is to ensure that you are following your money management rules, and this is what position sizing is all about.

Position sizing

For example, a trader will only risk a total of 1% of their account on any trade. If the account is $1,000, then 1% is $10. And so that $10 needs to be divided by the number of pips to be put at risk, in order to work out the exact trade size for that particular trade. By doing this, you give the market more room to move against you, without unnecessarily triggering your stop-loss order.

As an example, John has a $5000 trading account and would like to trade the EUR/USD. Using technical analysis he is determined that he will need to risk 30 pips to ensure some leeway for the trade to reach his target.

He decides to risk two percent of his account, which is $100, to figure out the correct position size, he needs to divide $100 by 30 pips, meaning that every pip should equal $3.33. One mini lot of EURUSD is $10,000 units and has a pip value of 1 dollar per pips. With this information, John knows that he needs to buy three mini lots, and three micro lots for his position sizing to be correct.

We can use this table to know the pip value for a mini lot of 10,000. The table was last modified in July 2019.

	Pip Value in USD	Pip Value in Euro	Pip Value in GBP
AUDCAD	7.66	6.79	6.09
AUDJPY	9.28	8.22	7.37
AUDNZD	6.69	5.93	5.32
AUDUSD	10	8.86	7.95
CADJPY	9.28	8.22	7.37
EURAUD	7.02	6.22	5.58
EURCAD	7.66	6.79	6.09

	Pip Value in USD	Pip Value in Euro	Pip Value in GBP
EURGBP	12.58	11.15	10
EURJPY	9.28	8.22	7.37
EURNOK	1.17	1.04	0.9315
EURNZD	6.69	5.93	5.32
EURSEK	1.07	0.9506	0.8524
EURTRY	1.79	1.58	1.42
EURUSD	10	8.86	7.95
EURZAR	0.7124	0.6315	0.5663
GBPAUD	7.02	6.22	5.58
GBPCAD	7.66	6.79	6.09
GBPJPY	9.28	8.22	7.37
GBPNZD	6.69	5.93	5.32
GBPUSD	10	8.86	7.95
NZDCAD	7.66	6.79	6.09
NZDJPY	9.28	8.22	7.37
NZDUSD	10	8.86	7.95
USDCAD	7.66	6.79	6.09
USDCHF	10.15	8.99	8.07
USDINR	14.6	12.94	11.6
USDJPY	9.28	8.22	7.37
USDMXN	0.5266	0.4668	0.4186
USDNOK	1.17	1.04	0.9315

	Pip Value in USD	Pip Value in Euro	Pip Value in GBP
USDSEK	1.07	0.9506	0.8524
USDTRY	1.79	1.58	1.42
USDZAR	0.7124	0.6315	0.5663
ZARJPY	9.28	8.22	7.37

If John's account size was a random number like $42342 then the process would be the same. If he wanted to trade the Dollar vs. the Mexican peso (USDMXN), and he would like to risk 5% of his capital, then this would be the calculation:

Five per cent of $42342 is 2117.1, and he is determined that he needs a 500 pips stop loss, this means that the pip value should be 2117.1/500 = 4.23, and as the pip value of one mini lot in USDMXN, is 0.4668, he then needs to divide the pip value over the pip value of a 10k lot to find out the correct position sizing.

The calculation is the following: 4.23 /0.4668= 9.07.

Conclusion

Correct money management trading begins with knowing how to calculate support and resistance level as there's an optimal price level for you to place stop-loss orders. The biggest mistake is to place stop-loss orders right above or below previous highs or lows. It seems logical and convenient. However, the market can perfectly breach such levels for many hours, and yet the major trend can remain intact.

Finally, when you know where to place your stop loss order, you should determine the correct position sizing, by taking a certain percentage of your account and divide it by the number of pips in your stop loss. The exact percentage of risk is linked to how good your strategy is, and can usually only be found by trading for a while. In general, most professional traders try to not to risk more than 1% of their capital per trade, so they can weather any adverse trading periods.

What is Maximum Drawdown in trading?

Drawdown is the decline in the balance of a trading account from its highest level from trades. As an example, if a trading account has a balance of $5000 and due to bad trading is now at $4000, then the drawdown is the loss over the max balance level e.g., $1000/$5000 = 20%.

The max drawdown is the maximum drawdown on the account e.g., if there is a drawdown ratio of 20% and another one of 35% then the latter one will be the max drawdown. Drawdown and max drawdowns are used to evaluate the stability of trading strategies.

How to calculate Maximum drawdown (Mdd) and why is it Important?

Most traders have stints of very strong returns and losses, if a trader shows you that they have turned a $5,000 account into $20,000 in a few weeks or months, then we can use the max drawdown concept to evaluate their trading. Did the account balance decline to $1000 before reaching $10,000, and then declined back to $5000 before reaching $20,000? Or did the balance steadily increase with a few thousand per month with no loss bigger than $2000?

In the former example, the max drawdown was 80% this is because $4000 over $5000 equals 80%, while in the latter the max drawdown was 20% as $2000 over $5000 equals 20%. Seeing this information we now know that the latter strategy is the safer one ignoring all other factors, as it reached $20,000 with less variability.

It is also fair to assume that the average trader and investor prefers the trading strategy with the lower max drawdown as it will suit their risk-averse personality. In fact, most people will prefer a lower return if it is stable. As an example, most people are happy to get a very low return on their money at the bank, as they know for certain that they will not lose any money holding it there.

There are traders who turned $10,000 into $100,000 or more in less than a year. However, if they had too much drawdown, and their success comes down to a few lucky trades, then they might as well have had lost and not won. At one point their luck might be up and they would blow up their account.

What is the Max Allowed Account Drawdown?

It depends on the trading strategy, and risk tolerance of the trader. In general, the higher the profits the larger the drawdowns. Even Warren Buffet's Berkshire Hathaway's share price has experienced large drawdowns, in 2007 to 2009 its share price fell by 51%.

It is possible to come back after a 50% drawdown, but the trader or strategy needs to produce a 100% return to come back to square one, and this is something that most traders struggle to do. Instead, they tend to overtrade and trade more aggressively, leading to them into a deeper drawdown.

Most new traders choose to follow signals or strategies where the maximum drawdown is 20% and in some cases up to 30% of the total account balance. But most traders struggle to deal with drawdowns larger than 30%, a higher drawdown normally indicates a weak and unstable trading strategy.

Limitation of the Drawdowns

When discussing max drawdowns it tends to be related to closed trades only. However, it is possible for traders to have much higher drawdowns than was can be seen from closed trades. As an example, the account balance of a trader is at $1000, and a few open trades take the account to $500, before the month is over the account is now at $1200. This account will not register a drawdown at all in the last month, instead, it will register a 20% profit. So using the drawdown of closed trades only could be misleading, and it is, therefore, important to evaluate how the trader or strategy deals with the drawdown of open positions as well as closed.

It is not uncommon to see strategies with very low drawdowns and stable returns blow up their trading accounts. The reason for their stable returns is that they will average down e.g. they will buy more of their bad positions until they can get out of the aggregate position with a profit. However, once a while the market never bounces back and the trader is stuck with a very large losing position. Here the trader might stick to the position until they get a margin call which would lead to a drawdown of nearly the entirety of the trading account. So what looks like a low-risk strategy could prove to be very dangerous.

What is the Risk-to-Reward ratio And Why is it Important?

How to Calculate Risk Reward Ratio and Why is it Important

Risk reward ratio is used by traders to evaluate various trading systems, algorithms, and strategies. The trader calculates and compares how much money is at risk per trade, to what the potential profit per trade. A risk-reward ratio of 1:3, is considered a good risk-reward ratio, this means that the trader will risk $1 while having the chance to win $3. However, the actual risk-reward ratio depends on the style of the strategy used as not all profitable strategies will have a positive risk-reward ratio.

A good risk-reward ratio is important in order to offset losses, a high risk-reward ratio strategy will be profitable even with a low win-rate. As an example, a coin toss game gives you a 50% chance of winning, but if you make two dollars each time you win, and lose one dollar each time you lose, playing the game is still profitable for you. However, as we have already highlighted, it is not always necessary to have a risk-reward ratio of 1 to 3 to be profitable, even though it is one of the most commonly used risk ratios for traders. Instead, the risk/reward ratio needs to be balanced with the win-rate to create a successful strategy.

The Reality of 1 to 3 Risk Reward Ratio

If a 1:3 risk-reward ratio worked all the time, in all time frames, and in every scenario, then forex trading would come down to just 2 trades. This would be done by placing a long and a short trade both with a 1:3 risk ratio, at the same time, on the same market and waiting to make the easy money. And yet the believers and people who teach the importance of 1 to 3 risk-reward ratio, fail to demonstrate it in live trading.

The 1 to 3 risk-reward ratio is only an abstract and theoretical concept. In actual trading, in most time frames, the market will simply take out your stop-loss order, before resuming to trade in the direction that you had projected. Even if you buy and sell a market at the same time, you will see just how easy it is for the market to trigger both of your stops.

What Risk-Reward Ratio Should We Expect?

IHigh-frequency Forex trading is very different from swing trading. A simple scalping strategy, for example, tends to have a negative risk-reward ratio, meaning that the trades the system takes will stand to lose more than expected profit e.g., risk 5$ per trade in order to make $1. From a classic trading theory perspective, it should be a losing strategy, but the market offers such trades all the time, and especially during quiet market hours. So a good Forex scalper trader with a high win-rate could potentially be making several $10 win trades while risking $50 to $60 per trade. The problem with this type of strategy is knowing when not to trade, as a few bad trades will wipe out hours if not days of profitable trading.

What Risk-Reward Ratio to Expect in Day Trading?

Day trading is said to be harder to master than swing trading as the markets can move up and down due to random events. Day traders need to adapt and will apply a variable risk-reward ratio, depending on important support and resistance levels that are relevant to that specific day. Some trades can have a 1:3 risk-reward ratio, however, most of them will be using near to 1:1 e.g. risk 20 pips to make 20 pips.

In algorithmic forex trading, the risk-reward ratio is always variable. And the risk itself is calculated through various parameters related to the market itself, not just money at risk. These algorithms are developed by hedge funds and are a well-kept secret. We can only assume that they use models similar to the ones used in the insurance industry. So it is wise to think like a hedge fund in your day trading, and have variable stops and a variable risk-reward ratio. Avoiding risk means to avoid big adverse market moves, and to avoid stopped out frequently. Even at a small stop loss, getting stopped out frequently is a bad thing, and it indicates a bad trading strategy. On the contrary, a day trading strategy where stops are large but rarely hit could be a better strategy.

Conclusion

Actual risk-reward ratios of profitable systems can be very different from the idealized 1 to 3 risk-reward ratio. They can be much worse or much better, and yet in every case, they can work wonders, as long as they fit the overall strategy. So, don't judge a trading system based on its risk-reward ratio alone, take the win-rate into account and the overall account risk as defined by the max account drawdown.

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