EXPLODING

5 MYTHS ABOUT TRADING FOREIGN EXCHANGE

Here's the real story about foreign exchange for you. It's not about cheaper imports or dearer exports, but about the trading profits that can be made if you're willing to take the time to learn how from experienced traders.

You know the Australian dollar has risen strongly in value in the past year or two. You know this because now when you check the price of a book or CD advertised on a website in US dollars, it's less in Australian dollars. An item priced at $US100.00 costs about $A95.00, give or take a few dollars depending on daily rate fluctuations. For decades we had been used to paying more in Australian dollars than the US dollar amount.

The rise in the Australian dollar's value is a big win for those of us buying things from the US. It's not so great if you work for a manufacturer selling into the US market. By March 2012, Australian goods cost around 15 per cent more for US buyers than they did in March 2010, when the value of an Australian dollar was only US90c. The higher cost of our goods tends to reduce overseas demand and sales.

In just a few weeks in the early part of 2012, the Australian dollar climbed from $US1.02 to $US1.07.

HOW DOES FOREIGN EXCHANGE AFFECT ME?

If you put aside media headlines about Australia's manufacturing competitiveness, day-to-day changes in currency values don't have much effect on our lives. Not unless we are among the few who have made a discovery about foreign exchange trading. Those few have found that with enough time and patience, they can learn to trade foreign exchange (FX) markets profitably from home, gaining a little more financial freedom at first and eventually getting to the point of becoming full-time traders.

→ MYTH 1: ONLY THE BIG PLAYERS CAN WIN

You've no doubt heard about foreign exchange trading and how popular it is, and you'd like to try, but you think the small player is at a big disadvantage and can't really take on the big banks and professional dealers in the market. They can trade faster than you and ahead of you.

It's true that banks have a lot of foreign exchange trading knowledge and experience, and they may even have computer-operated systems that trade quickly, frequently and automatically, without human intervention. Those systems are only as good as the people who program them, and they don't stop a currency from moving. If a currency moves in a strong trend, everyone who is on the right side of the trade wins. If you're trading with a licensed and trustworthy FX provider and you have the experience and skill, you can trade the currency's moves along with those banks trading the same way. It's not about beating the banks. Banks and other principal dealers are in the market for different reasons than you – such as foreign trade and hedging.

EURO VALUE IN US DOLLARS

→ MYTH 2: FOREX STRATEGIES ARE TOO COMPLICATED

In fact, traders find that simple trend-following strategies often give extremely good results in the foreign exchange market. That's not to say that making money from forex trading is easy – you still have to know about technical analysis and risk management. But foreign exchange reacts to macro-economic fundamental factors – the ones that affect whole economies –whereas a share price, for example, may react significantly to minor news such as a profit report, takeover bid, or change of management.

Currencies in long-term trends often return to the level of the trend line, even though there may be smaller moves against the trend (see chart). A currency in such a trend offers opportunities to profit from trend reversals within the main trend.

→ MYTH 3: I SUCCESSFULLY TRADE SHARES, SO I CAN TRADE FOREX TOO

Share trading, especially if you have made profitable trades and successfully restricted losses, is valuable experience, and many of the principles can be carried over to foreign exchange trading. But forex is a different market – extremely liquid, trading 24 hours a day except at weekends, and subject to big fluctuations on the release of fundamental news about the world's biggest economies, notably Europe, the US and China. You need to know when not to trade. It's also more highly leveraged than shares and you need to know how to adjust for that in your strategy.

→ MYTH 4: IT TAKES TOO MUCH CAPITAL TO TRADE FOREX

This may have been true in the days when the only contract size was around $100,000. Then foreign exchange brokers and CFD providers began offering mini contracts for amounts of around $10,000 in value and micro contracts for just $1000 value. With a required initial cash deposit of just 1 per cent, you can now trade a forex contract, once your account is funded, with an outlay of just $10. Remember that your risk on a trade is potentially much more, which is why it's essential to learn about stop-loss orders and the whole toolbox that traders use to manage risk.

→ MYTH FIVE: FOREX MARKETS ARE TOO HIGHLY LEVERAGED AND VOLATILE

FX markets do offer the highest leverage of all the financial markets. That's an advantage, not a problem, provided you take precautions – in trading terms, use stop-loss orders and restrict position sizes. The best traders limit their potential loss on any trade to 1 per cent of their total capital, and have a range of techniques to ensure this is the most they can lose in ordinary circumstances. They have a plan to cover the possibility of unusual volatility and a plan for the worst-case scenario. With these in place, they can trade in relative safety, taking advantage of the probability that a trade will succeed while taking protective action against runaway losses. It's unwise to attempt trading without these safety measures. But with them, leverage works for you as a risk-taker, not against you.

NEXT ISSUE: What you wish you'd known before you started trading forex

FORTHCOMING: Try this quick test – could your forex trading be better?

CASE STUDY: PIPS AND PROFITS

When the euro moves from $US1.3420 to $US1.3400, it means that the euro is falling in value while the US dollar is rising. A move like this of 20 pips (one pip being the smallest move) can easily happen in a day and could generate profits of $10 a pip through selling euros (buying US dollars against them).

- **At $10 a pip, you make $200 if the market moves in your favour.**
- **20 pips = $200**
- **You can learn to make several profitable trades like this each week.**
- **Over 10 trades, collect 200 pips and deduct 60 for losing trades = $1,400 profit**

+ EXPERIENCED TRADERS CAN MAKE ENOUGH TO LIVE ON AND MORE