FXCM

TRAITS OF SUCCESSFUL TRADERS

Four part series

TRAITS OF SUCCESSFUL TRADERS:
a four part guide

Research & Analysis: DailyFX

In the fall of 2011, the DailyFX research team and the DailyFX trading instructors closely studied the trading trends of FXCM clients, utilizing a full year of trade data from FXCM client accounts. They went through an enormous number of statistics and anonymized trading records in order to answer one question:

What separates successful traders from unsuccessful traders?

With this unique resource, they were able to distill some of the "best practices" that profitable FXCM traders follow, such as the time of day they trade, the amount of leverage they use, the currency pairs they trade, and more. Those best practices are outlined for you here in this guide.

We hope that this series will help you become a profitable trader.

-FXCM Inc.

Table of Contents

What is the Number One Mistake Forex Traders Make?

Summary: Traders are right more than 50% of the time, but lose more money on losing trades than they win on winning trades. Traders should use stops and limits to enforce a risk/reward ratio of 1:1 or lower.

Profitable Trades by Currency Pair
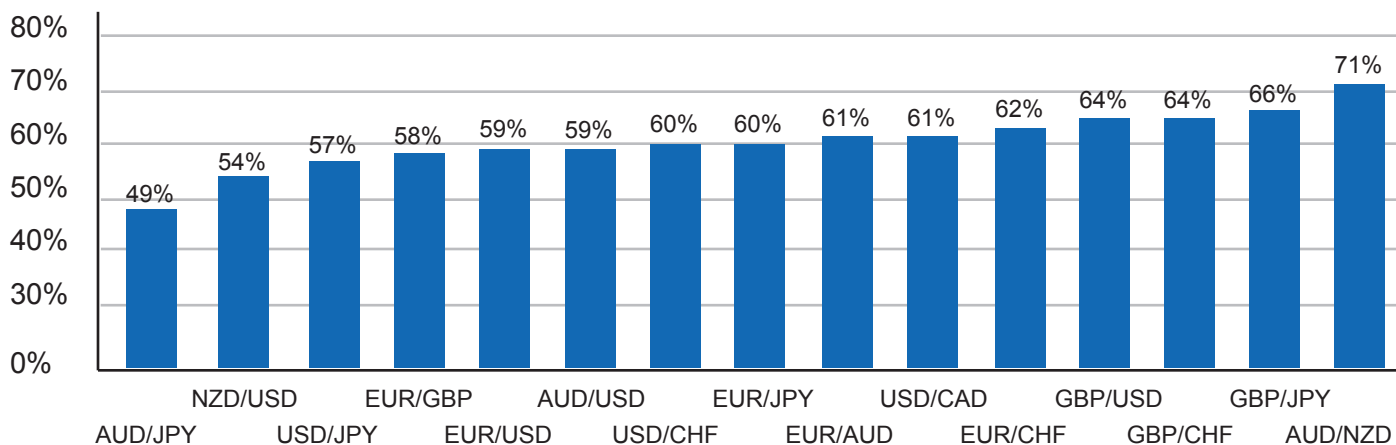
CHART 1.1
Percentage of trades that closed with a profit
Source: Appendix 1.1

INTRODUCTION

Big US Dollar moves against the Euro and other currencies have made forex trading more popular than ever, but the influx of new traders has been matched by an outflow of existing traders.

Why do major currency moves bring increased trader losses? To find out, the DailyFX research team has looked through amalgamated trading data on thousands of FXCM live accounts. In this article, we look at the biggest mistake that forex traders make, and a way to trade appropriately.

WHAT DOES THE AVERAGE FOREX TRADER DO WRONG?

Many forex traders have significant experience trading in other markets, and their technical and fundamental analysis is often quite good. In fact, in almost all of the most popular currency pairs that FXCM clients trade, traders are correct more than 50% of the time.

Chart 1.1 shows the results of a data set of over 12 million real trades conducted by FXCM clients worldwide in 2009 and 2010. It shows the 15 most popular currency pairs that clients trade.

The blue bar shows the percentage of trades that ended with a profit for the client. For example, in EUR/USD, the most popular currency pair, FXCM clients in the sample were profitable on 59% of their trades, and lost on 41% of their trades.

So if traders tend to be right more than half the time, what are they doing wrong?

Chart 1.2 says it all. In blue, it shows the average number of pips traders earned on profitable trades. In red, it shows the average number of pips lost in losing trades. We can now clearly see why traders lose money despite being right more than half the time. They lose more money on their losing trades than they make on their winning trades.

Average Profit and Loss per Trade (in pips)
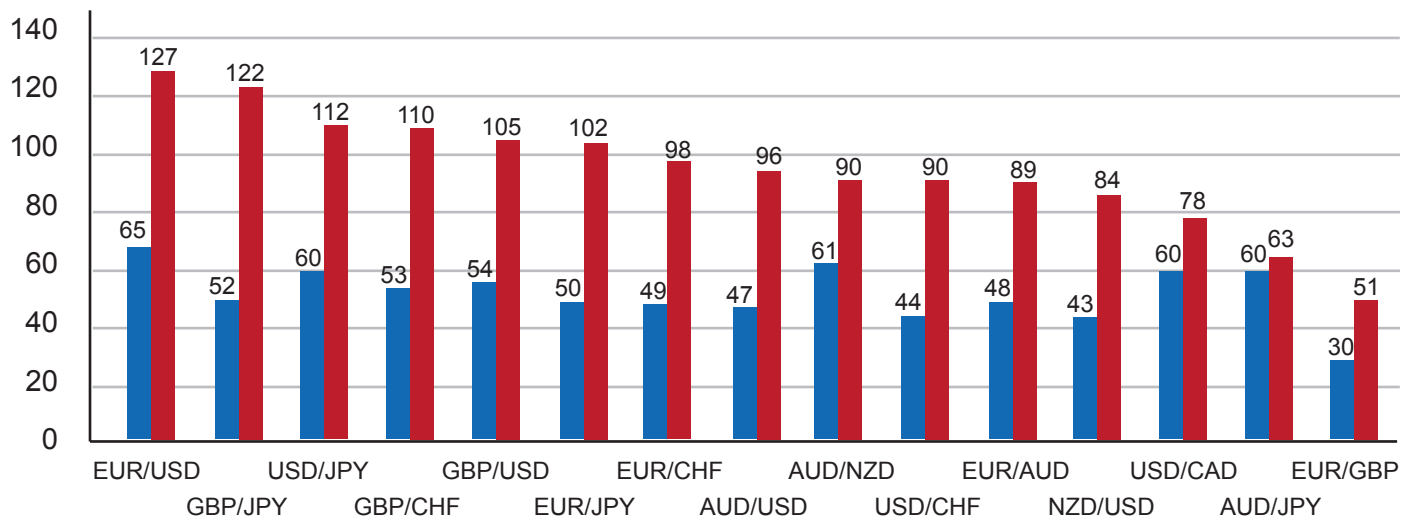
CHART 1.2
Average profit and loss per trade in pips
Source: Appendix 1.2

Let's use EUR/USD as an example. We know that EUR/USD trades were profitable 59% of the time, but trader losses on EUR/USD were an average of 127 pips while profits were only an average of 65 pips. While traders were correct more than half the time, they lost nearly twice as much on their losing trades as they won on winning trades losing money overall.

The track record for the volatile GBP/JPY pair was even worse. Traders were right an impressive 66% of the time in GBP/JPY – that's twice as many successful trades as unsuccessful ones. However, traders overall lost money in GBP/JPY because they made an average of only 52 pips on winning trades, while losing more than twice that – an average 122 pips – on losing trades.

CUT YOUR LOSSES EARLY, LET YOUR PROFITS RUN

Countless trading books advise traders to do this. When your trade goes against you, close it out. Take the small loss and then try again

later, if appropriate. It is better to take a small loss early than a big loss later. Conversely, when a trade is going well, do not be afraid to let it continue working. You may be able to gain more profits.

This may sound simple – "do more of what is working and less of what is not" – but it runs contrary to human nature. We want to be right. We naturally want to hold on to losses, hoping that "things will turn around" and that our trade "will be right". Meanwhile, we want to take our profitable trades off the table early, because we become afraid of losing the profits that we've already made. This is how you lose money trading. When trading, it is more important to be profitable than to be right. So take your losses early, and let your profits run.

HOW TO DO IT: FOLLOW ONE SIMPLE RULE
You can help avoid the loss-making problem described above by following one simple rule: **always seek a bigger reward than the loss you are risking.**

This is a valuable piece of advice that can be found in almost every trading book. Typically, this is called a **"risk/reward ratio".** If you risk losing the same number of pips as you hope to gain, then your risk/reward ratio is 1-to-1 (sometimes written 1:1). If you target a profit of 80 pips with a risk of 40 pips, then you have a 1:2 risk/reward ratio. If you follow this simple rule, you can be right on the direction of only half of your trades and still make money because you will earn more profits on your winning trades than losses on your losing trades.

What ratio should you use? It depends on the type of trade you are making. **You should always use a minimum 1:1 ratio.** That way, if you are right only half the time, you will at least break even. Generally, with high probability trading strategies, such as range trading strategies, you will want to use a relatively high ratio, perhaps between 1:2 and 1:1. For low probability trading strategies, such as trend trading strategies, a lower risk/reward ratio is recommended, such as 1:2, 1:3, or even 1:4. Remember, the lower the risk/reward ratio you choose, the less often you need to correctly predict market direction in order to make money trading.

STICK TO YOUR PLAN: USE STOPS AND LIMITS

Once you have a trading plan that uses a proper risk/reward ratio, the next challenge is to stick to the plan. Remember, it is natural for humans to want to hold on to losses and take profits early, but it makes for bad trading. We must overcome this natural tendency and remove our emotions from trading. **The best way to do this is to set up your trade with Stop-Loss and Limit orders from the beginning.** This will allow you to use the proper risk/reward ratio (1:1 or lower) from the outset, and to stick to it. Once you set them, don't touch them (One exception: you can move your stop in your favor to lock in profits as the market moves in your favor).

Managing your risk in this way is a part of what many traders call "money management".

The Importance of Money Management
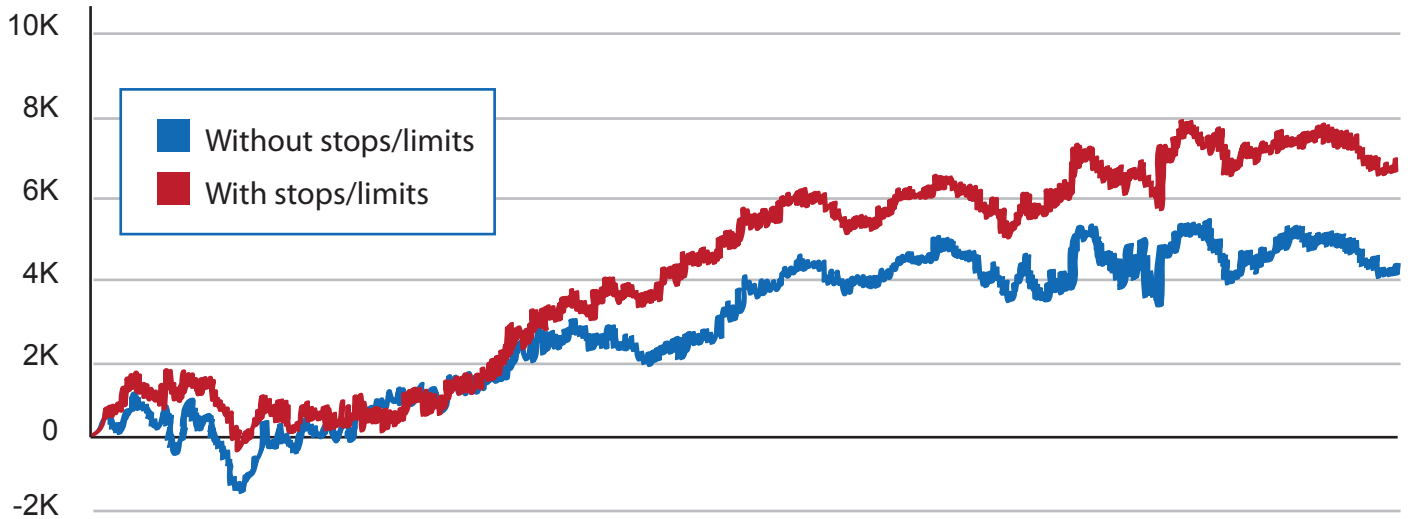
CHART 1.3
Hypothetical returns* from a basic RSI strategy trading USD/CHF (12/14/01 - 03/27/11)
Past performance is not indicative of future results
Source: Appendix 1.3

Many of the most successful forex traders are right about the market's direction less than half the time. Since they practice good money management, they cut their losses quickly and let their profits run, so they are still profitable in their overall trading.

DOES THIS RULE REALLY WORK?

Absolutely. There is a reason why so many traders advocate it. You can readily see the difference in Chart 1.3.

The 2 lines in the chart show the hypothetical returns from a basic RSI trading strategy on USD/CHF using a 60 minute chart. This system was developed to mimic the strategy followed by a very large number of FXCM clients, who tend to be range traders. The blue line shows the "raw" returns, if we run the system without any stops or limits. The red line shows the results if we use stops and limits. The improved results are plain to see.

Our "raw" system follows FXCM clients in another way – it has a high win percentage, but still loses more money on losing trades than it gains on winning ones. The "raw" system's trades are profitable an impressive 66% of the time during the test period, but it lost an average $165 on losing trades, while only making an average $98 on winning trades.

For our stop and limit settings in this model, we set the stop to a constant 115 pips, and the limit to 120 pips, giving us a risk/reward ratio of slightly lower than 1:1. Since this is an RSI range trading strategy, a lower risk/reward ratio gave us better results, because it is a high-probability strategy. Fifty six percent of trades in the system were profitable.

In comparing these two results, you can see that not only are the overall results better with the stops and limits, but positive results are more consistent. Drawdowns tend to be smaller, and the equity curve a bit smoother.

Risk-to-Reward Ratios Matter
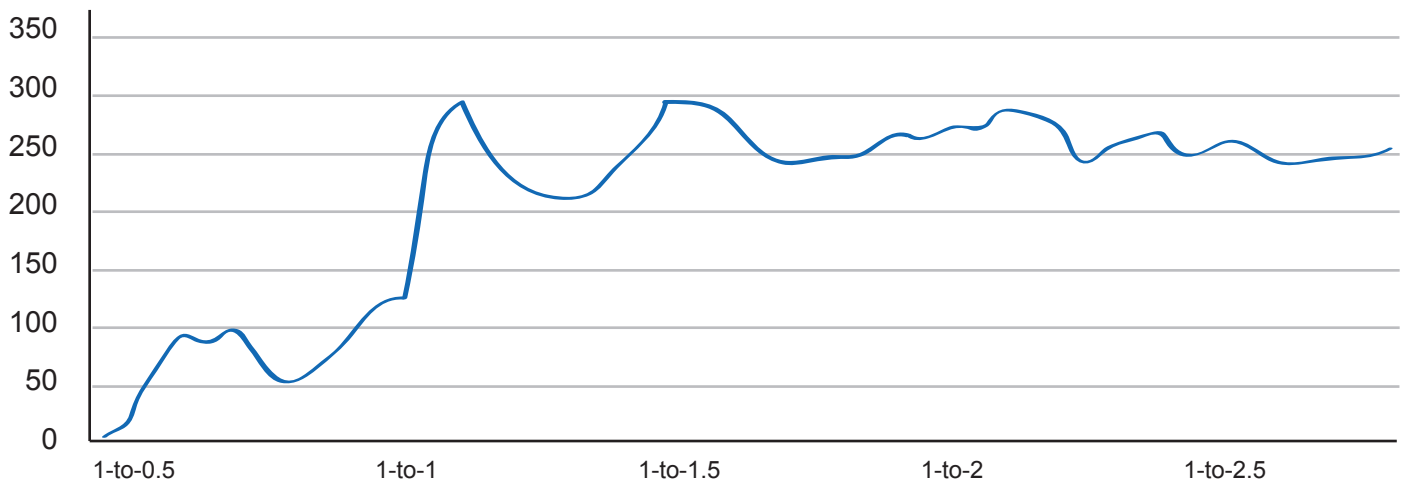
CHART 1.4
Hypothetical overall profit* from a basic RSI strategy using different risk-to-reward ratios
Past performance is not indicative of future results
Source: Appendix 1.4

Also, in general, a risk/reward of 1-to-1 or lower was more profitable than one that was higher than 1-to-1. Of course it must be said, with all backtesting, past performance is not indicative of future results.

Chart 1.4 shows a simulation for setting a stop to 110 pips on every trade. The system had the best overall profit at around the 1-to-1 and 1-to-1.5 risk/reward level. In Chart 1.4, the left axis shows you the overall return generated over time by the system. The bottom axis shows the risk/reward ratios. You can see the steep rise right at the 1:1 level. At lower risk/rewards levels, the results are broadly similar to the 1:1 level.

Again, we note that our model strategy in this case is a high probability range trading strategy, so a high risk/reward ratio is likely to work well. With a trending strategy, we would expect better results at a lower risk/reward, as trends can continue in your favor for far longer than a range-bound price move.

GAME PLAN:
WHAT STRATEGY SHOULD I USE?

Trade forex with stops and limits with a risk/reward ratio of 1:1 or higher.

Whenever you place a trade, make sure that you use a stop-loss order. Always make sure that your profit target is at least as far away from your entry price as your stop-loss is. You can certainly set your price target higher, and probably should aim for a ratio of 1:2 or lower. Then you can choose the market direction correctly only half the time and still make money in your account.

The actual distance you place your stops and limits will depend on the conditions in the market at the time, such as volatility, currency pair, and where you see support and resistance. You can apply the same risk/reward ratio to any trade. If you have a stop level 40 pips away from entry, you should have a profit target 40 pips or more away. If you have a stop level 500 pips away, your profit target should be at least 500 pips away.

DailyFX Resources for Successful Money Management

DailyFX and the DailyFX Trading Instructors have years of experience trading the markets and helping thousands of new traders learn forex. Here are a few of their many tips that can help you trade better by improving your money management:

VIDEO RESOURCES

Watch Money Management Basics

Watch David Rodriguez's presentation of this research at the FXCM Expo

LIVE ONLINE CLASSES

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Learn More about the DailyFX PLUS Trading Course

When is the Best Time of Day to Trade Forex?

Summary: We believe that for most forex traders, the best time of day to trade is Asian hours. During this time, European currency pairs such as EUR/USD show the best results.

Profitability by Hour of Day
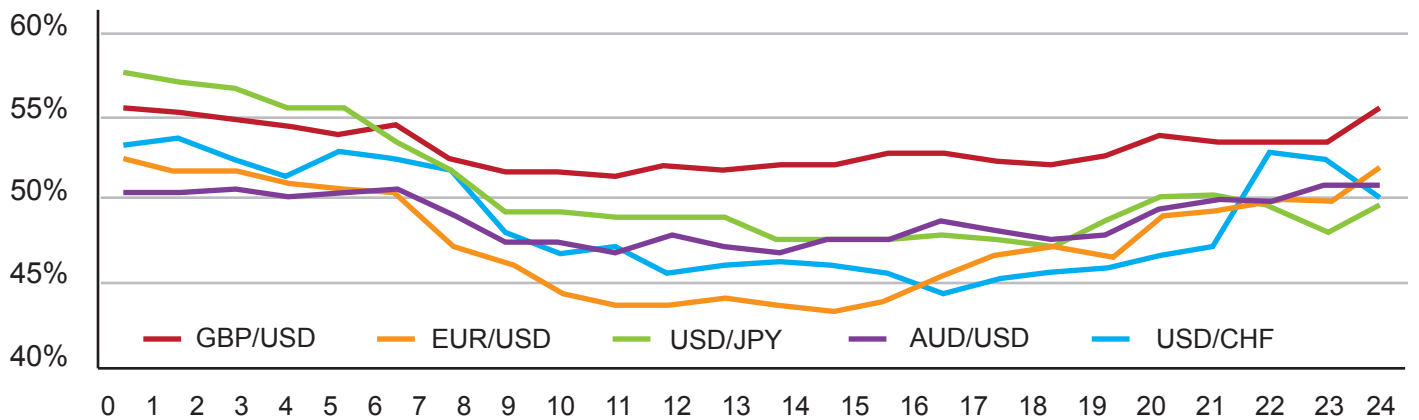
CHART 2.1
Percentage of trades in the given hour (Eastern Time) that closed with a profit
Source: Appendix 2.1

INTRODUCTION

In looking at the trading records of tens of thousands of FXCM clients, as well as talking with even more traders daily via webinars, email, and Twitter, we have come to believe that most individual forex traders are what are called "range traders". It also becomes apparent that many of them have trouble being successful in forex because they are trading during the wrong time of day.

Most forex traders should trade during the late US, Asian or early European trading sessions – essentially 2 PM to 6 AM Eastern Time (New York), which is 7 PM to 11 AM UK time.

They should avoid trading during the most active times of the trading day. Why? We've seen records for thousands of traders, and we've seen what works and what doesn't. Chart 2.1 shows the percentage of FXCM client trades in the five most popular pairs that closed with a profit, displayed by the hour of day.

EUR/USD - Average Hourly Range in Pips

Late US, Asian, and Early European Session
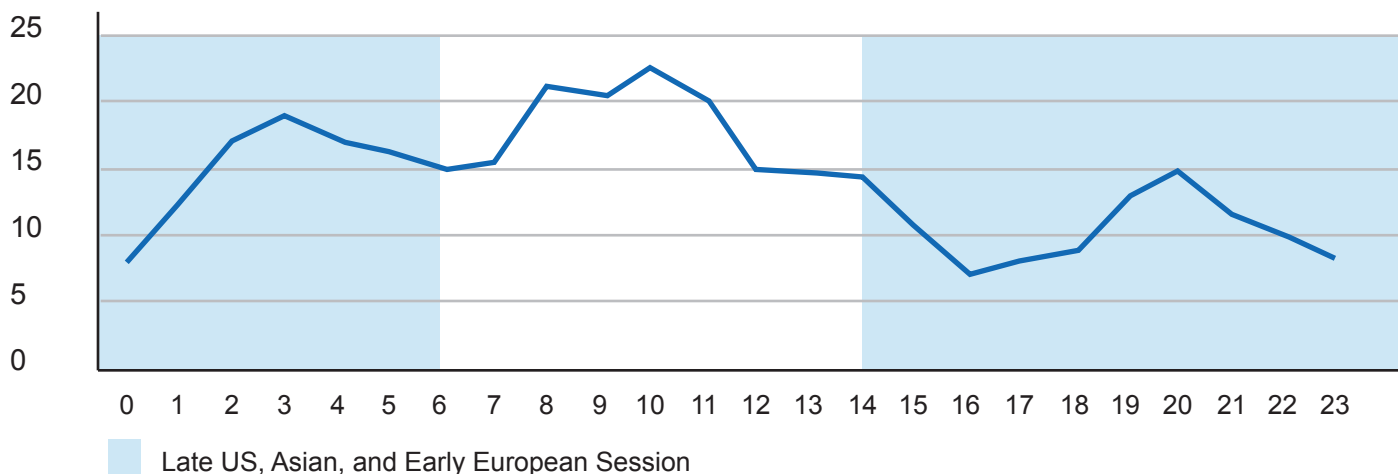
CHART 2.2
EUR/USD average hourly (Eastern Time) range in pips
Source: Appendix 2.2

By reviewing Chart 2.2, you can see that this generally correlates with the low-volatility trading hours. Traders tend to see the best results during the low volatility Asia Session hours.

This is because most individual forex traders use "range trading" strategies – buying oversold currencies near support and selling overbought currencies near resistance. These tend to work well during low volatility times, when support and resistance tends to hold. Range traders can incur

significant losses when support or resistance is broken, which happens most often during the more volatile times of day.

DOES THE TIME OF DAY THAT I TRADE MATTER?

Yes, it matters a lot. We have constructed a strategy that closely models your "typical trader" (You can find a full description of the model strategy at the end of this article). We simulated the strategy's performance trading the EUR/USD

24 hours a day during the sampling period. The results, shown in Chart 2.3, are not good.

However, once we factor in the time of day, things become interesting. Let's say you made a rule to only trade during low-volatility times. Chart 2.4 shows the same strategy over the same time window, but the system does not open any trades during the most volatile time of day, 6 AM to 2 PM Eastern Time (11 AM to 7 PM London time). The difference is dramatic.

By sticking to range trading only during the hours of 2pm to 6am, the typical trader would have been far more successful during the sampling period than the trader who ignored the time of day.

WHAT ABOUT OTHER CURRENCY PAIRS?

Of course, not all currencies act the same. For example, the Japanese yen tends to see more volatility during Asian hours than the Euro or British Pound, since that is the Japanese business day.

Model Strategy: No Time Filter
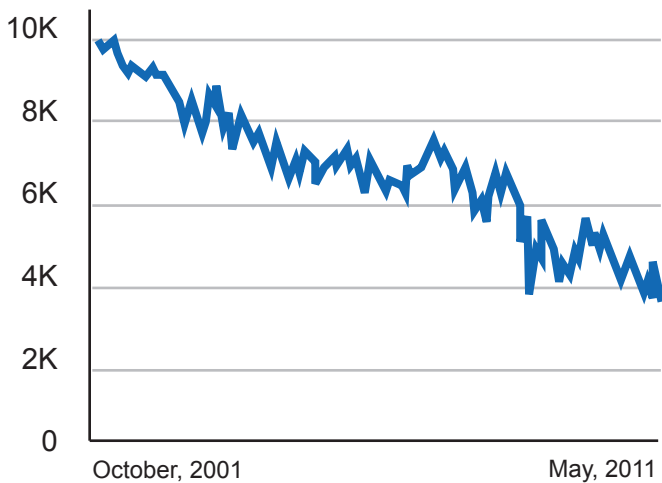
CHART 2.3
Hypothetical returns* w/ no time filter
Source: Appendix 2.3

Past performance is not indicative of future results

Model Strategy: Time Filtered

CHART 2.4
Hypothetical returns* using a time filter
Source: Appendix 2.3

Past performance is not indicative of future results

We simulated the same strategy, with several different possible time settings for the three major European pairs: EUR/USD, GBP/USD, and USD/CHF.

Chart 2.5 shows combined results for the strategy on the EUR/USD, GBP/USD, and USD/CHF during different time frames (in the New York Timezone). As you can see, using th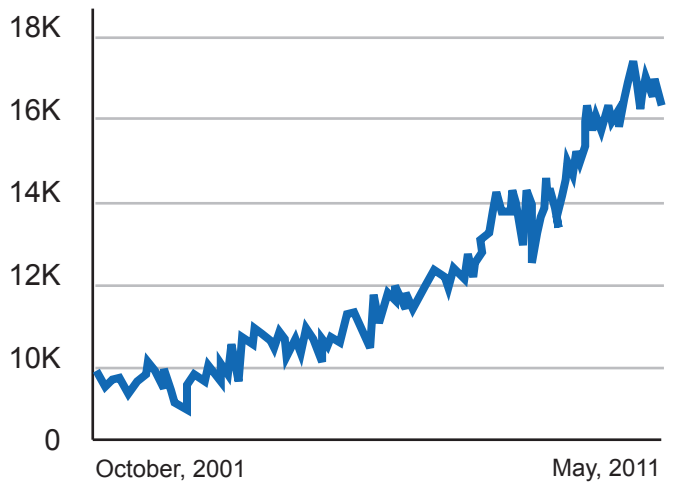is strategy overnight during Asian and early Euro session has yielded much better results than our baseline 24 hour RSI.

We find that the same time filters work very well for the EUR/USD and USD/CHF, as they are closely correlated. The filters also work fairly well for the GBP/USD. You should range trade these currency pairs during the 2 PM to 6AM time window.

Unfortunately, as Chart 2.6 shows, our optimal time window does not work well for Asian currencies.

Time-Filtered RSI Strategy on European Currency Pairs
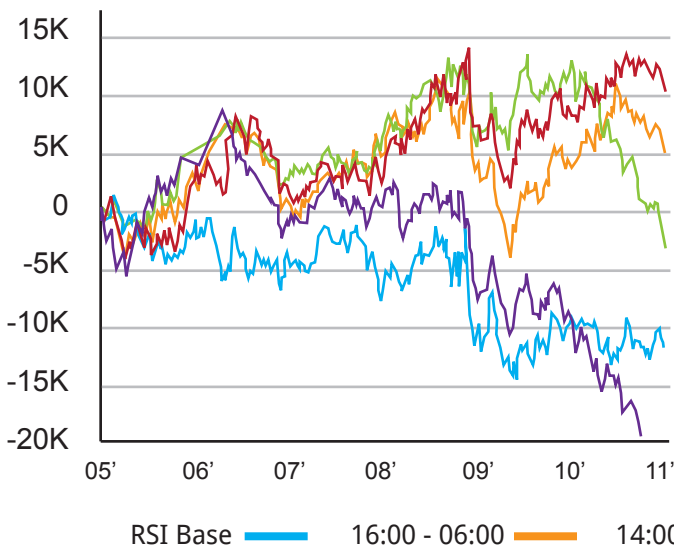
CHART 2.5
Hypothetical returns* from an RSI strategy
Source: Appendix 2.4

Past performance is not indicative of future results

Time-Filtered RSI Strategy on Asian Currency Pairs
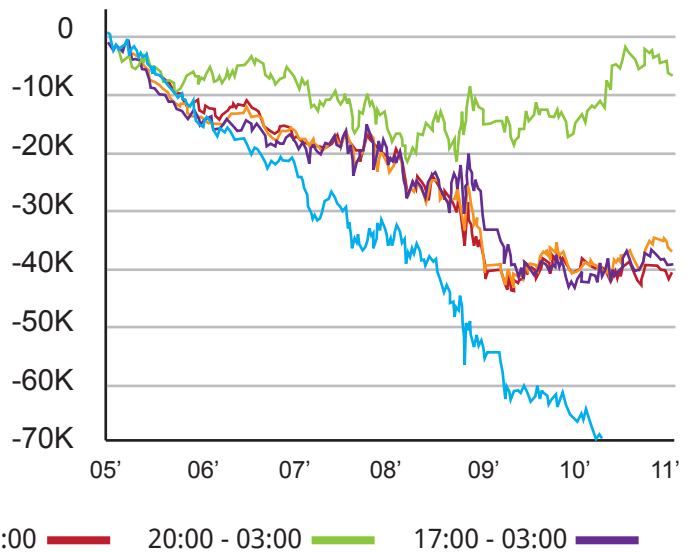
CHART 2.6
Hypothetical returns* from an RSI strategy
Source: Appendix 2.5

Past performance is not indicative of future results

Legend: RSI Base — 16:00 - 06:00 — 14:00 - 06:00 — 20:00 - 03:00 — 17:00 - 03:00

Our tests of different time windows on the USD/JPY, AUD/USD, and NZD/USD have not produced a single positive equity curve over the past 6 years. This is due to the fact that these currencies are more often subject to large moves during Asia Session than the European currencies.

It is worth noting that the time of day can have a significant affect on returns in these currencies as well. 24 hour trading shows far greater losses than the other time windows.

GAME PLAN:
WHAT STRATEGY SHOULD I USE?

Trade European currencies during the "Off Hours" using a range trading strategy.

Our data show that during the sampling period, many individual currency traders have been successful range trading European currency pairs during the "off hours" of 2 PM to 6 AM Eastern Time (7 PM to 11 AM UK Time).

Many traders have been very unsuccessful trading these currencies during the volatile 6 AM to 2 PM time period. Asia-Pacific currencies can be difficult to range trade at any time of day, due to the fact that they tend to have less distinct periods of high and low volatility.

DailyFX Resources for Successful Range Trading

DailyFX and the DailyFX Trading Instructors have years of experience trading the markets and helping thousands of new traders learn forex. Here are a few of their many tips that can help you trade better by improving your skill at range trading.

VIDEOS

Watch Support and Resistance Basics

Watch RSI Basics

Watch Range Trader Basics

Watch Focus Appropriate Strategies on Appropriate Markets

Watch Using Trend Lines to Optimize Entries

Watch David Rodriguez's presentation of this research at the FXCM Expo

ARTICLES

Read Trading with Support and Resistance (part 1)

Read Trading with Support and Resistance (part 2)

Read JW Ranger Strategy

LIVE ONLINE CLASSES

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Learn More about the DailyFX PLUS Trading Course

How to Trade the Majors During Active Hours

Summary: North American trading hours tend to be the most difficult to trade in due to the high level of volatility in the market. Breakout trading strategies tend to do relatively well in volatile environments, so if you plan to trade during these times, look to trade breakouts.

Profitability by Hour of Day
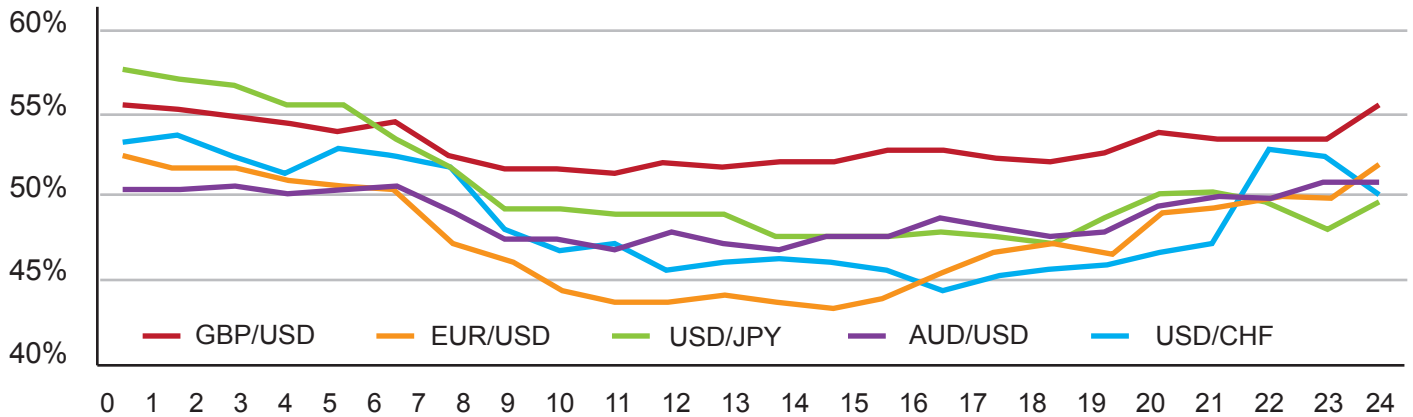
CHART 3.1
Percentage of trades in the given hour (Eastern Time) that closed with a profit
Source: Appendix 2.1

INTRODUCTION

Our past research shows that traders could be well-served restricting their trading to less-active trading hours, as general trader profitability tends to improve when markets are less volatile. But what if you can't trade when it's quiet? For traders who feel the need to be in the market during the more volatile times, here is some advice about how to do it.

Chart 3.1 emphasizes that FXCM clients tend to do poorly in the 5 most popularly traded pairs during the North American daytime.

If we compare these results with measures of volatility, we can see that this poor performance seems directly correlated to sharp price swings, as this time of day tends to be the most volatile. Chart 3.2 shows the average hourly moves in pips for the EUR/USD, the most popular currency pair to trade. You can see that traders' best results coincide with the times of day that have lower volatility, such as the Asia trading session.

EUR/USD - Average Hourly Range in Pips

Late US, Asian, and Early European Session
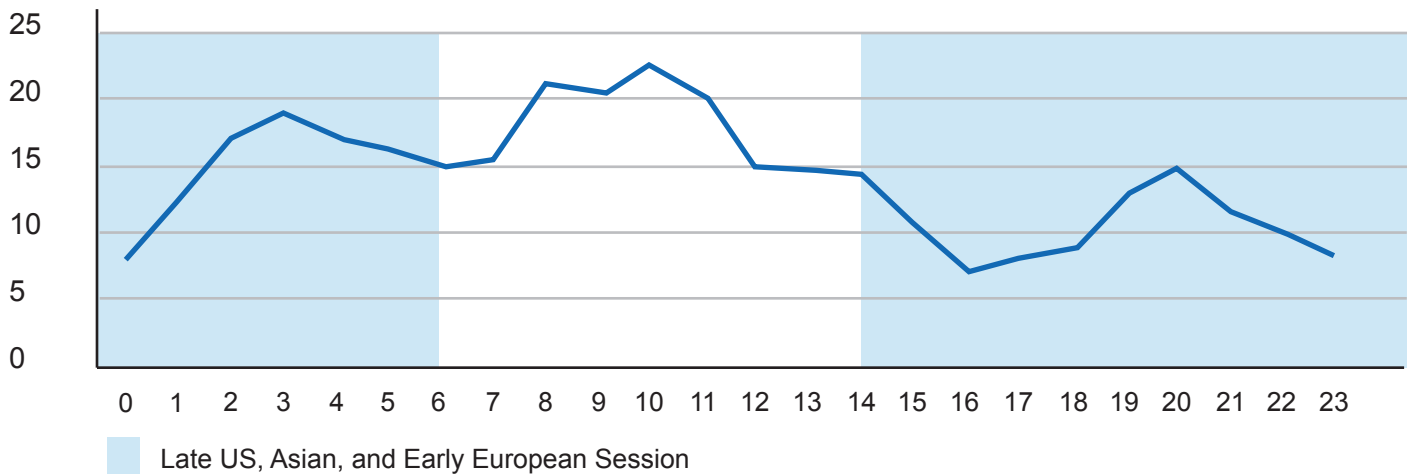
CHART 3.2
EUR/USD average hourly (Eastern Time) range in pips
Source: Appendix 2.2

In part two of this series, When is the Best Time of Day to Trade Forex, we showed that the highly popular Relative Strength Index trading strategy produced significantly better risk-adjusted returns if we limited it to trade exclusively during the least-volatile hours of the trading day, 2 PM to 6 AM Eastern Time (New York).

WHAT STRATEGY SHOULD I USE TO TRADE THE US DAYTIME?

As mentioned before, we advise traders to trade during the lower-volatility times of day due to the risks that volatility present, and the better results we see in the range trading strategies that FXCM clients tend to use. Some traders may prefer to trade during the volatile US daytime, however. So, if you're going to do that, make sure that you use the appropriate strategy at the appropriate time. **Do not try to range trade. Instead, do the opposite: trade breakouts.**

WHAT IS A BREAKOUT?

A breakout is when a currency that has been trapped in a range or channel on the chart breaks through support or resistance, escaping the channel. When this happens, the movement in prices tends to be very powerful, and can create a trading opportunity.

Here is an example where the EUR/USD Daily chart had a channel for two months. You can see that when this channel broke, the move was swift and powerful.

HOW DO YOU TRADE BREAKOUTS?

Trading breakouts is almost the exact opposite of trading ranges. When price moves upwards through resistance, look to buy. When it moves downard through support, look to sell. In the above example, a range trader would have tried to sell at the top of the channel and would have likely lost money. A breakout trader would instead have looked to buy.

Identifying a Price Channel

Channel Breakout Example

February 2011   August 2011
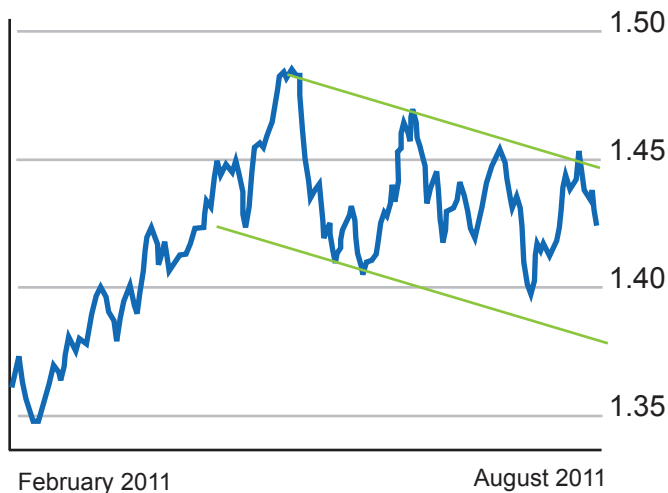
CHART 3.3
EUR/USD daily chart showing price channel
Source: Appendix 3.2

07/25/11   07/27/11

CHART 3.4
EUR/USD five minute chart showing breakout
Source: Appendix 3.3

SAMPLE STRATEGY: CHANNEL BREAKOUT

Past performance is not indicative of future results, but the Channel Breakout strategy is quite straightforward and has performed fairly well historically. The system draws a channel surrounding price action, with the top of the channel set at the highest high and the bottom set at the lowest low of the past twenty bars.

In Chart 3.5 below, you can see the top of the channel in light blue and the bottom of the channel in red. The green dotted line shows profitable trades made by the system, while the red dotted line shows losing trades made by the system.

Model Channel Breakout Strategy

Buy when price touches the top channel

Sell when price touches the bottom channel

CHART 3.5
Sample channel breakout strategy illustrating buy and sell signals
Source: Appendix 3.4

Past performance is not indicative of future results

We sell the currency pair if the price breaks below the channel bottom. If price quickly reverses, we will be taken out of the trade at a loss. Yet if price continues lower, we stand to see profits on the continued moves.

Thus we can conceptualize this trade system might work especially well during times of high volatility, when channels tend to be broken. Let's test by looking at how well it has done on the Euro/US Dollar in the past several years.

The channel breakout system did reasonably well overall, and especially well during times of strong market volatility in late 2009. Yet it has also had long stretches of underperformance and noteworthy losing streaks. Since we know that breakout strategies tend to work better during times of higher volatility, how can we instruct our system to trade only during those times?

EUR/USD Channel Breakout Strategy (2005 - 2011)
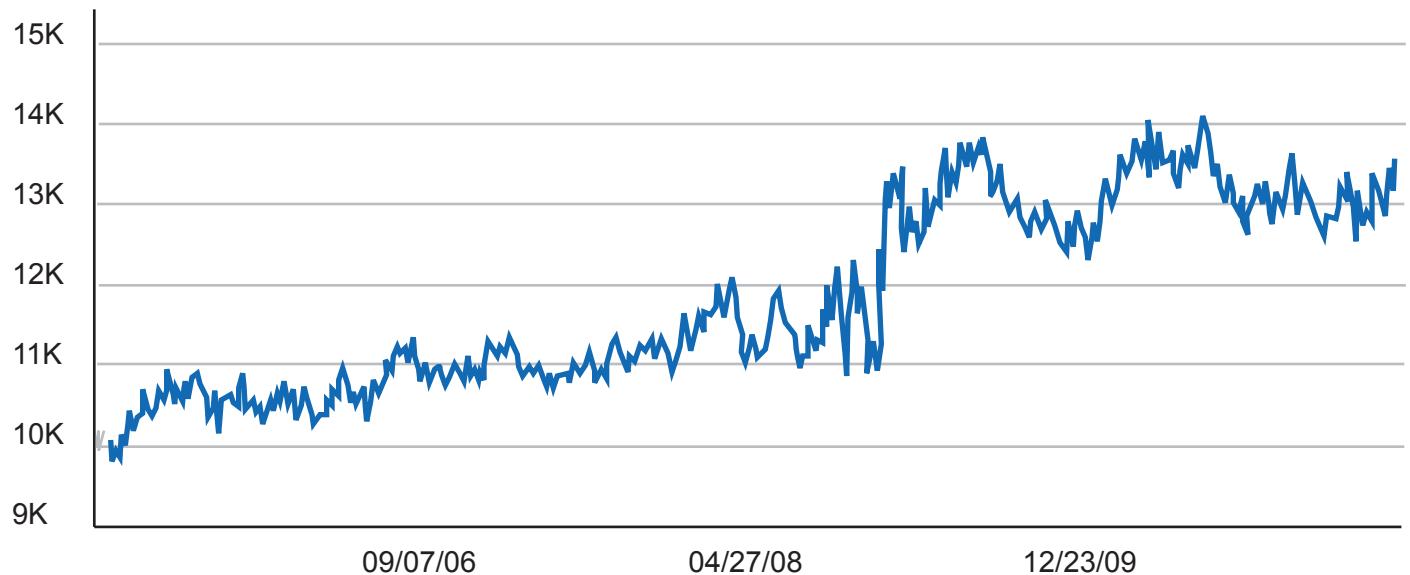
CHART 3.6
Hypothetical returns* from the model channel breakout strategy (2005-2011)
Source: Appendix 3.5

Channel Breakout Strategy Filtered
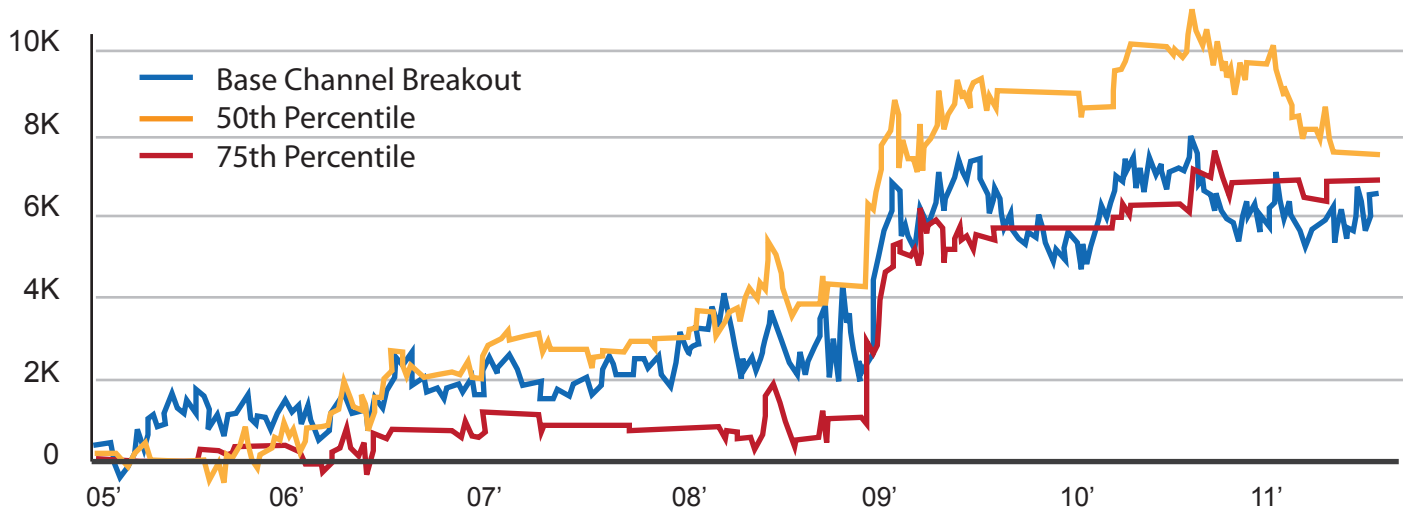
CHART 3.7
Hypothetical returns* using a model channel breakout strategy and volatilty filter
Source: Appendix 3.6

Past performance is not indicative of future results.

WHEN SHOULD I LOOK TO TRADE BREAKOUTS?

Every day, we publish Volatility Percentile figures on the DailyFX Technical Analysis page for reference. The Volatility Percentile is derived from FX options prices. The higher the number, the more volatile options traders expect the currency pair to be. We can use these volatility percentages to judge when it is best to use particular strategies. When volatility percentages are high, we look to trade breakout strategies. When they are low, we look to avoid them.

When looking at the Channel Breakout strategy above, a quick optimization shows that the strategy improves noticeably when we apply filters. We simulate two cases below. In one case, the strategy is only allowed to trade when our Volatility Percentile is above 50%. In the other, it is only allowed to trade when it is above 75%. As you can see in the chart below, in both cases we see better overall results than the "base case" of letting the system trade at any time.

With the 50 percentile filter, the strategy is allowed to trade about half the time. With the 75 percentile filter, the system can only trade about 25% of the time. Over time, the 50 percentile filter has been shown to prevent many of the losing trades in the system, while preventing only a few of the winning trades. This has produced some of the best historical returns on an overall final net-profit basis but has also shown significant losing streaks. Keep in mind that past performance is not indivative of future results.

With the 75 percentile filter, prevents even more trades – both good ones and bad ones. While the overall result over the past six years has not been quite as good as the 50 percentile one, there were few times of significant losses. Indeed, when we fully take risk into consideration, we prefer the 75th percentile filter, as it makes rather fewer losing trades and we are glad to forego some potential profits in order to lower our risk of potential loss.

GAME PLAN:
WHAT STRATEGY SHOULD I USE?

When volatility is above 75%, trade using a breakout strategy.

Our data show that over the sampling period many individual currency traders have generally been unsuccessful trading in times of high volatility. We generally recommend trading European currencies during the "Off Hours" using a range trading strategy, as we found that this approach tends to perform well and best matches how most FXCM clients trade.

Traders who feel the need to trade during times of high volatility should use a different strategy and look to trade breakouts rather than ranges. Breakout trading tends to show the best risk-adjusted returns if limited to the most volatile trading days. Use the DailyFX Volatility Percentage to gauge what FX options traders expect for volatility in the near future. When above 75%, breakouts are significantly more likely than normal.

DailyFX Resources for Successful Breakout trading

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VIDEOS

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ARTICLES

Read How to Trade a Breakout Strategy on the EUR/USD
Read Breakouts: How to Stay Away from Some Losing Trades

LIVE ONLINE CLASSES

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Learn More about the DailyFX PLUS Trading Course

How Much Capital Do I Need to Trade Forex?

Summary: Our research shows that the amount of capital in your trading account can affect your profitability. Traders with at least $5,000 of capital tend to utilize more conservative amounts of leverage†. Traders should look to use effective leverage of 10-to1 or less.

TRAITS OF SUCCESSFUL TRADERS: PART FOUR
How Much Capital Do I Need to Trade Forex?

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Profitability by Account Equity
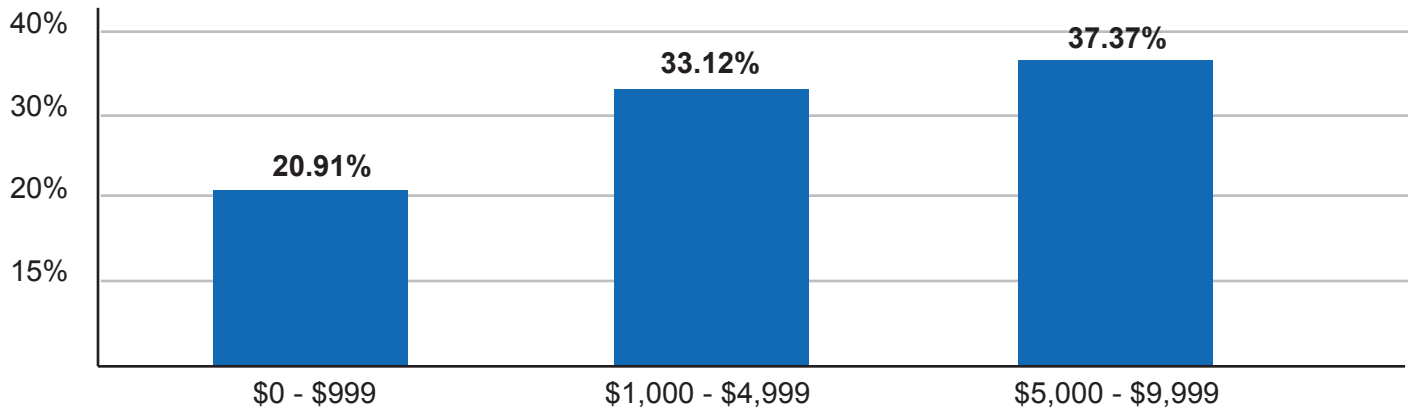
CHART 4.1
Percentage of accounts in the given equity range that were profitable
Source: Appendix 4.1

INTRODUCTION

In looking at the trading records of tens of thousands of FXCM clients, as well as talking with even more traders daily via live webinars, Twitter, and email, it appears that traders enter the Forex market with a desire to cap their potential for losses on their risk based capital. Therefore, many newer traders choose to start trading forex with a small capital base.

What we have found out through the analysis of thousands of trading accounts is that traders with larger account balances tend to be profitable on a higher percentage of trades. We feel this is a result of the "effective" leverage used in the trading account.

A LIKELY CULPRIT

Since many smaller traders are inexperienced in trading forex, they tend to expose their account to significantly higher levels of effective leverage. As a result, this increase in leverage can magnify losses in their trading account.

Profitability & "Effective" Leverage
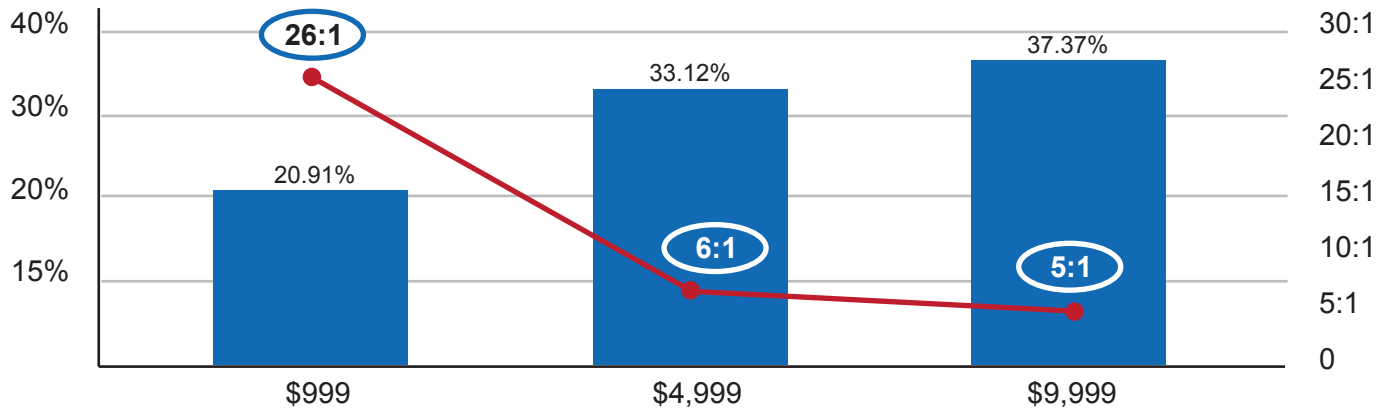
CHART 4.2
Average "effective" leverage given account equity
Source: Appendix 4.1

Emotionally spent, traders then either give up on forex or choose to compound the issue by continuing to trade in relatively high amounts of effective leverage. This becomes a vicious cycle that damages the enthusiasm which attracted the trader to forex.

No matter how good or bad your strategy is, your decision (or non-decision, as the case may be) about effective leverage has direct and powerful effects on the outcomes of your trading. Last year, we published some tests showing the results over time of the same strategy with different leverage.

In Chart 4.2, we have modified 2 elements of the chart in figure 1. First, we renamed each column to represent the highest dollar value that qualified for the given column. For example, the $0-$999 equity range is now being represented as the $999 group. The $1,000 - $4,999 equity range is now being represented as the $4,999 group. And likewise, the $5,000 - $9,999 range is now being represented as the $9,999 group.

The second change made was that we calculated the average trade size of each group and divided it into the maximum possible account balance for that group. In essence, this provided us a conservative and understated effective leverage amount. (A larger balance reduces the effective leverage so the red line on the chart is the lowest and most conservative calculation of the chart.) For example, the average trade size for the $999 group was 26k. If we take the average trade size and divide it by the account equity, the result is the effective leverage used by that group on average.

As the effective leverage dropped significantly from the $999 group to the $4,999 group (red line), the resulting proportion of profitable accounts increased dramatically by 12 basis points (blue bars). Then, as further capital is added to the accounts such that they moved into the $9,999 category, the effective leverage continued to incrementally drop pushing the profitability ratio even higher to 37%.

HOW MUCH EFFECTIVE LEVERAGE SHOULD I USE?

We recommend trading with effective leverage of 10 to 1 or less. We don't know when the market conditions will change causing our strategy to take on losses. Therefore, keep the effective leverage at conservative levels while using a stop loss on all trades. Here is a simple calculation to help you determine a target trade size based on your account equity.

(account equity) X (effective leverage target) = maximum account exposure

EXAMPLE: 10-TO-1 TARGET

Account Equity	Max. Exposure
$5,000	$50,000
$10,000	$100,000
$25,000	$250,000
$100,000	$1,000,000
$1,000,000	$10,000,000

FIGURE 4.1

The above illustration shows a trader's account size and the maximum trade size based on 10 to 1 leverage. That means if you have $10,000 in your account, then never have more than 100,000 of open trades at any one time.

The precise amount of leverage used is decided entirely by each individual trader. You may decide that you are more comfortable using an even lower effective leverage such as 5 to 1 or 3 to 1.

Most professional traders enter into trading opportunities focused on how much capital they stand to lose rather than how much capital they are looking to gain. Nobody knows the future movement of prices so professional traders are confident in their trading approach but conservative in their use of effective leverage.

ADJUSTING EFFECTIVE LEVERAGE TO SUIT YOUR RISK TOLERANCE

Our research indicates that accounts with the smallest capital base (the group labeled $999) have an average trade size of 26k for each trade.

Their effective leverage is at least 26 times which is significantly higher than the 10 times leverage discussed earlier. If these traders want to trade at no more than a 10 to 1 effective leverage, they would need to make at least one of the adjustments noted below.

Increase their trading account equity by depositing more funds to an amount that reduces their effective leverage to less than 10 to 1. So our average trader, who is averaging 26k trade sizes, would need at least $2,600 in their account to trade 26k on a 10 to 1 effective leverage.

Decrease their trade size to a level that reduces their effective leverage to less than 10 to 1. Use the figure 3 calculations and chart above.

In Chart 4.3, notice how the trade size remains relatively stable as the account equity increases from the $999 group to the $4,999 group. In essence, this indicates that traders are looking for, on average, at least $2.60 per pip (if they average 26k

"Effective" Leverage & Account Exposure
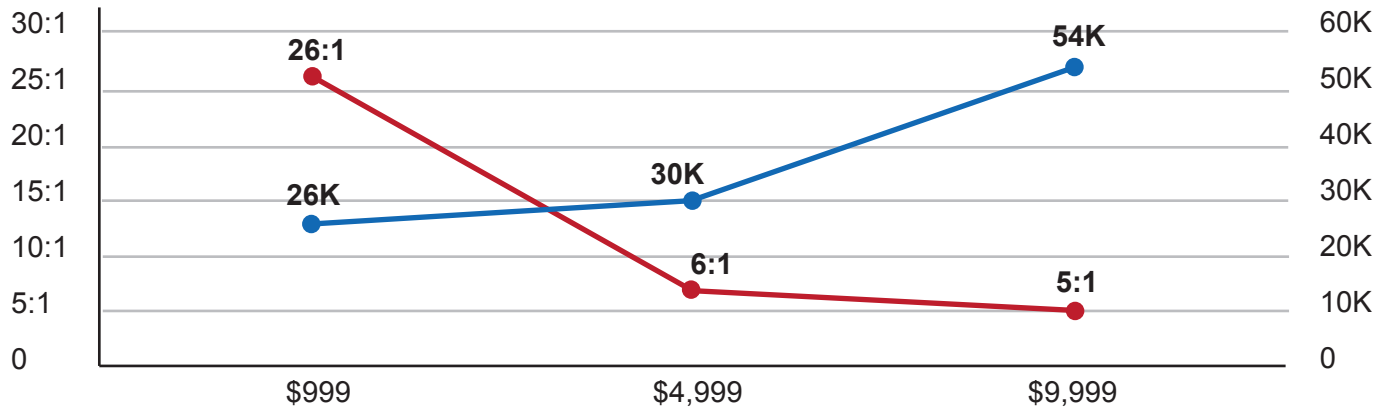
CHART 4.3
Average market exposure and "effective" leverage for the given equity level
Source: Appendix 4.3

for each trade, or $2.60 per pip. Perhaps they want a large enough trade size to make their time invested trading worthwhile. In other words, traders may be seeking a price per pip value and $2.60 is the minimum threshold on average. If these traders were to use no more than 10 to 1 effective leverage, they would need at least $2,600 in their account to support $2.60 per pip.

Another possibility is that many newer traders simply don't understand the power of leverage and how one large losing trade can wipe out several winning trades in a row.

Using a conservative amount of leverage will help slow down the rate of capital losses when a trader goes through a losing streak.

Regardless of the reasons, our goal is to use conservative amounts of leverage. If you know how much risk capital you have available, then use the chart and calculations in Figure 3 to determine the right trade size for your account.

If you have a target "per pip" value, then use the calculations in figure 5 to determine the minimum amount of account capital needed to support your trade size. Increasing your capital base does not mean you will become more profitable. It means that you can stay in a trade longer if it goes against you. On average, traders that use a combination of sufficient capital (at least $5,000) and conservative use of effective leverage (10 to 1 or less) tend to be more profitable.

Leverage is a double-edged sword and can dramatically amplify your profits. It can also just as dramatically amplify your losses.

GAME PLAN:
WHAT STRATEGY SHOULD I USE?

Trade with "effective" leverage of 10:1 or less.

Leverage is a double-edged sword that can dramatically amplify your gains and losses. If you choose to trade with leverage, we recommend that you do not lever your account more than 10 times (10:1). Doing so can greatly decrease your chance of being profitable.

Most professional traders enter into trading opportunities focused on how much capital they stand to lose rather than how much capital they are looking to gain. Nobody knows the future movement of prices so professional traders are confident in their trading approach but conservative in their use of effective leverage.

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Appendix

1.1 - Chart 1.1

Chart 1.1 shows the percentage of trades in the given currency pair that closed with a profit. The data is derived from Forex Capital Markets LLC accounts—excluding managed and Eligible Contract Participant accounts—from 10/01/2009 to 09/30/2010. All data is rounded to the nearest whole number.

1.2 - Chart 1.2

Chart 1.2 shows the average profit and loss per trade in the given currency pair. Profits and losses are shown in pips. The data is derived from Forex Capital Markets LLC accounts—excluding managed and Eligible Contract Participant accounts—from 10/01/2009 to 09/30/2010. All data is rounded to the nearest whole number.

1.3 - Chart 1.3

Chart 1.3 shows the hypothetical returns from a model RSI strategy trading USD/CHF on a 60-minute.

- The blue line is the model strategy's hypothetical returns when stops and limits were not used in this backtest.

- The red line is the model strategy's hypothetical returns when stops and limits were used in this backtest.

The model RSI strategy was designed to mimic a "typical trader" using one of the most common intraday range trading strategies—following RSI on a 15 minute chart.

Entry Rule: When the 14-period RSI crosses above 30, buy at market on the open of the next bar. When RSI crosses below 70, sell at market on the open of the next bar.

Exit Rule: Strategy will exit a trade and flip direction when the opposite signal is triggered.

When adding in the stops and limits, the strategy can close out a trade before a stop or limit is hit, if the RSI indicates that a position should be closed or flipped. When a stop or limit order is triggered, the position is closed and the system waits to open its next position according to the "Entry Rule." Backtests were generated using FXCM's Strategy Trader platform.

1.4 - Chart 1.4

Chart 1.4 uses the same model RSI strategy as described above in appendix 1.3. It shows how the overall profit changes when different risk-to-reward ratios are used.

The stop distance was held constant at 110 pips of risk for every trade that opened. The limit distance was adjusted accordingly for each backtest so that the following risk-to-reward ratios could be achieved: 1-to-0.5; 1-to-1; 1-to-1.5; 1-to-2; 1-to-2.5.

2.1 - Chart 2.1 and Chart 3.1

Chart 2.1 and Chart 3.1 shows the percentage of trades in the given currency pair that closed with a profit. The data is derived from Forex Capital Markets LLC accounts—excluding managed and Eligible Contract Participant accounts—from 10/01/2009 to 09/30/2010. All data is rounded to the nearest whole number.

2.2 - Chart 2.2 and Chart 3.2

Chart 2.2 and Chart 3.2 shows the average hourly range, in pips, for the EUR/USD. All times are displayed in Eastern Time.

2.3 - Chart 2.3 and Chart 2.4

Chart 2.3 shows the hypothetical returns from a model RSI strategy trading EUR/USD 24 hours a day during the sampling period. Chart 2.4 shows the hypothetical returns from the same model strategy. However, in Chart 2.4 no trades were placed from 6AM to 2PM Eastern Time.

The model RSI strategy was designed to mimic a "typical trader" using one of the most common intraday range trading strategies there is—following RSI on a 15 minute chart.

Entry Rule: When the 14-period RSI crosses above 30, buy at market on the open of the next bar. When RSI crosses below 70, sell at market on the open of the next bar.

Filter: Strategy cannot enter trades between the "end hour" and the next "start hour".

Exit Rule: Strategy will exit a trade and flip direction when the opposite signal is triggered. This strategy has worked best over the past 10 years using European currency pairs and setting the start hour to 2 PM and the end hour to 6 AM Eastern Time (New York). Please note, past performance is not indicative of future results. Backtests were generated using FXCM's Strategy Trader platform.

2.4 - Chart 2.5

Chart 2.5 uses the same model RSI strategy as described above in appendix 2.3. However, the strategy trades the EUR/USD, GBP/USD and USD/CHF. Five backtests were performed using different time filters: 1) no time filter; 2) 16:00 - 06:00 ET; 3) 14:00 - 06:00 ET; 4) 20:00 - 03:00 ET; 4) 17:00 - 03:00 ET. The same sampling period was used.

2.5 - Chart 2.6

Chart 2.6 uses the same model RSI strategy as described above in appendix 2.3. However, the strategy trades the USD/JPY, AUD/USD, and NZD/USD. Five backtests were performed using different time filters: 1) no time filter 2) 16:00 - 06:00 ET 3) 14:00 - 06:00 ET 4) 20:00 - 03:00 ET 4) 17:00 - 03:00 ET. The same sampling period was used.

3.1 - Chart 3.2

Chart 2.6 uses the same model RSI strategy as described above in appendix 2.3. However, the strategy trades the USD/JPY, AUD/USD, and NZD/USD. Five backtests were performed using different time filters: 1) no time filter 2) 16:00 - 06:00 ET 3) 14:00 - 06:00 ET 4) 20:00 - 03:00 ET 4) 17:00 - 03:00 ET. The same sampling period was used.

3.2 - Chart 3.3

Chart 3.3 is a daily chart of the EUR/USD from February 2011 to August 2011. It is used to illustrate a price channel.

3.3 - Chart 3.4

Chart 3.4 is a five minute chart of the EUR/USD from 07/25/11 to 07/27/11. It is used to illustrate how an instrument's price can breakout significantly if/when its price moves through a price channel boundary.

3.4 - Chart 3.5

Chart 3.5 is a model channel breakout strategy. For our models, we used one of the most common and simple breakout trading strategies there is, creating channels on a 60 minute chart.

Entry Rule: When price crosses above the highest price of the last 20 bars, buy at market on the open of the next bar. When price crosses below the lowest price of the last 20 bars, sell at market on the open of the next bar.

Filter: Strategy can only enter new trades when the Volatility Percentage is above the specified level (such as the 50% or 75% examples used in Part Three of this series).

Exit Rule: Strategy will exit a trade and flip direction when the opposite signal is triggered.

The EUR/USD this strategy has shown the best risk-adjusted returns in the EUR/USD over the past 6 years when it was restricted to trade only when the Volatility Percentage was above 75%. Past performance is not indicative of future results.

3.5 - Chart 3.6

Chart 3.6 shows the hypothetical returns of the model channel breakout strategy described in appendix 3.4. The EUR/USD pair was traded from 2005 - 2011 using a 60 minute chart. No volatility filters were applied to this backtest.

3.6 - Chart 3.7

Chart 3.7 shows the hypothetical returns of the model channel breakout strategy described in appendix 3.4. The EUR/USD pair was traded from 2005 - 2011 using a 60 minute chart.
Three separate backtests were performed using the following volatility filters: 1) No filter; 2) trades are only entered when the Volatility Percentile is greater than 50%; 3) trades are only entered when the Volatility Percentile is greater than 75%.

4.1 - Chart 4.1

Chart 4.1 shows the percentage of accounts in the given equity range that were profitable at the end of the quarter. The data is derived from Forex Capital Markets LLC accounts—excluding managed and Eligible Contract Participant accounts—from 10/01/2009 to 09/30/2010. All data is rounded to the nearest whole number.

4.2 - Chart 4.2

Chart 4.2 shows the average "effective" leverage used assuming the given equity figure. Effective leverage is calculated by taking the average notional account exposure divided by the given equity figure (i.e. $999, $4,999 or $9,999). The data is derived from Forex Capital Markets LLC accounts—excluding managed and Eligible Contract Participant accounts—from 10/01/2009 to 09/30/2010. All data is rounded to the nearest whole number.

4.3 - Chart 4.3

Chart 4.3 shows the average market exposure and "effective" leverage for the given equity level. The data is derived from Forex Capital Markets LLC accounts—excluding managed and Eligible Contract Participant accounts—from 10/01/2009 to 09/30/2010.
All data is rounded to the nearest whole number.

Disclaimers

High Risk Investment Warning

Trading foreign exchange on margin carries a high level of risk, and may not be suitable for all investors. The high degree of leverage can work against you as well as for you. Before deciding to trade foreign exchange you should carefully consider your investment objectives, level of experience, and risk appetite. The possibility exists that you could sustain a loss of some or all of your initial investment and therefore you should not invest money that you cannot afford to lose. You should be aware of all the risks associated with foreign exchange trading, and seek advice from an independent financial advisor if you have any doubts.

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One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk. Variables such as the ability to adhere to a particular trading program in spite of trading losses as well as maintaining adequate liquidity are material points which can adversely affect actual real trading results.

Past Performance is not indicative of future results.

†Leverage Risk Warning

Leverage is a double-edged sword and can dramatically amplify your profits. It can also just as dramatically amplify your losses. Trading foreign exchange with any level of leverage may not be suitable for all investors.