Beginners Guide to Forex

This Beginners Guide to Forex is not theory or some feel-good claptrap. What makes it different is that it's been written by real traders.

Our aim is to share with you lessons from our years of real-life experience and provide a framework for making money out of forex.

We can't possibly cover every aspect of forex trading, but we have included the things we think are important, namely:

- What to trade and when
- A simple yet effective winning strategy
- Two easy ways to protect your profits
- Four common mistakes made by beginners
- How to avoid forex frauds and scams

A brief introduction to forex

The forex market is the largest market in the world.

It's estimated that around $4 trillion is traded on forex markets every single day. It's impossible to appreciate how big that number is. But put it this way: that's greater than the turnover of all of the world's stock and bond markets combined.

The US Dollar is the most traded currency in the world. It's estimated to be involved in around 90% of all currency trades.

Even though the Dollar is the dominant currency, London is the dominant financial centre for forex trading, with around 37% of the global market. New York is a distant second, with around 17% of the market.

Forex is not a new business and its history is as old as the history of money. But forex markets have grown rapidly in recent years. In fact, trading volumes have more than doubled since 2004.

The increase in popularity has been due to a number of factors: the growing importance of foreign exchange as an asset class, the increased trading activity of high-frequency traders, and the emergence of private investors as an important market segment.

The main advantages of forex trading are:

- 24-hour trading, 6 days a week
- Zero commissions
- Enormous liquidity means tight dealing spreads
- Leveraged trading with low margin requirements
- The ability to profit in rising or falling markets

The forex market is the only financial market in the world that is truly open 24 hours a day, 6 days a week. As one market goes to sleep, another one opens. Trading starts in New Zealand followed by Sydney, and moves around the world to Tokyo, London and New York.

The sheer size of the forex markets keeps dealing costs very low.

Forex trading is typically commission free. And the high volumes of trading (called 'liquidity') means dealing spreads (the difference between the buy and sell price) are tiny. How tiny? In forex markets, we're talking as small as 1/100th of 1%.

Forex is also normally traded on 'margin', meaning you only need to put down a fraction of your actual trade size. Because of the huge liquidity of the forex markets, the typical deposit or 'margin requirement' is only 1%. In other words, with a deposit of £1,000 you can place a £100,000 trade.

You can make a lot of money by spending a small amount of money. Of course, leverage magnifies both profits and losses. It amplifies your results.

A key feature of forex trading is that it's always done in 'pairs'. Every forex trade consists of two currencies. You are effectively buying one currency and simultaneously selling another - you exchange one for the other. That's why the rate at which they are traded is called the exchange rate.

The first currency in a pair is referred to as the "base currency" and the second is called the "quote currency".

Most currency pairs are priced out to four places past the decimal point. When the very last number moves up or down by one increment, that's called a 'pip'. A pip is the smallest price change that an exchange rate can make. On an average day, a major currency pair moves between 100 and 200 pips.

How to make money from forex

To make money from forex trading you buy a currency you expect to increase in value relative to the currency you are selling.

Note it's the relative performance of a currency that matters. That means even during a global recession when stock markets and property prices are plunging, some currencies go up while others go down.

Access to forex markets is easier than ever. Most people trade through an online platform, allowing trades to be placed and managed from anywhere in the world that has internet access.

What to trade and when

Which currency pairs to trade?

When you first login to your forex trading account you'll see a wide range of different currency pairs available to trade.

Broadly speaking, currency pairs fall into three main categories:

Majors
There are six 'major' currency pairs. Each has its own nickname too.

1. EUR/USD ("Euro")
2. GBP/USD ("Cable")
3. USD/JPY ("Yen")
4. USD/CHF ("Swisse")
5. AUD/USD ("Aussie")
6. USD/CAD ("Loonie")

EUR/USD is the world's most traded currency pair accounting for more than a quarter of all forex trades, closely followed by USD/JPY and GBP/USD.

Crosses
The 'crosses' are those currencies that are not paired against the US Dollar. There's typically a list of well over 20 crosses to choose from. The most popular ones are GBP/JPY, EUR/AUD, and EUR/GBP.

Exotics
The 'exotics' are those pairs that include a currency from a developing or emerging economy. The most common exotic pairs are:

- USD/TRY – US Dollar v Turkish Lira
- USD/ZAR – US Dollar v South African Rand
- USD/MXN – US Dollar v Mexican Peso
- USD/SGD – US Dollar v Singapore Dollar

Exotic currency pairs tend to be much less liquid and therefore more volatile than the majors or crosses.

They also tend to have a much higher 'spread' (the difference between the buy and sell price) which makes them more expensive to trade.

We would recommend as a beginner that you stick to trading the majors and a small selection of crosses.

This ensures that your trading costs are minimised and your ability to exit positions isn't compromised.

When is the best time to trade forex currency pairs?

Before you place a trade, it's important to decide on your trading timeframe and also understand when to place your trade.

The forex market doesn't sleep.

The 24-hour nature of the forex market means traders have the opportunity to place trades at any time of day or night. You can't buy shares in Barclays after 4.30pm but you can buy EUR/USD at midnight if you want!

Whilst this flexibility is a huge advantage, it does mean that your open trading positions will be moving whilst you're tucked up in bed. For this reason we always recommend using a stop-loss when trading forex (see preserving your capital).

Trading volumes are at their highest during European and US trading hours, whereas Asian trading is generally much quieter. In fact, forex trading volumes hit their peak during the crossover period of the UK and US trading sessions – this is from 2.30pm to 4.30pm British time. So technically, it's best to place a new forex trade during this 'crossover' period.

However, different currency pairs are more likely to move during certain times of the day.

For example, EUR/GBP will experience its greatest movement during the European session. Whereas AUD/USD can regularly experience large moves overnight during Australian market hours.

This isn't to say that you shouldn't be trading pairs that are likely to move overnight. You just have to be adequately equipped to trade them.

When trading a currency pair that is likely to be volatile during the Asian session we recommend placing a limit order along with your stop-loss.

A limit order is essentially an order to close your position when it reaches a certain level of profit. So placing a limit order will ensure that if the market moves heavily in your favour overnight, your position will be closed and your profits will be taken.

In some instances, you will literally be making money while you sleep!

A simple yet effective winning strategy

Okay, so you've decided on which currency pairs you feel comfortable trading and when you want to trade them, now what do you do?

The majority of beginners will be so eager to trade that they will simply rush into opening a position based on last night's news. In our view, this is the fastest way to lose your money.

Consistently profitable traders have a strategy and we're going to share a simple yet effective trading strategy to get you started.

This strategy is based on technical analysis, which is the study of price behaviour as opposed to fundamental analysis, which looks at the underlying political and economic factors which move currencies.

The 'wave rider' strategy
It's called 'wave rider' because it's a lot like surfing. Surfing actually has a lot of parallels to trading.

A surfer lies ready on his board and waits for a wave to come along. When the wave starts to form, he paddles in the direction of wave. A surfer then rides the wave as long as possible. The surfer hops off when the wave runs out of momentum.

A trader waits for a trade set-up (visible pattern) to come along. He then takes a position in the direction of the trend and rides that trend. When the momentum of the trend starts to fizzle out, the trader closes the position.

A decent surfer knows there's no point trying to catch a wave too early, because it needs to build up enough energy to carry you along. Nor can he try and surf every wave, just the ones that look easy to catch and worth the effort. If he misses a wave, another one will come along soon.

The ocean is powerful. Don't fight it. Go with it. The forex markets are just as powerful. So go with the flow.

The flow of water is like the flow of money.

In order to understand the flow of money we follow the 'price action'. Thanks to modern day technology, the price action can be easily observed on a price chart. Charts are the lifeblood of forex traders. And every chart tells a story.

There are two steps to the 'wave rider' strategy:

1. Swim with the tide

This is the very important.

With governments and banks moving the market day and night, our job is to ride the waves of money flowing in and out of different currencies pairs.

The best way to do this is by trading in line with the dominant trend.

'Trading with the trend' sounds very simple, but you will be amazed how many traders fail to adequately establish the 'dominant' trend before entering a trade.

Simply put, an uptrend is a series of 'higher highs' and 'higher lows' and a downtrend is a series of 'lower highs' and 'lower lows'.

Perfect uptrend:

Perfect downtrend:

The key to successfully identifying the dominant trend in the market is to use **multiple-timeframe analysis.**

Multiple-timeframe analysis is the process of viewing the same currency pair over different time frames in order to gain 'perspective' on the current trend. The larger your time frame, the greater your perspective.

Under this strategy, you should only trade when the trend on the 3-month daily candle chart is the same as the trend on the 1 year weekly candle chart.

2. Momentum makes you money

Once you've established the dominant trend, you need to 'refine' your entry level by entering the market at 'peak momentum'.

Momentum is the 'speed' of price movement in one direction. The greater the momentum, the higher the probability of a continuation in the same direction.

This strategy uses two moving averages to identify short-term momentum – the 8 and 21 day exponential moving averages (EMAs).

EMA's are more responsive to the most recent price action therefore give a better indication of current price momentum.

When the 8 day EMA crosses above the 21 day EMA, momentum is bullish. This means that the odds of further price rises are tipped in your favour and if the dominant market trend is up (bullish) you should enter a long position.

Close your position when the price closes below the 21 day EMA.

Example pic:

By contrast, when the 8 day EMA crosses below the 21 day EMA, momentum is turning bearish. This means that the odds of further price rises are tipped in your favour and if the dominant market trend is down (bearish) you should enter a short position.

Close your position when the price closes above the 21 day EMA.

Example pic:

Strategy Summary:
BUY when the 8 day EMA crosses above the 21 day EMA and the 'dominant' trend is bullish.

SELL when the 8 day EMA crosses below the 21 day EMA and the 'dominant' trend is bearish.

This basic trading strategy illustrates the importance of trading in line with the dominant trend and current momentum.

Trade entry and exit levels can be optimised by using powerful price patterns and additional technical indicators but this falls outside the scope of this guide.

Two easy ways to protect your profits

Whatever trading strategy you chose, without any risk management you will struggle to be consistently profitable.

The key to successful trading is to consistently apply your trading strategy over the long-term. To keep trading long-term, it's essential for you to protect your capital.

Here's two easy ways to 'stay in the game'.

1. Use a stop-loss

As we've established, when you place a live forex trade you become part of the world's biggest, most liquid market.

Forex trades have the potential to move very quickly both for and against you, so the first step in preserving your capital should be to always use a stop-loss.

A stop-loss order helps to manage risk by ensuring that your live trading position is closed if the market moves too far against you. Stop-losses are freely available on all trading platforms.

2. Position size relative to your account size

Position size is rarely discussed, but it's very important.

Trading too small is not normally a problem. Trading too big can be.

There's always a temptation to 'bet the ranch' on one trade. But when it comes to trading 'greed kills'.

Firstly, big positions can make trading too emotional – something you want to avoid. If a trade needs to work, it's too big for your account.

Secondly, if you risk too much per trade, you risk being wiped out by a bad run of losses.

The best way to think about position size it is to calculate how many losses in a row it would take to wipe you out.

If you risk 10% of your money on every trade, it would take 10 losers in a row to wipe you out.

If you risk 5%, then that equates to 20 back-to-back losers.

Don't forget that using a stop-loss order substantially reduces your money at risk. Say you have £10,000 in total. You decide to do £1,000 trades using a 10% stop-loss on each trade. That means you are only risking £100 per trade, which is 1% of your total money.

There are no hard and fast rules on how much money to risk per trade. Position size is a trade-off between keeping risk low enough to survive a bad run but keeping the reward big enough to get a decent return on your capital.

The answer is a function of your risk tolerance and the consistency of your trading approach. Don't forget you can always start small and trade bigger when you gain more experience and confidence.

Four common mistakes made by beginners

As a trader, success comes from two things: making big profits and avoiding costly mistakes.

Many a portfolio has been ruined by just a small number of really bad trades.

We will now look at four of the most common and costly mistakes made by forex traders – both new and old.

1. Failing to cut your losses

It's a cliché, but "cut your losses" will always be the central rule for effective money management.

The problem is that human nature is programmed to seek pleasure and avoid pain. It's a survival mechanism that keeps our species from extinction.

In terms of financial markets, profits give us pleasure and losses give us pain.

That means that we "naturally" avoid taking losses. No one enjoys taking a loss. No one likes admitting they are wrong.

But the truth is a big loss can quickly undo months or years of your hard work.

The world's best traders know that to succeed at trading, you have to overcome your natural tendency to avoid taking a loss. That doesn't mean you have to like them, but you have to accept them.

Paul Tudor Jones is one of the world's most successful hedge fund managers. He's been trading for 35 years and Forbes lists his wealth at over $3 billion, so he knows a thing or two about making money from trading the markets. Here's what he has to say on the subject:

"If I have positions going against me, I get right out; if they are going for me, I keep them... Risk control is the most important thing in trading. If you have a losing position that is making you uncomfortable, the solution is very simple: Get out, because you can always get back in."

There's a simple way to avoid this mistake: Place a stop every time you make a trade.

2. Adding to a losing trade

Adding to a losing trade or "averaging down" as it's sometimes called, is equivalent to not admitting your mistakes.

As we've discussed earlier, successful traders are brave enough to cut their losses. Adding to a losing trade is doing the exact opposite of this (throwing fuel on the fire).

Sure, sometimes a trade might hit your stop-loss and then turn around and go back up. That can be very frustrating, but that doesn't mean you should abandon money management.

Adding to a losing trade effectively ties up more and more of your money in the trades that aren't working. It's putting added pressure on the weakest part of your portfolio. This could back you into a corner, shutting you off from reason or clear thinking. Your trading will become paralysed by emotion rather than logic.

Adding to a losing trade is the most direct road to ruin that we know of.

3. Focusing on the news not the price

Successful forex traders don't watch business channels all day long. Watching TV is more likely to confuse, scare or mislead you.

To find out what's going on at any time, just watch the price. The market tells you when to be bullish or bearish, not the media.

Here's a key lesson: The price leads the news, not the other way around. Most days, the media is simply reacting to market movements. If it's an up day, then good news is reported. If it's a down day, then bad news is reported. The truth is on any given day there is good news and bad news, but chances are you are only hearing the news that fits the market move for that day.

Always keep in mind: news doesn't make major trends, news comes from the trends.

4. Not learning from your mistakes

As the saying goes "Those who don't remember the past are doomed to repeat it."

Admitting mistakes is difficult. It's a lot easier to blame something else. But you can only learn from a mistake after you admit you've made it.

Most people give up on their goals because they're not prepared for the mistakes and setbacks they'll face on their way to what they want.

The larger your ambitions, the more dependent you will be on your ability to overcome and learn from your mistakes.

Most costly mistakes don't stem from a lack of knowledge but from a lack of discipline.

Understanding what and why you made a mistake will help you avoid repeating it again. Brushing it under the carpet will not.

It doesn't mean you will never make a mistake again. None of us perfect. But avoiding major pitfalls will help you achieve what you set out to do - to make money.

How to avoid forex frauds and scams

Today, forex trading is firmly established as a major asset class.

Unfortunately, there are a number of bogus companies profiting from forex-related frauds and scams.

Although this is troubling, most frauds and scams are easy to avoid when investors do a little bit of due diligence.

Here's two simple checks to carry out:

Who are you dealing with?

It's important to deal with a reputable firm.

These days it's easy for a company to give the appearance that they are legitimate. For example, it's not difficult to build a flashy website, buy a UK domain name (ending in .co.uk) or redirect a local phone number to an untraceable offshore location.

But a serious company will be authorised and regulated by their local financial authority. In the UK, that's the Financial Services Authority (FSA).

Every regulated firm will be granted a licence number. This licence number can be entered into the FSA Register, which is available for free online. It allows you to cross-check that a firm are who they claim to be.

To become authorised in the first place, a firm must have an approved product and sufficient capital. Also background checks are run on the people and their qualifications – which is a key control.

Once regulated, a firm needs to submit regular information to the FSA and comply with a wide range of rules covering their dealings with customers, information systems, promotional material and financial position.

Frauds and scams won't want to go down the regulated path for obvious reasons.

Is the product credible?

Over the last few years there's been an explosion in the number of automated trading systems – known as 'forex robots'.

You know the ones - you download the software onto your computer and after a few blinks and flashes it spits out a trade signal. Most are useless, many are scams.

Don't get me wrong – the companies that promote these products are masters of seduction. The marketing message is powerful and cleverly appeals to the masses.

But if you know what to look out for, you can spot them a mile off.

The first giveaway is their website is typically full of flashy graphics and outrageous claims. Look out for the pictures of bags or bundles of cash.

The second giveaway is that scams usually focus on customer desires rather than the product itself. The most commonly used image is a relaxed looking guy sat somewhere with a laptop. In the background there's usually a water shot of some sort (pool, river, ocean). For some reason, he often has a glass of orange juice nearby. I assume this is a subliminal message about being alert and healthy.

The third giveaway is they go on and on about how once you buy this product you will be able to tell your boss to stick it. No more Monday morning blues. Leaving the rat race behind. Having all the things you've ever wanted: round the world cruises, exclusive golf memberships, the big yacht. There's nothing wrong with having dreams. But a shoddy product won't make them come true.

The fact is most of these mechanical models end up falling apart in the future. You not only lose the money you paid for the system, you lose your capital too – often enough to wipe novice traders out.

Beneath the surface these automated systems are effectively blind, meaning their 'static code' can't adjust to changing market conditions (and markets always change).

So how can their track record be so good?

Some computer programmer has just back-tested a period in the forex markets and 'optimised' the results. For a half-decent programmer, it's not even hard to do.

After gathering the raw data from the forex markets, a programmer finds the best combination of indicators and parameters until the system performs its best. It's just hindsight trading.

That's why these automated systems have no place in real world trading.

You can't expect to make the same profitable trade tomorrow as you did today, because each day in the market is different. These systems don't and won't adapt.

Getting started

When we first started forex trading we were just like you - a little lost with all the choices available. We weren't sure where to turn. Every broker says they offer competitive pip spreads. Every training course claims to be the most in-depth. Every forex system claims to be able to make you money.

Hopefully, we've helped highlight the sorts of things you should consider.

If you want to go it alone, then reading some good trading books is not a bad way to build your knowledge. It will be more informative and a lot cheaper than an over-hyped and over-priced crash course.

Another way to learn to trade profitably is to tap into the knowledge of experts with proven track records. It could also help you avoid costly mistakes, saving you thousands of pounds in the process.

At Faraday, we have our own forex product. It's called FX Daily. As the name suggests, we provide our member's with daily trade recommendations in the forex markets. Our recommendations are underpinned by a team of professional analysts.

It's a genuine product with a solid track record. Our members range from beginners right through to advanced traders – so we're doing something right. And you get the peace of mind from knowing that our firm is fully regulated by the FSA.

I hope you found this Beginners Guide to Forex useful. Thanks for reading and good luck with your trading.

How to contact us

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