THE DEFINITIVE GUIDE TO BUILDING A
WINNING FOREX TRADING SYSTEM

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The secrets to success are not really secrets at all.

Those traders who have succeeded have developed a winning formula that can be copied and taught. In *The Definitive Guide to Building a Winning Forex Trading System*, I harness my learnings from the careful study and application of the principles of top traders and share them with you.

Armed with this knowledge, your Forex trading success or failure truly is up to you.

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FOREWORD BY SEAN LEE OF FOREXTELL AND FXWW

When Sam Eder told me he was going to write an eBook on Forex system development, I must admit I was intrigued. Sam is one of the new breed of young trader, forged in the fires of retail trading, instead of on an interbank dealing desk like I was. When I received my copy of *The Definitive Guide to a Winning Forex Trading System*, I was pleasantly surprised at how well it captures the important elements of building a successful system...which most traders tend to miss. In fact some of my ex-bank colleagues could very well do with reading this eBook too!

Like every profession, there are basics that need to be mastered before one can excel. Most trades start out with technical school and apprenticeship programs, while most white-collar jobs begin with a university degree.

Trading is different in that there is no school (except the hard knocks variety!) These days, most traders are self-taught. However, learning the foundations of trading is essential to success.

What can be taught are entry strategies, exit strategies and money management principles. Not only can the entry/exit points and money management strategies be learned, they can also be translated into simple trading systems.

There is no single strategy that guarantees perfect entry and exit levels, but there are strategies that work better in different markets. If you can devise a series of strategies for different market types, and then recognise the type of market you are dealing in, you will be a long way towards becoming a gun trader.

Thanks to *The Definitive Guide to a Winning Forex Trading System*, you can kickstart this educational process at your own pace. Get to know yourself and what makes you tick, and build systems that reflect the type of person you are. I highly recommend you take your time and go through this guide in detail.

About Sean: Sean has been an FX trader since 1986 when he began in the interbank market. Nowadays he leads the way in improving market access, services and information for the aspirational retail trader. His FXWW business manages allocation programs for the new breed of FX professional as well as providing unbeatable market coverage through his chat-rooms on Reuters Messenger. He is also Managing Editor of Forextell and aims to provide plenty of good trading ideas from professional traders (in an entertaining format).

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INTRODUCTION: WHY I CHOSE TO WRITE THIS EBOOK

This eBook was not planned, rather it evolved.

I have dedicated my last eight years as a Forex trader to studying the principles of the world's top traders. In particular, I have an interest in how they build their trading systems.

What I have come to realise is that the market is not random. Rather, it has structure, and patterns based on the collective psychology of the market participants repeat time and time again. And it depends on the quality of the systems that the trader employs as to how well they can harness these patterns to generate profit.

When I was asked to write about these topics on the AxiTrader blog, the positive response from readers was overwhelming. Here is a selection of comments I received from the first couple of posts:

> ***"Thanks for the very enlightening information"***

> ***"Once again thanks heaps for a very informative post. I have learnt far more and gained a far better insight into the world of FX trading from your post than all the other training tools I have been using."***

> ***"Excellent pieces"***

> ***"Thank you for sending this information. It is extremely informative and I am looking at starting a whole new system of trading based on your post...Keep up the good work."***

> ***"I found the blog quite interesting and educational. The tips for trading techniques to suit the different market types was the best part for me."***

> ***"Thanks for the "Heads up"...It is so easy to get involved in the detail, that you can't see the wood for the trees! Thanks."***

As I wrote more posts, the feedback continued to roll in and the idea germinated to collect the articles on system development together in an eBook. So here it is, *The Definitive Guide to Building a Winning Forex Trading System*, which contains updated versions of some of my best work, along with a ton of new material that is exclusively available here.

In the Guide, we will cover everything from market types through to position sizing, and, importantly, how to trade your system mistake-free.

Once you have read through the material, please get in touch and let me know your thoughts.

Stay disciplined in your trading,

SAM EDER
Author & Forex Trader

(**Note:** I am not talking about Forex robot systems in this guide. Personally I am a robot-free zone, and The Definitive Guide to Building a Winning Forex Trading System is for use by traders who wish to use their discretion to outperform the markets – not that mechanical traders won't benefit from this material too.)

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We have all done it.

Embarked on the quest to find the Holy Grail of Forex trading – a system that produces consistent results, week in, week out, with a limited drawdown and a nice upward-sloping equity curve.

But there is a problem with the Holy Grail approach to system development that means the search leaves us more frustrated than enlightened. If you can understand the problem, then you will have one of the keys to a winning Forex trading system firmly within your grasp.

The problem is the failure to understand market types.

Market types – the first key to building a winning Forex trading system

"Expecting the same system to work in all market types is the definition of insanity."
– Van K. Tharp

Market type refers to the different stages or states that a market flows through.

The market type concept was made popular by trading coach and psychologist Van K. Tharp in his books and courses. Tharp believes that while it is insanity to expect a system to work in all conditions, if you can define the market type then it is relatively easy to design a system that provides an edge in that specific market.

Think about it.

If you are in a sideways volatile market, should you be running your buy dips in a trend system? Or: how many traders get blown out of the water trying to buy and hold a strong bear?

While there are up to 25 different market types according to Tharp, there are six that should be of primary consideration when trading Forex.

1. Bull normal
2. Bull volatile
3. Bear normal
4. Bear volatile
5. Sideways quiet
6. Sideways volatile

You can see market types in action if you study a price chart for a moment. You will notice that each currency pair is in constant flux. Sometimes it is trending nicely; at other times it coils into a tight range, or is choppy and volatile.

The core problem with most Forex systems

The core problem with most Forex systems (and incidentally why most Forex robots tend to fail in time) is that they are only designed for use on one or two market types. If you instead shift your focus to identifying market types and then applying a system to that market type, you might find your Forex trading becomes more fruitful.

How to identify the market type

Market types are not so difficult to identify. Normally it's just a matter of looking at a chart.

If the market is going up quietly then it is a bull normal market type. If it's going down it's a bear normal. If it's in rapid descent or rapid ascent it's a volatile market. If the price is oscillating between two support and resistance levels then it's a sideways market. If the sideways range is wide then it's sideways volatile, if it's tight then the market type is sideways quiet.

The trick is remaining aware. Be centred enough that you can do the following:

1. Notice the current market type
2. Notice when that market type has changed.

There is a very useful tool you can use to help identify the market type – Bollinger Bands.

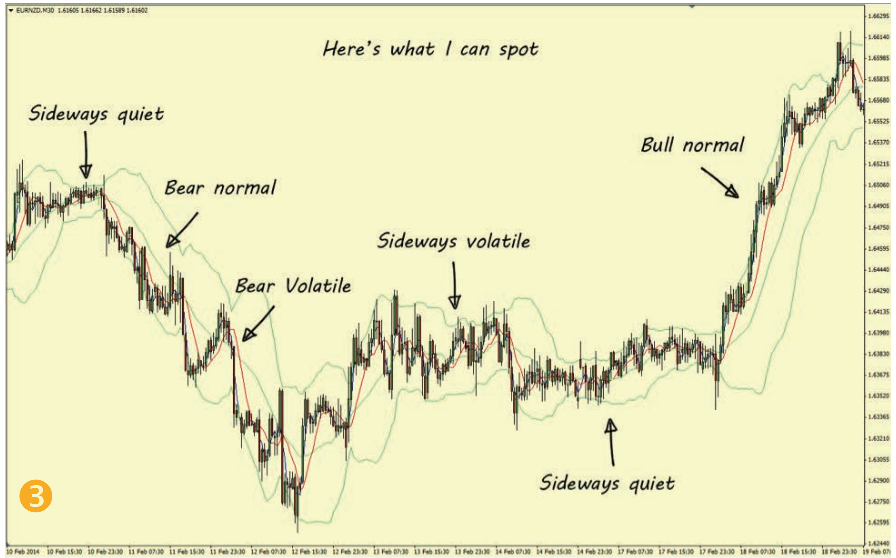
Bollinger Bands

The technique here is quite simple.

Bring up a chart and apply the Bollinger Bands. Bollinger Bands are a volatility-based indicator. When they contract it is a sign that the market type is normal or quiet; when they expand it is a sign that the market type is more volatile. ❶

You can also use the Bollinger Band to determine direction. If the price is bouncing off either side of the band, then the market is sideways; if it is trending in the direction of the Bollinger Band, then you likely have either a bull or bear market type.

Look at the following EUR/NZD 30-minute chart and tell me what market types you can identify. ❷



How did you go? 3

In the chart above, you can see the Bollinger Bands contract into a sideways quiet, followed by a breakout to a bear normal, into a bear volatile. The next part is a bit harder to classify but it could be bull volatile or sideways volatile. Next it moves into a sideways volatile followed by a sideways quiet and finally what I would call a strong bull.

Now that you can identify market types, is there anything else you notice on the chart? Can you spot the transitions?

The secret sauce – market type transitions

Markets are like the ocean.

The primeval forces of human emotion drive the ebb and flow of the price, just as the wild and unpredictable forces of Mother Nature drive the tides.

Like the ocean, the market transitions from calm to restless.

A stormy night clears into a sunny day. Choppy foam settles into a peaceful blue-green glaze...or morphs into a squally and dangerous tempest.

Just as sideways volatile settles into sideways quiet and then transitions into a strong bull.

There is an edge if you understand market types, but there is a greater edge if you understand the *probability* of what the next market type will be. If you know that historically more often than not a bull volatile ends in a bear volatile, then you can plan accordingly. Similarly if you understand that a sideways quiet usually results in a breakout to a bull or bear, then you could develop a system to capitalise on this knowledge.

Trading is a statistical game and knowing probabilities is important.

Market types across timeframes

Some of you may be wondering which chart timeframe you should be looking at to determine the market type.

The fact is that all charts will display all market types. Really it comes down to preference.

The lower the timeframe, the more agile you need to be in adjusting to changes – and the more likely you will get fake-outs, so be wary. Higher timeframes give you more time to adjust to changing conditions and your trading efficiency (trading without mistakes) will be higher.

Importantly, a higher timeframe is often the set-up for a lower timeframe. For example, once you determine the market type on the weekly charts, you can slide down to the daily or hourly charts to snipe for an entry.

Personally I like to define market direction on the weekly or daily charts and then move to a lower timeframe like the 15-minute chart for an entry. Shorter-term market types seem to show up pretty clearly on the 15-minute chart so it could be a good place to start.

As a tip, you might notice the market changes type at certain times of day. Knowing this can be very valuable for your trading. You might not want to take a range trading position on the London open, for example.

Manage your stops based on market type

If you know that a bull volatile typically turns into a sideways or bear volatile, then you can adjust your stop types based on that information.

For example, you might switch to using a Parabolic SAR indicator with a steep gradient that keeps your stop nice and tight in a volatile market, or perhaps you limit your risk to one or two times your initial stop.

Having an appropriate exit system that is intelligently adjusted depending on market type is a good way to keep hold of your profits on a trade.

Systems for each market type

At the start of this chapter, I mentioned that trying to develop a system that works in all market types is the metaphorical search for the Forex Holy Grail. Instead you could look to build a system that works well in each market type and switch between them as the market type changes.

Is it a lot of work? Yes it is. But is it worth is? Definitely.

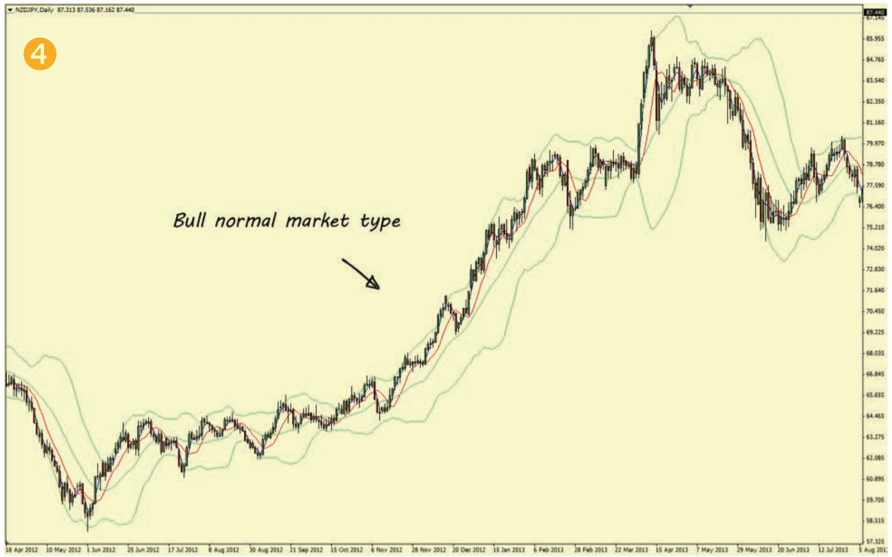
Here are a few rough concepts for systems that tend to work in each market type.

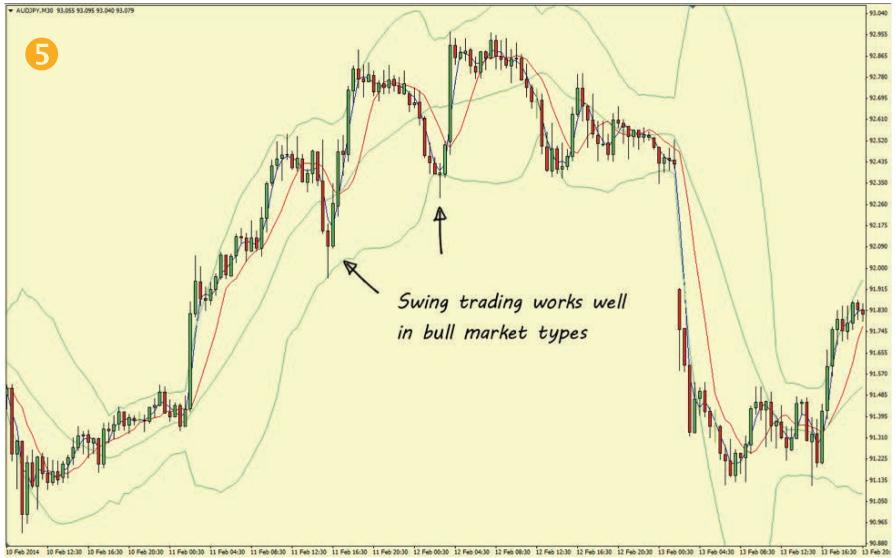
➡ Bull normal – buy and hold

In a bull normal market type you can simply buy and hold with a trailing stop-loss. As long as the market type does not change this can be a pretty successful system.

TIP! Watch for a change to a volatile market. You might find that that the bull market is coming to an end and it's a good time to tighten your stop.

Here is an example on the NZD/JPY on a daily chart. Notice the long bullish candles and widening Bollinger Bands at the top of the chart, signalling a move to a more volatile market type. Here would be a good time to tighten your stop. 4





Bull volatile – long swing trading

Bull volatile markets are suited to a more active trading style. Profit targets are the order of the day in this market type. Look for a pull back, a reversal, and then find a logical profit-taking objective on the long side. You may want to consider dropping to a lower timeframe to improve the risk/reward on the entry.

Here is a bull market that has turned volatile on the AUD/JPY 30-minute chart. See how a buy and hold approach would have struggled while profit targets would have helped you capture the majority of each swing. 5

Bear normal – sell and hold

Bear normal markets are the opposite of bull normal markets. Sell short and hold with a trailing stop to help capture the majority of the move. The 2013/14 fall in the AUD from 1.06 cents to 88 cents is a good example of this market type in action. 6

Bear volatile – short swing trading

In currencies, the bear volatile is the opposite of the bull volatile (this is not so true if you are trading stocks). Try a short swing trading approach with a profit target that gives you a good risk to reward on your trade. 7

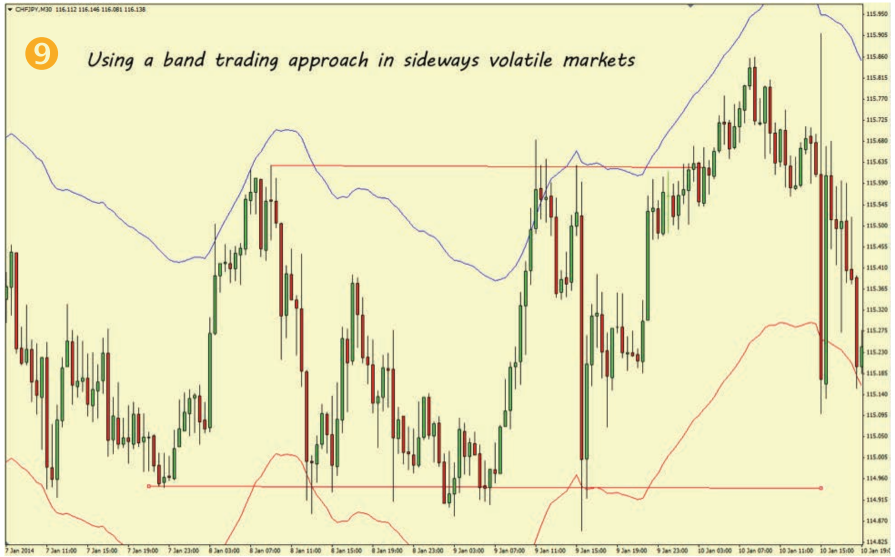
Sideways quiet – breakout

There are two ways (at least!) to trade a sideways quiet market. You can move to a lower timeframe and use a band trading system (like in the sideways volatile section below). This approach can be very lucrative if the currency pair stays in this market type for some time. There will be lots of 2:1 and 3:1 risk/reward trades you can pick off in a row.

Often sideways quiet markets result in a strong breakout and trend. Instead of trading the sideways quiet you can stalk the shift to a new market type by trading breakouts.

A breakout system is not for the faint-hearted.

You will face fake-out and false breakout and then need to have the psychology to hold on for the big wins. But a breakout system that is executed with efficiency is perhaps one of the most powerful systems in the Forex market, where trends can last a long time. You can see the breakout from a sideways quiet market below on this 4-hour chart of the USD/HKD. 8



Sideways volatile – band trading

Sideways volatile markets can be targeted with a band trading approach.

In the below example on the CHF/JPY 30-minute chart, I have replaced the Bollinger Bands with moving average envelopes and customised the settings to the timeframe and currency pair. With envelopes you want the majority of action (90% or so) to be contained within the Bands. Once the price touches an outer band, look for a reversal off a support and resistance level to give you a nice risk/reward on your trade. 9

Don't throw the baby out with the bath water

If you have a good system that works *sometimes*, don't give up on it.

Instead identify the market types where the system performs and **trade those market types only**.

It's like playing golf.

You pull a different club out of the bag for each different scenario you face. You would never use a putter to hit a tee shot, or a driver when you are stuck in sand.

The same applies to trading. Build a toolkit of systems that perform well in different conditions and *use them as appropriate, depending on the market type*.

The hunt for the Holy Grail

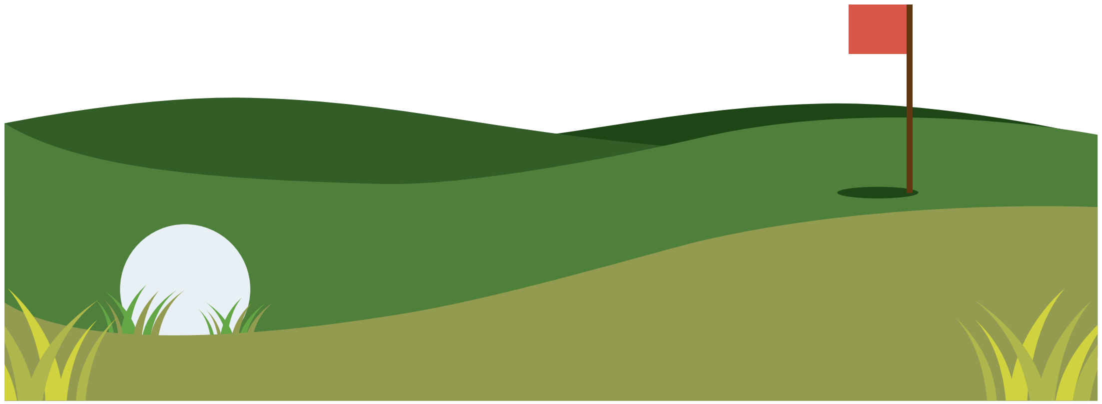
Van K. Tharp still believes in Holy Grail systems.

But his definition is different. To Tharp, the Holy Grail is a system that performs exceptionally well in a particular market type. Think of it this way. If you know that you are able to meet your trading objectives for a system operating in a certain market type, then all you need to do is hunt for the market type you wish to trade.

Imagine if you were a golf player who excels at putting and could only play on the putting green – *and still win golf tournaments.*

In trading, you can take this approach.

You make the rules of the game so **if you only want to trade one market condition, you can.**



CHAPTER 2: DAMN GOOD SET-UPS

"Although the cheetah is the fastest animal in the world and can catch any animal on the plains, it will wait until it is absolutely sure it can catch its prey. It may hide in the bush for a week, waiting for just the right moment. It will wait for a baby antelope, and not just any baby antelope, but preferably one that is also sick or lame; only then, when there is no chance it can lose its prey, does it attack. That to me is the epitome of professional trading."
– Mark Weinstein

Do you remember when you first got into trading?

Set-ups are among the first things to enchant the wide-eyed new entrant to the world of Forex. Those glittering charts with all their indicators that promise to give you a glimpse of the future...and all the profit that portends.

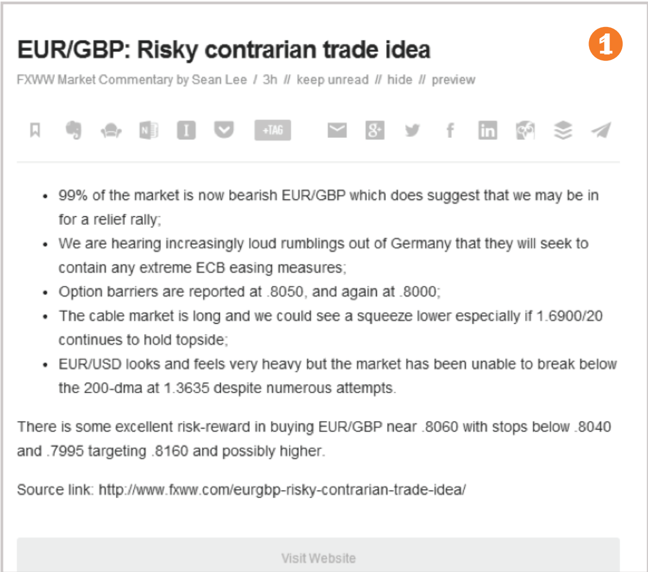
There are five primary types of set-ups:

1. Technical set-ups
2. News-based set-ups
3. Big picture fundamental set-ups
4. Sentiment set-ups
5. Expert set-ups

These set-ups can be used on their own or combined to create high probability, low risk/ high reward trade ideas.

But be careful...

The essence of a good trading plan is simplicity. Pick and choose only the best set-ups that suit your trading personality. Doing more than that is a recipe for disaster as conflicting set-ups cause confusion, indecision and mistakes.



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EUR/GBP: Risky contrarian trade idea

FXWW Market Commentary by Sean Lee / 3h // keep unread // hide // preview

- 99% of the market is now bearish EUR/GBP which does suggest that we may be in for a relief rally;
- We are hearing increasingly loud rumblings out of Germany that they will seek to contain any extreme ECB easing measures;
- Option barriers are reported at .8050, and again at .8000;
- The cable market is long and we could see a squeeze lower especially if 1.6900/20 continues to hold topside;
- EUR/USD looks and feels very heavy but the market has been unable to break below the 200-dma at 1.3635 despite numerous attempts.

There is some excellent risk-reward in buying EUR/GBP near .8060 with stops below .8040 and .7995 targeting .8160 and possibly higher.

Source link: http://www.fxww.com/eurgbp-risky-contrarian-trade-idea/

Visit Website

So you can get an idea of what a good set-up looks like, I have borrowed an example from Sean Lee, the founder of FXWW and Forextell. 1

You can see how Sean combines a fundamental directional bias with technical factors to generate an idea for a trade.

A set-up is not a buy signal

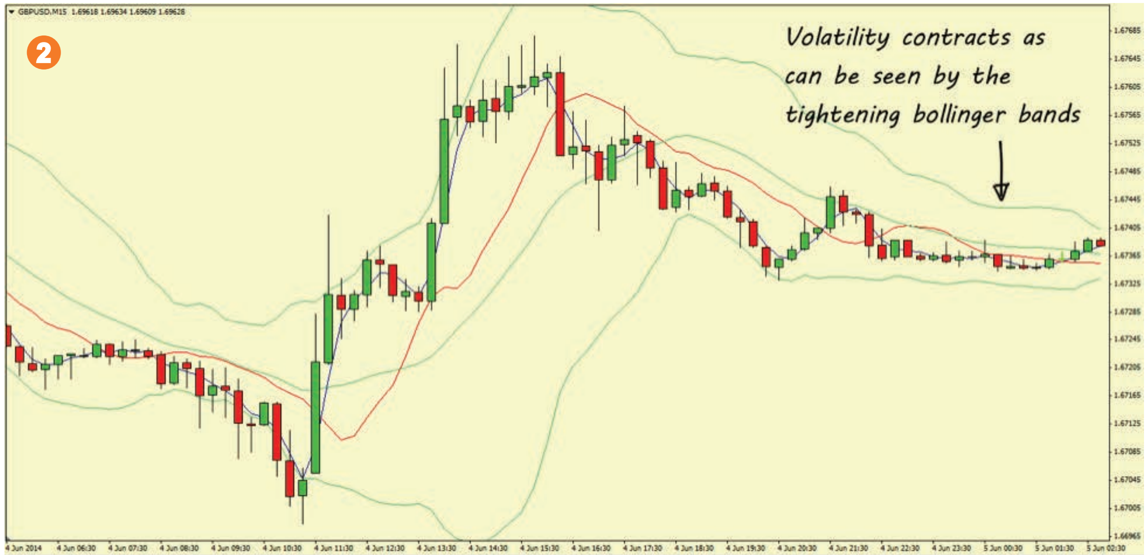
Great traders stalk their trades like the cheetah lies in wait for the antelope.

The set-up is the scenario that occurs before the trade is executed. It is not the trade itself.

Once the set-up conditions arise, you don't necessarily enter straight away. You want to time your entry with precision to increase the risk/reward on the trade.

To continue with the cheetah analogy, once the cheetah chooses its prey using patience (the set-up), it still needs to execute the kill (the entry). For this, it has a specific routine involving stealth, speed and strength. The cheetah moves low in the grass using the small rises of the land to disguise its approach. This is followed by a terrifying burst of speed to get close enough to pounce on its prey. Then the cheetah closes in, using raw strength and skill to target the prey's vulnerable areas with its powerful jaw and sharp claws.

I'll illustrate with an example using a simple volatility contraction set-up on the GBP/USD with a breakout entry. You can see how volatility contracts on the right-hand side of the chart, which is our set-up. 2



We then wait until we get our specific entry signal before we place the actual trade, which in this case is a breakout buy signalled by a close of the 15-minute candle above the Bollinger Band. 3

And the result of our patience is a trade that returns three to four times our risk depending on our exit system. 4

As a trader you have set-ups that alert you to a good trade, but you still need to time your specific entry to maximise the potential profit.

How to think about your set-up

> *"Luck is what happens when preparation meets opportunity."*
> *– Seneca (Roman philosopher)*

Once you find a good set-up, it is helpful to have a framework for thinking about how you are going to best exploit it.

Consider as your framework:

- What are 2–4 options of that can come out of this set-up?
- How am I going to make money out of this set-up?
- Where are my potential entry points?
- Where are my potential profit targets?
- What could happen after I enter my trade?
- Where can I re-enter if I get stopped out?
- Where can I scale into the trade?

Let's use our GBP/USD example again to go through this step by step.

In this case, our main set-up is a low volatility sideways market type.

What are 2–4 options that can come out of this?

What options do I have for a sideways market? Typically it could either breakout or stay within the range.

How am I going to make money out of this?

In this example, I think the best risk/reward trade opportunity is the breakout, so I will ignore the range trade for the moment.

Where are my potential entry points?

A close above or below the Bollinger Band on the 15-minute charts would be a suitable entry on this set-up.

Where are my potential exit points?

As I believe that prices tend to move towards the clusters of stops at the highs and lows (represented by the red lines on the chart below), I see these as potential profit areas.

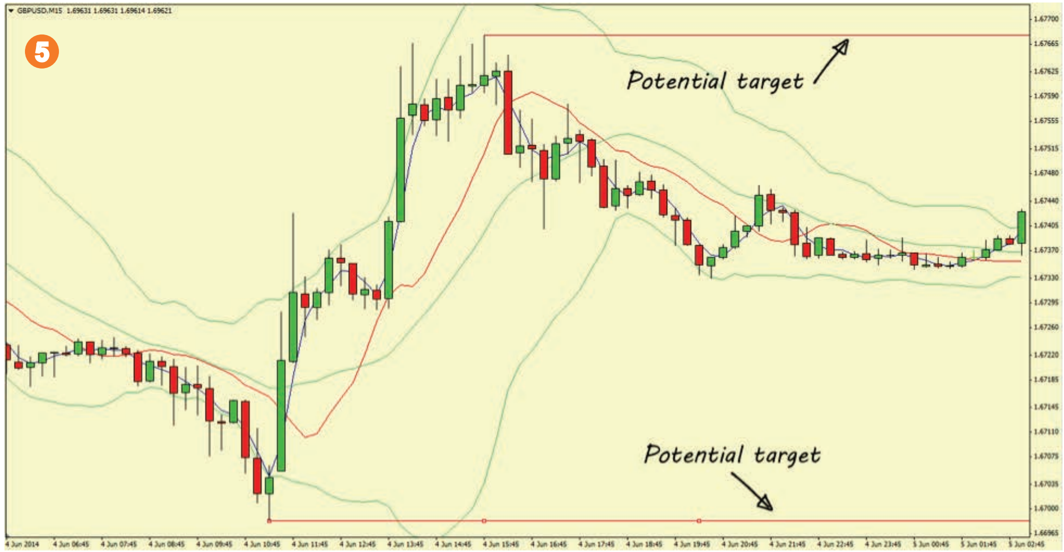
I could place my stop on the lower Bollinger Band, meaning that I have a risk/reward of at least 3:1 on the trade.

I would also look to apply the complex exits approach in chapter 5 to the trade. 5

What could happen after I enter my trade?

Once I enter into the trade, there are four things I think could happen:

1. The breakout continues and a trend forms
2. The breakout fails and goes down and hits my stop-loss



3. There is strong reversal signal
4. The strong reversal signal fails and the breakout continues.

I should consider how to handle each option and note it down if it is not already in my trading plan.

Where can I re-enter if I get stopped out?

If I do get stopped out, then I would look to re-enter in either direction if I get a similar signal.

Where can I scale into the trade?

If I get a reversal failure, I will scale into the position on a close over the reversal candle.

If a strong trend develops from a breakout, then that is a new set-up that allows me to add another position, in the direction of the trade. (I would then need to ask myself the same set of questions about the new set-up.)

Selecting your system's currency pairs is part of your set-up

It's my bet that you have been told to keep it simple and stick to the major currency pairs such as EUR/USD or GBP/USD.

While this may be true for some of you, the smarter trader might decide to trade the cross rates instead. Don't be shy in exploring the full spectrum of currency pairs that are on offer to see what is going to best suit your system. The cross rates often now have spreads that are very close to the majors, and because less people specialise in them, you may find you develop a nice edge by choosing to focus on them.

The art of the chart – some damn good technical set-ups

> *"The 10-day exponential moving average (EMA) is my favourite indicator to determine the major trend. I call this 'red light, green light' because it is imperative in trading to remain on the correct side of moving average to give yourself the best probability of success. When you are trading above the 10-day, you have the green light, the market is in positive mode and you should be thinking buy. Conversely, trading below the average is a red light. The market is in a negative mode and you should be thinking sell."*
> *– Marty Schwartz*

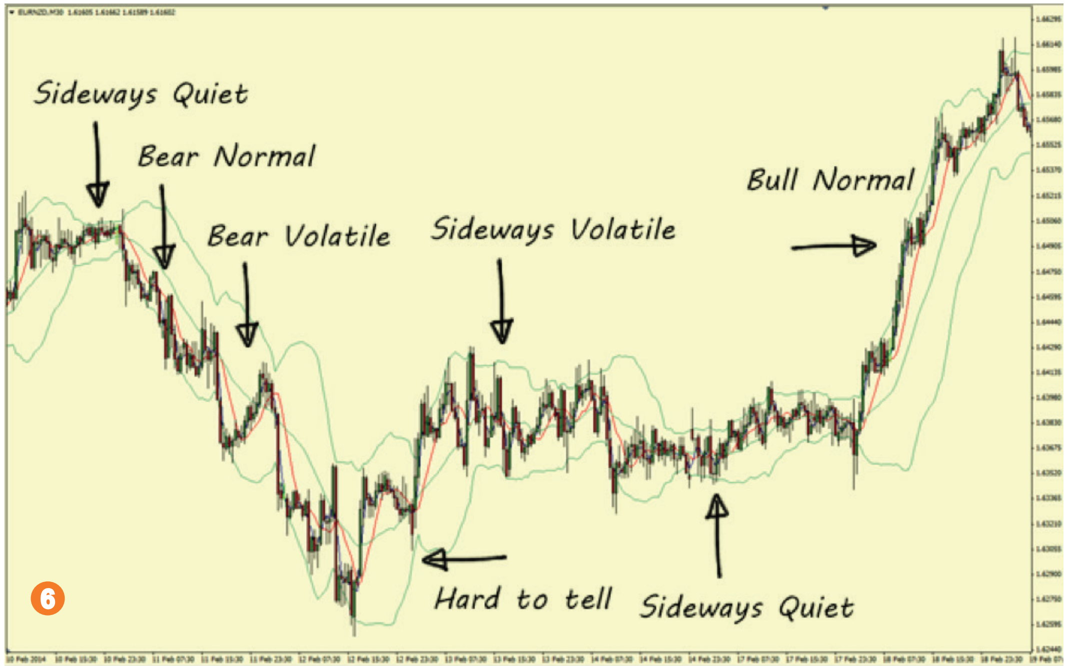
Some of the simplest and best set-ups are derived from the art of technical analysis.

Your primary guide should always be price. Ignoring what the price is telling you is the nautical equivalent of ignoring a rocky outcrop because it is not marked on your ship's chart. Don't ignore the evidence in front of your eyes.

But there are hundreds of set-ups that you can potentially use, so let's help you simplify by selecting a few of the most useful.

Know your market type

Market types (see chapter 1) make excellent set-ups. You should be aware of the market type you are in before you trade. In addition, consider using the transition from one market type to the next as the set-up. 6



Use a trend filter to befriend the trend

Forex system development is about trial and error. You can make systematic changes step by step, which will improve your results over time. A trend filter is a set-up that can be used in this way.

You simply apply a trend-following indicator to a chart and never trade against it, like Marty Schwartz with his 10-day EMA. If the price is above the indicator you never go short; if it is below the indicator then you never buy. 7

You can test the effectiveness of a trend filter by back-testing, either manually by looking on the charts or, if you have the skills, by programming a back-test. Personally I like manual testing as it can give you insights you can't glean from a computerised back-test (though the same could be said for the reverse).

Marty Schwartz's 10-period EMA on a daily chart

Some useful trend filters

10-day Exponential Moving Average	You would never trade against the 10-day EMA. In this case your entry would be on a lower timeframe.
Displaced moving average. Try a 25-period moving average displaced by 5 periods for short-term trends or on a higher timeframe for long-term trends.	I came across this indicator through Joe DiNapoli who recommends displaying moving averages to avoid whipsaws experienced by the typical moving average.
Displaced moving average. Try a 200 x 5 period moving average on your entry timeframe.	A variation of the 25 x 5 above for use on the main timeframe you use for the trade.
MACD – Normal settings of 12/26/9	You can use this on both your entry timeframe and on a higher timeframe.
MACD – Settings of 70/200/70	Use this on the main timeframe you use for the trade.

Let's look at an example of how a trend filter works using the 70/200/70 MACD. In this example, I am operating a simple support and resistance trading system that sells on resistance in a downtrend and buys on support in an uptrend. The exit is on the opposite support/resistance level. Each winning trade has a 3:1 risk/reward ratio. 8

By trading with the trend filter there are five wins and three losses, but the winners are three times bigger than the losers, returning twelve times the amount risked over eight trades.

Note this is an idealised example. With any trend filter you can experience periods of whipsaws as markets consolidate before a new trend forms.

Chart patterns, trend lines, and support and resistance levels make excellent set-ups

Maybe you're an avid chartist, with a comprehensive knowledge of charting that you don't want to go to waste.

Never fear – your carefully drawn triangles, wedges and Fibonacci levels can serve as perfect set-ups.

The distinction here is that when you use a chart pattern as a set-up, it is not your entry. Once you see a likely pattern, you then move to a lower timeframe to improve the risk/reward on the trade. For example, on the GBP/CAD trade we have a resistance level on the weekly chart that has held six times before the breakout finally comes. 9

After the breakout, rather than rushing to enter the market, you move to a shorter timeframe to improve the risk/reward on the trade. [10]

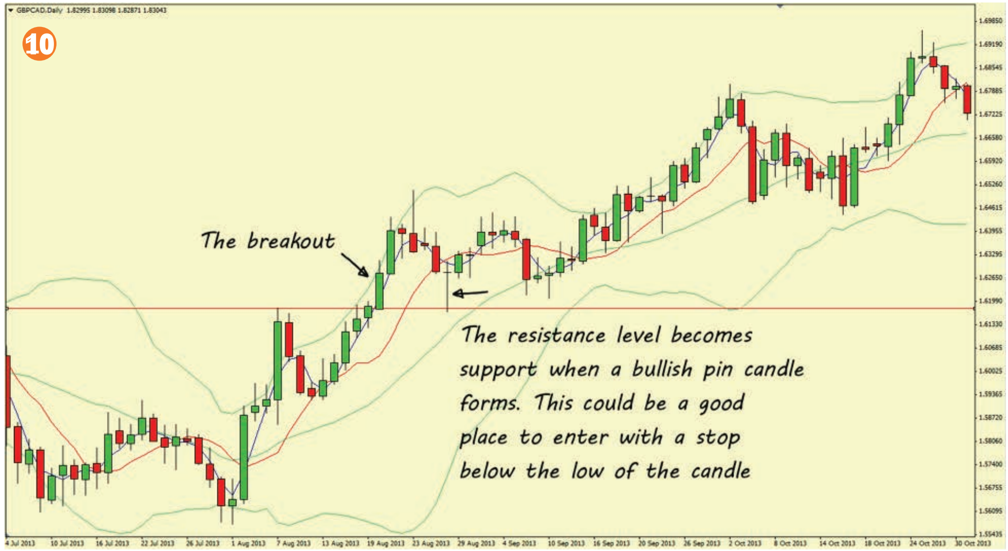
You can see that not only do you improve the risk/reward on the trade by using the resistance level as a set-up instead of an entry, but also you could have potentially avoided several failed breakouts.

Some damn good news-based set-ups

Some people are attracted to Forex trading for the buzz of it.

You can spot them a mile away.

They have itchy trigger fingers, they trade big because it gives them a rush, and they tend to lose. Forex trading is not the place to get your thrills. That part of your psyche needs to be put aside when you trade. Needless to say, this type of trader is attracted to the thrill of the news announcement. The promise of quick profits is hard for the gambler inside to resist.



And this presents opportunity.

Where there is a lack of discipline and emotion in the markets, there is profit potential for the prepared and patient trader. For you to take advantage of this opportunity, you will need a thorough knowledge of news set-ups. Here are some important ones.

How has price has reacted to this news event in the past?	You can get this information from a service such as Autochartist's event impact analysis tool.
What have previous news results been like?	Do they come in as expected or is there a typically a variance? How does the market typically react if numbers come in over or under? You can see past results in any decent Forex economic calendar.
How important is the event?	Some events move the market more than others. Again, you can find this in an economic calendar.
How long do the moves typically last?	The reaction to events can be fleeting or can last for months. Try to know how long you can expect the move to last.
What are analysts' predictions?	You could read your favourite sources of expert commentary about what to expect from the news event. Try **www.forextell.com**.
Do you think what the market expects has been priced in?	Harder to gauge, but see if you can glean from market sentiment, analysts' commentary or chatter if the market is overly long or short and likely to get caught out.
Is there news divergence?	A powerful set-up can occur if the price reacts the opposite to how it should. For example, if there is negative news and the price reacts positively then it could be a good set-up for a buy.
If it is an interest rate announcement, what do the Central Bank minutes say?	Some traders read the Central Bank minutes to get an insight into their directional bias.

When two trades diverge

Trading the news presents you with a clear choice. Do you enter your trade

- Before; or
- After?

This decision will influence how you use the news as a set-up.

If you are placing your trade prior to the event, then it is *your prediction of what is actually about to occur* that is the set-up. If you are waiting for the news result to come out, either for a technical move or for the news result to become apparent, then this is actually your set-up.

Some damn good fundamental set-ups

In effect most fundamental information is a set-up. Here are two very important fundamental set-ups you could consider before each trade, particularly if you are holding long-term positions.

Interest rates

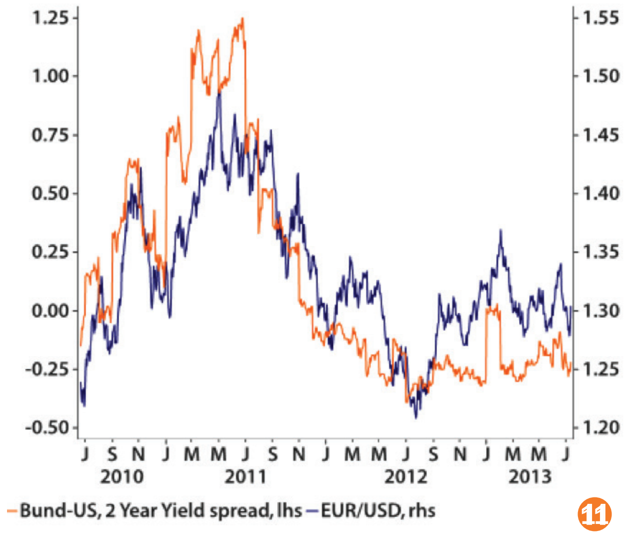
The interest rate differential between countries is one of the best predicators of currency movements.

Currency trading can be seen to be a form of leveraged fixed interest trading. So if a currency pair has a higher rate, then it can be an attractive long-term buy. When there is demand, there tends to be price increases.

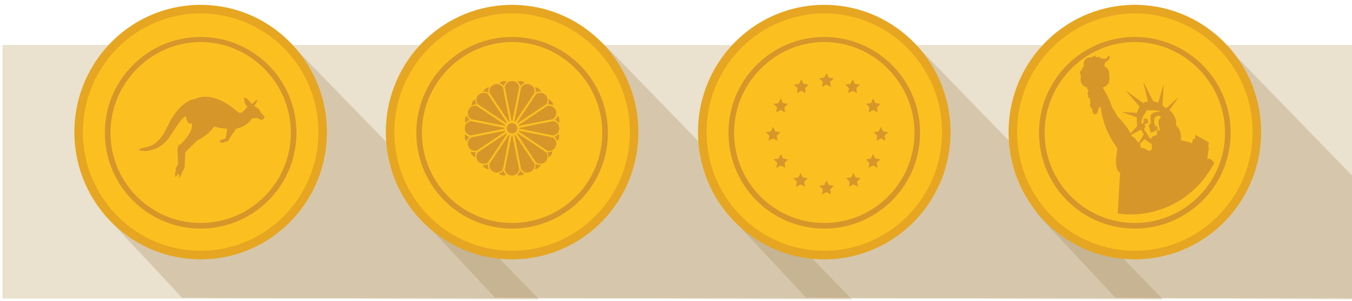
In addition, they have a very real impact on your account balance. If you are buying the currency pair with the lower interest rate, you are likely to have the interest charge subtracted from your account each day.

Chris Lori, a popular American trader, takes this set-up very seriously. He recommends trading only the AUD/JPY and only buying AUD so that he is always earning interest on his trades.

There is an example of interest rates at work on the following chart. Here you can see the correlation between the spread on German and US bonds, versus the price of the EUR/USD. 11



Source: Forexlive.com



Central bank bias

It used to be all about interest rates, but after 2008 central banks across several major developed nations dropped interest rates to close to zero.

Their main tool became quantitative easing, where (essentially) they would inject cash into the economy in exchange for toxic debt. This bias towards easing had a telling impact on the movements of currency pairs. Thus currency traders tune in to the easing or tightening proclivity of central bankers to get an idea of the direction they want to trade. You can see the impact quantitative easing has on the movement of currency pair on the following chart of the EUR/USD. [12]

So take note of directional biases caused by fundamentals as they can make very good set-ups for longer term trades.

Some damn good expert set-ups

Trade ideas dominate Forex websites and for the uninitiated it can be hard to sort the wheat from the chaff.

But if you do find an expert source of information about the Forex pairs you are tracking, it can give you a built-in edge. The experience and connections of those in the industry are not easy for us retail traders to emulate and their trade ideas can prove well worth tracking.

You should not go all in on the "hot tip" of an expert. You should treat an expert's trade idea like you would any other set-up. It is simply a component to be added into your complete Forex trading system.

Why not follow these ideas in full? Because you have your own unique objectives, psychology and

motivations, which if not considered will lead to trading failure.

What will you do if the experts you are following:

- Experiences a drawdown
- Trades a timeframe that does not suit you, or
- Doesn't give you a place to put a stop-loss?

And they certainly won't have a position-sizing model designed to fit you.

If you don't treat their ideas as your own in an integrated manner, then over time the incongruences will pile up and you will make mistakes that harm your trading account.

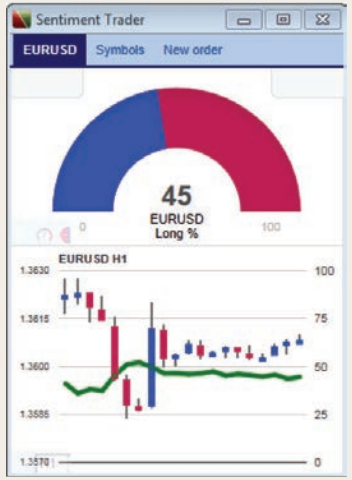
Some more damn good set-ups

Set-ups abound. Wherever you can find a Forex trader you can find a new set-up.

In fact entire books have been written on one or two set-ups alone. Here are a few more set-ups that you should know about.

(Please note that just because I did not include these above does not mean they are any less useful or important. It all depends on the trader and the edge they are seeking to find.)

See which ones suit you and your trading style. Avoid the temptation to overcomplicate. You must have a specific reason for adding a set-up into your plan, and then you should rigorously test it like a scientist tests a hypothesis.

Time of day/ session	The time of day and the session you are trading in can have a big influence on the outcome of your trade.
Divergence	Lookout for indicators that are signalling a change in trend before the price reverses.
Size of the candle	Large candles can signal an important event has happened that may create a change in the trend.
Information about the order flow	Information about where orders and stops are sitting in the markets can be excellent set-ups.
Options barriers	If market participants are looking to either protect their options from execution or make sure that an option is executed, then their actions could move the market.
Sentiment indicators	Sentiment trading is a relatively new innovation in the Forex market. By knowing which way the "herd" is positioned, you can choose to either follow or fade the trend. 

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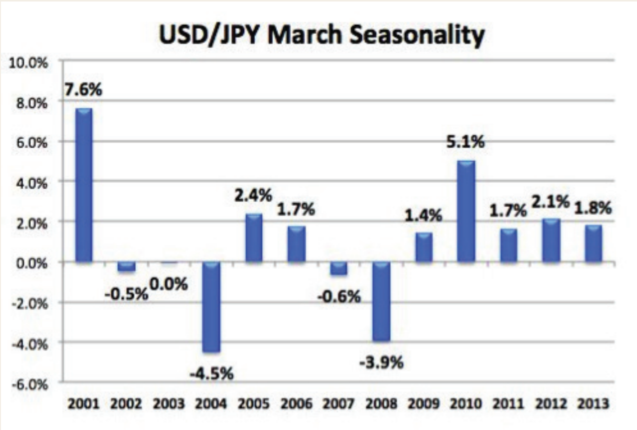
(Table continued)

Correlations	Correlations between currency pairs can be important leading indicators across multiple timeframes.
Upcoming news events	If you assess the events that you have on the horizon for the coming week, you can get a sense of what can move the market and where.
Why a pattern is formed	If a pattern is formed because of a news event or not.
Seasonality	Historically currency pairs may have performed differently based on the time of the year. You can see an example in this chart where for the last 5 years USD/JPY has been strong in March. (chart courtesy of Kathy Lien) 
Environmental or geopolitical events	Such as 9/11, the Japanese tsunami or Russian troops in the Crimea in 2013 can heavily influence the direction of currency pairs.
Corporate buyers	A large corporate purchasing currency (perhaps due to a merger and acquisition) can be a powerful set-up.

Here's what to do next

Smart traders know that the search for the perfect combination of set-ups is a *chimera*.

As you develop your Forex trading strategy, you will be tempted to spend the lion's share of your time in this area.

But don't be so easily seduced.

I suggest you choose:

1. A market type
2. A trend filter

Then choose one other set-up from those listed above (or one of your own that you already like).

And simply move on. Go and work on other aspects of your system or your position sizing. You can then experiment with the set-up as a variable as you make changes down the track.

CHAPTER 3: SIMPLE ENTRIES AND RE-ENTRIES

The questions I get asked the most about Forex trading are:

1. When to enter
2. Where to place your stop
3. When to exit.

They are some of the most important questions you'll answer in your Forex trading plan. Together they form the decision-making engine of your Forex trading system.

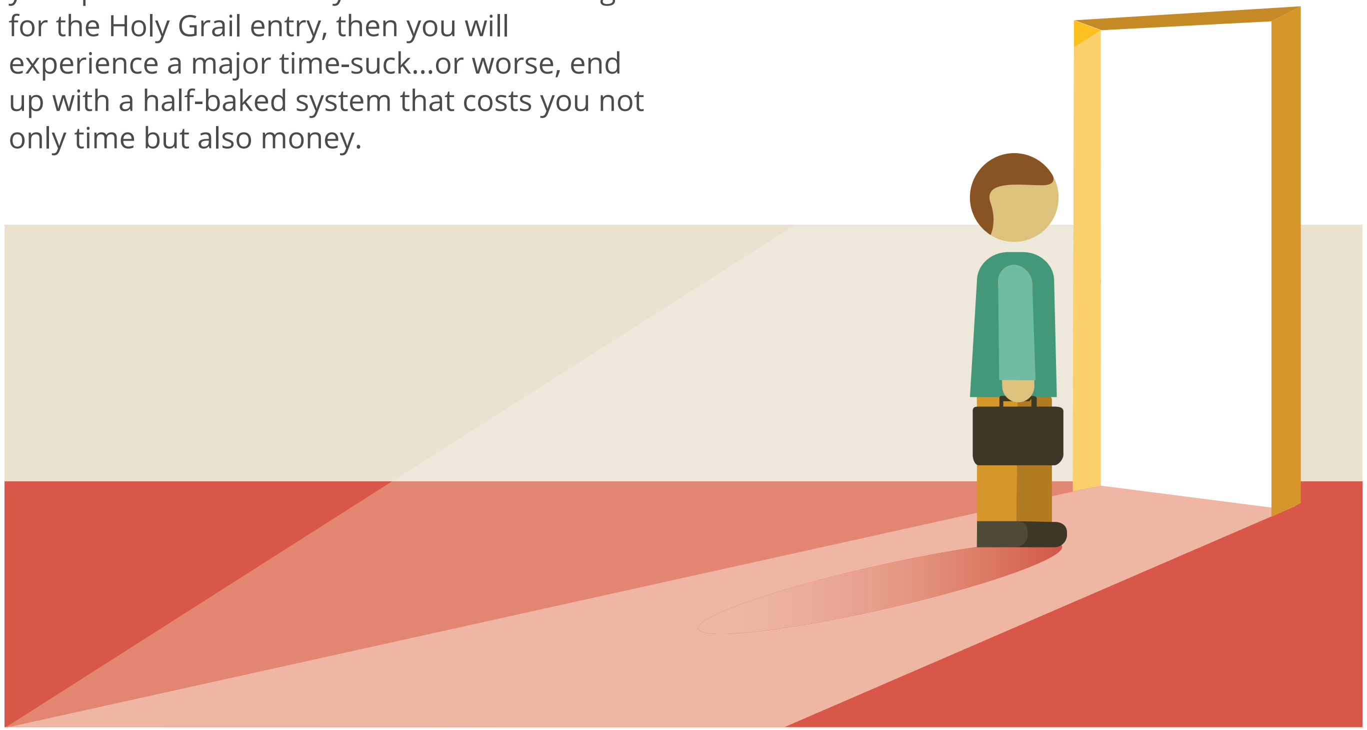
Over the next three chapters we will cover each of these questions, but before we get started, the first step is to understand how they fit into your trading plan. While entries and particularly exits are critical to your system's performance, we have not yet touched on your trading psychology, your position-sizing model, how to trade mistake-free, or the power of objectives.

You can have the best entries and exits in the world and still lose if you don't integrate all these factors. My belief is that around 15% of your energy should be spent on this area, with the majority of that time on the exit part of the equation.

You have spotted it, right?

I started this chapter by talking about the importance of entries and exits and now I am saying they are not to be treated with such reverence.

The reason why this is important is because if you spend too much of your focus searching for the Holy Grail entry, then you will experience a major time-suck...or worse, end up with a half-baked system that costs you not only time but also money.



The true role of entries and exits

Each trade is like a draw from a lucky dip or a spin on the wheel of fortune.

The better your entries and exits, the more winners in the draw, the easier it will be for your Forex trading system to meet your objectives. Your goal for your entries and exits is to add as many winning tickets into the draw as possible – or to add in tickets that when you do pull them ensure you win the jackpot.

When you internalise this concept, you can start to see how entries and exits fit into the bigger picture of your Forex trading system. They lose their mystical appeal. You don't need to have a system that is perfect, just one that produces enough winners over time, with which you can bet enough on each trade to:

1. Not experience a drawdown over 25% (it's hard to recover from a drawdown this large without being extra risky – see the table);
2. Achieve your objectives over time.

Recovering From a Drawdown

Trading account loss %	Gain required to recover %
5	5.3
10	11.1
15	17.6
20	25.0
25	33.3
30	42.9
35	53.8
40	66.7
45	81.8
50	100.0
55	122.0
60	150.0

Are high probability entries better?

Building a trading system is a little like building a house.

When you construct a house, you decide how many rooms it will have, the layout, how many floors and so on. These decisions are based on your needs (objectives), budget (trading capital) and what suits your personality (psychology).

Similarly, when you develop entry and exit rules for a Forex trading system, you get to choose things like its targeted risk/reward ratio, win rate and the number of trades over a time period (i.e. five trades a week). Your choices here will be a reflection of your needs, budget and goals.

Take a look at these three basic examples of Forex trading systems.

System 1

System 1 generates 10 trades a month with a 90% win rate. Winning trades make $100 and losing trades lose $1000.

System 2

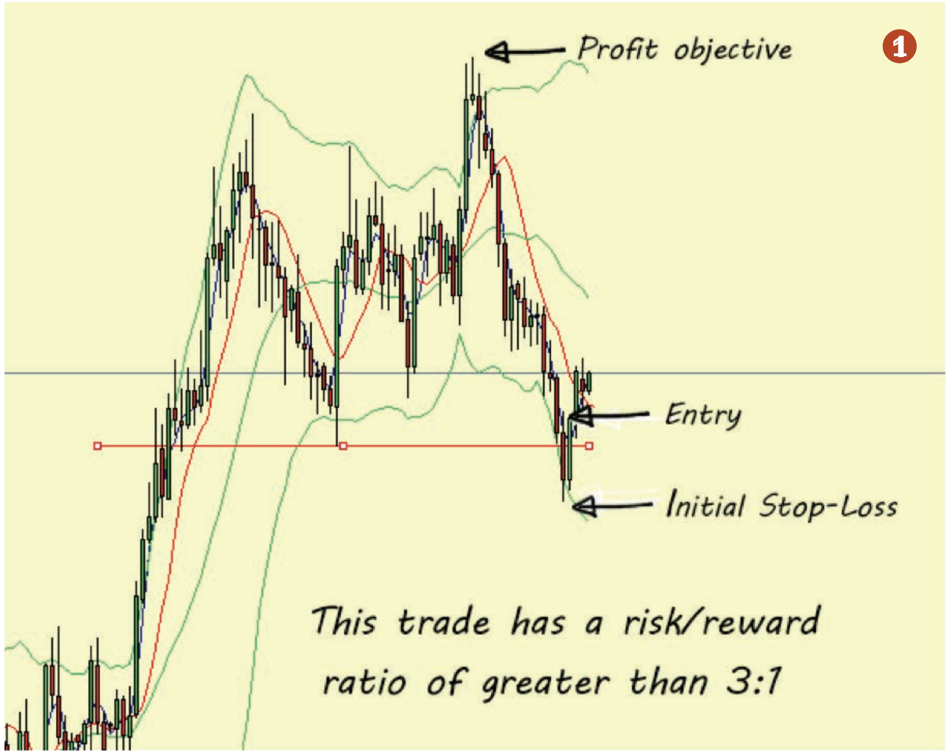
System 2 generates 80 trades a month with a 60% win rate. Winning trades make $60 and losing trades lose $50.

System 3

System 3 generates 10 trades a month with a 15% win rate. Winning trades make $1800 and losing trades lose $150.

Before you read on, which system would you prefer?

Note it down along with the *reasons why* it is your system of choice.



Here are the results for a month's trading for each system in dollars:

- System 1 with a 90% win rate had a $100 loss
- System 2 with a 60% win rate had a $1280 profit
- System 3 with a 15% win rate had a $1425 profit.

What do you notice here?

The system that made the most profit had the lowest winning rate – and the system that lost money had the greatest win rate.

Now would you still choose the same trading system you chose above?

When you are developing your entry and exit, the one with the most wins is not always the best. Be careful not to fall into this trap.

(As a side note, it is possible to have a system that has a high win ratio and larger losses than profits. It's just tough if you experience four or five losses in a row, so make sure you position size accordingly.)

A risk/reward ratio filter for your trades

Entries and exits should never exist independent of each other. Their relationship can be expressed though the risk/reward ratio. Your risk/reward ratio is how much you can potentially profit on the trade compared to your initial risk.

You determine this by working out your initial stop and profit objective. For example, if you are risking $1 to make $3 you would have a risk/reward of 3:1, like you can see on the below USD/CAD chart. 1

It can be beneficial to have a rule in your trading plan that you only place trades that have a certain risk/reward ratio.

You may only take trades that have a risk/reward ratio of 3:1 on longer-term positions, or of 2:1 on shorter-term positions. This would mean you avoid placing the following trade (or look for a profit objective further out). 2

Entries vs. re-entries

For the sake of system development we define some types of entries as re-entries.

Re-entries occur in two circumstances:

1. The initial entry is stopped out but the set-up conditions still exist. I.e. a breakout fails and then goes back within the range before attempting to breakout again.
2. The initial entry is successful and you get a new set-up that you want to take. I.e. you enter on a breakout and the market starts to trend. You then get the chance to add an additional position based on a pullback in the trend.

The trick to using re-entries is in the planning. If you have just had a losing trade, or are already in a winning trade, it can change your psychology and cause you to make mistakes.

Note down in your trading plan exactly what you will do in a re-entry scenario.

Reversals

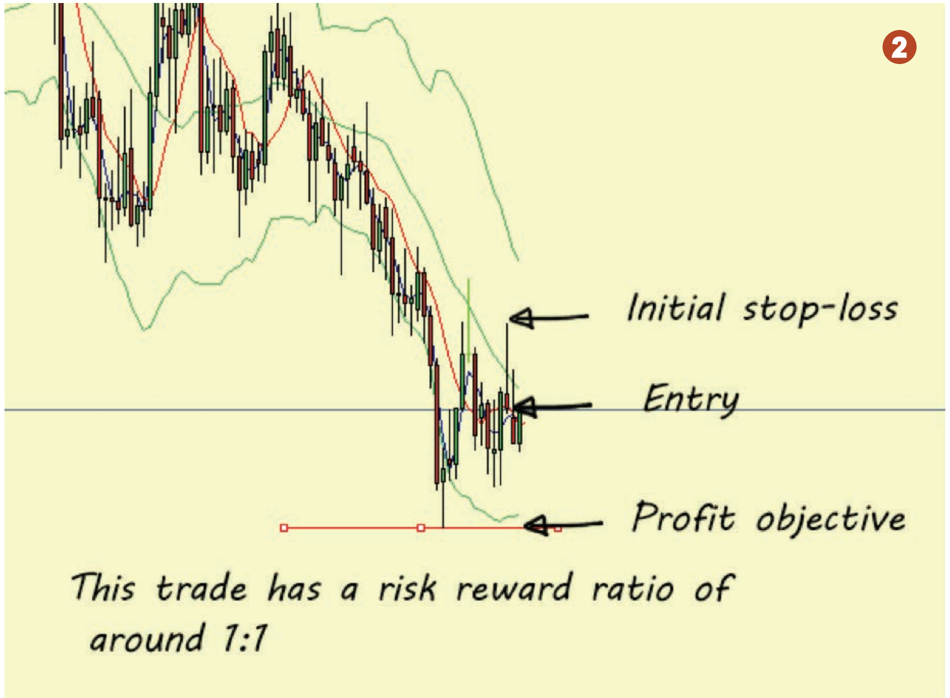
Occasionally you will be in a trade and get a set-up for a trade in the opposite direction. Like re-entries, these can be a little difficult psychologically as you could be influenced by your current position.

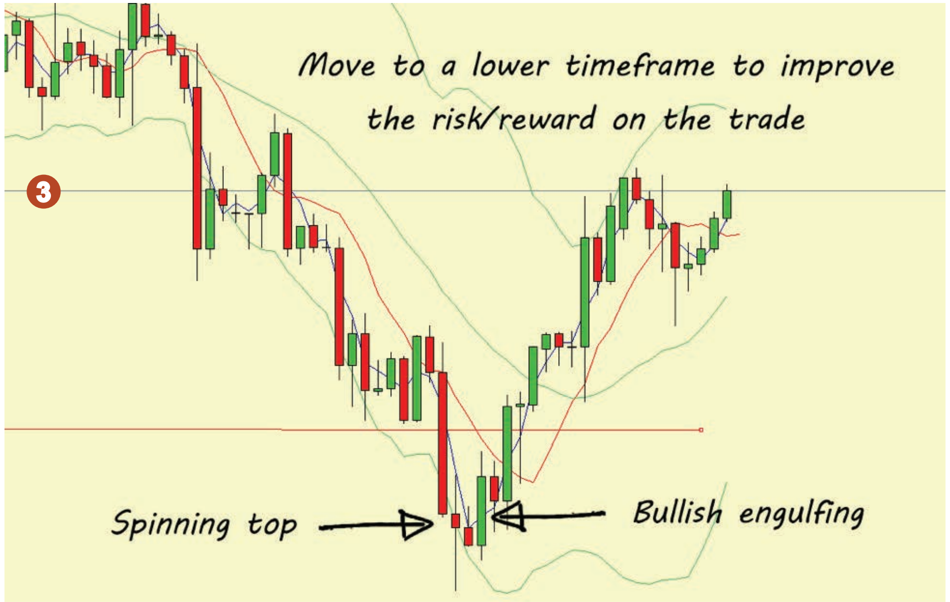
What to do?

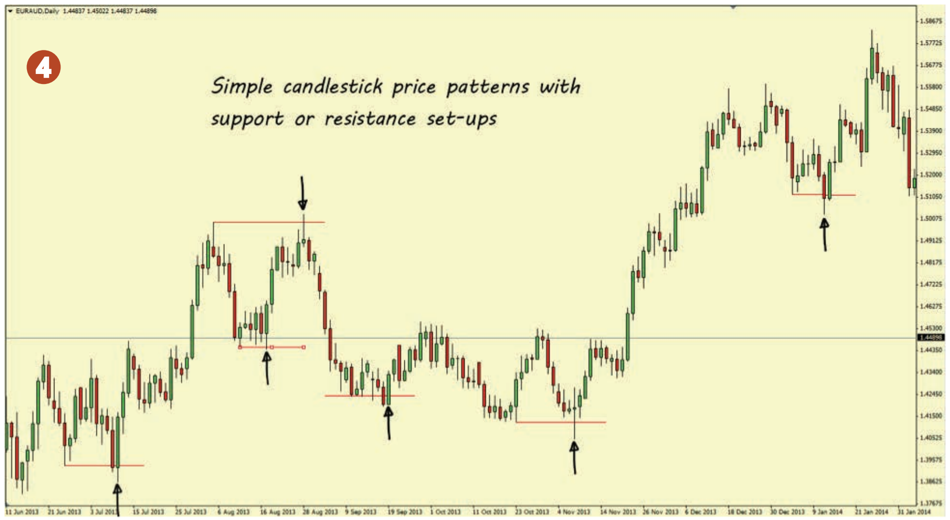
As above, it is all in the planning.

Note in your trading plan:

- What constitutes a reversal?
- Under what circumstances will you take a reversal?
- What if you get another reversal after you have already taken a reversal? Do you reverse again?







Simple entry techniques work

Simple entry techniques allow you to focus on managing your trade after you enter rather than on interpreting a jumble of indicators to work out the best time to buy.

A good entry has two main criteria.

The set-up

A set-up is a condition you watch for prior to entering your position, which is chapter 2 in this eBook. Once your set-up occurs, you then move into stalking mode for a high quality entry.

The entry

Now you become the hunter or huntress, spear in hand, pursuing a high-quality entry with dogged determination. You are face-to-face with the markets, unwavering while you wait for the perfect moment to strike.

When the time comes, you execute with aplomb, your supreme skill ensuring you net your target with ease...

Typically you will look to drop to a lower timeframe from your set-up to improve the risk/reward ratio. You could then employ a technical analysis technique such as candlestick analysis for the actual entry. For example, on the earlier USD/CAD trade, if you went to a lower timeframe you would have seen a strong reversal pattern (a spinning top followed by the bullish engulfing candle) that would have allowed you to get in earlier and improve the risk/reward ratio. 3

Entry methods that work

Almost all entry methods work, but they work differently depending on your set-up, psychology, objectives and the market type.

Candlestick patterns

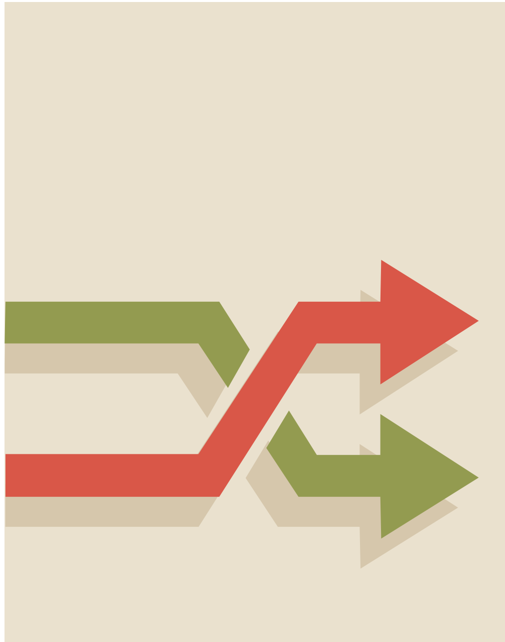
Price action candlestick patterns can be excellent entries as these give an indication of the buying and selling pressure between market participants. 4

Indicator cross-over

Indicator cross-overs are popular for their simplicity. They tend to work better in trending markets.

Some indicators that can be used for this approach include:

- Moving averages
- MACD
- Stochastics 5



Price crosses moving average

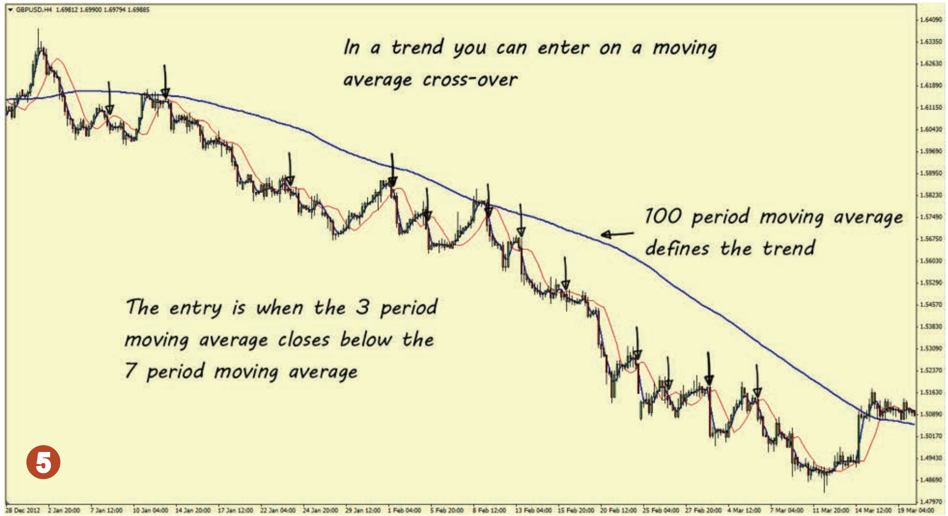
As a variation of the moving average cross-over approach, simply place your trade when the price either touches or closes over the moving average. You will find that you get into your trade earlier, but that you suffer more whipsaws.

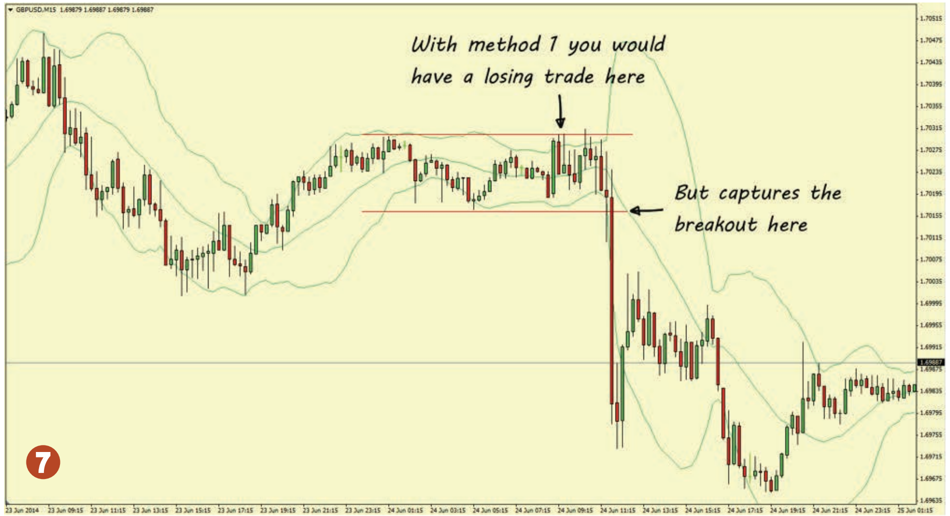
Here I have zoomed in on the above chart so you can see the difference. 6

Breakout

There are 2 main ways or methods you can use to trade a breakout.

1. Use a limit or stop order that enters automatically once the price moves outside the range. This will ensure you get in even if the breakout bar is strong.
2. Wait for the price to close outside of the breakout range. You may avoid some whipsaws with this method, at the cost of either missing the breakout or entering later with an inferior risk/reward.





Method 1 example: 7

Method 2 example: 8

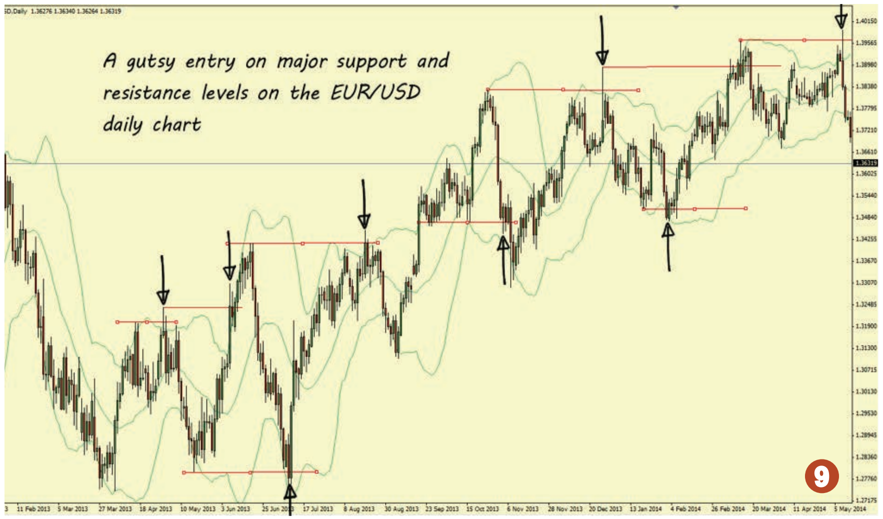
Support and resistance levels

Gutsy traders can enter on support and resistance, trusting in the level to hold. This entry can improve the risk/reward on the trade, but can decrease your percentage of winners. 9

So in summary, here is the entry process in its entirety:

1. Wait for your set-up conditions
2. Drop to a lower timeframe
3. Apply your chosen entry technique
4. Check your risk/reward is acceptable
5. Unleash your inner trader to execute the entry flawlessly.

Once you have entered, the real trading begins. You need to manage your trade to capitalise upon how the market moves. You do this using complex exits.



Complex exits are essential to building a winning Forex trading system that works for you.

The term "complex exits" is somewhat misleading. Each exit is quite simple on its own. The complexity comes with the variety of exits that are required so that you can:

1. Trade what is in front of you
2. Achieve your objectives.

It is how you react to what happens *after you enter* the trade that matters. Here is a list of some exits to consider for your trading system.

➡ Profit target

A profit target is an order you place in the market to close your position once it hits a certain price. These are useful in sideways markets, but some experts suggest that they work well in trends too.

➡ Profit objective

A profit objective is different to a profit target. A profit objective is a goal for your trade. When you understand your system, you will know how much profit a trade is capable of making. You can then manage the trade in a way that seeks to maximise profits.

All sounds a bit mystical?

In essence, it is about letting profits run or altering profit targets based on what the market is doing in front of you, while considering the objectives identified for the trade before it was placed.

➡ Trailing stop (price or indicator)

A trailing stop (surprise, surprise) trails the current market price. There could be a whole article on trailing stops there are so many, suffice to say they can be based on a set price (say 50 pips) behind the market or they can be based on an indicator such as a moving average.

If you like moving averages, try *displaced* moving averages. There is something to them, but I don't use them myself these days as I tend to look at price action for my exits, but for certain trading styles they are very good.

I will cover two more types of trailing stop below that are particularly important.

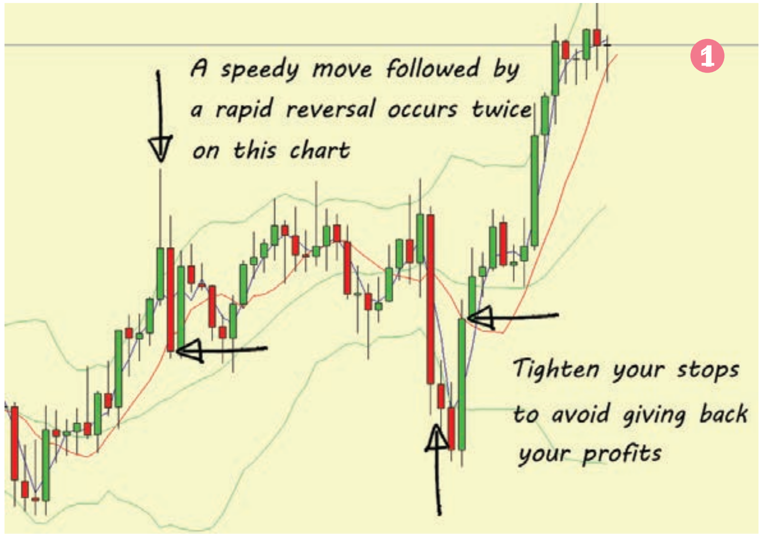
➡ Rapid market trailing stop

Sometimes the market defies gravity and launches into a rapid move, only to come crashing back down.

If you are in a trade that takes off like this, then you can adjust your trailing stop to avoid giving back your gains. Perhaps you go to a lower timeframe or are prepared to only give back one or two times your risk. You can see on this one-hour chart on the USD/JPY how speedy moves can quickly reverse. 1

➡ Support and resistance trailing stop

Support and resistance are difficult prices for the market to move through. They also form a platform for a further extension of the price. With a support and resistance trailing stop, you *logically* trail your stop behind the market in order to protect profits.



TIP! Be wary of short, sharp penetrations of resistance levels, and be ready to get back in using a re-entry. 2

➡ Price action

You can exit based on price action. For example, you might see a candlestick reversal pattern that indicates the trend is coming to an end. 3

Large daily move

Depending on your trading timeframe, if there is a large daily move of say 300 pips, you could look to sell as the market has most likely overshot.

Fundamental exit

You can exit a position based on market fundamentals and news. For example, you might close out of your short-term positions prior to a major news announcement or exit a position following negative news.

Time stop

You may exit after a specific period of time in a trade or on Friday before the market closes for the weekend.

The cross rates

Savvy traders often monitor the cross rates to get an indication of the direction of the currency pairs they are trading. If the price action on the cross rates is signalling weakness, then it might be time to exit your trade.

Expert exit

If you follow a particular expert, you may choose to close your position if they suggest the market is about to turn.

Risk/reward stop

With a risk/reward stop, you adjust your stop-loss to maintain a minimum risk/reward of at 1:1 at all times. This powerful approach helps you to maintain your profits if your trade gets close to your profit target, does not touch it, and reverses.

Account target

If you have a specific account-based goal such as 25% for the month, then you may close all positions in your account once this target is achieved.

Scale out

By scaling out, you exit portions of your position, based on different criteria. For example, you might take a small amount off when the market first makes some available, some more at a pre-planned target, and finally leave some on a trailing stop to capture the big wins.

Complex exits enable you to trade the market in front of you

By having a variety of exit systems in your toolbox, you can effectively manage your position based on what happens in the market after you enter.

You can *intently* watch the market and adapt to its movements in order to generate the best possible result for your trade.

Be in the moment with it.

As a trader you can only plan and then be *present.* Once you execute the trade you are simply experiencing, not creating. Your exit decision should be based on what the market is doing right now, not dependent on a perfect recreation of a historical pattern that conforms to your back-tested indicators.

It's not difficult. If you enter simply and apply the right exit to the right scenario.

As always, I encourage you to get out your trading plan or trading journal and integrate this lesson into your Forex trading for maximum effect. Pick one or two exits from the list you'd like to add today. Over time you can come back for more.

CHAPTER 5: DIFFICULT-TO-HIT STOP-LOSSES

Do you sometimes feel like the market is out to get you?

Have you ever had your stop hit at what turned out to be the low? Was it just bad luck? Or is there something more at play?

The chances are there actually is.

Forex trading is a zero sum game and you can bet that the strong players (the bank dealers) with more information, more money and the ability to move the market are out to get as much easy profit as they can. This means that the retail players left holding the weak hand (you and me) had better watch out.

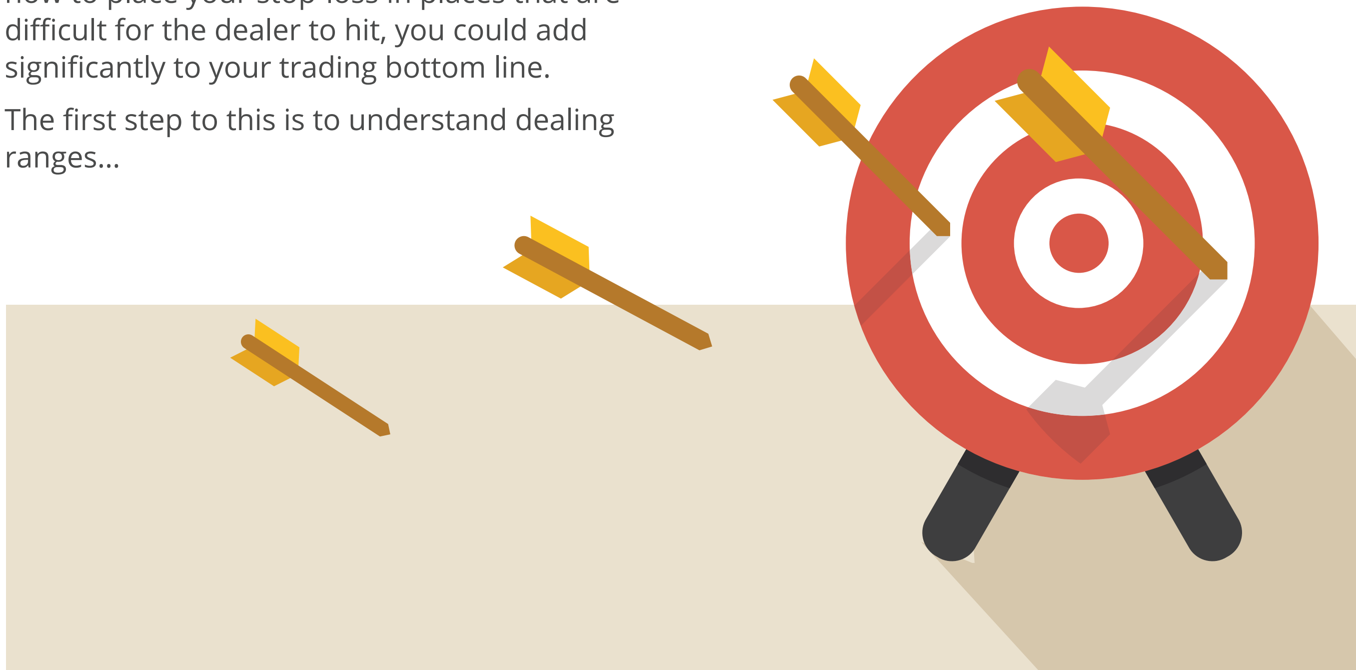
But the dealers can be beat.

Having the advantages dealers do breeds complacency. Most of them are not actually very good traders once you take them away from their screens and their order flow information. They also are not good at risk management *when they don't have corporate orders to backstop their poor trades*.

[Note: Corporates are the real losers in the Forex market. Retail traders (and other not-so-savvy bank traders) do provide a constant source of profit for the bank dealers, but we are still small fry compared to the seven trillion dollars of foreign currency that are traded each day.]

By sidestepping dealer traps and learning how to place your stop-loss in places that are difficult for the dealer to hit, you could add significantly to your trading bottom line.

The first step to this is to understand dealing ranges...



How dealing ranges influence the price

Dealing ranges drive market behaviour.

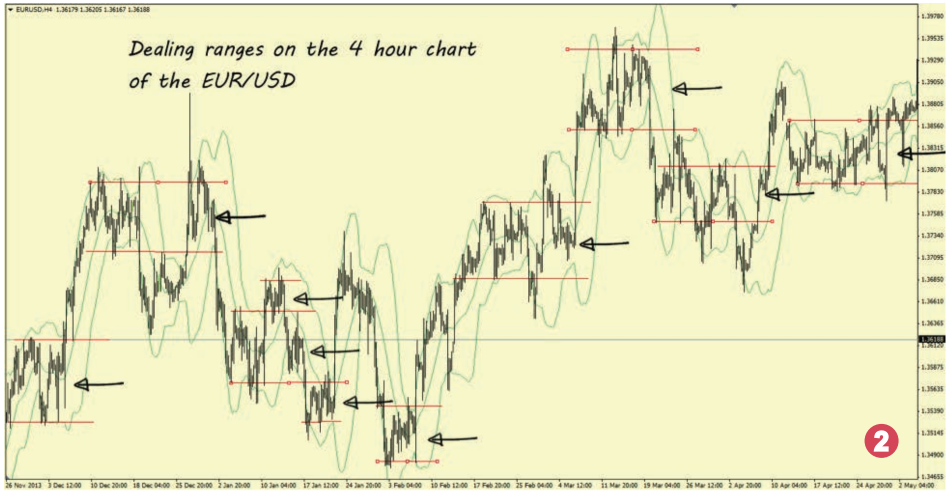
A dealing range is simply a high and a low for a trading session or a time period, such as day, week or month. Dealers use these levels to work out their orders and manage their positions. You can see examples of dealing ranges on the 15-minute chart of the EUR/USD here: 1

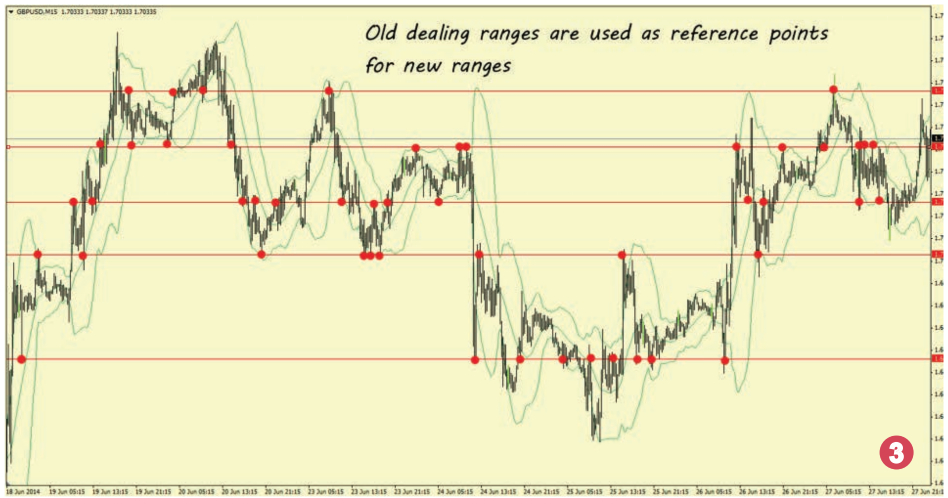
Dealing ranges exits on multiple timeframes. You can see the dealing ranges here on the 4-hour chart: 2

Dealing ranges are imprecise. The edges of the range are often pierced and the levels the dealers use for reference are fluid.

You will notice that an old dealing range will often form the basis for a new dealing range; i.e. they act as support and resistance levels. This is a type of market structure that is tradable and can provide you with an edge.

In the following chart you can see old ranges are used as reference points for new ranges where I have marked with a red dot. 3





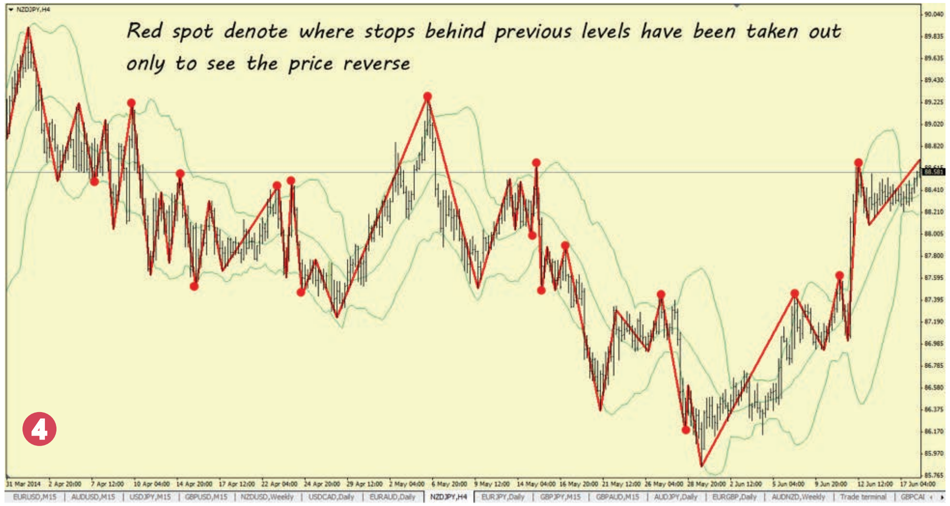
Traders who are taught to put their stops behind support and resistance levels will often put their stop-loss orders behind dealing ranges. But the problem for these traders is that their stops then become a target for the bank dealers. (This is also true of any major level.)

You can see this quite clearly on most Forex charts. On the following chart, I have marked with red dots where a move has taken out stops before reversing above or below either the dealing range or a support and resistance level. 4

You can see how often your stops would be taken out if you were not careful about your entry or where your stop-loss was placed.

So the solution is simple, right? Widen your stops and don't put them so close to the edge of the dealing range.

Not so. There are other factors to consider first.



Tight stops improve the risk-to-reward ratio of your trades

There is a problem with widening your stops.

Every extra pip you give away means that when you have a losing trade you will lose more, or when you win you will have traded a smaller size to compensate for the wider stop.

Both of these methods will have a negative impact on the risk/reward ratio of your trades. When you do win, you will make less than if you had a tighter stop. On the flipside of the coin, it could mean that you will have more winning trades to compensate for the smaller wins. By widening your stop, your win percentage improves.

Stop-losses are inextricably linked to your entry system and trade objectives

This goes without saying.

Your stop-loss should be a logical extension of your entry system and the objectives you have for the trade.

For example, if you are a trend follower looking to catch a breakout, you might have a tight stop-loss that you expect to get hit more often than not. Or if your goal is to have a 3:1 risk/reward ratio on your trade, you will have a tighter stop that if you are going for 1:1.

Logically choose a stop that fits holistically into your trading system.

Market types and stop-losses

As the market types shift and change, so should your approach to the market.

This goes for stop-losses too. Consider if your stop-loss placement is suited to the current market type. In addition, be prepared to change your stop-loss if the market types change during a trade.

A note on volatile market types

Common wisdom espouses that during a volatile market type you should widen your stop-loss. I am of a different opinion. If the market type becomes volatile you want to tighten your stop-loss. The markets have just got a whole lot more hairy and you don't want to give the market room to move against you. You will need to be prepared to be stopped out more often in this market type. However, by having tight stops, you will have the opportunity for some quick profits if things do go your way. 5

Superior options for stop-loss placement

You have four main considerations for stop-loss placement:

1. The dealing ranges
2. The risk/reward ratio
3. Your entry and trade objectives
4. The market type.

Understanding this, here are some different systems for placing stops that can help to improve the profitability of your trades.

Classic support and resistance stop-loss

The classic place for Forex traders to place stops is behind support and resistance levels. Just be aware of the stop-hunting intentions of those participants who can move the market. You could put your stop 7–25 pips beyond the level (depending on your timeframe), which will help you to avoid some of the whipsaws, but remember this will impact the risk/reward on the trade. 6

Shakeout stop-loss

This is perhaps a smarter way to place your stop-loss.

Wait until after the stops have been hunted and the price has reversed before you enter. Then place your stop-loss either directly behind the support or resistance level (or even slightly inside it) to improve the risk/reward on the trade. On the following chart, you can see how once the stops have been taken out (the thin red line) it is now safe to place your own stop-loss (the thick red line). 7

Indicator stop-loss

Indicator stop-losses can be quite useful for three reasons:

1. They give you a consistent place to put your stop that requires little discretion
2. They are (or should be!) relevant to your entry and trade objectives
3. The stop will not be in the usual place that dealers go a-hunting.

For example, you could put your stop-loss on the blue (100 period) moving average on the 15-minute chart of the USD/JPY when you enter short on this moving average crossover system. 8

The dealer's worst enemy – the mid-air stop-loss

To avoid being a target for the bank dealers, a mid-air stop is just the ticket. Mid-air stops are set a far enough distance away from the edge of the range to make it difficult for the dealers to hit. If a dealer pushes too far out of the dealing range, they risk being picked off by other dealers who gang up to drive the price against them. In addition, as your stop is likely to be on its own and not grouped with a bunch of others, there will be little point in the dealers going for it anyway.

Mid-air stops work best when trading directly off support and resistance levels, as you can still maintain your risk/reward ratio. You simply place your stop far enough away from the dealing range that the dealers won't be interested in chasing it. It will look like it is hanging in mid-air, away from the action. 9

A special note on break-even stops

Break-even stops are a hot topic for traders.

There are both pros and cons for breakeven stops. Only you will know what is right for you.

On the one hand, a breakeven stop is a powerful psychological tool. It ensures your winning trades don't turn into losing ones. This means that your winning percentage will increase, which can make it psychologically easier to follow your system and trade mistake-free.

On the other hand, if you move your stop-loss to breakeven you may end up putting your stop in an illogical place the dealers can easily go for. In my experience, this can mean that although you have less losing trades, you will actually make less overall. The winning trades that you do miss out on will reduce the profitability of your system over time.

This means you are faced with a choice. Which is more important to you?

- Consistency; or
- Profitability.

So what to do next?

> ***"Simplicity is the ultimate sophistication."***
> *– Leonardo da Vinci*

Now, it becomes a simple matter of testing. Try adjusting the following combination to see what suits your system:

- The risk/reward ratio by tightening and widening stops
- The stop-loss method.

Always think about the dealing ranges. Keep in mind where the market is likely to move to next, and avoid putting your stop in places that are easy for the dealers to hit.

CHAPTER 6: SYSTEM POSITION-SIZING BASICS

Everyone knows that risk management is a core component of trading success, but very few understand what this means on a deep level.

Indeed, most experts barely scratch the surface, with the extent of their contribution being "risk 1%–2% of your account on a trade", as if this was a magic bullet to trading success.

But there is so much more.

A well-designed **position-sizing model** gives you the ability not only to manage risk but also to *meet your trading objectives*, unlike any other aspect of your Forex trading system.

Before we continue, we must give credit where credit is due. It's upon the shoulders of giants that we stand and much of this topic can be attributed to the work of Van K. Tharp, the world's pre-eminent expert on position sizing. I recommend you get his book *The Definitive Guide to Position Sizing*. The first step in implementing an effective position-sizing model is to understand what Tharp calls R-Multiples.

R-multiples – the key to effective position sizing

R-multiples are a way of defining the initial risk you take on a trade by thinking in terms of risk/reward.

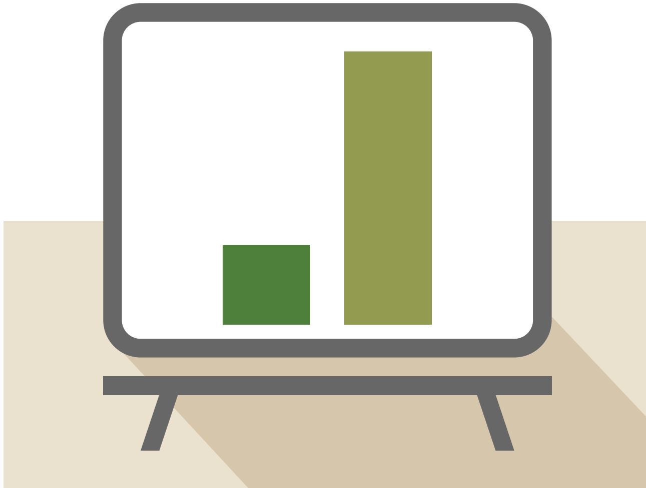
If you place a currency trade with a stop-loss 50 pips away from the market and you are risking $10 per pip, then your loss would be $500 if the trade went against you. This initial loss of $500 is your 1R risk. The R, of course, stands for risk.

You can then start to express your trades in terms of R, instead of in terms of dollar or pips. For example, if you place a trade that risks $100 and you make $200, you have made 2R (two times your risk). If you lose the $100 you would have lost 1R.

If you talk to a trader who thinks in terms of R-multiples, they may say:

"I made 2.4R today".

Or when they are assessing if they want to get into a position, they may think:



"I have the potential to make 3.6R on this trade".

The reason R-multiples are so important is that, as a trader, you are in complete control of this input into your trading system. You can effectively manipulate the R-multiple to be whatever you want it to be by adjusting how much you trade. For example, if you decide that you want your one-R-risk to be $100, you can do this, or if you want it to be $200, you can do that too, by changing your position size.

Your position-sizing model is independent to your entries and exits

This is one of the most important things to understand in trading.

How much you trade is a **completely separate decision** from your entry and exit decision. Your Forex trading system is actually separated into two distinct components, each of which can – and should – be worked on independently:

1. A entry and exit system that generates an average number of R-multiples over time; and
2. A position-sizing algorithm that is then applied on top of the entry and exit system.

The performance of your trading system as a whole will depend on the combined performance of each component, minus any trading mistakes you make.

Let's take a look at an example.

Say you see a trade you would like to place on the EUR/USD at a price of 1.3600. You set a stop-loss 50 pips away at 1.3550 and a profit target at 1.3750.

Your 1R in this case is 50 pips.

If the trade goes well, you manage to sell it for three times your risk, booking a 150-pip profit or 3R winner.

If the trade goes against you and hits your stop-loss, then you would lose 50 pips, a 1R loser.

Pretty simple, right?

Now let's see how applying three simple position-sizing algorithms to the same trade generates completely different results.

In each model, let's assume you have $100,000 in your trading account for the sake of simplicity.

Model 1: number of lots

In this model, you decide to buy one lot ($100,000), so for each pip you make or lose $10 USD. If the trade goes against you, then you would lose 50 x $10 or $500 (making 1R $500). If it goes for you, then you would have made 150 x $10 or $1500.

Model 2: fixed cash risk

In this model, you decide to risk $800 of your trading capital on the position. To do this, you would need to buy 16 mini lots (160,000), so for each pip you make or lose $16 USD. If the trade goes against you, then you would lose 50 x $16 or $800 (making 1R $800). If it goes for you, then you would make 150 x $16 or $2400.

Model 3: fixed percent of equity risk

In this model, you decide to risk 2% of your capital. To do this, you would need to buy 40 mini lots, so for each pip you make or lose $40. If the trade goes against you, then you would lose 50 x $40 or $2000 (making 1R $2000). If it goes for you, then you would make 150 x $40 or $6000.

As you can see, the profits or losses on the same trade are altered dramatically depending on which model you choose to apply. In this case, there was up to a *400% percent difference* in your profit or loss.

And these are only the barest bones of the different position-sizing models you could choose to use when you invest.

So to reiterate, you can have exactly the same entry and exit and have a completely different result depending on your position-sizing model. That is why position sizing is so critical.

Your position-sizing model depends on the quality of your system

The better your system, the more you can invest, the easier you can achieve your goals.

While you achieve your objectives through position sizing, the better your overall trading system is, particularly your entries and exits, the easier it will be for you.

You will be able to:

- Trade larger sizes
- Achieve more consistent returns
- Suffer less drawdowns
- Protect your investing capital.

It's important to understand that your position-sizing model, while independent from your entries and exits, should be relevant to the *quality* of your entries and exits.

The impact of currency differences on your position-sizing model

When trading Forex, position sizing difficulties are exacerbated by two factors:

1. The point value per pip, which is different based on the currency pair you trade;
2. Your account base currency.

Just be aware, if you are not already, that pip values differ depending on what currency pair you trade. For example, if you have a 50-pip loss when trading one lot on the EUR/USD, you would be risking $10 USD per point, whereas if you placed the same trade on the EUR/GBP, you would be risking $17.50 per pip. If you were expecting to risk $500 on the trade and ending up losing $875, it would not be a happy outcome.

This equation would also vary depending on your account base currency. For example, the pip value on one lot on the EUR/USD is $10 with a USD base currency, but $10.57 with an AUD base currency.

At the time of writing, here are the pip values of USD, EUR, GBP and AUD base currency accounts.

Currency	USD	EUR	GBP	AUD
AUD/JPY	$9.80	€7.20	£5.70	10.40
AUD/NZD	$8.76	€6.40	£5.10	9.26
AUD/USD	$10.00	€7.31	£5.83	10.57
CHF/JPY	$9.80	€7.20	£5.70	10.40
EUR/CAD	$9.40	€6.87	£5.48	9.94
EUR/CHF	$11.26	€8.24	£6.57	11.91
EUR/GBP	$17.15	€12.55	£10.00	18.14
EUR/JPY	$9.80	€7.20	£5.70	10.40
EUR/USD	$10.00	€7.31	£5.83	10.57
GBP/CHF	$11.26	€8.24	£6.57	11.91
GBP/JPY	$9.80	€7.20	£5.70	10.40
GBP/USD	$10.00	€7.31	£5.83	10.57
NZD/USD	$10.00	€7.31	£5.83	10.57
USD/CAD	$9.40	€6.87	£5.48	9.94
USD/CHF	$11.26	€8.24	£6.57	11.91
USD/JPY		€7.20	£5.70	10.40

A bag of marbles

Let's tie this all together with a story.

I attended a nine-day trading course with the aforementioned Van K. Tharp. During the course, we did a series of trade simulations using a bag of marbles to help us better understand position sizing.

While there are several different variations of the game, the basic premise remains the same:

- Each marble pulled from the bag is a trade in R-multiples. I.e. you may lose 1R or make 5R on a pull;
- Everyone has the same amount of starting capital and you must risk a certain amount on each pull from the bag;
- There is real money on the table for each game (up to $1200 at one point).

Each pull from the marble bag is considered a trade and everyone gets exactly the same trades. Each simulation lasted at least 30 pulls from the marble bag (trades). There were up to 27 different participants in each game.

Ok, just to reiterate, everyone had **exactly the same trades.**

The systems also tended to have a majority of losing trades, with some big winning trades on occasion. So each pull from the marble bag is like a trade; i.e. your entry and exit.

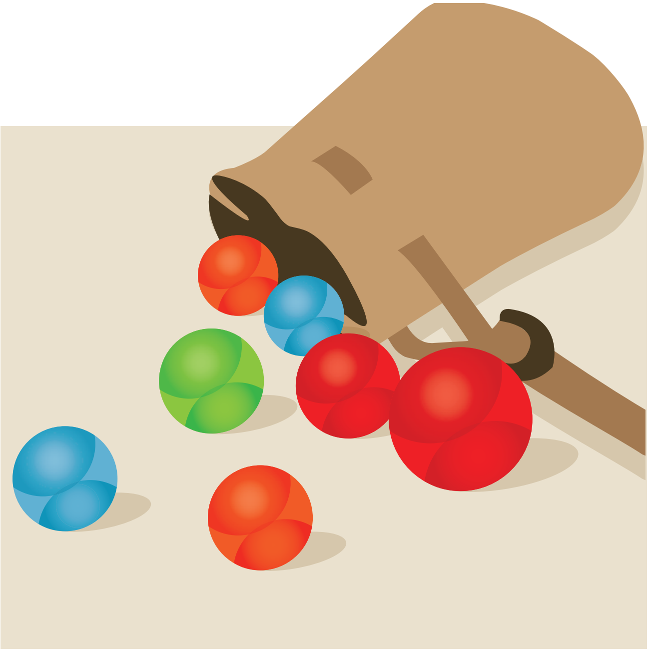
The only control that each participant had was their position-sizing rules. Of course each person also had very different objectives. Some wanted to do anything to win, whereas others were concerned about trading like it was their own money on the line, or about not going beyond a certain drawdown.

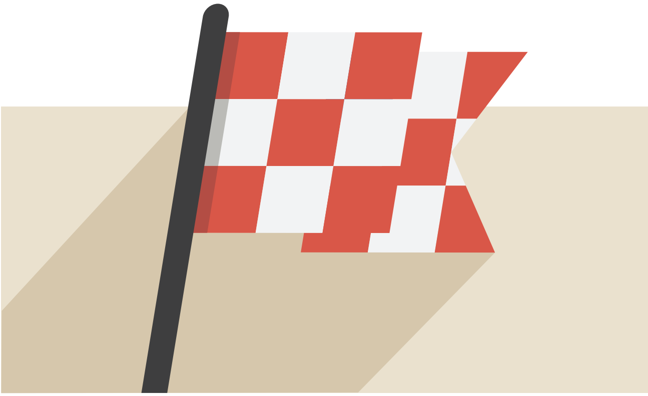
At the end of every game, *every single person had different equity, no exceptions.* The variation between individuals was massive, **from bankrupt through to several million dollars profit.**

After playing the game a few times it became very apparent how position sizing:

- Is highly dependant on the trader's objectives
- Is critical to the performance of your trading system
- Is a completely separate decision to your entry and exit decision
- Should be adjusted based on the quality of your system.

Now you have a handle on the basics of position sizing, let's look at exactly how you can use position sizing to achieve your system's objectives.





Top traders use position sizing very precisely to achieve the objectives of their system.

Tharp's belief is that:

> *"Position sizing is 90% of the reason for the variance in the performance of the professional traders".*

As you now realise, this is a decision about how much you want the R-multiple to be on each trade, based on your objectives.

Setting objectives

There are numerous objectives to consider when developing your trading system, but the first two most important are:

1. Profit, and
2. Maximum drawdown.

A profit objective is expressed as a percentage return you wish to achieve over a certain time period. For example, I want to achieve a 10% return a month.

A maximum drawdown is the total percent loss you are willing to risk on your account in order to achieve your profit objective.

To achieve those objectives, you devise a position-sizing model. This in turn, with the help of R-multiples, tells you exactly how much to buy or sell when you place a trade.

How to build a position-sizing model – a basic example

Let's say I am a day trader who wants to make 10% a month on my account. I am prepared to risk 5% of my account a month to achieve this. I know that my system:

- Generates around two trades a day
- Has a 50% win rate
- Makes on average 2R per winning trade
- Loses 1R per losing trade.

If I make two trades a day and one wins (+2R) and the other loses (-1R), I will make on average 1R per day.

If I trade for 20 days, this means that by the end of the month I will make 20R. If I divide my 10% profit target by 20, I get 0.5%. This 0.5% is then my 1R risk per trade. I.e. I would risk 0.5% of my account on each trade.

I can then look at this in the context of my 5% maximum drawdown target. If I am risking 0.5% per trade, then I will need to have 10 losing trades in a row to hit my target. I assess that there is only a 20% chance of this happening, which I am happy with. In contrast, if I had a 2% maximum drawdown target, then there would be quite a high chance of me hitting my drawdown target (say around 50%), so perhaps I would need to consider a different position-sizing model.

Position-sizing models

There are literally hundreds of different variations of position-sizing models for you to choose from. Here is a selection.

➡ Model 1: percent of equity risk per trade

With this position-sizing model, you risk a fixed percent of your account balance on each investment. For example, you might risk 1% or 2% on each trade.

There are a number of variations you can take when using this model.

- **Percent of starting balance.** You risk a fixed percent of your starting balance.
- **Percent of current equity.** You risk a fixed percent of your current account balance at the time you place the investment.
- **Percent of equity high.** You risk a fixed percent of the highest point of your account balance.

While the differences here may seem subtle, they can lead to quite different performances over time.

➡ Model 2: market's money

I'm sure you have heard how important it is protect your initial investing capital.

You will have also heard about how some people became very rich trading Forex with very little money. This is where a market's money position-sizing model can help.

With a market's money position-sizing model, you use profits you have made to trade larger positions, while trading small with your own investing capital.

For example, say you have a $100,000 account. You risk 0.25–0.5% of your account per trade, but when your account gets into a profit, you risk 2%–5% or more to trade larger sizes.

This way you limit the risks on your initial capital, yet can go for big wins when an opportunity presents itself.

Personally I am a big fan of the market's money position-sizing model.

One question you will need to answer is: when does the market's money become your own?

You could do this based on:

- A time period, such as a year or month
- A profit objective such as 50%
- A combination of the two.

Have a think about how you would feel risking some of your profits to make large gains, to see if this approach would suit you.

A word of warning about being respectful with your money.

Just because you are calling it "markets money" does not give you an excuse to trade recklessly because "it's not yours". Always treat the money in your account with respect and discipline.

Model 3: scale in to the trend

> *"The trend is your friend."*

A scale-in position-sizing model takes advantage of trends to add to winning positions as they go your way. As the currency you purchase goes up, you add additional smaller positions to create one large position. As you add positions, you move your stop-loss up to keep your risk on the overall position small (1R or less).

This way if a currency pair goes for you then you could have a big win, but at no time are you exposed to a large loss.

For example, when you see your initial entry, you buy your first position, risking 1% of your account. Once the currency goes up by 50 pips, you add another position and move the original stop-loss up. You then continue to add positions and trail the stop-loss up until you have reached your targeted trade size with your core position.

As the currency continues to go up, you trail the stop-loss higher until you eventually have a large position that is essentially "risk free" or with locked in profit, because your stop-loss is above your entry points.

Model 4: position size for the occasional spectacular profit

Some traders let the market tell them how to run their position-sizing model.

If they are not getting a sense where the markets are heading, they just dip their toes in, taking light positions. Conversely if they are in the zone and the market is providing them with clear signs of its future direction, they take larger positions.

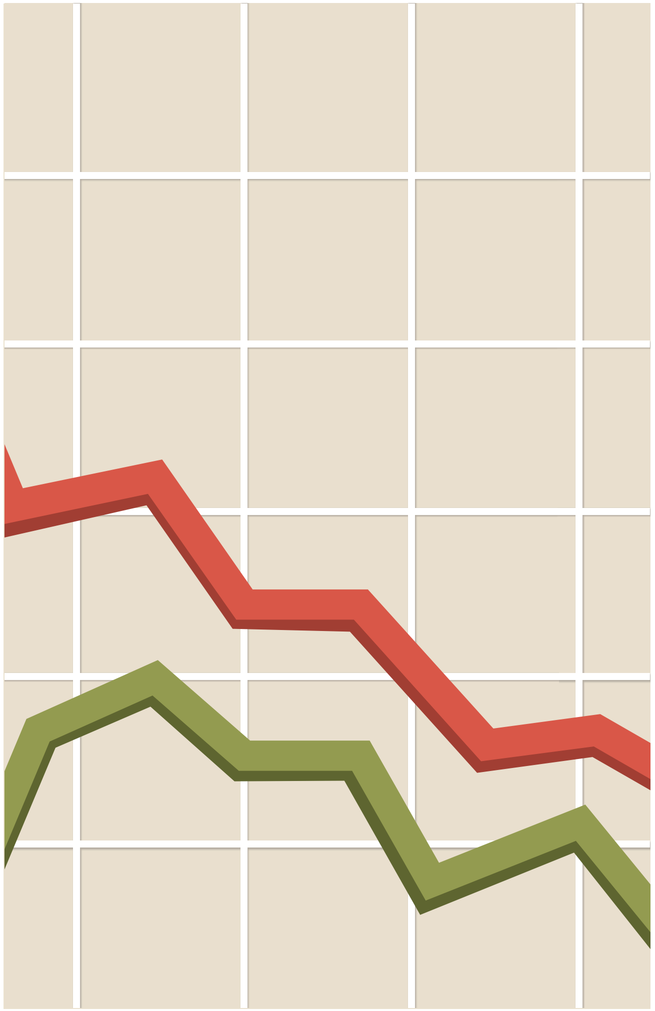
While this type of position sizing is somewhat intuitive, if you are confident in your system it is a very powerful way to capitalise when the markets are going for you.

Your position size is the most influential decision you will make on your success.

Your turn.

Take your thoughts on position sizing and put them down on paper. How well you answer the questions will have a significant impact on your success, so take your time. Do it thoroughly.

But, as always, remember you can change your model in the future as you learn more, so if you are feeling stuck choose the simplest option and revisit later.



All professional traders record their trades and track the performance of their system.

They do it almost obsessively.

They know that if you don't record your results...

You are not tracking what you are doing right or wrong...

So it's difficult to know what to do to improve. But it's hard for me to remember the last time a retail trader told me that they diligently record their trading performance. They all know they should.

But they don't. So they don't improve.

Why you should record your performance

Try this on for size.

Imagine:

1. You place 20 trades exactly per your rules and record your results
2. You make a change to improve your system
3. You place 20 more trades exactly per your rules and record your results
4. You make a change to improve your system
5. You rinse and repeat, making small controlled changes until you have a successful trading system.

Can you see how, if you make meaningful changes (almost like a scientist tests a hypothesis), your system cannot help but improve over time?

Grading your system's performance using expectancy

As you improve your system you will want to track its performance. One of the best ways to grade your system's performance is to understand your system's expectancy. By grading your system's performance in real time, you can:

- Plan in advance in case performance degrades (see chapter 9)
- Monitor the impact of changes in real time
- Adjust your position-sizing model depending on the quality of your system
- Understand how your system performs in different market types.

How to calculate the expectancy of your trading system

You calculate your expectancy by adding up your average risk/reward over a series of trades using Van K. Tharp's R-multiple concept, discussed in chapter 6.

1. Add up the total R-value of your trades
2. Divide this total by the number of trades you have made.

Here is the formula:

(total R) / (number of trades) = expectancy

For example:

If you had placed 30 trades and earned 45R in the process, your equation would look like this:

45R /30 = 1.5

In this case, your system has an expectancy of 1.5.

Rating your trading system

Once you understand your system's expectancy, you can give it a performance rating.

Here is a specific method for achieving this:

1. Benchmark your performance by placing 30 trades with a consistent, small position size (like 0.5% of your account).
2. Work out your trading system's current expectancy.
3. Create a table to rank your system's expectancy. For example:

Excellent	Expectancy above 2
Very good	Expectancy between 1
Good	Expectancy between 0.5
Break-even	Expectancy between -0.1–0.1
Poor	Expectancy below -0.1

As you continue to trade, track your expectancy over the rolling last 30 trades.

You will need to fit this approach to your own trading methods

For example, your benchmark for excellent may be having an expectancy above 1 instead of 2. You need to base it on your own systems results. Simply use logic to work out what is right for you.

Tracking your system's performance without the hassle

Tracking your system can be challenging. Even with the best of intentions, too many traders don't do it due to time constraints (or simply because it can be a real pain to do).

Here are two little tips for tracking your system.

Hire a freelancer

Go to a website such as **www.elance.com** and hire a freelancer to record your trades. You will need to give them specific direction on what information to record, but if you set it up well they may be able to do it by simply using your account statement. A service like this using a skilled freelancer may cost $5 an hour or less.

(For the parents out there, this is a good way for your children to earn a bit of pocket money.)

Use an automated service

There are several web-based services you can explore to help you record your trading. Each service has different benefits. Check out:

- Myfxbook
- TradingView
- AxiTrader's MT4 NexGen

System death.

Forex trading systems stop working. Edges disappear. Market conditions change.

The trader is left *hanging*, hopes unfulfilled.

But disaster can be avoided. You don't need to experience system death, if you know how to tell if a system has stopped working *before you lose money*.

Understanding how to avoid system death has other benefits. If you have a pre-defined process for when you will stop trading a system, it gives you confidence. As Marty Schwartz, Wall Street's champion day trader, said:

> ***"Confidence is essential to a successful trader".***

You can trade with confidence and discipline, trusting in your rules to protect you, instead of worrying about if what you are doing has a limited shelf life.

Why trading systems stop working

The number one reason systems stop working is that they are optimised to work in a particular market type. When the market type changes, the system stops working. Knowing this could solve a lot of your trading problems.

Other reasons Forex trading systems stop working include:

- **The system is poorly designed.** For example, it is curve-fitted to historical data and is not robust enough to survive live trading.
- **The edge disappears.** The reason for the system working no longer exists.
- **Trader mistakes.** The trader is unable to trade the system efficiently, so consequently it performs below expectations.
- **Position-sizing errors.** The system may have an edge, but position-sizing errors cause it to underperform.

Plan for your system to stop working

It's ok for a Forex system to stop working.

If you could have a high-performing system that makes a 100% return, but it only lasted for three months, would you use it?

Systems that work and then stop are not a bad thing. The bad thing is to continue to trade them, not knowing that their time has come. Here are some ways to plan for your system stopping working:

- **Trade multiple systems.** Don't keep all your eggs in one basket. Have at least two different systems at any one time (preferably for different market types).
- **Position sizing.** In your position-sizing rules, make sure you cater for the "worst case scenario". In particular, protect your core capital.
- **Don't become emotionally tied to your system.** Sometimes, when the idea is yours, it can be difficult to let go. Don't get your sense of self-worth wound up in your system's performance.

More importantly, you want to have a benchmark of your system's performance. Once you see a deviation from this benchmark, you can go into "high alert mode" and monitor your system closely to see if its performance recovers or simply stop trading the system altogether.

A methodical approach to managing system death

Avoiding system death is simpler than you may think, though it can be a bit of work to track your trades.

1. Track your system's performance using the benchmark outlined in chapter 8.
2. Notice when the system performs outside of expectations. For example, over the last 30 trades your performance goes down.
3. If your expectancy ever goes down a rating, you have a few options:
    a. Reduce your trade size.
    b. Allocate less of your trading capital to that system.
    c. Stop trading the system.

Note that **you don't need to wait until you are losing money** to stop trading a system. Instead you can simply reduce your trade size as performance degrades.

Let's look at this in action.

You have benchmarked your performance and your trading system currently has an expectancy of 1.5. As you trade, you notice that your expectancy over the last 30 trades has gone down to 0.9. When this happens you continue to trade, but cut your position size in half.

You also do a review to check where the fault lies. Perhaps it is simply market conditions are not so suitable, or you are making a mistake that you hadn't noticed. You continue to trade at a reduced position size and your expectancy drops down to 0.2. It is now dramatically different from the expected performance and you decide to stop trading it all together for now.

You have now avoided system death without losing much money in the process. Nice!

An alternative method of monitoring your system performance

Another method traders use to avoid system death is to monitor each system's equity curve. As the equity curve flattens or starts to go down, you allocate less trading capital to that system; as the equity curve turns up, you allocate more capital to that system.

Depending on your system, you might find this method more useful than the one above.

You have now avoided disaster and conquered system death!

By benchmarking your system and tracking its ongoing performance, you have a powerful tool to prevent losses while remaining confident and disciplined in your trading.

So it's time to get to it! Knowledge requires action for you to benefit.

Keep the first step simple, and resolve to track your expectancy of the next 30 trades in your trading journal.

(Note while the views in this chapter are mine, they borrow heavily from the work of Van K. Tharp.)

"You can only predict the markets over the short-term."

"You can only predict the markets over the long-term."

"Forex trading is difficult."

"Forex trading is easy."

"Technical analysis works."

"The stochastics are overbought so the market is likely to go up."

"There is resistance at 0.92080."

"Trading Forex is risky."

What do all these statements have in common?

They are all beliefs about the market and they all shape the trading of the person who has the belief.

And beliefs can be painful.

Some of our beliefs are formed out of traumatic experiences – or at least that's often the case with the ones we find most difficult to change. These beliefs are not necessarily bad. They serve/served a purpose at one point in our lives, but they may not be that useful for our trading.

Your trading system is all beliefs

Trading is an unlimited environment.

You have no teacher, parent or boss who controls what you do. You have the freedom of choice to trade however you like. So if you are free and unencumbered, what is it that influences your trading system decisions?

It is your beliefs.

You may think it's a piece of news or the price action on a chart, but it's not. It's your belief about what the news or the chart means that is causing you to take action.

From the point of decision, without fail you can trace a path back to a belief (or typically a series of beliefs) that caused you to make that decision. For example, why is it you choose to trade a specific currency pair? Or: what causes you to use that particular set-up?

There is a belief somewhere along the line that is guiding your hand. Awareness of this belief is a powerful thing. Awareness is the first catalyst of change.

What are your beliefs about the markets?

Take out a pen and paper and see if you can list 10.

Here are some of mine to get you started.

- I must not trade without a trading plan
- Forex is no more or less risky than trading any other market – risk depends on my position size.
- I need to have a different trading system for each market type
- I must know my risk/reward ratio before I place a trade and it must be at least 3:1
- Trading is all about beliefs (that's a belief 🙂)
- Support and resistance levels can help you predict the market
- Professional traders record their trades diligently and amateurs don't.

There are many more.

Can you see how having these beliefs shapes my trading? Can you see how the 10 beliefs you wrote down do the same for yours?

The origin of beliefs

> ***"I would never die for my beliefs because I might be wrong."*** *– Bertrand Russell*

I mentioned earlier that beliefs with charge are often formed during times of pain.

That may be true, but there are many sources for beliefs.

At the most basic level, beliefs are evolutionary. They are programmed into us as part of the fight and flight response that has evolved over thousands of years. These beliefs are part of our DNA. Some beliefs are a product of our environment. Would you have different beliefs if you grew up in a rainforest compared to growing up in London or New York? Or: would you have the same beliefs about food if you grew up hungry compared to growing up well-fed?

Other beliefs are indoctrinated in us. To a certain degree, all of us (except perhaps the truly enlightened) accept common-held "wisdom". Our subconscious absorbs much information that is never questioned, and some of our most influential beliefs are never challenged. Think about fluoride in toothpaste for example. Is it good? Is it bad? Where did that belief come from?

There are other beliefs too, such as spiritual beliefs formed out of your relationship with God, or identity beliefs such as "I am a technical analyst".

Is the belief useful?

“We trade our beliefs about the market.” – Van K. Tharp

There are as many different approaches to the market as there are traders.

That is because there are *as many different beliefs about the markets as there are traders.*

It’s like we’re wearing blinkers of our own design. We see what we want to see.

The good news is we get to choose the blinkers. We have the choice to wear only the beliefs about the market that serve us. We can decide if the belief is useful to our trading or not.

We don’t even have to *believe the belief.*

If it serves us to think that if two moving averages cross then it is a good time to buy, then we can wear that belief. Even if deep down we know that two moving averages crossing has little or no influence on the market itself.

The beliefs of top traders

“Strong beliefs win strong men, and make them stronger.” – Richard Bach

If you can choose to take on and take off the beliefs, why not wear the ones that are the most productive for your trading?

During my years of trading, study and interaction with successful traders, I have noticed that most of them tend to hold a number of similar beliefs.

- They take personal responsibility for their trading
- They have developed a highly organised mental model of the market
- They recognise that their mental model could be wrong and often is
- They understand that position sizing is the key to achieving their trading objectives
- They are often wrong more than they are right, but they still make money
- They see trading as a business, not a hobby, and plan rigorously
- They recognise that losses are a part of doing business and are willing to take them
- They believe in the importance of recording their results
- They believe that they can win...and that the key to winning in the markets is themselves
- They are comfortable with taking calculated risks
- They understand risk and reward ratios
- They believe in simple entries with complex exit systems
- They believe their trading system has an edge over the market and this makes them confident
- They believe in gratitude and being thankful.

How do these beliefs compare to your own? How many of these beliefs would you like to have as your own?

Reorganising you beliefs

Have you ever noticed that you can hold conflicting beliefs at the same time? This may be because as Van K. Tharp suggests, we are all a "mix of conflicting parts" inside.

For example, you could have a:

- Trader part
- Husband part
- Mother part
- Rebellious part
- Gambler part
- Child part
- Fun part

And so on. You get the picture. Each of these parts holds different beliefs that can impact your Forex trading. For example, the fun part might want you to place a trade out of boredom, while the trader part knows you should wait for a clear opportunity.

The process of reorganising a belief can be quite simple. Firstly, recognise that you would like to have that belief. Secondly, take action. For example, if you decide that you believe position sizing is now an important part of your trading (if it was not before), then you can read about position sizing and make sure that you place your next trade according to your new position-sizing model.

If you have no negative charge about taking that belief on and continue to take action, then you will have a newly integrated belief. However, if you have an emotional charge around this new belief, or you have an interfering part (such as the gambler part, making you want to trade bigger than you should), then taking on this new belief may be more difficult.

If this is the case you might need a technique to help you. Van K. Tharp in his book *Trading Beyond the Matrix* suggests a couple of different methods that you could try, which I will paraphrase below.

Feelings release

The feelings release process involves turning the traditional way we react to negative thoughts on its head. Instead of resisting a belief, you feel it fully. This serves to dissipate the belief and after a point it tends to fizzle out.

Parts integration

Parts integration involves negotiating between different parts of yourself. One part mediates while another two parts discuss with each other and come to a mutually beneficial arrangement. For example, you decide that you will go surfing on the weekend to satisfy the fun part, while the fun part agrees to stand aside while you are trading.

This may sound a little off the beaten track, but when I first did this under Van K. Tharp it had a powerful transformational effect on my trading.

It's much better to be an integrated trader.

(If you are feeling resistance to these ideas, perhaps you have some emotionally charged belief you are holding onto? Just sayin'.)

For further information on these processes I recommend you read *Trading Beyond the Matrix*.

Creating a "beliefs" self-improvement routine

To be the best trader you can be requires constant work.

Top athletes work as much on the mental side of their performance as the physical. Top traders are the same. They work as much if not more on the psychological side of Forex trading as they do on their techniques.

As beliefs are such a critical part of Forex trading psychology, you could consider adding a self-improvement routine to your trading plan.

This could involve:

- Listing your beliefs about Forex trading
- Listing your beliefs about your Forex trading system
- Regular feelings release
- Regular parts integration
- Focusing on what you want to attract
- Using the routines in one of Paul McKenna's books such as *I Will Make You Confident* to removed negatively charged beliefs around self-worth
- Practicing gratitude by following the 28 steps in *The Magic* by Rhonda Byrne (highly recommended for traders).

With a routine in place that helps you to develop powerful beliefs that *serve you*, you are in a strong position to get what you want from your Forex trading.

Why am I am including a section on awakening your inner trader in a book on system development?

One reason: **Mistakes**.

It's actually relatively easy to build a workable Forex trading system, as long as you understand market types and complex exits. *The challenging part is executing your winning system mistake-free.*

With money on the line, things are different. When your rules say buy or sell sometimes you just don't, or perhaps you fail to see something obvious until after the event.

These are mistakes, and everyday mistakes cause winning trading systems to lose. In fact, a single mistake can be the difference between trading failure and success. This is why it is imperative that you awaken your inner trader.

When you are operating through your inner trader you are pervaded with a sense of calm. This has incredibly positive implications for your ability to trade mistake-free and execute the system you have developed.

Luckily finding your inner trader is not something mystical. Rather it is an exciting process of discovery. So here are some initial steps you can take to help awaken your inner trader.

Get clear on your goals

Without a "glide path" to success, you will struggle to maintain disciplined in your trading when temptation arises. Remember that if you only make 5% a month consistently when trading, you would be one of the best traders in the world. Imagine the impact that could have on your personal finances.

Too often traders are trying to double or triple their account in a short space of time, leading to a high chance of ruin. Two to five good trades a month where you let your profits run may be all you actually need. When you are clear on what you are setting out to achieve, it becomes much simpler to trade with restraint.

TIP #1

Less is more. The less active you are, the more successful you may be. Overtrading is one of the key issues that can negatively impact the likelihood of you achieving your trading goals.

Develop the habit of persistence

It took Mozart 10 years of failure before he produced his first masterpiece, and it took Bill Gates 10,000 hours of programming before he created the Microsoft Windows operating system.

Now we are not trying to create a masterpiece or one of the largest companies in the world – we only want to be pulling a few pips from the market each month – but the habit of persistence exists in every successful trader.

Most people experience failure before they achieve success, and in trading it is no different. The ability to "rise from the ashes" is a core part of a trader's personality.

If you are struggling with this, it can be helpful to remember the carrot: that is, remember *what you are here to achieve*. Motive yourself to be persistent by understanding why you got into trading in the first place. If you can hold on to that, then your stickibility will be assured.

TIP #2

How to handle losses. For this tip, we interviewed AxiTrader's Geoff Last. Geoff is by his own admission an old dinosaur in the market and was the first person to make a market on the Aussie Dollar way back in the 1980s. Let's see what Geoff has to say about how to handle losses.

1. First admit your mistake rather than blame the market.
2. Re-assess your system. For example, are you trading the correct currency pair, time zone or chart time frame?
3. Address your risk management. For example, are your goals too lofty or is your position size too large?

TIP #3

Trading in the zone. Just like athletes get "in the zone", traders get in the zone too. The more you can remain in the zone as a trader, the better off you will be. For an in-depth look at trading in the zone, read the book of the same name by Mark Douglas.

Notice your emotions before you trade

Your inner trader appears when you are in a calm state (or perhaps when your inner trader is with you, you become becalmed). Whichever way it is, you should check your emotions before you trade. If you are in the wrong headspace, you are likely to place false trades or chase the market.

If you are afraid of missing out and need to get into a position, you should avoid taking it. Similarly, if you are fearful of entering a position, that is a sign that you are not operating out of the optimal mindset. You want to be in a state of mind whereby you enter your trade solely because *it is a good trade*, not because of any other motivation.

TIP #4 Remaining focused in your trading state is not about remaining focused on the markets. Unless you are a scalper you should consciously avoid checking on the markets, except when you need to make a buying or selling decision.

Connect your mind and body

A key aspect of attaining a high-performing trading state is the unification of mind and body. In fact, when you examine your emotions as per step 3 above, you will find that they are often physical. You will most likely be feeling them in your body, not in your mind. For example, if you try sitting still for a moment right now, you may find that you have the physical urge to do something with your legs. If not that is ok, the important thing is that you take note of what is going on inside, so you can manage it effectively.

By balancing your physical and mental wellbeing, you can connect deeply with your inner trader. Many professional traders engage in yoga or some sort of physical release before they settle into the trading day. But it can be as simple as taking some deep breaths and doing some stretches. It's funny how we can so easily forget to breathe deeply.

Verbalise not internalise

One of the easiest ways to uncover your inner trader is to talk through your trades with a colleague. This person does not even need to be a trader. The very act of voicing your decision-making process allows you to pick up on those moments when you are acting irrationally or emotionally. To be clear here, you are not seeking advice. Instead you are using a sounding board to make sure you have your head screwed on straight.

TIP #5 Write down your plan. When what you verbalise does not match your plan, then that is a sure sign that you are not placing the best trade you possibly could.

TIP #6 See trading as an extension of a meditative or spiritual practice. Listen to your inner trader and where you can, let go and watch it trade on your behalf.

Let go and trust your inner trader

Some of the best traders I know have moved beyond the conventional to reach their inner trader. These traders tend to be spiritual people who use trading as a vehicle for growth. As they let go and trust in their inner trader, it begins to trade through them.

And their inner trader tends to be a pretty good trader.

CONCLUSION – OVER TO YOU

Your future is now in your own hands.

As a Forex trader **you have the power** to make or break your trading account. I have seen everyday people turn small amounts of money into large sums and I have seen traders lose on a regular basis. Both these types of traders are like you and me with no special equipment or information, simply their free charts from their broker, their knowledge of the markets and their mindset.

With *The Definitive Guide to Building a Winning Forex Trading System*, you have the tools to create a system that can help your goals come to fruition.

The best way to get the most out of this eBook is to keep it simple. As you read through it, you will have noticed that some things attracted you. Start with these. Then go back to the beginning of this document and work through the system development process step by step, until all elements are included in your trading plan.

You will have also noticed that there are parts of the eBook that you skimmed over or even avoided. The interesting thing about your trading psychology is **the parts you avoid are most likely the parts that you need the most**.

Note down these areas now. This is where you should be spending the majority of your system development time.

Ok, now it's over to you.

Thank you for reading our eBook and I wish you all the best in your Forex trading.

If you have any questions, please email me at **seder@axitrader.com**
or join me to discuss on **Facebook**.

All the best,

SAM EDER

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