TRADING MISTAKES:

Avoid Online Forex Pitfalls

By Brian Dolan

Online currency trading has absolutely exploded in popularity over the last several years. Hundreds of thousands of traders from around the world have flocked into the forex markets. Some are experienced traders from other markets who are branching out into forex while many others are entirely new to financial market trading. The appeal of online forex trading is easy enough to understand: 24/7 market access, generous leverage ratios, ease of execution, and a narrow universe of active currency pairs.

But just because it's easy to get into a market does not mean it's easy to be successful trading in that market. To be sure, currency markets can be as rewarding or unforgiving as any other trading market. Beyond that, there are the many self-imposed errors that can lead to unfortunate trading consequences. From my vantage point at an online currency brokerage (full disclosure) I'd like to review some of the more common trading pitfalls so you can avoid them.

OVERTRADING

It might seem odd that an online brokerage would single out overtrading as the first pitfall to avoid. After all, like brokers in any market, we earn our money from volume, so why would we try to discourage overtrading? The answer is simple enough: the more successful our customers are, the longer they'll be trading with us and the more volume they'll trade in the long run. In terms of pitfalls to avoid, overtrading ranks as one of the more easily avoided risks, since it's one the individual trader can control as opposed to an intrinsic market risk.

Overtrading typically comes in two main forms: trading too many positions at once and trading too frequently in the market, or always having an open position. Trading too many positions at once highlights several strategic errors as well as a very real financial risk. The financial risk is that too many open positions uses up your available margin collateral very quickly, which can lead to margin-based liquidations if prices move sufficiently against your positions. When that happens, the loss is primarily the result of overtrading relative to your margin rather than simply being wrong in the market. It's hard enough to get it right in the market in the first place, so don't make it any harder by reducing your flexibility or margin staying power with too many positions.

But let's say you just won the lottery and have more than enough margin to hold as many open positions as you want. This brings us back to the strategic errors I mentioned above. Running several positions at once implies a trader has analyzed multiple currency pairs and crosses and has a well-developed strategy for each. Unless you're trading a system-based model, this seems highly unlikely.

More probably, the trader has adopted the dartboard approach and keeps entering positions in the hope that some of them will be profitable, which suggests the overall strategy is based on hope rather than analysis. It also suggests a reluctance to take losses on losing trades, which is another strategic flaw. Traders are generally better off studying a few pairs for trade opportunities and pursuing the one that has the clearest potential. If you're able to identify simultaneous trade opportunities in multiple pairs, more power to you.

The second form of overtrading is always having an open position in the market. At the minimum, this suggests that a trade opportunity is ever-present in the market and you know what it is. In the bigger picture, though, all it means is that you're constantly exposed to market risk. But the essence of disciplined trading is avoiding unnecessary risks. The key is to identify viable market opportunities and pursue a diligent, risk-aware strategy to exploit them. If you're constantly in the market, it suggests you're not aiming at well-defined trade set-ups.

OVERLEVERAGING/UNDER-FUNDING

Overleveraging refers to holding too large a position relative to your available margin balance. Under-funding is the flip side of the same coin, not having enough margin collateral to support your desired position size. Viewed from either side, these errors can indicate a lack of understanding of your online brokerage's margin requirements. When a margin account is fully leveraged, meaning the largest available open position based on margin collateral, it generally has very little room for adverse price movements. Even a few pips on too large a position can be enough to drop the available margin below the required margin, leading to liquidations of open trades and locking in a loss. So the first step is to be crystal clear with your broker about how much margin is required to hold an open position and what happens if your available margin falls below that level.

The second step is to manage your expectations realistically when it comes to deciding on position size. Sure, it's a lot sexier to have as large a position as your margin can support, but whoever said prudent trading was supposed to be sexy? Just because online brokerages offer 100:1 leverage or more doesn't mean you have to fully utilize it. Remember, leverage is simply a trading tool that allows you to implement your trading strategies.

The starting point is to determine how much risk capital you're able to devote to currency trading on margin. Risk capital is typically defined as an amount of money that will not materially alter your standard of living if it's lost. Once you've settled on that amount, you'll have an idea of what your maximum position size is. Keep in mind that positions in different currency pairs carry different margin costs: for example, at current market rates, to open a 100,000 British pound/U.S. dollar (GBP/USD) position requires roughly $1,900 of available margin, while a 100,000 Australian dollar/U.S. dollar (AUD/USD) position requires only about $780 of available margin. See Table 1.

Now comes the part about managing your expectations realistically. After you've done your market analysis and identified a trading opportunity, you now have to decide how much capital you're prepared to risk on the trade, not how much you think the trade will earn. Minimizing losses is the key to successful trading over time, so always start by gauging the downside risks first. Once you've pinpointed how much you're prepared to risk on a trade, whether based on money (a financial stop) or price levels (a technical stop) the position size calculates itself for you. At the minimum, you've now got a risk-defined trading strategy that will allow you to go on trading if the particular strategy fails. At the maximum, you've developed a more disciplined approach to trading and risk management.

TABLE 1: Margin Costs Vary by Currency Pair [Initial Margin Cost Per Standard Lot (100,000) at 100:1 Leverage]

Currency Pair	Reference Rate (Base Currency)	Margin Utilization
EUR/USD	1.3000	$1,300
USD/JPY	120.00	$1,000
USD/CHF	1.2500	$1,000
GBP/USD	1.9500	$1,950
AUD/USD	0.7800	$780
USD/CAD	1.1700	$1,000
EUR/JPY	1.3000	$1,300
EUR/GBP	1.3000	$1,300
EUR/CHF	1.3000	$1,300
EUR/AUD	1.3000	$1,300
GBP/JPY	1.9500	$1,950
GBP/CHF	1.9500	$1,950
CHF/JPY	1.2500	$800
AUD/JPY	0.7800	$780
NZD/USD	0.7000	$700
NZD/JPY	0.7000	$700

A Few Simple Rules For Successful Forex Trading

CONSTRUCT A DETAILED STRATEGY
Entry level, take profit and stop-loss for each trade and stick to it.

ALWAYS USE STOP LOSS ORDERS AND DON'T ADJUST THEM
Except to lock-in profits.

CONCENTRATE YOUR TRADING ON A FEW CURRENCY PAIRS
Learning the "personalities" of these pairs will help you anticipate price action.

DO NOT OVER-LEVERAGE
Maintain sufficient available margin balances to protect yourself from liquidation in the event of an adverse market move.

TRADING WITHOUT STOP LOSS ORDERS/MOVING STOP LOSS ORDERS

Trading an open position without a stop loss order is a recipe for disaster in any trading environment. It's tantamount to saying "I know I'm going to be right, it's just a question of when." The problem with that rationale is that the "when" part can take a lot longer than your margin collateral might support. Many new traders also mistakenly believe if they don't have a stop loss order, they can't get stopped out. Online currency brokerages typically reserve the right to liquidate your positions if your available margin collateral falls below specified levels. So without a stop loss order, your minimum margin requirement is effectively your stop loss order, but you may also lose more depending where your broker actually closes your position.

Moving stop losses as the market gets close to them is also a dangerous habit, effectively nullifying the purpose of the stop loss in the first place. If you've done your analysis and developed a trade strategy, you've likely pinpointed a price point where the strategy is wrong and that's where you placed your stop loss to begin with. To later move the stop loss suggests an overly emotional reaction in which fears of taking a loss overwhelm your rationally designed trade strategy. Once the emotional dynamic kicks in, moving stop losses can lead to a costly negative spiral—as losses increase, the reluctance to take the losses will too, with only the minimum margin requirement left as the ultimate stop. Traders are better off focusing their time and energy on analysis and trade strategy before a trade is opened rather than second-guessing the objectively developed strategy if it goes south.

TRADING AROUND DATA RELEASES

Most SFO readers are probably aware of this already, but it's important to stress that newcomers to forex trading should generally avoid trading around economic data releases. By "trading around" I mean going into data events with open positions or having orders that are likely to be triggered in the immediate reaction following any data release. The reason for this is simple—market reactions to data can be both volatile and unpredictable. The news might be U.S. dollar-positive, for example, but the dollar might still weaken if the overall trend is negative for the dollar. There's an old market truism, which holds that the reaction to the data is more important than the data itself.

When it comes to trading around data releases, experienced traders know to sit back, watch the report, assess the market reaction and then get back into the market. Think of it in terms of WWI trench warfare—when the whistle blows, do you really want to be in the first wave "over the top?" Until you get a better idea of how forex prices react to data, you can save yourself a lot of unnecessary grief (and money) by keeping your head down, assessing the reaction and then deciding how to trade.

LESSONS TO LEARN

Many of the errors I've discussed above are variations on the same theme—bad things happen when you don't have a trading plan - or fail to stick to one. The other major theme running through these missteps is avoiding unnecessary risk. The forex market, online or otherwise, is just another market. The same trading rules that apply to other financial markets will work with forex too, but you need to apply them if you want to succeed. Keep your focus on developing and implementing a disciplined trading strategy and avoiding unnecessary market risk. ●

Brian Dolan is director of research at GAIN Capital Group. He is a 16-year veteran of the currency markets, having worked as a senior trader and analyst at some of the world's leading international banks, including Dai-Ichi Kangyo, Credit Suisse and American Express. Dolan publishes a daily technical analysis report and weekly macro research report for the exclusive use of FOREX.com & GAIN Capital clients. Frequently sought after by the financial press for his insights into currency movements, Dolan has also published numerous articles on short-term trading strategies and risk management in journals such as Futures Magazine, Technical Analysis of Stocks & Commodities, and SFO Magazine.

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