WHAT YOU WISH YOU'D KNOWN BEFORE YOU STARTED FX TRADING

First, trading currencies is almost certainly quite different from anything else you've done for a living. Traders in foreign exchange (forex or FX) are dealing with the inherently unpredictable – the movement of the price of a currency like the Australian dollar in terms of another, such as the US dollar.

Taking risks in unpredictable markets would be a fool's game unless market behaviour showed some consistency. We don't know what the exchange rate will be tomorrow, but a sound knowledge of technical analysis – the study of price movement – can tell us whether the rate will probably be higher or lower than today's rate.

Trading then becomes a numbers game. If you can keep losses on any one trade to 1 per cent of your capital or less, and your ratio of reward to risk (see Case Study) is at an ideal level of 2:1 or better, you only need half your trades to be winners to come out ahead. Five winning trades at $2 each give you $10 in wins, while the loss on five trades risking $1 each is $5.

WHY DON'T MY WORK EXPERIENCE SKILLS HELP ME IN FX TRADING?

They will, or at least some of them will. But trading also involves a skill set that ordinary occupations don't teach you – the ability to recognise that a loss is not an error. Losses are inevitable. And a winning trade is not a sign that your intuition is becoming infallible. The market gives inconsistent feedback – it doesn't always reward a correct trade with a big gain. It does reward those who consistently make correct trades – that is, trades executed as indicated by a tested trading system and managed under a regime that pares losses and takes full advantage of gains.

→ RULE 1: DON'T TRADE BY THE SEAT OF YOUR PANTS

It's fun, it's exciting, it's easy, and it's fraught with problems. A beginning trader sees news that is likely to move the market and jumps in with both feet, putting up nearly a quarter of his trading capital as a deposit (initial margin) on a trade and sitting back to watch his profits grow.

That's like trying to fly a modern plane without instruments. If by luck the trade makes money, there is a sense of euphoria that can itself become the goal of trading, sustaining the motivation through multiple losing trades. If the first trade loses, there may be a maddening desire to win the money back, to prove the trader can beat the market, or to restore wounded pride.

Meanwhile, euphoria and wounded pride tend to dislocate a trader's reasoning. Even if they know about technical analysis, rules and trading systems, they probably won't use them. Trading for emotional reasons almost inevitably leads to losses in the long run.

→ RULE 2: DON'T TRADE ON NEWS ALONE

Markets tend to over-react to relevant news – like a change in interest rates and then compensate, often in the opposite direction. Well-educated traders rarely enter a trade in the hour or two before or after major news announcements and many will tighten their stop losses or even close trades to take profit before any big news announcement.

Technical analysis, and its use in setting stop-loss orders and profit targets, will confirm whether the trade you are considering is advisable, but the market's response to the news is always difficult to assess. It is often best for new traders to stay out at these times.

→ RULE 3: DON'T TRY TO PREDICT THE MARKET

Traders looking for winning trades often search for ways to make more and more accurate market predictions, not realising that this is both impossible and unnecessary. Adding more and more complex technical analysis to your trading mix won't improve your performance unless you have the other fundamentals in (see next section).

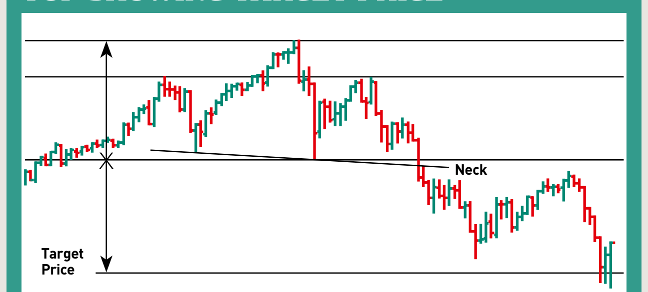
It's human nature to celebrate wins and to take losses badly. Before you celebrate, ask what risk-reward ratio the win represented. Did you win enough to overcome an expected small loss on another trade? Before you rebuke yourself for making a loss, ask if the loss was kept as small as possible. Was it acceptable under your trading rules? If the answers are yes, you can tick the box for a correct trade.

→ RULE 4: EDUCATE AND PREPARE YOURSELF FOR TRADING

Trading successfully in any market demands careful attention to each of the steps necessary to acquire the requisite skills. After deciding what currencies to trade and over what time frame, forex traders need to establish a system or strategy for using technical analysis to determine entry and exit points. They then need to test the system on past and real-life trading and price data, refining it to ensure that it gives the required edge a risk-reward ratio and a win-loss ratio that together are sustainably profitable.

That all takes some time. Whether you do it yourself or start with a trading strategy from a forex educator, the secret is in implementing it, using standard risk management and position sizing rules to prevent over-trading and to maximise the profits from winning trades. The trading strategy should match the trader's personality type and temperament, and they must know the system intimately – well enough to be able to refine it further in the light of the current trading environment.

HEAD AND SHOULDERS TOP SHOWING TARGET PRICE



Use technical analysis to determine your target price. This will show whether a trade is likely to have a high enough risk-reward ratio (ratio of dollars risked to dollars won) if entered. The target price for a head-and-shoulders top formation, for example, is as far below the central neckline as the central peak is above it.

CASE STUDY: RISK-REWARD RATIOS

The risk-reward ratio is badly named since it is actually the ratio of potential profits to the potential loss on a trade. For forex trading, at least in the beginning, we look for a ratio of at least 2:1 (compared to a minimum of 3:1 in the sharemarket) – that is, for every dollar risked, and possibly lost, we must have the potential to make at least $2 if the trade moves in the right direction. Successful traders with, say, 75 per cent winning trades, may have lower risk-reward ratios.

Amount risked on a trade (maximum expected loss)	$500
Amount likely to be won at target price	$1250
Risk-reward ratio: $1250/$500 =	2.5:1

→ RULE 5: OVERCOME PSYCHOLOGICAL BARRIERS

Having rules in place is not enough. Developing the discipline to follow them, in the face of human nature and its tendency to react emotionally to trades, can be as difficult as, or even harder than, creating the trading system itself. The best insurance against second-guessing your trading system is faith in its long-term ability to produce results. While the best traders may allow themselves some discretion in where they enter and exit, based on long experience reading the markets, your system and its rules must be followed without fail until you reach that point.

JUNE ISSUE: Have you really mastered forex trading? Find out if you could improve