

# **FOREX TRADING FOR PROFIT**

*Trading The Odds For Bigger Profits*



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## **An Introduction to the World's Most Exciting Investment**

Forex trading is the biggest, most exciting, and potentially one of the most lucrative forms of trading you can engage in. It is one of the few ways where traders can start with small stakes and build significant wealth quickly.

Of course, where there are large rewards, there are also risks, and forex trading is no exception.

If however, you can learn to control risk, harness the power of leverage, run your profits and cut your losses, you can make a lot of money and build significant wealth. That's what this document is all about: turning the potential of currency trading into consistent profits.

We're not going to tell you how to place orders or any of the mechanics of trading. You can get that free on the net; Here, we are going to walk you through specific tools that you can combine to make a robust trading system that will help you get the odds on your side and potentially, make big profits in the world's largest and most exciting investment medium.

Welcome to the world of global forex trading!

### **1. Currency Trading Success - Basics**

Currency trading looks easy, but very few traders succeed. The statistics show, that over 90% of forex traders lose all of their money. This is despite the fact that everything about trading currencies can be specifically learned in advance.

So why do the majority fail?

There are several reasons, which we will now look at in more detail. You can become a winner, and enter the elite 10% of traders who make consistently make big currency profits?

FIRST, let's look at some basic points that you need to consider before you decide to trade forex.

#### **You're on Your Own**

The first point you need to accept is that you are responsible for your currency trading success.

When you're trading currencies, it's tempting to follow a guru who has made money, or claims to have made money. However, in most instances, the people selling this information are marketing organizations, and have no real statistics to back up their claims.

The Internet is full of forex education that you can buy for \$100 or so. The claim is that it'll make you rich, but this is not the reality of trading! Think about it, if they were earning so much money then why are they bothering you?

The only way to succeed is to rely on yourself. No one else can give you success. If you can't take responsibility for your actions, then don't trade the currency markets.

However, if you can accept the fact already stated, and have the desire to succeed, then there is no reason why you can't become a successful currency trader.

## **Learning the RIGHT Knowledge**

Keep in mind, that if you want to trade currencies successfully, then you will need to concentrate on acquiring the knowledge that you will need to succeed

Conventional teaching methods do not necessarily, lead to success!

For example, avoid ways that are usually guaranteed to lose you money. The best example of which is possibly:

Forex day trading

If you try it, you will wipe out your equity. You simply have no chance of winning in the longer term. The logic is totally flawed.

So why doesn't forex day trading work?

All short term volatility is random. Prices can, and do, move anywhere within a day. Traders who think that they can predict these moves get wiped out.

There are many more examples, but this is the perfect illustration of how not to be successful in currency trading, and how traders attempt to win by applying their knowledge incorrectly.

You need to concentrate on applying your knowledge correctly, and avoid most of the marketing hype that you read. Most of it will simply point you in the wrong direction. We will be looking at this in more detail later.

## **Leave Your Ego Behind**

Being clever, or smart, doesn't mean that you'll achieve success in forex trading.

There are plenty of both clever and smart traders out there, who don't make money.

A lot of traders have the problem in that, because think that they are clever; they have a divine right to win! Whereas, in most instances all that they have is an ego.

This means that they tend to see the market as they want to see it, and not how it really is.

Do you want to make money, or feel clever?

The market won't accommodate both. Decide before you start trading.

If you want to make money, leave your ego behind. Simply focus on the main objective of forex trading. If you only focus on making money, then you will out perform a clever trader with an ego, who is obsessed with beating the market.

Be humble, accept the market is all powerful, and don't feel bad when it makes you look stupid it does this to even the world's best traders.

Let's move onto the next essential point to remember:

## **Keep It Simple**

Not only should you leave your ego behind, but you should also use a simple system when trading currencies.

Many Forex traders think that the more complicated their system is, the more successful it's likely to be. This logic is totally incorrect.

Simple systems tend to be more robust than complicated systems. They tend to have fewer elements to fail, when faced with brutal, ever changing market conditions.

In forex, when developing your own method, it is imperative that you keep it simple. If you do, then you will have a much better chance of making consistent profits.

## **Work Smart, Not Hard**

This really leads on from the previous points.

Many forex traders work hard. They think that the more effort they put in, the more that they will get out in terms of profit.

This may well be true in many areas of life, but not in forex trading.

You get your reward for being correct right about market direction, nothing else!

In fact, if you work smart and acquire the correct forex knowledge, then you can be trading in just a few weeks. The time you spend trading, should be no more than an hour a day.

Let's look at an example that will graphically illustrate this point.

## **The Turtle Experiment**

In 1983, the legendary trader Richard Dennis, had a debate with his long-time friend William Eckhardt, about whether traders were born or made. Following this friendly debate, they decided to have a bet on it!

Dennis thought that it is possible to be taught to be a good trader. Eckhardt thought the opposite. They then devised the turtle experiment, to prove who was right. Dennis won!

Dennis took a group of 23 traders with no trading experience, from all walks of life and he taught them all to trade in just 14 days.

The turtles achieved a collective compound rate of return, of over 80%, and made Dennis over \$100 million dollars!

This is the perfect example of how concentrating on acquiring the correct knowledge, and keeping it simple, can make a lot of money.

If you read about the turtle experiment, you will learn that the success of these traders was based on a combination of:

A simple system, rigid money management, and the discipline to follow the system through periods of losses in order to achieve outstanding long term gains.

Let's look at the traits of successful traders like the turtles in more detail.

### **The Traits of a Winning Trader**

There are really three traits that come together to make a successful trader:

#### 1. Acceptance of Responsibility

We have already discussed this, but it's of vital importance. All successful traders rely on themselves, and this gives them the next vital character trait that they, (or you), need to succeed.

#### 2. Confidence

If you want to succeed, then you need to have to have confidence in what you are doing.

While this may sound obvious, many traders never acquire this trait. They follow gurus or mentors, and they think that they can have confidence in them. However, this confidence soon crumbles along with a few losses.

#### 3. Discipline. The key To Success

If you read any of the interviews with the world's top traders, then you will find the word discipline mentioned time and time again.

Discipline is absolutely vital to your forex trading success. Lack of discipline is probably the major reason most forex traders fail to succeed.

You will need to have the discipline to follow your method through the inevitable losing periods, which will lead you to longer term success, without letting your emotions getting involved.

Discipline is built on confidence, and without it you simply won't succeed.

Keep in mind, that if you don't have the discipline to follow your method, then you have no method at all!

In addition, there are a couple of personality traits that you will also need to become a successful trader. They are:

#### 1. The Ability To Isolate Yourself

You must be able to rely on yourself. Don't be tempted to discuss your trading with anyone, or give anyone else advice. You will simply allow your emotions to get involved, and you need to keep them out of your trading to succeed.

#### 2. Patience

Patience is a must in forex trading. You need to not only have, the patience to wait for the right forex signals to come, in order to trade them in line with your forex trading strategy, but you must also have the patience to execute your trading system through periods of inevitable losses. Patience is an essential trait.

## **Trading the Truth**

The forex market forces you to confront truth. Your opinion counts for nothing; the truth is the market price - nothing more.

If you do not force yourself to confront your own weakness and the market's inherent unpredictability you will fail to make money over the long term.

This is why you have to create a framework or set of rules, that allows you to keep your emotions or weaknesses under control and allows you to confront an unpredictable market and come out a winner. This is why you cannot find market success through someone else.

Confronting a market that moves to its own rules is easy – you are dealing with an environment where only you can be wrong and the market price which is the truth is always right.

Traders need to find their own truth and work out how to confront the market - this is why you must do their own research and trust yourself. The trader who knows the truth and trusts his own judgment will prevail in the long term and make money and the above character traits will help you achieve this.

Now we have looked at the basic mindset you need to become a successful trader, let's look at devising a currency trading method for long term success.

We are going to start by looking at how and why forex prices move and the best way to trade them for profit

## **2. How and Why Markets Move**

We need to look at two specific factors that determine forex prices.

### **1. Supply and demand fundamentals**

A trader, who makes trades based upon fundamental analysis, will look at the supply and demand situation relevant to the particular currency studied, and try and predict the impact of such factors as:

- The health of the economy
- Interest rates
- Balance of payments
- Employment
- Trade deficit
- Other factors

The facts are there for all to see but price is ultimately determined by individuals such as you and me and we all draw our own conclusions from the data that is presented to us.

This is why a market moves - the difference of opinion of traders and investors.

### **2. Investor Psychology**

Investor psychology ultimately determines the price of anything including currency prices.

Everyone who trades makes a contribution to the price and they are influenced by a number of factors. When doing so they make judgements based upon their emotions and that's why it is so hard to determine where prices will go next.

### **The Equation for Market Movement**

Is simple and here it is:

Market Fundamentals + Investor Perception = Price movement.

We all see the facts, but we make our own judgments based upon them. Millions of traders do this and all these traders opinions combined, determine the price.

A technical approach to trading currencies is best, as it takes into account both the supply and demand situation, as well as investor psychology. We can see the impact of both at once in the reality of the market price.

Many traders don't believe that technical analysis can work, as they don't believe it can take into account the impact of the fundamentals but this is not correct - it does.

A technical trader simply assumes that all known fundamentals are going to show up instantly in price action and in today's world of instant communications this is truer than ever before. Technical analysis therefore is simply a short cut way of taking into account the fundamentals influence on price.

The big advantage of technical analysis is that it also studies human psychology at the same time.

As human nature is constant, it shows up in repetitive price patterns that can be traded for profit.

By concentrating on price action, you can see the reality of price without being influenced by your emotions. Technical traders don't care why prices are moving, they simply concentrate on making profits when they do.

Let's look at technical analysis in greater detail.

### **An Introduction to Technical Analysis**

There are many different methods and tools utilized in technical analysis, but they all rely on the same principles - that price patterns and price trends exist in the market and that they can be identified and turned into profit opportunities.

Technical Analysis in currency trading is based upon three core principles:

#### **Markets Discount**

The actual price is a reflection of everything known to the market that could possibly have an affect on price movement and includes supply and demand, political factors, and the market sentiment.

The pure technical analyst is only concerned with price movements, NOT the reasons behind the price movements.

## **Prices Move in Trends**

Prices can move in three directions - they can move up, down or sideways.

Once a trend in any of these directions is in effect it usually, will persist and create a trend.

The market trend is simply defined as the direction of market prices, a concept that is essential to the success of technical analysis in currency trading.

Identifying trends in theory is simple; a price chart will usually indicate the prevailing trend as characterized by a series of waves with obvious peaks and troughs.

It is the direction of these peaks and troughs that constitutes the market trend, if they move up, the trend is bullish, if they move down the trend is bearish and of course if they move sideways then the market is in a period of consolidation.

## **History Tends to Repeat Itself**

To a technical analyst in currency trading, the trader psychology that affects prices is extremely important, as human nature is repetitive and this shows up in repetitive price patterns.

This allows anyone using technical analysis in currency trading to see where prices are likely to go next and traders can then act upon this information for profit.

## **The Market Price Reflects Everything**

Technical analysis in currency trading is primarily concerned with price trends and everything that can possibly affect a currency is reflected in price action.

Now we need to look at some of the components that can be used in technical analysis to build a successful technical system

## **3. Technical Tools for Profit**

Here we are going to put some technical tools you can use to generate profitable trading signals.

Let's look at the 4 main groups of indicators that you can use.

### **Trend Indicators**

A trend is a term used to describe the persistence of price movement in one direction over time. The easiest way to spot trends is via trend lines, drawn below price lows or above price highs.

While basic trend lines have gone out of fashion in recent years in favor of more complicated indicators, they are still one of the most effective ways to technically analyze currency movements.

Another effective method is a moving average but as a general rule we like to start with trend lines and use these as a back up tool in trend identification and not use them on their own.

Trend lines will help you easily spot support and resistance areas and all successful trading methods are based upon it.

Support and resistance describes the price levels where markets repeatedly rise or fall and then reverse. This phenomenon reflects basic supply and demand and when prices break above or below significant support or resistance, a big move can follow very quickly.

We believe that trend lines should be the basis on which ANY technical analysis of currencies should be based on - The indicators below are used for confirmation of price strength and weakness:

### **Volatility Indicators**

Volatility is a general term used to describe the magnitude, or size, of day-to-day price fluctuations independent of their direction. Generally, changes in volatility tend to lead changes in prices.

### **Cycle Indicators**

A cycle is a term to indicate repeating patterns of market movement, specific to recurrent events, such as elections, year-end monetary repatriation etc.

Cycle indicators determine the timing of a particular market patterns. A good example would be Elliott Wave theory. Cycle indicators however in our view are of little or no use, in the technical analysis of currencies as they are highly subjective, unreliable and inaccurate – avoid them!

### **Momentum Indicators**

Momentum is a general term used to describe the speed at which prices move over given time periods. If you want to get the odds on your side when trading you should ALWAYS enter a market with price strength on your side ( if bullish) or weakness (if bearish) If you want to win you need to trade with momentum.

Momentum indicators determine the strength or weakness of a trend as it progresses over time. Momentum is generally highest at the start of a trend and lowest at market turning points.

Any divergence of directions in price and momentum is a warning of weakness; if price extremes occur with weak momentum, then an end of movement in the current direction could occur.

If however momentum is trending strongly and prices are flat, it signals a potential change in price direction.

### **Scientific Theories V Odds Theories**

Trading is game of odds not of certainties, yet many traders think that markets move with scientific accuracy and fall for several theories that that simply wipe them out.

Elliott wave theory is probably the most well known of the scientific theories and enjoys massive popularity - being described as advanced technical analysis, by many brokers and publishers.

Elliott, concluded in his book “natures law” that the movement of financial markets could be predicted by observing, and identifying a repetitive pattern of waves.

Elliott wave theory is supposed to be an objective investment theory - but there isn't any objectivity in it at all. Elliott wave theory claims to be able to predict the market - but gives no objective way of doing it in practice.

There many other scientific theories, but the above is a good example of how ridiculous they are and its surprising how many traders believe in them.

FACT – Scientific theories cannot be right for the following reason:

If markets moved scientifically, there'd be no market – we'd all know the price in advance!

A currency market by its nature, involves uncertainty - that's what makes a market move - the fact that human nature is un-predictable.

Market prices are a reflection of the following equation which we stated earlier:

Supply and demand fundamentals + human psychology = price action

This looks simple, but is in reality, is a complicated equation - which is impossible to predict in advance, but that doesn't mean you can't make a lot of money – you can.

All you need to do is get the odds on your side and you will have far more winners than losers and make big consistent gains.

### **Trading the Odds Successfully**

Just as the successful poker or blackjack player knows he won't win every hand, the successful financial trader knows that he won't win every trade.

They both know that if they play the odds, they will make a lot of money over time. Its no coincidence that some of the top traders in the world started out playing poker or blackjack.

Blair Hull is a good example - he was a successful blackjack player, he then tried his hand at financial trading and turned \$25,000 into \$500,000, within a couple of years.

Blackjack Success is based on the Following:

1. Playing when the odds are in your favor
2. Adjusting the bet size when the odds are favorable
3. Using a system, and rigidly applying it with discipline
4. Playing un-emotionally, and with focus

Just as most players in the casinos lose, so do most traders in the financial markets - and the reason is all down to not having a plan, and executing it with discipline.

The Key to Success in the Casino, or in Financial Trading is:

Trading method + Play the odds + Execute with discipline = Financial Success.

Most traders fail to do this and lose.

## **Dow Theory**

So were dealing with an odds game and a good place to start when looking at forex markets is with Dow Theory.

Dow Theory is one of the most important trading theories ever. Whilst today's traders like to look at trendy theories, nothing beats Dow Theory in terms of logic - and getting the odds in your favor.

In 1901, in the Wall Street Journal, Charles H. Dow compared the stock market, to the tides of the ocean, - and the quote below neatly sums up in essence what the theory is all about:

"A person watching the tide coming in and who wishes to know the exact spot which marks the high tide, sets a stick in the sand at the points reached by the incoming waves until the stick reaches a position where the waves do not come up to it, and finally recede enough to show that the tide has turned. This method holds good in watching and determining the flood tide of the stock market."

## **Probability and the Odds**

Just like the waves of the ocean, we know that markets ebb and flow, one way, and then the other. Just as the waves of the ocean don't move to an exact scientific theory neither do the Forex markets.

The good news is: Currencies do move in repetitive patterns.

## **The Three Phases of a Trend**

Dow and Hamilton identified three types of price movements:

### **Primary Movements**

Primary moves generally last a few months to several years. These primary moves represent the broad underlying trend of the market – the health of the underlying market in currency trading. These are the trends that currency traders should focus on, as they are the trends that yield the biggest profits.

### **Secondary Movements**

Secondary Movements, also known as reaction movements generally last a few weeks to a few months - and move counter to the primary trend. These secondary movements are moves that can be affected by such things as, central bank manipulation, and geo political events.

### **Daily Fluctuations**

Daily fluctuations generally move with, or against the primary trend - and last from a few hours to a few days - but usually not more than a week. These daily fluctuations moves, are really random - and are un-tradable in currency markets.

So you forget about "sure fire methods" "scientific theories" and "forex secrets" and trade the odds.

If you understand Dow Theory you will understand two key points:

1. Trading is nothing more than an odds game.
2. Focus on the longer term trends and not the market noise, if you focus on the former your chances of success are greatly enhanced.

We now need to look at how you can put the odds in your favor, by constructing a specific system that can do just that.

#### **4. Building a Forex Trading System for Profit**

##### **Using Forex Charts**

If you understand support and resistance correctly, it can be the basis of a very successful Forex trading strategy.

##### **Support and Resistance**

Support and resistance simply describes the levels where prices are drawn to move to and either break it or reverse. In a bull market prices rise to resistance levels and fall - in a bear market prices fall to support and then rise. When prices break above or below significant support or resistance, a big move can follow - especially if the resistance or support is valid.

So how do you know if support or resistance is valid?

Look for many tests - and look for how many different time periods these tests have occurred in.

As a general rule look for a minimum of 4 tests and they're even better if they occur in two time frames at least a few weeks apart.

##### **Chart Time frames**

While many traders just use daily charts to determine support and resistance, if you want to be successful you can get the bigger picture and gain a trading edge by using weekly charts.

##### **1. The weekly trend**

Very few forex traders look at the weekly charts, but the weekly chart shows you the longer term trends and effectively separates out the "wood from the trees", so you can see the important long term trends.

##### **2. The daily chart**

Look for the points support and resistance on the weekly chart, to be in synch with the daily chart, so the same important price levels are lining up on both charts.

If you do this you will spot some great trading set ups.

##### **Why Breaks of Valid Resistance are so Important**

If you have support and resistance that is valid, then chances are there are clusters of stops behind these levels, where traders have stop losses and trend followers are waiting to kick in and execute new trades on the break.

If these levels are broken, the odds are high that the break will continue and a new trend will develop.

When these breaks occur they tend to move quickly and it's a fact that most traders miss them because they don't understand the concept of going with price momentum. If you don't enter trades with price momentum then you won't catch some of the best trades.

### **Buying High & Selling Higher**

A basic wisdom of trading is "buy low, sell high" - well, the reality is, if you try this in FOREX trading, you'll end up losing money.

#### **Why Buy Low and Sell High doesn't Work**

"Buy low, sell high" is accepted wisdom by the majority of traders - but this logic is fundamentally flawed - use it in FOREX trading, and you're asking for trouble. Why? - If you wait for a pullback, you're going to miss some of the biggest moves.

Think about it - what if a currency starts to trend and doesn't pullback? (How often have you seen this?) If you're waiting for a pullback that never comes, you'll never get in on the trade - and you'll miss a major opportunity and this is EXACTLY what the majority of traders do and that's why they lose.

### **You Need to Feel Uncomfortable!**

When trading in the FOREX market, you should usually feel uncomfortable (and that's why most traders don't make these trades) - as no one likes to buy or sell after the market has started trending - but doing this will make you money.

The fact is, the more comfortable you feel when entering a trade at support; the less likely the trade will be a big winner.

During any given year, many of the big moves in currencies take place from new market highs or with no pullback.

### **Buying Low and Selling High Involves Prediction**

If you want to buy low and sell high you are also making a fundamental error in your trading which is:

You are predicting where prices may bottom and this simply involves hoping that the level will hold and if you want to rely on hope you are going to lose. On the graph below you don't predict you act on the acceleration of price.



If you base your FOREX Trading strategy around waiting for a warm comfy entry right at a market low or, at key support, you're going to miss lots of profitable trades – so step away from the losing majority of traders.

Your FOREX trading strategy should give you a different mindset - most traders “buy low and sell high” - so you should “buy high and sell higher” – i.e. you should be doing the opposite of what the crowd are doing.

Don't worry - most traders lose money, and their FOREX Trading strategy is based on the flawed logic we have just discussed - so not doing what they do makes total sense. Therefore, look for breakouts through support and resistance - and sell and buy respectively.

### **Its Tough Mentally - But it Makes Money!**

Sure, it's hard to do - the majority don't agree with you - and no one likes to go against the majority. However, it's the right thing to do, to make your FOREX trading successful. Think about what we've just said, and you'll see it makes logical sense.

### **If Levels Hold**

Of course big breakout trades don't come round all the time but you can still use price momentum on smaller moves.

If you are looking for support and resistance to hold you need to wait for prices to bottom above support and turn higher and vice versa if you are trading into resistance.

Again, you will miss a bit of the move by waiting for a clear indication the level will hold but this is the ONLY way to get the odds in your favor.

## **Confirming Entry Levels**

You need to act on confirmation on any trade you do and you need some indicators to help you, so here are two of the best.

### **1. Stochastics**

Quite simply, the ultimate momentum indicator to help you time your trading signals with greater accuracy.

#### **The logic**

Of the stochastic is based on the assumption, that when a market is rising, it will tend to close near the highs of the session - and when a market falls, it tends to close near the lows.

Lets look at the calculation – although you don't need to understand just as you don't need to understand an internal combustion engine to drive a car – you can look at it visually which we will return to in a minute first:

#### **The Calculation**

The stochastic oscillator is plotted as two lines called %K, a fast line and %D, a slow line.

- %K line is more sensitive than %D
- %D line is a moving average of %K
- %D line gives the trading signals

It's actually similar to the way a moving average is plotted.

Therefore consider %K as a fast moving average, and %D as a slow moving average.

The lines are plotted on a scale of 1 to 100.

"Trigger" lines are normally drawn on stochastics charts at the 80% and 20% level – this indicates when markets are overbought or oversold and a trading signal maybe generated.

#### **Using Stochastics**

The best way to get a feel for stochastics and how they can help your forex trading strategy is to look at them – you can see them free on many services and a good one is [futuresource.com](http://futuresource.com)

The 80% value is normally used as an overbought signal, while the 20% is used as an oversold signal.

The signals are even more reliable if a forex trader waits until the %K, and %D lines turn upward, below 5% before buying - and in conversely, above 95% before selling.

The most reliable way to trade stochastics is to use the above as a warning sign and wait for the stochastic lines to cross with bullish or bearish divergence.

For example, buy when the %K line rises above the %D line, and sell when the %K line falls below the %D line.

Beware of short-term crossovers these can generate a false signal and cause losses.

The best crossover is generated when the %K line intersects, "after" the peak of the %D line.

Why they are so valuable

Because they allow you to shift the odds in your favor instead of relying on hope when you trade into support or resistance you will shift the odds in your favor by knowing the strength of price momentum. On the example below you can sell the price spike on confirmation of waning price momentum via the stochastic



### Using the Relative Strength Index (RSI)

Stochastics are a great market timing tool on their own but when combined with the RSI they become even more effective.

The Relative Strength Index was developed by trader Wells Wilder (check out his excellent book *New Concepts in Technical Trading*) and is a Momentum indicator and probably the most widely used contra-trend-oscillator in the world.

The RSI does not show just the markets strength but the strength compared to the markets former price history.

The technical bit first

The RSI is calculated in the following way:

Within a set period, the individual differences between the upward closing prices (Close today < Close previous day) and downward closing prices (Close today > Close previous day) are added.

Then the number is divided by the number of observations in the period studied minus one.

The result is the day's mean value of the upward and downward strength of the market studied.

Then the relative strength is calculated by dividing the average upward strength by the average downward strength.

The RSI is found by subtracting from 100 the quotient of 100 divided by one plus relative strength.

This is then displayed visually and you can see it on free chart services such as [futuresource.com](http://futuresource.com) Properties

If the chart displays daily data, then period obviously denotes days; in weekly charts, the period will be weeks etc

The shorter the Period of time used for the calculation, the more volatile the RSI will be.

The RSI has a default of 14, which is the value devised by Wilder when originally calculating RSI.

Other values have become popular such as 9, 11, and 25 days.

Overbought – Oversold

The main purpose of the RSI is to measure the market's strength and weakness An RSI, above 70, indicates an overbought bull market.

On the other hand an RSI, below 30, indicates an oversold market.

While the RSI can be used as an overbought and oversold indicator it does have other uses.

Divergences between Price and RSI

For example, the market makes new highs on the chart but the RSI fails to exceed its previous highs indicating that the trend is about to exhaust itself – this combined with stochastic weakness or a crossover give you advance warning that the odds are shifting to the bears. On the graphs below notice the double top on the RSI and the way the stochastic confirms the move.

**NOSE [10] - SWISS FRANC** LAST: 0.8359 CHANGE: ▲ 0.0011 HIGH: 0.8382 LOW: 0.8322 7/20/2007



**NOEC [10] - EURO** LAST: 1.3847 CHANGE: ▲ 0.0015 HIGH: 1.3870 LOW: 1.3806 7/20/2007



## **Contrary Trading Tools Catching the Turning Points**

Here we are going to look at two tools that can help you gain advance warning of EVERY major trend change before they occur – you can't trade off them (you need the timing indicators above) but they will alert you to the biggest trades of the year in advance.

Why are they so effective?

Fundamental analysis does not make any effort to study investor psychology - whereas technical analysis does so - in terms of repetitive price patterns. However, technical analysis still does not predict when a price pattern is at an extreme - it simply follows market action.

These indicators will tell you when investors have pushed a trend too far with the emotions of greed and fear to the fore.

When markets become excessively bullish or bearish they reverse and it's a fact that the biggest bull markets in history have collapsed when investors are most bullish and some of the biggest trends have developed when investors have been at a bearish extreme.

### **The Importance of Market Psychology**

In any investment market, we know that investor psychology is vitally important when analyzing currency movements - as investors push prices too far in either direction, as the emotions of greed and fear come into play.

Investors push prices away from fair value - and then prices recoil in the other direction.

Ever wondered why big price moves take place when the market is at its most bullish, or bearish? - This is investor psychology at work.

### **So, How can we Measure Investor Psychology?**

There are two powerful tools you can use - and they can help you spot every major top and bottom forming in advance - yet few traders use them.

Here are the two tools:

#### **1. The Commitment of Traders Report**

This is published bi weekly by the US government and breaks down the open interest of the US futures markets, (which include currencies) into three separate groups:

Commercial hedgers – These are savvy traders who are hedging, not speculating - and they are unaffected by the emotions of greed and fear.

Large speculators – These are mostly funds, who are trend following - and always get caught at turning points.

Small speculators – This represents small individual traders - and they are the worst traders of all, as they are mainly motivated by the emotions of greed and fear

Profiting from Tracking the Pros

So, what use are these positions? - Commercials are hedging, and if prices spike too far from fair value, the commercials will move aggressively the other way - starting a buying frenzy - and the buying price collapses when they have gone too far.

The Commercials are hedging – so no greed or fear comes into play - they are just looking at the facts. When you have an aggressive price move, and commercials trade in the opposite way to the trend, and the positions of large and small speculators – then a trend change is imminent.

#### A Word of Caution

When analyzing currency movements with net trader's positions, it is important to only trade extremes. If you watch for these extremes, and trade with the commercials you can catch the big turning points.

### **2. % Bullish**

This is a good backup tool to the Commitment of Traders Report, and is a poll of investors; brokers, fund managers, etc. - Percent bullish expresses their bullishness as a percentage.

Traders in currencies should look for a figure below 20%, to indicate a market that's too bearish - and above 80%, for a market that's too bullish. When these numbers are hit - look closely at commercial selling and buying - if they line up, get ready for a turning point.

Consider this fact: Currency markets tend to have huge trend changes when the fundamental consensus is extremely bullish or bearish – and the % Bullish measures peoples view of the market.

In simple terms when the consensus is over 80%, then price is too bullish. When the consensus is under 20% then price is too bearish - and a trend change is due.

If you combine these two tools and look for extremes in speculator positions and extremes in investor sentiment, you can then look to time your entry once resistance or support forms.

### **Using Bollinger Bands**

Bollinger bands will help you to predict big trending moves, act on big trend reversals and finally, time trading positions with greater accuracy for bigger profits.

What are Bollinger Bands?

Developed by John Bollinger, Bollinger bands are volatility bands drawn around a simple moving average.

You calculate Bollinger bands using the standard deviation of price over the same period as moving averages and plotted as lines above and below the moving average.

As moving averages have been traditionally used to identify the underlying trend, Bollinger bands combine this with the volatility of the individual market (or the standard deviation) – to plot a trading envelope.

The distance between upper and lower Bollinger bands reflects the volatility of the market traded.

As prices force themselves away from the longer-term average, the standard deviation rises - and thus the bands will fluctuate in varying amounts, away from the average.

In any market, the value of currency traded tends to rise slowly over the longer term.

Prices may spike short term, but will normally dip back to the longer term moving average (the centre band) - which represents realistic value.

The volatility of the outer bands therefore gives us an indication of how volatile prices are - and how far away price is from longer-term value.

Most price spikes are caused as much by trader psychology, as the supply and demand backdrop - and this scenario is reflected in the concept of Bollinger bands.

### **Why are Bollinger Bands so useful?**

Bollinger bands perform three major functions for traders:

#### **1. Spotting a Breakout and New Trend**

Markets move between low volatility trading ranges, to high volatility trending moves.

When a market makes trades in a narrow range, the Bollinger bands will narrow together and this shows a market with extremely low volatility - however this is a warning that a high volatility trending move is likely to follow.

When prices break above or below the upper or lower band, it is an indication that a breakout and trend is about to develop - traders will then take a position in the direction of the breakout, and try to ride the trend.

#### **2. Timing Entry Levels in a Trend**

We all know long term currency trends last for months or years - but we need to get in at the best risk / reward level.

Bollinger bands will help get you in to the trend and help you time your entry.

All you do is watch for dips toward the centre band - and enter in the direction of the trend - it really is that simple!

To time your entries with greater accuracy, and filter out "false" breaks you need to use a momentum indicator - such as the stochastic, to confirm the move. Simply buy on dips to the centre band there is one example highlighted below but there are many others on this graph.



### 3. Spotting Market Reversals

When the price touches the top of the band, a sell is generated, and prices should revert back to mean, or the middle moving average band.

If the price touches the bottom of the band, traders can buy a currency, assuming that it is oversold, and will rally back towards the top of the band.

The spacing, or width of the band, is dependent on the volatility of the market, but gives traders a clear indication of where prices will go, and when to enter. Below you can see a sample top and bottom forming on high volatility spikes.



## A Simple System for Big Profits

The system outlined above is simple - but if you learn to combine the elements correctly, then you have the basis of a system that is based on sound logic and will work.

You can:

- \* Easily spot valid support and resistance levels.
- \* You can then time your entry levels with price momentum on your side.
- \* You can decide price targets and entry levels.
- \* You can take advantage of extremes in investor psychology that give the best risk to reward trading opportunities.
- \* You can trade long term trends.
- \* You can trade within the longer term trends and swing trade.

The above system will help you trade with the odds on your side, while you will lose some trades, you will win more than you lose and finally, you will have bigger profits than losses.

While you have the basics of a system that can work and make you big consistent gains, we need to cover money management and risk in more detail. First though - here are some examples of spotting market tops and bottoms and also entering breakout trades using price momentum.

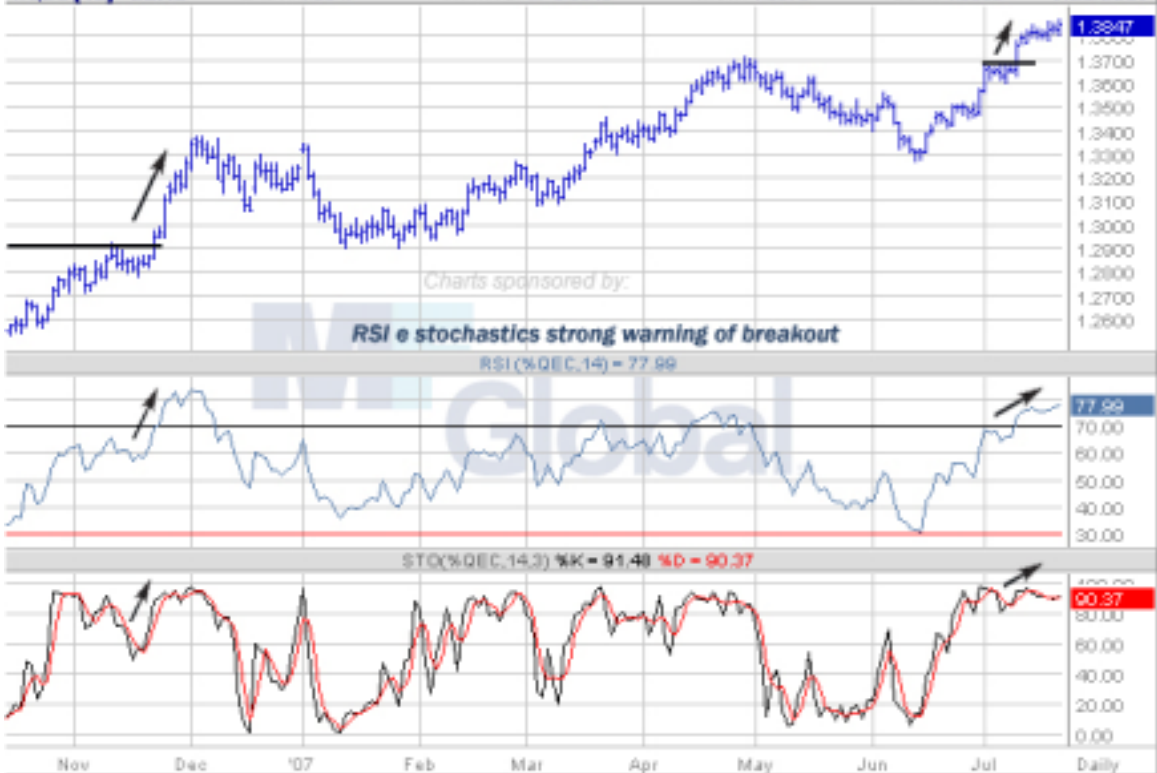


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#### 4. Risk Reward and You

If you want to make money from forex trading you need to adopt the right mindset to help you confront and deal with risk. Risk strikes fear into many traders and they try so hard to avoid it, they end up creating it and lose.

A great place to start looking at the right attitude in terms of confronting risk is a classic investment book:

##### The Zurich Axioms

Written by Max Günter the book contains a timeless philosophy to help you adopt the right mindset toward risk and make bigger profits and it's a great book for anyone involved in speculation, not just forex traders.

The wisdom is simple, timeless, unconventional and full of humor, it will get your adrenalin pumping as you read it, and it remains one of the most inspiring investment books of all time.

The 12 major and 16 minor Zurich Axioms in the book are a set of principles, providing a practical philosophy, for the realistic management of risk.

Several of the Axioms are totally opposed to traditional investment wisdom - however the Swiss speculators who devised them became rich, while most investors who follow conventional wisdom do not.

Accept and Enjoy Risk!

Most Investors as stated don't make big gains, because they are so afraid of risk, they totally restrict the gains they can potentially make.

Does this mean you should take unnecessary risks, or act in a rash manner?

Of course not!

The fact is however, you won't make much money if you don't take risks – with risk goes reward and the bigger the risk the bigger the reward – PERIOD

The Zurich Axioms show you how to confront risk in a positive way, manage it, and enjoy the challenge and take calculated risks at the RIGHT time.

### **Risk and Reward**

Lets just take a brief look at some of the Axiom's on risk – which tell us why most people don't ever make big gains from their investments.

Here are some quotes from the book with our comments below.

1. "Worry is not a sickness but a sign of health - if you are not worried, you are not risking enough".

How often are you told only to risk 2% on any one trade - when you know you should risk more?

You then see the gains you could have made, if only you had the courage of your conviction to risk more on the trade.

It's better to risk 20% on one great trade than 2% on 10 marginal ones.

2. "Always play for meaningful stakes - if an amount is so small that its loss won't make any significant difference, then it isn't likely to bring any significant gains either".

If you don't risk much, you won't gain much. If however you play for meaningful stakes, you have an opportunity to make above average gains - if you don't, you never will.

3. "Resist the allure of diversification"

Diversification is the buzz word in the modern investment community - but all it does is dilute your potential profit and ensure mediocre gains on small accounts.

The Zurich Axioms encourages you NOT to diversify for small gains, but to look for the big potential winners risk as much as you can.

An easy way to explain this is the Pareto principle - the Pareto principle is commonly known as the 80/20 rule.

The rule states that 80% of your results come from 20% of your activities - and this is true in many areas of life, including investing and forex trading. It means, by concentrating on the best investments, and ignoring the others, you can improve your results dramatically.

By only focusing on this 20%, you will see better gains, and you will create a new Pareto principle, refined from the old one, but at a new higher level.

There is much more to the Zurich Axioms to enjoy, and many areas are covered, including the following:

- Greed
- Hope
- Forecasts
- Patterns
- Mobility
- Intuition
- Religion
- Optimism
- Pessimism
- Consensus
- Stubbornness
- Planning

If you can get the book and read it as it's a timeless blueprint on how anyone can make money, by investing in the right opportunities, at the right time and adopting the correct mindset for success.

Max Günter (who wrote the book) was one of the original speculators who devised the Axioms, he made his first big gain in stocks at the age of thirteen, and never looked back and went onto amass a fortune.

This book may not be conventional wisdom but as we said earlier the majority of investors don't win - so be different and if you want to become a successful speculator there is no better place to learn about taking risks and making money than this book.

## **5. Keep Your Losses Small and Learn To Accept Big Gains**

We have seen that you need to accept taking risks to win, however this does not mean being rash; you just need to take calculated risks at the right time.

While you will read a lot about how you need to restrict losses to succeed, there is another issue that relates to money management that is just as important and that's getting the right mindset to be able to accept big profits.

You may find the last statement rather odd – surely every investor wants to make big profits and is happy to accept them?

The answer is most traders want profits - but can't accept them due to their mindset.

This will become clearer as you read to the end of this section, but first, we are going to look at setting stops to exit your trades and keep losses small.

### **Placing Stops**

The system we have outlined in this document makes stop placement easy:

It's behind support and resistance lines which are clearly defined.

Ensure you place the stop immediately – when you enter the market NEVER use mental stop losses.

In certain circumstances, the stop can be a stop and reverse.

For example, if you are taking a short position on waning momentum into major resistance and its penetrated - you may want to reverse your position on the break to take advantage of a potential breakout.

Well that's nice and simple - now for the hard part.

### **Trailing stops and locking in profits**

This really is the key to making profits in forex trading.

You need to trail stops far enough behind that you don't get stopped out by normal counter trend volatility and know when to take in your profit.

Most forex traders experience the following scenario:

They enter a trade and their position and it moves into profit.

They get excited and the bigger the profit becomes the more excited they get and the more tempted they are to take it.

What do they do?

They move up their stop to quickly and get bumped out of the trade by normal volatility and bank a marginal profit.

What happens next?

The trade continues the way they originally thought and goes on to pile up \$10 or \$20,000 or more and their not in!

Accept this fact:

If you want to follow and make money from long term trends you need to keep your stop far enough back that you don't get bumped out by normal volatility within the trend and this is very hard to do even for the most experienced traders.

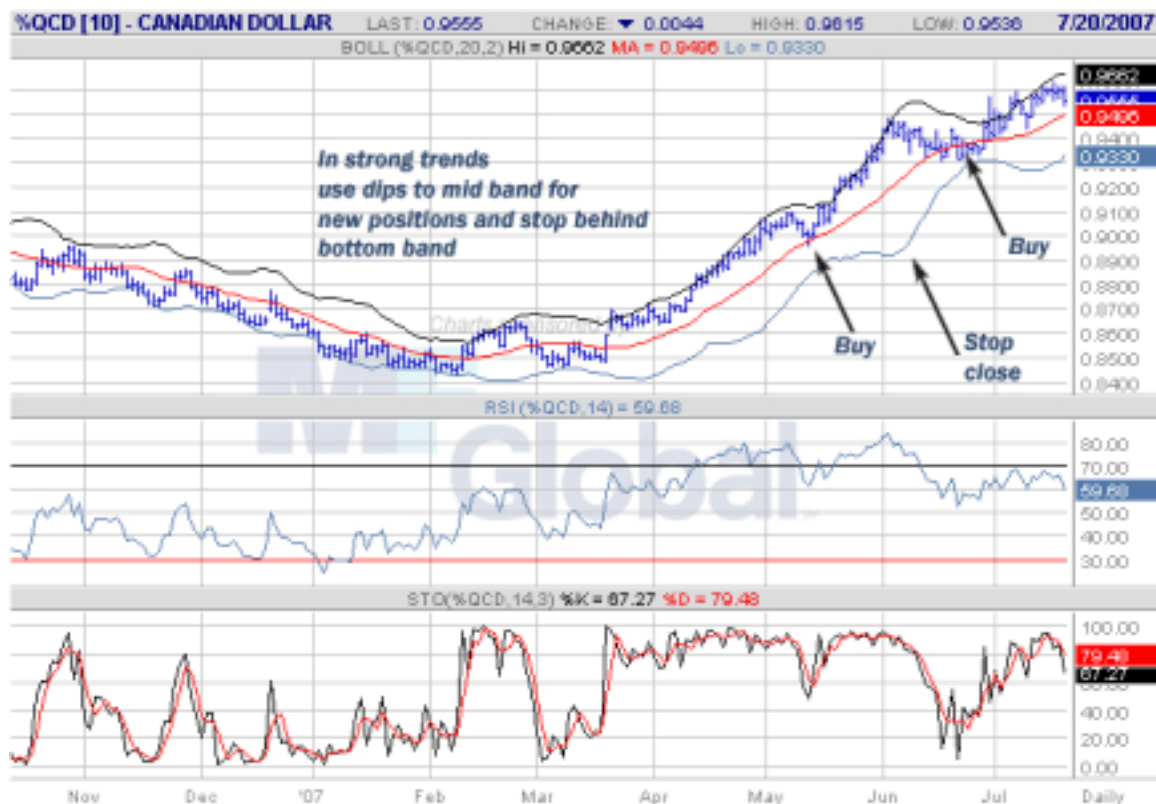
No trader likes watching open equity being eaten into and seeing their profits dip by thousands of dollars but you must accept it – it's the only way to stay with longer term trends.

The fact is most people move their stops too quickly and get so obsessed with restricting risk, they actually guarantee they won't make much.

If you want to make money from the big trends you need to hold your stop at entry at least for the first few days on a major breakout and move it slowly up.

Sure, you are going to lose open equity in the short term – but over the longer term you will ensure that you get a big chunk of the major trend, so keep your eyes on the bigger prize and don't be tempted to lock in profit to soon.

To do the above requires courage and iron discipline to do – it's hard but you need to do it if you want to make money trend following. On the graph below the stop is a long way back at the outer Bollinger band while you buy dips to the mid band.



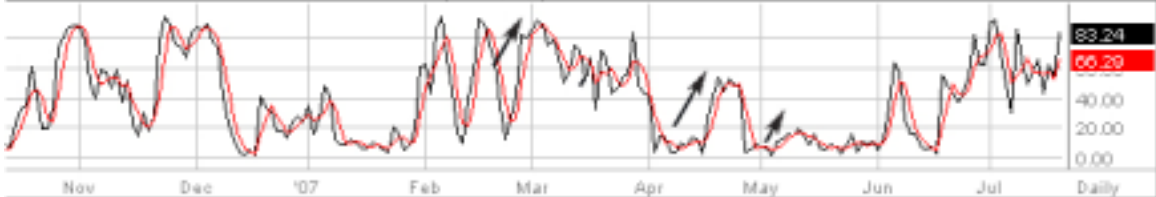
## Swing Trading

If you feel you lack the mindset to be able to cope with long term trend following, stick with swing trading support and resistance within the major trend.

Swing trading is easier to cope with mentally - as you will be only holding trends for a few days and existing on a target. The graphs below show several examples of using the tools we have looked at to buy and sell. Always work with a target of just above the mid band and take profits in as the price moves to this level.

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## 6. Putting It All Together

The above system will work - but it's up to each individual to make it work for them.

With a bit of practice, you will soon be able to apply the tools outlined in this document and seek big longer profits from forex trading.

Successful forex trading involves taking responsibility for your actions, having the confidence and discipline to apply the tools provided and make them work for you.

The framework is here you simply need to fit it to your investment aims and personality.

Try practicing it with a demo account first, before risking real money and familiarize yourself with the tools for as long as you need, then its time to try them in real time trading.

Keep in mind that even if you are successful in a demo account, trading for real is much harder.

In a demo account there is no pressure because there is no money on the line and when money is at stake you will have a hard job keeping your emotions under control.

### **Finally - Remember This:**

Have confidence in what you are doing, accept and take meaningful risks when the odds are in your favour and be prepared to have the courage of your conviction - to catch and hold the big trends and you could soon be making big consistent profits in the worlds most exciting investment.

**Good Luck!**