PART I

The World's Most Dynamic Trading Market

Trading the forex market is one of the most exciting and potentially profitable endeavors that you can undertake. We trade the entire world, matching the world's economies against one another. This market is vast, much larger than any stock or futures market. There is nothing else like it on earth.

The stakes are high; fortunes can be won or lost quickly. In order to succeed in this realm, we must first learn to understand it. . . .

CHAPTER 1

Getting Started in Forex

Call me Ishmael . . .

Just kidding. I'm sure that when anyone is blessed with the task of writing a book, that person secretly (or not so secretly) wishes that it might attain the status of a classic, like Melville's whaling tale.

You may be an experienced trader, or perhaps you're just starting out. Either way, remember: Everyone begins at the same starting point. Every trader who ever made money in any market began as a novice. Nobody is born with a deep, innate understanding of trading.

Maybe you believe that superior intelligence is required to succeed at trading. While being bright is not a disadvantage, it is no guarantee of success. Often, very intelligent traders overanalyze trading situations.

Maybe you believe that a good formal education is required to succeed, but this is not the case. What you are about to learn is not taught in any school. Traders learn through study, through trial and error, and through intense analysis of markets, strategies, and techniques. Most of all, traders learn through experience.

Maybe you believe that you must read every trading book you can find. I've read dozens of books on trading, most of which are not worth your time. Most of the books that I've read contained a kernel of useful information, buried beneath an avalanche of filler. I decided that if I were ever asked to write a book about trading, it would be the antithesis of those books. Instead of performing a sort of "Dance of the Seven Veils," I'd present an abundance of useful information in a way that most people could understand and appreciate.

My feeling is that the material is useless unless it is explained well, and my goal of helping you to succeed is best served by relating the concepts you are about to study to everyday life. This is a big part of my teaching technique, and you'll see it demonstrated repeatedly on these pages.

Perhaps you are wondering, "Where should I begin?"

FROM STOCKS TO FOREX

Like most traders in the United States, my first experiences involved stock trading. My first trade, 100 shares in a NASDAQ biotech stock, yielded a small loss.

I was lucky to have started out during the mid-1990s, during one of the most outstanding bull markets in history. In that environment, as long as a trader went with the trend, it was not too difficult to make money. It was a very forgiving market that would bail out even poor traders. The trick was to understand the difference between being good and merely being lucky. Many traders who I believed were talented began to falter when trading conditions became less than ideal. I realized that, like them, I had been a lucky trader, and that luck was transitory. I didn't want to be lucky; I wanted to become a good trader, one who could make money in any market environment. I wanted to work on Wall Street.

GETTING TO WALL STREET

After sending out dozens of resumes, I was interviewed and hired by a Wall Street firm as a trader. The fact that I didn't live in New York at the time was a minor detail, and soon I was getting up at around 4:00 A.M. to begin the trek to work.

I would exit my train beneath the World Trade Center, meet up with some coworkers for coffee, and grab copies of the *Wall Street Journal* and the *Investors Business Daily*. Once in the office, we would review dozens of charts, discuss recent market tendencies, study economic indicators—in short, we would do everything possible to prepare for the all-out war that would begin every day at 9:30 A.M.

Spending time in the Wall Street environment is an invaluable and irreplaceable experience. There were so many intelligent, driven people, with so much creative energy that you could feel it in the air like static electricity. We lived and breathed trading 24 hours per day, and learned concepts that changed the way we thought about the markets and trading, as well as the world in general. Much of what I learned in this environment would translate well to other trading markets, such as forex, and would become the basis for much of the material in this book.

Eventually, I was lured away by another firm and began working on another trading desk in Manhattan. I moved to New York City, shortening my daily commute from two hours each way to two blocks.

The new trading room was vast, with hundreds of desks and terminals. Having so many traders together, without walls or barriers to separate them, would facilitate the exchange of knowledge and information.

I sought out the best traders and questioned them relentlessly, absorbing and applying the information as quickly as possible. I was introduced to concepts that went far beyond anything I had seen earlier, and the pieces of the puzzle began to fall into place. I began to achieve a level of consistency that had been missing from my earlier trading, which had been profitable but erratic.

WELCOME TO THE JUNGLE

I also learned the disadvantages of trading in this environment, as there were too many people in the room expressing too many ideas and opinions. Essentially, it was a huge room full of ambitious and highly competitive alpha males. Some of the traders had egos that were out of control, and couldn't help but loudly express every mundane thought that rattled around their skulls. Others would merely express anger and frustration; the distinctive sound of a computer keyboard being smashed, along with the odd tinkling sound of letter keys flying through the air, is etched into my memory.

Jealousy reared its ugly head, as losing traders sought to distract and disrupt the winners. One trader took particular glee in trying to break my concentration, because he felt that my results were making him "look bad." If he had put as much effort into improving his own trading as he did into disrupting mine, he might have succeeded. He later left the firm to take a sales position.

Eventually, the market reached a point where the easy money had already been made. One by one, the marginal traders began to disappear. The market environment was changing, and traders would have to adapt to the changes or face failure.

FOOTBALL AND FOREX

One of the many benefits of living and working in New York City is exposure to people and cultures from around the world. One of the "new" concepts (at least it was new to me) to which I was exposed at this time was the currency market.

It was shocking to learn that foreign exchange trading, or forex, was tremendously popular in the rest of the world, and had been for many years. For most of the world, the forex market, not the stock market, is the market to trade. You could compare forex to football, which is the world's most popular sport—except in the United States, where it is considerably less popular and is referred to as "soccer." Here was a trading market that enjoyed wide popularity overseas, yet at the time it was "off the radar" in the United States.

A trader friend told me that he had decided to quit stock trading and instead switch to currencies, and that my style of trading would be perfectly suited to this new endeavor. I laughed, not knowing that soon I would make a similar move. Why on earth would I ever want to give up trading stocks?

STOCK MARKET HEADACHES

In life, there are certain unpleasantries with which we must learn to deal. We have to go to school, pay our bills, watch our weight, and so on. We accept these unpleasantries with thoughts such as "deal with it" or "that's life." After a while, we no longer think of these things as a burden; instead, they become the norm.

For equity traders, there are many unpleasant situations that are considered to be normal, just "part of the game." Stock traders don't think twice about these situations, because they are an ingrained part of their daily lives.

Partial Fills

For example, the "partial fill" is a normal occurrence in stock trading. A partial fill occurs when a trader places an order for a certain number of shares, let's say for 2,000 shares of stock, and instead receives only a portion of the order, for example, 300 shares. This happens all the time; the most logical explanation is that perhaps there were only 300 shares available at that particular price.

In trading terminology, we say that the market is too "thin" to absorb the entire order, meaning that there are not enough shares available at that price. This can be really frustrating, especially if the trader wants to enter large orders, but it is something that equity traders accept as normal, just another hurdle to overcome on the road to success.

The forex market, however, is highly liquid or "thick." Partial fills are extremely rare for all but the biggest traders.

Slippage

"Slippage" is another problem that stock and futures traders must deal with every day. Slippage is defined as "the difference between estimated transaction costs and the amount actually paid."

For example, suppose you purchased 1,000 shares of stock XYZ at a price of $50 per share. In order to protect yourself in the event that the price moves against you, you place a protective "stop" order (an order to sell) at $49. So your worst-case scenario is that you'll lose $1 per share, which in this case equals $1,000, right?

Wrong. If the price falls below $49 without touching the *exact price* of $49 (remember, stock markets are "thin" compared to forex), one of two things will happen. Either your order will not be executed at all, or it will be executed at a price *in the vicinity* of $49. Amazingly, the executed price is almost always less favorable than the price you desired! Slippage cuts into a trader's profits and is a major headache for stock and futures traders.

Slippage is rare in the currency market. Many forex market makers have a "no slippage" policy, giving currency traders a greater degree of price certainty.

The Specialist

Another hurdle to successful professional stock trading is the specialist. The specialist is a single individual who literally controls all of the trading activity of a listed stock. Early in my Wall Street career, I had an unforgettable trading experience that featured the specialist of a once high-flying stock that has since crashed in disgrace and scandal.

One day while trading shares listed on the New York Stock Exchange, I was long (meaning that I purchased shares in anticipation that the price would rise) 4,000 shares of stock, and the price began to fall toward my protective stop. Subsequently, the price reached my stop, and I took a small loss on my 4,000 shares. *Or so I thought. . . .*

Imagine my surprise when I looked at the computer screen to see that the stock was continuing its rapid descent, and I was still the unhappy owner of 3,900 shares. This was the day I learned that the specialist has the discretion to give a partial fill on a stop order.

Apparently, the specialist decided that the price was likely to continue falling (bad news about the company had just hit the newswire, obviously not for the last time), so he or she only filled my order by the minimum amount required (just 100 shares), leaving yours truly in a rather painful position.

There are no specialists in the forex market.

The Spread

In the stock market, the specialist also controls the spread (the difference between the buy and sell prices), and can widen or narrow the spread at his or her discretion. Since the specialist is trading against you, he can make your life miserable by widening the spread just as you are trying to exit a profitable trade. Gee, thanks, Mr. Specialist!

> In the forex market, the spread is often "fixed," allowing the trader a greater degree of certainty.

The "Uptick Rule"

Yet another frustrating roadblock to the success of equity traders is the "uptick rule." Stock traders can "go long" (place a trade that will become profitable if the stock rises) whenever they wish, but in order to "sell short" (place a trade that will become profitable if the stock falls), equity traders must go through a series of machinations that can prove both maddening and costly.

This rule requires that every short sale transaction be entered at a price that is at least equal to, or higher than, the price of the previous trade. The uptick rule prevents short sellers from adding to the downward momentum when the price of a stock is already experiencing a sharp decline. The problem this presents for the trader is that an opportunity to sell a stock short is often missed, because the stock was ticking down at the time, making it ineligible for a short sale.

In order to circumvent this rule, professional equity traders use various hybrid instruments known as *bullets*, *conversions*, or *married puts*. These instruments accomplish their intended task, but they are not always available, and they are not free. There is a cost involved—one of many that eats into the profits of equity traders.

There is no uptick rule in the forex market. You can buy or sell at will. There is no need to purchase bullets, conversions, or married puts.

WELCOME TO FOREX

While these impediments make stock trading more difficult than many of us would like, some good traders can and do overcome these hurdles. Yet I often hear stock traders complaining about how the specialist ruined their trade (in language that would scorch your ears), or how they've been "slipped" out of their profits, or that they placed a perfect entry, only to be foiled by a partial fill, or that they missed an opportunity to sell short because of the uptick rule.

What if these hurdles didn't exist? What if they were removed from the playing field, so that traders could relax and stop worrying, and instead get on with the business at hand? What if traders could just *trade? What would that be like?*

I was about to find out. One day after the closing bell, I had a few drinks with a trader friend who had quit the stock market to focus solely on the forex market. The conversation went something like this:

> *"It's called forex, short for foreign exchange. I just grab on to the trend and ride it for all it's worth."*
>
> *"Haven't I seen that on TV? Something about green and red arrows?"*
>
> *"Don't be a rube. When was the last time you saw someone on a trading floor looking at green and red arrows?"*
>
> *"Okay, I get it. So what's so special about forex?"*
>
> *"Ed, you've got to try this market! It's huge, it's liquid, and it's open for business 24 hours per day. You've never seen anything like it!"*
>
> *"That's what I'm afraid of. I'm pretty happy right now trading stocks, so why would I want to switch to forex?"*
>
> *"Because it's liquid! I can always get in, I can always get out, and I never get a partial fill."*
>
> *"You never get a partial fill? Yeah, right."*
>
> *"It hasn't happened yet. And I haven't been slipped yet either. My fills are always at the exact price where I place the order."*
>
> *"You're lying! Where are you trading, in Disneyland?"*
>
> *"You have no concept of how liquid this market is. It hardly ever gaps!"*
>
> *"Okay, but how does it trade? Is it random, or does it trend?"*
>
> *"That's the best part! The trends go on and on!"*
>
> *"Kind of like you?"*
>
> *"Very funny. If you don't believe me, open up a practice account and see for yourself."*
>
> *"What are you talking about?"*

"They have these practice accounts. You can trade real time, on their price feed, without any risk. It's a great way to get a feel for this market. It's free!"

"So I go to their office and trade their practice account while they try to sell me stuff, right? Sounds like a nightmare."

"No, genius, you trade the practice account from your home. You download it to your computer."

"Hmmm. No more tantrums. No more chair throwing. No more letter keys flying past my head while I try to decide if I should raise my stop. Maybe I'll give this market a shot."

A NEW BEGINNING

And so the journey began. As much as I used to enjoy trading stocks, I don't miss the headaches. It took a while to get used to the "feel" of the forex market, as it trades very differently from the way stocks trade. At first, I tried to trade forex the same exact way that I traded stocks, and for a few months I lost money. Once I adjusted to the different speed of the forex market, things eventually fell into place. You see, individual stocks move like jackrabbits—one moment they are standing still and the next moment they are zigzagging and flying around.

The forex market is huge compared to the stock market, so it takes a while longer for it to get moving. Once a currency pair does begin to move, it can continue moving in one direction for an incredibly long time.

The good news was that much of what I already knew about stock trading was transferable to the forex market. A chart was still a chart, and a trend was still a trend. The important concepts of risk management that I had learned from working on the equity desks in New York were still applicable.

At first, trading the forex market felt like visiting a foreign country. I was worried that it would feel as if I were visiting a distant planet. The difference in the market's reactions to economic news was startling. I was coming from an environment where traders had mere split seconds to react to news events. When trading stocks during a news release, if you don't get in right away, you are not likely to get in at all.

In the forex market, at first it almost seemed as if I had *too much* time to react to news and events. I actually had time to think about what was happening and to analyze the data. Better still, the forex market's reactions to news events usually made sense. As a certifiable "news junkie," it seemed that I had found the perfect trading vehicle.

It was almost too good to be true. It was a strange new market, yet something about it seemed so familiar. . . .