JULY 2004

The Six Forces of Forex

By Scott Owens

Few traders ever stop to consider the context that defines the foreign exchange marketplace, but all of them should. As forex matures in its role as a retail investment environment the rules – and the stakes – will only multiply.

ANALYSIS

- Who: The faces of forex that shape market action
- Why: Understand the nature of forex, and its inherent opportunity
- Where: Matching your objectives to the optimal dealer
- What: Choosing a trading vehicle based on your investment premise
- When: Time your trades for maximum efficiency
- How: Select a toolkit that actually improves your trading ability

ACTION

- Take an inventory of your personal trading plan
- Find solutions that can help you execute your plan, step by step

WHAT IT MEANS

- Bad News: Successful trading is more work than you thought
- Good News: Everything you need to win is right at your fingertips

RELATED MATERIAL

Test-drive FX Engines for free online at www.fxengines.com to see the power of system building, system testing, and system automation.

ABOUT THIS REPORT

The Forex Report is a periodic publication that investigates advanced strategies for superior trading performance in the foreign exchange markets. These reports utilize advanced statistical and econometric modeling techniques to create new insight into the trading strategy of the average trader. This report, The Six Forces of Forex, is a more general report intended for all audiences, including those new to the forex market.

To learn more about The Forex Report or to register for delivery of all future reports by email, including Case Studies, please visit www.fxengines.com.

A N A L Y S I S

For most traders, a comprehensive trading plan is an unmet ideal. In the foreign exchange markets in particular, the lure of easy money often distracts the trader from the reality of hard work. But as anyone who has had success trading can attest, trading is a discipline. It requires a plan informed by extensive knowledge of the markets *and* the ability to carefully, consistently apply that knowledge. The main ingredient of any trading plan is an understanding of the context that defines the trading environment.

THE SIX FORCES OF FOREX

Trading forex is like watching a school of fish move. One minute is total harmony, the next, complete chaos. As the observer of this school of fish, do you believe you can accurately predict the direction the school of fish will move each time? Would you bet on it?

What causes the fish to move the way they do? Why do they work together in one moment, moving with force and precision, and move in what seems to be an infinite number of directions the next? There's no way to know unless you can sense what the fish sense each time they move. The fish have an instinct about the nature of their environment. They understand the context of all things around them – natively – and can react accordingly. Surely if you shared this understanding you'd be a much more accurate predictor of fish movement!

Trading forex is not much different - we need to develop that keen sense of what is happening around us. Will we ever be able to predict every move in the forex markets? Absolutely not. But we can use our understanding of the context of the market – the six forces of forex – to make better, more profitable trading choices. Once we understand these forces, we can create and operate within a comprehensive trading plan:

- **Who trades forex?** Understand who participates in the markets, why they are successful, and how you can emulate them.

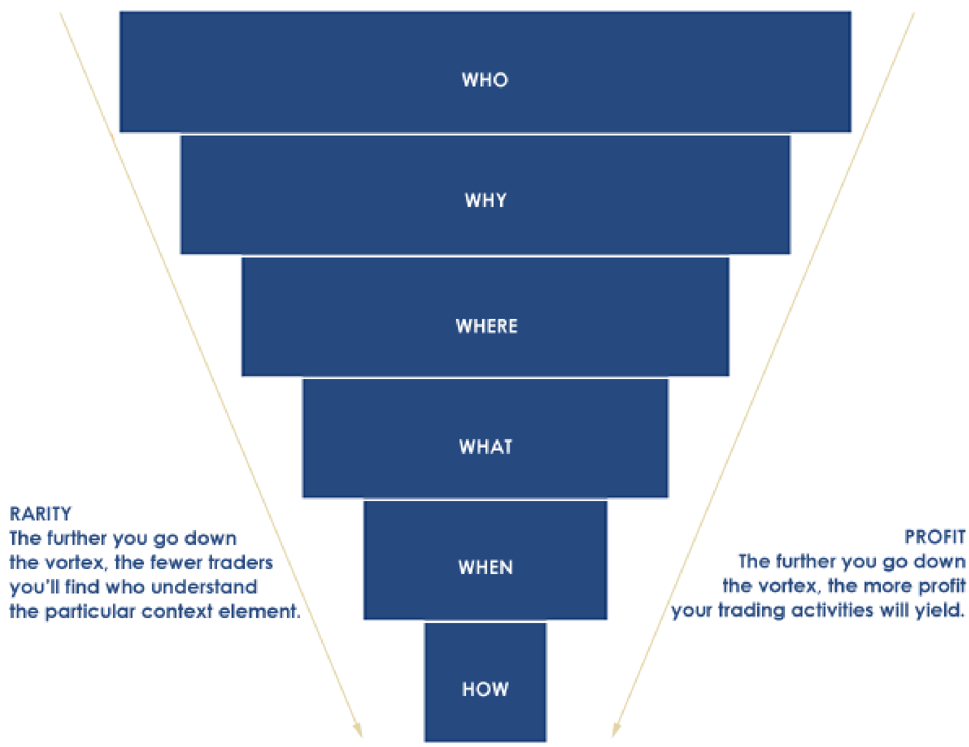
- **Why trade forex?** There are superior returns in forex, but not for all investors. Are you one of them?

- **Where should you trade?** Choose to work with service providers who can efficiently enable your style of trading.
- **What should you trade?** Select the currency pair, entry, exit and money management methods that will maximize your returns.
- **When should you trade?** Trade when the environment is most likely to produce the best conditions for executing your system.
- **How should you trade?** Trade using methods that maximize your ability to emulate the proven winners.

Knowledge of these forces and how they work is a major determinant of your success as a trader. Figure 1 shows these 6 forces, their relative rarity, and their effect on profitability.

Figure 1: The Forex Vortex

Natural selection takes on a whole new meaning in the forex markets, where survival of the fittest is the only rule, and market action ruthlessly eliminates anyone who has not uncovered the context of the game.

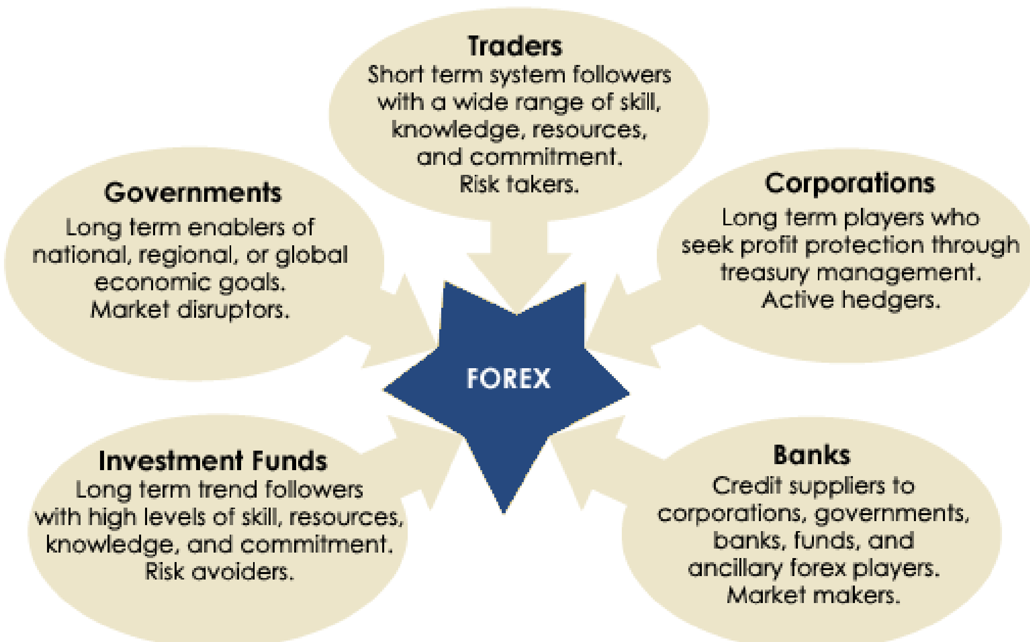


WHO

Far more important than knowing who trades forex is knowing who trades forex *successfully*, and how they do it. The players in the forex markets operate with widely varying perspectives. When one of these players enters the market, a force is created that is proportional to the perspective of the trade initiator. That force can play a role in the short term, creating radical price changes, and it can play a long term role, defining trends. Figure 2 shows the major perspectives in the forex markets.

Figure 2: The Who's Who of Forex

Each perspective carries a different attitude, goal, investment horizon, and market impact.



They key difference among these market participants is their level of sophistication, where the elements of sophistication include:

- Money management techniques
- Profit objectives
- Level of computerization
- Quantitative abilities
- Research abilities
- Level of discipline

Of course there are sophisticated and non-sophisticated banks, governments, corporations, investment funds, and traders. But among these segments it is the individual trader who has the least amount of external governance. Whereas governments, banks, corporations, and investment funds adhere to regulations and restrictions (to a certain extent), traders are only restricted by their level of capital.

In the absence of these external restrictions, traders fall into two groups: those who can impose internal restrictions – discipline - on their trading strategies and those who cannot: the fence-swingers, et al.

Those who can impose this discipline we will call the sophisticated investor. In the zero-sum game of forex trading, the sophisticated investor uses tools and strategies that emulate those of the highly sophisticated institutional participants to extract profits from the novice participant. It is only the sophisticated investor who has the ability to extract positive returns from the forex markets.

WHY

Forex trading has surged in recent years, as more individuals earn their living trading and the popularity of riskier investment vehicles like hedge funds has increased. The bottom line for these investors is superior returns, and in foreign exchange four major factors create a unique investment environment:

- Liquidity
- Leverage
- Convenience
- Cost

In no other market can you find a playing field that is so biased to the investor, at least on the surface. But to take advantage of these factors you have to be constantly aware of their downside.

Liquidity

In a liquid market there is a high degree of transparency, even when large transactions change hands. The sophisticated investor understands what this means: forex attracts huge players. As a trader grows in sophistication, they understand that these huge players have significant price impact, and watch for their market entry.

Leverage
The low margin requirements in the forex markets make everyone's what-if analysis yield forecasts with 1000% growth annually. What those forecasts fail to account for is the multiplying effect of leverage during periods of consecutive losses.

Figure 3: The Leverage-Loss Matrix
What's the ultimate worst case scenario? Consecutive losses. Knowing how many consecutive losses your system is likely to sustain is the key to capital conservation. Examples of leverage: 1:1 = one $100K contract per $100K in capital. 20:1 = 20 $100K contracts per $100K in capital

LEVERAGE / CONSECUTIVE LOSSES / % REMAINING CAPITAL

CONSECUTIVE LOSSES	1:1	5:1	10:1	20:1	30:1	40:1	50:1	60:1	70:1	80:1	90:1	100:1
1	99.75	98.75	97.50	95.00	92.50	90.00	87.50	85.00	82.50	80.00	77.50	75.00
2	99.50	97.50	95.00	90.25	85.50	81.00	76.50	72.25	68.00	64.00	60.00	56.25
3	99.25	96.25	92.50	85.75	79.00	73.00	67.00	61.50	56.00	51.25	46.50	42.25
4	99.00	95.00	90.25	81.50	73.00	65.75	58.50	52.25	46.25	41.00	36.00	31.75
5	98.75	93.75	88.00	77.50	67.50	59.25	51.25	44.50	38.25	32.75	28.00	23.75
6	98.50	92.50	85.75	73.50	62.50	53.25	44.75	37.75	31.50	26.25	21.75	17.75
7	98.25	91.25	83.50	69.75	57.75	48.00	39.25	32.00	26.00	21.00	16.75	13.25
8	98.00	90.00	81.50	66.25	53.50	43.25	34.25	27.00	21.50	16.75	13.00	10.00

* Assumes 25 pips per loss in EURUSD, $100K starting capital, full $100K lot contracts.

Convenience
The fact that you need to go to bed or spend time with your family does not stop the forex markets from operating. In other markets you can trade a specific window that usually lasts 6-10 hours, which is physically manageable. Forex, on the other hand, demands 24 hour monitoring. That can be accomplished through automated trading systems or, less optimally, through pre-set stop and limit orders or physical monitoring of a trade.

Cost
"No commission trading" is a marketing slogan many dealers offer as a perceived benefit of forex. But the fact that there is no commission does not change the high level of transaction costs paid to dealers through the bid-ask spread.

There is no doubt that the liquidity, leverage, convenience, and transaction costs found in the forex markets are great tools for investors – but not always. Just as easily as these tools can be used for wealth creation, they can be misused for wealth destruction. The novice investor destroys wealth, and the sophisticated investor creates it.

WHERE

It is one thing to choose a dealer, and quite another to choose *the correct* dealer. Dealers' service offerings can take many forms, and each dealer usually has one or two major features that they highlight above all others. When analyzing dealers, first understand and rank all of their service offerings, then apply those findings to your trading style to arrive at your optimal dealer.

Figure 4: The Dealer Comparison Matrix

Comparing different dealers using common metrics helps to clarify where each dealer's strength lies. Armed with that information, the trader is ready to choose the dealer who best fits his trading style.

	Dealer A	Dealer B	Dealer C
Spreads	5 pips on the majors	4 pips on the majors	3 pips on the majors
Execution	No slippage	No slippage	Some slippage
Leverage	50:1	100:1	50:1
Service	Average	Excellent	Fair
Technology	Good	Average	Excellent
Tools	Fair	Average	Good
Affiliations	Fair	Average	Good
Management	Excellent team	Good team	Not sure
Regulators	CFTC/NFA	CFTC/NFA	CFTC/NFA
Interest	Paid to some	Paid to some	Paid to all
Security	High	Average	Not sure
Publicity	Average	Excellent	Good

Which dealer would you choose? Novice traders will often choose the dealer with the best marketing, simply because it's the one they know.

They learn about the dealer, visit the site, register for a demo, then scale the learning curve to grow comfortable trading with that dealer, using their charts, etc.

Frequently, the dealer with the best marketing is not the best dealer for the trader, or perhaps, for any trader. Traders use systems that work in the short term, mid term, or long term, with varying holding times and strategies. The type of dealer needed for each approach is quite different.

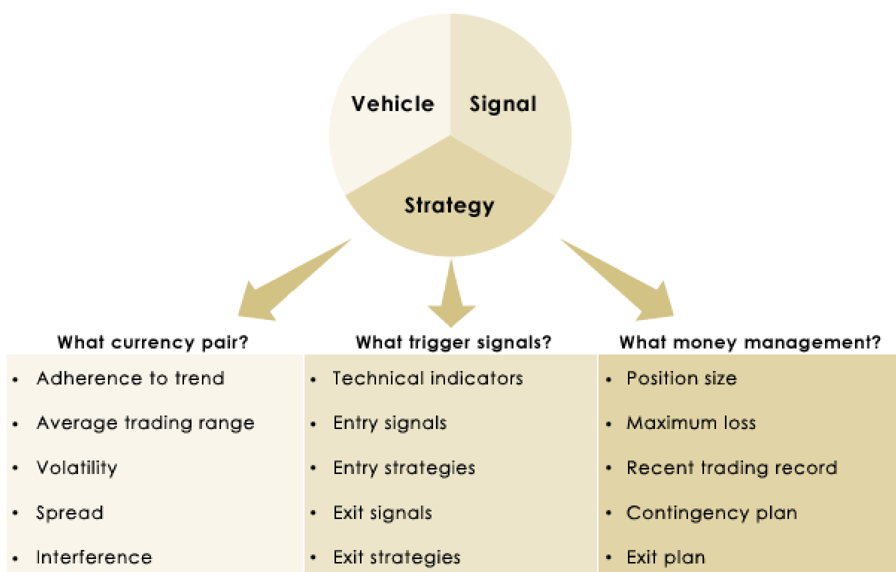
For every trader there is an optimal dealer. For many, the path of least resistance leads to the dealer who makes first contact, not the dealer who will provide the best trading outcome. The sophisticated investor optimizes returns by matching his trading style to his dealer.

WHAT

A comprehensive trading plan is framed by three main elements: the trading vehicle, or currency pair, the events that trigger market entry and exit, and the overall approach to trade management.

Figure 5: What to Trade

Understanding the major components of a trading plan is a prerequisite for successful trading.



All of these factors work together. Trading a high spread currency using short interval entry signals and highly leveraged positions will probably be a failing strategy. Conversely, trading a tight spread currency using mid- to long-interval entry signals and little leverage has a better chance of success.

In the final analysis, the currency, signals, and money management approach must all gel together and exist without contradictions. Novice investors make critical errors by trying to patch together strategies from various sources, rather than systematically building, testing, and deploying a comprehensive trading plan. The sophisticated investor, who does this difficult work, operates with a complementary trading plan that creates consistent profit opportunities.

WHEN

Forex is a 24/7 market – but is the market action the same at all times? Of course not, but not many traders stop to consider the impact of this fact on their trades. Studying historical price data reaching back to January 2000, the impact is clear, as shown in Figures 6 & 7.

Figure 6: When to Trade - AM

Give yourself a chance! Trade when the market is most likely to help you. Take a look at the average trading ranges for the four majors below.

EST	EURUSD	USDJPY	GBPUSD	USDCHF
12 AM - 1 AM	10 PIPS	14 PIPS	11 PIPS	15 PIPS
1 AM - 2 AM	13 PIPS	15 PIPS	15 PIPS	20 PIPS
2 AM - 3 AM	21 PIPS	20 PIPS	25 PIPS	30 PIPS
3 AM - 4 AM	23 PIPS	21 PIPS	29 PIPS	34 PIPS
4 AM - 5 AM	20 PIPS	20 PIPS	27 PIPS	29 PIPS
5 AM - 6 AM	17 PIPS	18 PIPS	25 PIPS	26 PIPS
6 AM - 7 AM	17 PIPS	18 PIPS	24 PIPS	26 PIPS
7 AM - 8 AM	18 PIPS	19 PIPS	24 PIPS	27 PIPS
8 AM - 9 AM	26 PIPS	25 PIPS	31 PIPS	39 PIPS
9 AM - 10 AM	24 PIPS	23 PIPS	29 PIPS	36 PIPS
10 AM - 11 AM	30 PIPS	26 PIPS	34 PIPS	45 PIPS
11 AM - 12 PM	24 PIPS	22 PIPS	29 PIPS	36 PIPS

Figure 7: When to Trade - PM

The markets sleep when London and New York are off.

EST	EURUSD	USDJPY	GBPUSD	USDCHF
12 PM - 1 PM	20 PIPS	19 PIPS	25 PIPS	31 PIPS
1 PM - 2 PM	16 PIPS	15 PIPS	19 PIPS	25 PIPS
2 PM - 3 PM	16 PIPS	15 PIPS	18 PIPS	24 PIPS
3 PM - 4 PM	12 PIPS	12 PIPS	15 PIPS	19 PIPS
4 PM - 5 PM	9 PIPS	10 PIPS	11 PIPS	14 PIPS
5 PM - 6 PM	9 PIPS	9 PIPS	9 PIPS	12 PIPS
6 PM - 7 PM	8 PIPS	11 PIPS	9 PIPS	12 PIPS
7 PM - 8 PM	10 PIPS	15 PIPS	11 PIPS	15 PIPS
8 PM - 9 PM	11 PIPS	17 PIPS	11 PIPS	16 PIPS
9 PM - 10 PM	10 PIPS	15 PIPS	10 PIPS	14 PIPS
10 PM - 11 PM	10 PIPS	13 PIPS	12 PIPS	16 PIPS
11 PM - 12 AM	8 PIPS	11 PIPS	9 PIPS	11 PIPS

One of the best ways to validate a technical indicator is volume. When volume is strong, indicators tend to be more accurate. Unfortunately, there is no volume data available for the forex markets. Using trading ranges is the next best thing.

Having this data in hand, the trader can more carefully evaluate when to trade. Not only will technical indicators generally have more accuracy at different points of the day, but there is both more profit potential and less loss potential at other times of the day.

Consider a trade in EURUSD at 10 AM EST vs. one at 10 PM EST. The first has an average trading range of 30 pips, the second, 10 pips. Entering the market during the morning trade creates some interesting possibilities – the market may go against you or with you, but you should be prepared for a ride in either case. On the other hand, if the market goes against you 10 pips at 10 PM, how concerned should you be? Probably not as much as if it was 4 AM.

For a more in-depth discussion of when to trade, including trend, days of the week, and other metrics, register for your free trial at FX Engines. All FX Engines users receive our periodic Case Studies which highlight automated trading strategies.

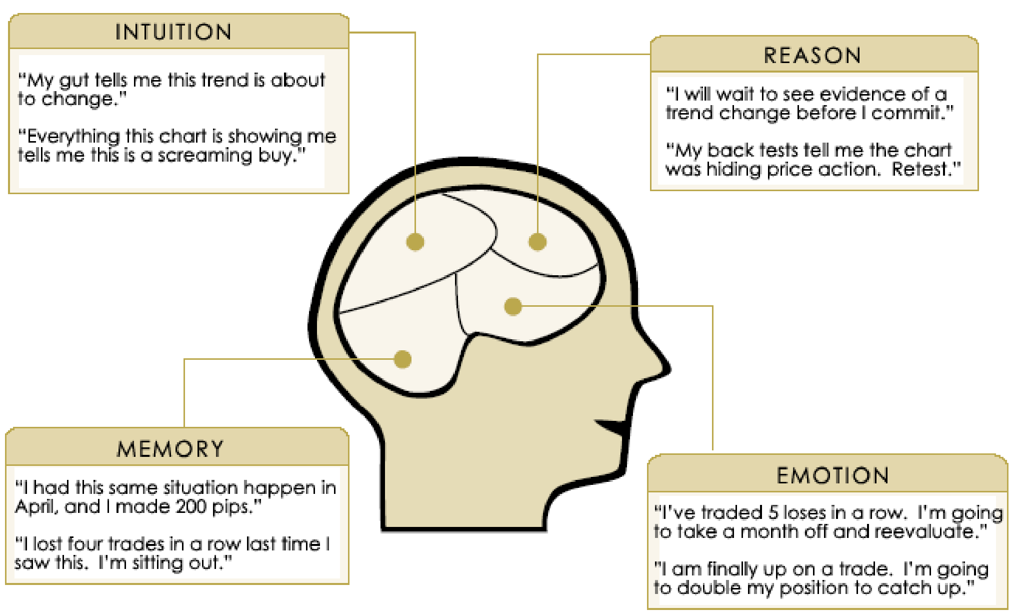
Anybody can trade based on technical indicators. The novice, in particular, ignores the importance of "when" as he makes trading choices. The sophisticated investor is the one who uses timing to his advantage – creating profit opportunities and limiting losses by observing the market with more perspective.

HOW

Once an understanding of the external elements of trading is completed, the hard work begins: the trader must understand his own mind. The external elements are easy – they are usually rational, factual, consistent, and ordered. The trader's mind, however, is far from all of that.

Figure 8: The Trader's Mind

The trader goes through an enormous array of emotions and thoughts during a trade. Some are good, some are bad, but it is rare to find a trader who consistently applies his plan.



Emotion, or lack of discipline, is the greatest enemy of every trader. This is so true that one could argue that discipline is a more precious trading commodity than capital itself, since capital can only be sustained with discipline.

This is not to say that the trader does not have value to bring – he does. In moments of clear, objective contemplation, many traders – even novices – can be builders of excellent trading systems. These systems can take advantage of their understanding of the forces of forex and test out incredibly. Once live, however, the system falls apart. Why?

The simple reason is that emotion has no place in trading. Emotion causes the trader to act differently following large wins or losses. Emotion causes the trader to act irrationally when large moves occur. Emotion causes the trader to apply his trading system inconsistently.

If you took a survey of successful traders you would find many similarities. The traders would understand and apply all of the forces of forex. They would usually trade incredibly simple trading systems. They would trade using conservative, well thought out money management philosophies, and they would trade with *absolute consistency*.

For the institutional investor, absolute consistency is not a problem, since they have an array of personnel and resources at their disposal. For individual investors, there are three groups. Those who trade without consistency, those who trade with manual consistency, and those who trade with automated consistency. The novice, of course, is the trader who thrashes from trade to trade. The individual investor who uses consistent discipline or automation as the foundation of his trading activity maximizes his level of sophistication.

ACTION

The sophisticated investor understands the six forces of forex. They operate with awareness of their environment, and that awareness informs their trading plan. *To succeed in forex trading, you must become a sophisticated investor.*

INVESTOR SOPHISTICATION 101

Reading *Market Wizards, by Jack D. Schwager* for the first time, it's difficult not to notice that most, if not all, of the successful traders use computerized systems. These traders realize the importance of doing solid research, system building, and testing in an environment without trading stress. And they realize the importance of implementing those systems in a computerized environment.

Of course, working at Solomon Brothers or Fidelity has its perks, and these traders all have access to massive IT budgets and staffs. What about the individual trader? In recent years, a number of traders have sought to automate their systems by hiring software developers. Too often, the trader didn't know enough about software to make the system work correctly.

In other attempts, software developers have tried to create automated trading systems that could run on the trader's computer. These attempts were also flawed, since the software engineer was not likely to have sufficient trading knowledge. Beyond that, software programs installed on a home or office based computer are susceptible to power and bandwidth outages, and a number of other serious deficiencies.

FX Engines was created to solve all of these problems. Our service is an automated trading platform with all of the sophistication of the institutions, designed by a trader with software experience, implemented by a group of software experts, and hosted in one of the world's most advanced, secure, redundant data centers.

FX Engines is designed to create sophisticated investors, which is another way of saying: *FX Engines helps traders succeed*. We invite you to visit us at http://www.fxengines.com to check out our service with a 15 day free trial, after which you may still use the basic service free of charge. Live trading will be available soon, so get started building and testing today.

WHAT IT MEANS

Take your medicine, one way or another – put in the time or lose the dime.

THE BAD NEWS

Successful trading is hard work!

Forex in particular paves the way for many traders to think they've found the Land of Easy Money, but it is exactly the opposite. Forex is the market with the biggest rewards, but it is also the toughest market to crack. Compounding the problem is the fact that there are not many well made, honestly offered tools or services in the market to aid the average trader.

THE GOOD NEWS

FX Engines was designed to fill this void. Our service is built to give the average trader the same, if not more, sophistication than the tools at the disposal of the traders at the world's biggest banks.

FX Engines allows traders to embark on the biggest learning experience of their trading careers: extensive back testing. Only through back testing can you develop a sense of the magnitude small changes have on price action. Back testing hones the trader's skill in determining market entry, market exit, and position sizing. And FX Engines has the most advanced back testing tool available.

Once you've identified tradable engines FX Engines provides a way for you to test them out live, matching what you see on a chart to test trades in real time, automatically. This hands-free trading style gives the trader access to the trader's most precious resource: discipline. Our automated trading system handles every aspect of trading, freeing you to spend moments of clear and organized thought building systems, not managing emotion.

Once you've traded in test mode, you're ready to go live. FX Engines will execute your trades through a dealer using the EXACT SAME system used to back test and live test your engines. Develop systems, build them, test them, and trade them. At FX Engines, it's that simple, and it's that powerful.

MORE INFORMATION

For more information about The Forex Report, visit www.fxengines.com or email info@fxengines.com. The Forex Report is available for distribution on third party websites as a co-branded offering. Contact us for more information.

THE FOREX REPORT

Analyzing statistical, econometric, and behavioral trends in the foreign exchange markets for insight into the optimal use of the FX Engines automated trading platform.

The information contained in this report is represented without warranty or any statement of its veracity. The contents of this report are intended to stimulate thinking on issues related to trading forex. This report does not suggest any particular action that could be utilized in live trading for profit or loss.

I can put it no better than Hoffer, who deferred to Montaigne:

"All I say is by way of discourse, and nothing by way of advice. I should not speak so boldly if it were my due to be believed."