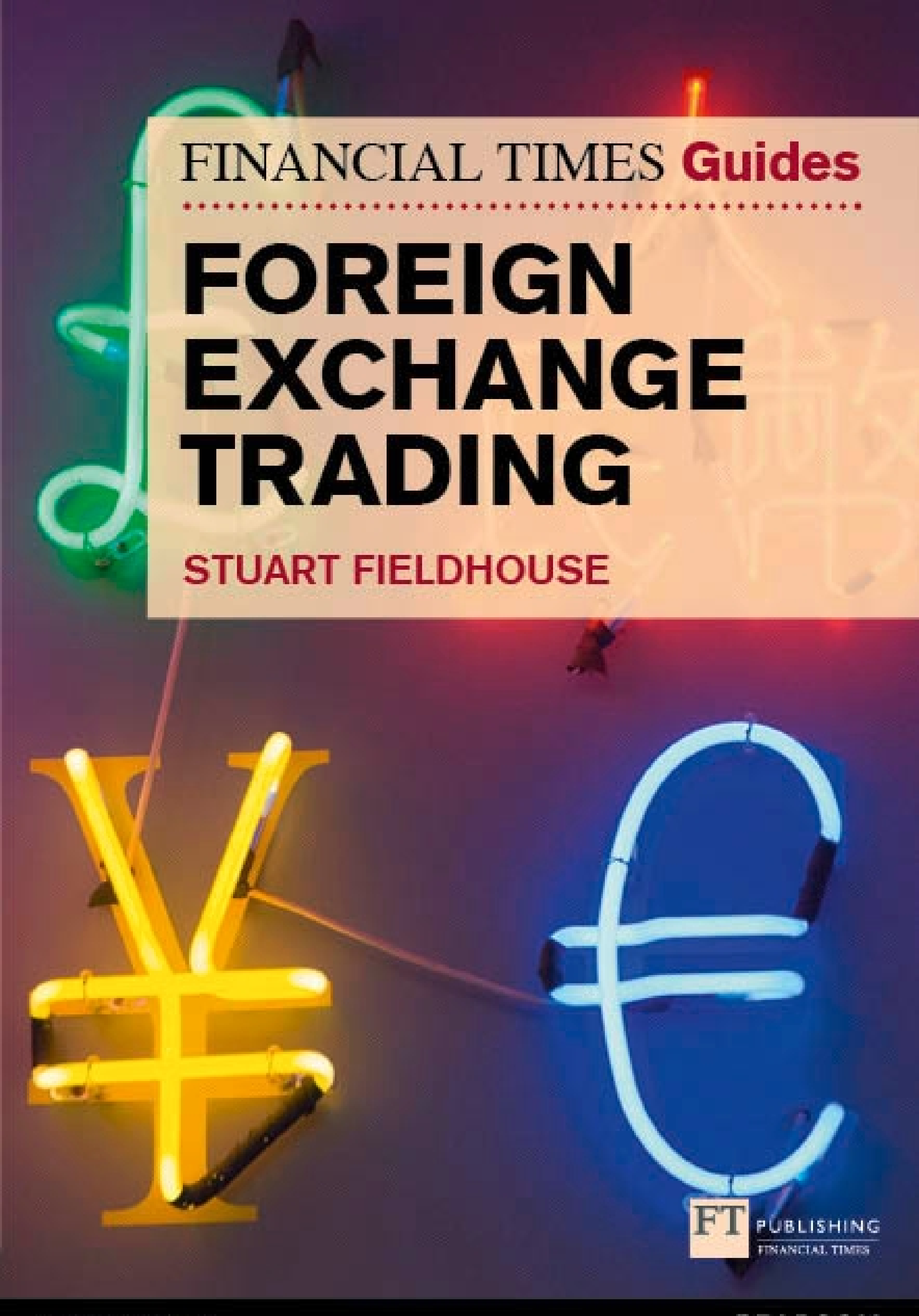


FINANCIAL TIMES **Guides**

FOREIGN EXCHANGE TRADING

STUART FIELDHOUSE

FT PUBLISHING
FINANCIAL TIMES

ALWAYS LEARNING

PEARSON

Praise for *The Financial Times Guide to Foreign Exchange Trading*

'The must-read Bible for everything there is to know about the forex markets and trading. Miss it at your own peril.'

Lianna Brinded, Journalist and Broadcaster

'Stuart gives a comprehensive introduction to the inner workings of the currency markets, outlining how all the different elements link together, at the same time warning of the perils and pitfalls to the unwary.

He underlines the importance of effective risk management using the time honoured tools of technical analysis in any effective trading strategy.'

Michael Hewson, Senior Market Analyst (CFTe), CMC Markets UK that £150, you would then have only £4,850 to bet with. Your next maximum trade would be around £145. As you can see, if you were particularly unlucky and took a string of hits to your trading capital, you would be risking progressively less on each trade. What you would *not* be doing is putting more risk on the table in order to make up for previous losses – this is the road to eventual trading disaster.

Under this conservative scenario, it may seem like it will take you for ever to make any money trading currency markets, and certainly that dream of perhaps one day trading by the pool of your villa in Spain may seem even further out of reach, but bear in mind you are also using leverage here. Even with £150, at 1 per cent margin your total market position would be £15,000.

Position sizing also helps you to evaluate your stop losses. If you are betting with a maximum loss per trade of £150, you will be able to see which markets are too volatile for your current risk tolerance. You don't want to be spread betting in a market which regularly sweeps through 100 points if you are betting £2 per point.

Not all currency trades are created equal

When trading forex, you are allocating risk against a currency pair and will make or lose money according to how many pips that currency moves through. Some currencies move around more than others and can go through periods of volatility, basically the degree to which the price of that currency fluctuates against another. Traders often like volatility because it means there is the potential to make a lot of money in a short period of time – so long as they get it right, of course.

The volatility of different currencies will tend to change over time. There are periods when the currency markets will seem quite quiet, for instance when traders are away from their desks over Christmas; at other times they can be particularly busy. Recent EU summits to discuss the future of the euro have provoked plenty of speculative activity in EUR currency pairs.

Source: www.forexpros.com

Figure 3.8 **USD/PLN Oct/Nov 2011**

Because some currencies move through such wide swings, it is important that you take this into consideration when you are setting your stops.

Not all pips are created equally, either. Most currencies are quoted to four or five decimal points. Any currency quoted in terms of USD – the right-hand currency is USD – will usually be to five decimal points, with a pip value of $10. This makes it easy to work out how much a position is changing in value.

In Figure 3.8 we have an emerging markets currency pair experiencing high volatility. Take into consideration the number of pips this market moves by. The Polish zloty gained by 3,500 pips against the US dollar between the end of September 2011 and the last week of October.

Consider this example, using a simple spot trade in the market – no margin involved:

£10,000 of USD/PLN sold (offer) at 3.55000 (short trade on the USD/PLN pair).

Because we have five figures quoted to the right of the decimal place, we're effectively risking a pound for each pip the price moves.

USD/PLN bought (bid) at 3.47500

Profit = 0.07500 x £10,000 = £750

Remember, if you had been trading on margin, you would have been using far less of your own money, maybe only £100 at 1 per cent margin, but you would still have been looking at a big loss if you got it wrong. Your stops would have had to have been set much wider.

In Figure 3.9 we have a less volatile pair, namely the GBP/EUR rate. Here we can see a strong move by sterling from the beginning of December, when it is just above 1.60000, to over 1.21000 at the beginning of January 2012. It is a move of just over 39,000 pips.

Again:

£10,000 of GBP/EUR bought (bid) at 1.60020

GBP/EUR sold (offer) at 1.21020

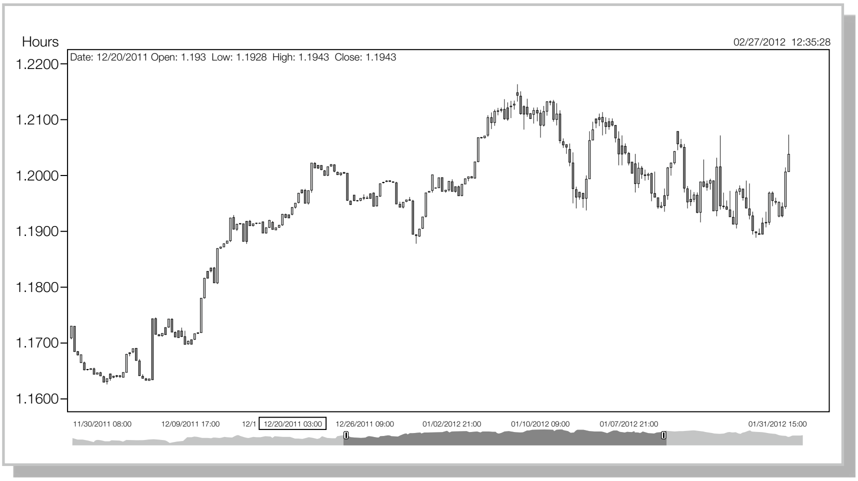
Profit = 0.39000 x 10,000 = £3,900.

Here we see less volatility – the pair fell into a bit of a tight trading range from about the 14th of December, but this was predictable as traders and central bankers were all away on their Christmas holidays. As you can see, it picks up again after New Year.

However, it is important to note that the profit potential, and the risk, is much reduced in the GBP/EUR market. For starters, it is not an emerging markets currency, and much more heavily traded than, say, the PLN. Second, a more conservative stop loss of, say, 120 pips would not have been hit. Stops can thus be a lot closer to the price in this market.

Make sure you have a back-up plan

Beyond the risks you take on with margin trading in the market, there are unforeseen risks that might impact your trading strategy and for which it can be useful to have a plan. What happens, for example, if you lose your internet connection, or you spill your coffee on your computer and it shorts out? What is your back-up plan?



Source: www.forexpros.com

Figure 3.9 **GBP/EUR Nov 2011/Jan 2012**

It is worth thinking about these key risks early on so that you have a plan in place should something like this happen. Problems with technology are often cited, but there are other questions, such as your ability to trade. What happens if you are taken ill suddenly, with live positions in the market? Is anyone authorised to close your trades for you if this happens?

If your brokerage – your counterparty in industry parlance – should fail, it is worth knowing what your recourse is. After the events of 2008, when queues formed outside branches of the Northern Rock building society, many traders and investors became much more cautious about who their counterparties were. In the wake of the collapse of Lehman Brothers the same year, it seems as if no financial institution is theoretically too big to fail, and as a trader you won't know which banks your trading company is exposed to.

The failure with the most direct impact on traders in recent history has been MF Global, the spin-out from Man Group, which collapsed in 2011. While it was strongly positioned in commodities markets, MF Global also had spread betting and CFD trading arms in several countries. Its unexpected demise left many traders with their capital locked up in the company, often with trades still live in the market, at the mercy of the administrators. At the time of writing, many traders were still waiting to see funds released, and while some accounts had been transferred to other brokerages, margin deposits had not.

The best protection under these circumstances is to use more than one counterparty, and if you can afford it, split your trading cash between them. It will mean you can't trade some markets, which have to be a bit tighter in terms of your overall margin, but this is no bad thing, particularly for the beginner.

When trading companies fail

Under normal market conditions, it is unlikely that FX brokerages will fail, but under extreme circumstances, as we saw in 2008 and more recently with the collapse of MF Global, trading firms can get into difficulties with their own creditors, and can collapse.

Echelon Fund Management was a Scotland-based spread betting firm which collapsed in 2008 with debts of more than £30 million as its credit lines were severed. This was happening to a lot of companies in 2008, not just spread betting firms, but Echelon was forced to close its doors when a major creditor in Switzerland turned off the taps. Approximately 900 Echelon clients ended up as creditors of the now-insolvent spread betting firm. Under these circumstances, because Echelon was regulated by the UK regulator, the Financial Services Authority (FSA), its spread betting clients were entitled to recompense to the tune of up to £48,000 each. This was because spread betting companies in the UK are covered by the Investors Compensation Scheme.

Smaller trading concerns are also more vulnerable to big losses being run up by their own clients. Companies will sometimes have blue-chip clients who trade large sums of money. They need to keep a close eye on them because it is possible for large losses sustained by a single customer to bring down the whole firm, as happened to Global Trader Europe (GTE) in 2008. In the case of GTE, the losses caused a shortfall in the minimum amount of regulatory capital, which the firm is obliged to keep on deposit to meet FSA requirements. Its South African parent company took the decision not to continue to support it, forcing it out of business.

Smaller firms are much more prone to collapse than their bigger cousins, and it seems that periods of market volatility and uncertainty can increase this risk. The fall of MF Global in 2011 is arguably the largest single instance of a major brokerage with retail clients going to the wall. Retail traders have ended up in exactly the same position as many institutional clients of MF Global. Because it was an international operation, with offices as far afield as Chicago and Sydney, MF Global's subsequent break-up is being handled according to the prevailing law and regulatory environment in each country. Hence, traders in Singapore seem to be getting their money back faster than traders in the US.

One of the controversies that arose from the case of MF Global has been the way client funds are managed. Some regulators, like those in the UK and the US, insist that client money is segregated, making it easy to calculate who is owed what in the case of the collapse of a big brokerage. However, this seems not to have been the case in Australia. At the time of writing details were still being established, but it seemed that MF Global had been pooling client funds in Australia for the purposes of hedging, using a regulatory loophole in that country.

When the dust settles from MF Global, there will undoubtedly be more scrutiny on the way brokerages around the world manage client accounts. It always, always pays, however, to make sure you have more than one trading account. Don't put all your eggs in one basket. Shop around and use two or more brokers, even if this means you don't have as much capital on tap and might find some markets are beyond the reach of your trading resources as a consequence. This also lets you compare the prices and speed of execution of each firm. If a brokerage is not coming up to scratch, close your account and go somewhere else.