PRICE ACTION TRADING

FOR FOREX TRADERS

TOM KANCHESKY

Contents

Introduction

In this book, I'm going to cover the most important aspects for successfully trading the forex market. First we'll talk about the basics of the forex market, so you get a solid understanding.

Then, we will cover my favorite high-probability price action setup for trading forex.

After that, we will discuss the importance of money management and the right trading psychology.

Sounds exciting? Let's begin.

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Chapter 1 - Basics Of The Forex Market

Although my intention here isn't necessarily to write about the basics of Forex, it's such an important element that I decided to start here.

Too many traders today look at the world of Forex, they see dollar figures and possibilities, and they just want to start trading.

But without a clear understanding of what Forex is, how to trade it, and other simple things like how to calculate pip-values and profits, that trader is almost guaranteed to fail.

Since a firm grounding of the basics of Forex is so important that is where we will start.

GETTING STARTED

The term FOREX refers to foreign exchange, and more specifically it refers to the huge trading realm that now surrounds the currency exchange marketplace. To trade Forex means to buy/sell one currency against another with the intention of profiting on the difference in the exchange rate over a given period of time.

At this point in time, Forex is one of the largest trading vehicles in the world. To clarify this, the average trading volume of all the world's stock exchanges combined is about 167 billion US dollars each day. As of 2007 the average volumes of the currency exchange markets exceed 3.2 trillion US dollar each day.

In other words, Forex is huge, and the growth of Forex is expected to continue for years to come. As a trading vehicle it is one of the easiest markets to get into. And, if you take the time to learn what you're doing, it can be one of the most profitable.

All you need to get started in trading currencies is a Forex broker, and the software they use to allow you to trade. With a broker's software installed you are then able to instantly connect to that broker and make trades in real-time.

CURRENCY PAIRS

Currency is always quoted and traded in pairs. That is, you are buying or selling one currency against another, and the money you earn/lose is based on the exchange rate between those two currencies.

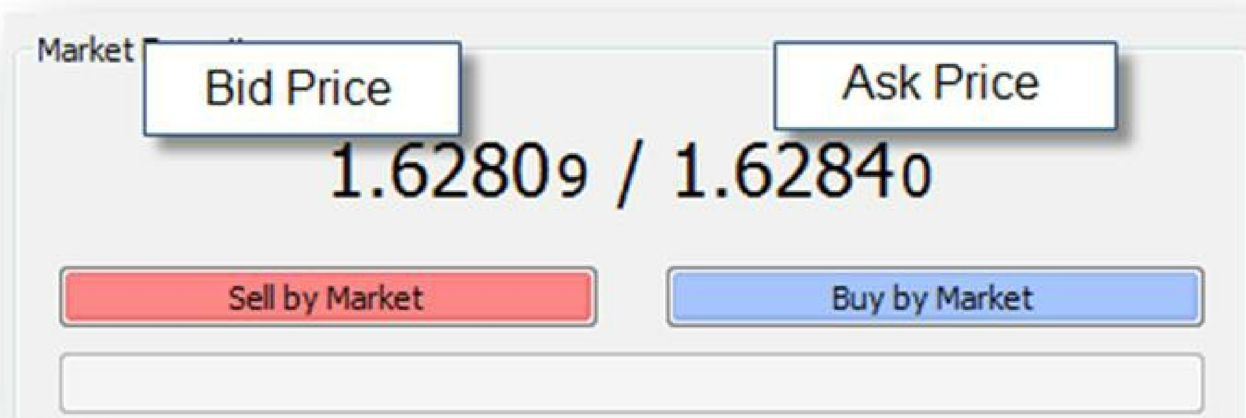
Some common currencies include USD/CHF (US Dollar/Swiss Franc), EUR/USD (Euro/US Dollar), or the GPB/USD (British Pound/USD). When buying or selling a currency pair it is important to understand the Bid/Ask prices and the Spread between them.

BID/ASK AND SPREAD

Whenever a currency pair is quoted (as shown in the chart above, and the order window below), the prices are quoted with both a bid price and ask price.

The bid price is the price that you would pay to sell the currency pair (go short), and the ask price is the price you would pay to buy the currency pair (go long). The difference between the two numbers is known as the spread.

Looking at the order window below:



The bid price is 1.6280. The ask price is 1.6284. The spread is then 1.6284 – 1.6280 = 0.0004.

The spread is something that any trader should be aware of. It's important to note that if you made a trade with the intention of earning 30 pips, and the spread was 4 pips, the currency pair would have to move 34 pips before you hit your profit target. This becomes more important when you trade currency pairs that have a larger spread.

Most currencies are quoted with 4 decimal places, and the 4th decimal point is known as 1 pip. There are exceptions to this, so let's take a moment to talk about pips, profits and trades.

PIPS, PROFITS, AND TRADES

When you trade Forex you will always calculate your profit or loss in pips. A pip is the smallest price increment in Forex and the term itself stands for “percentage in point”.

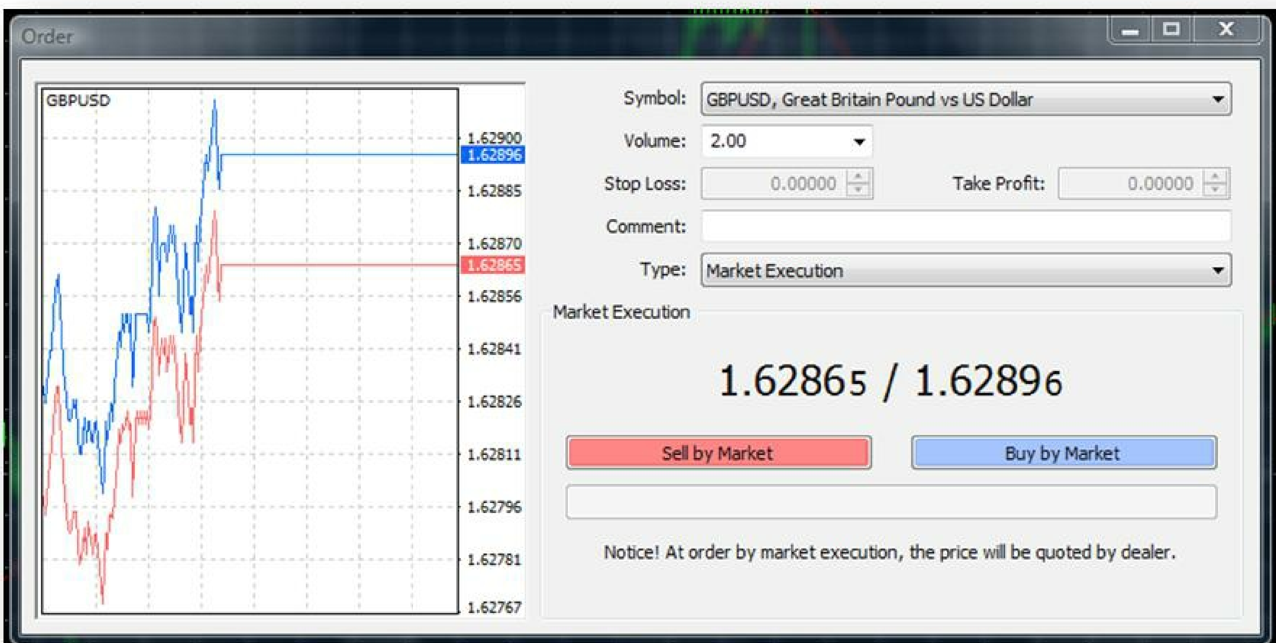
With most currency pairs you’ll trade a pip is 0.0001. The exception to this is currency pairs that include the JPY (Japanese Yen). In that case one pip is .01 of price movement.

To add some clarity here let’s talk about how to calculate a per-pip value and then move on to calculating the profit from a single trade.

Let’s start by calculating a per-pip value. To do so, the formula looks like this:

(1 pip with proper decimal placement/currency exchange rate) x amount being purchased = pip value.

Let’s assume we were about to trade 1 lot ($100,000 worth) of a currency pair. To give us something to calculate, look at the buy window on the following page.



If we were to buy one lot of the GBP/USD currency pair, at the current ask price of 1.6289, then our per-pip value would be:

(0.0001/1.6289) x 100,000 = ~6.13911

Of course we’ve just calculated the per pip value in British Pounds, to convert that number back to USD, we need to multiply by the exchange rate again.

6.13911 x 1.6289 = $10.

It should be noted here that whenever the currency pair includes the USD on the right side of the pair (as is does with GBP/USD), the per-pip value will always be $10 for a full lot of currency or $1 for a mini-lot ($10,000 worth of the currency pair).

LEVERAGE

The next thing that's important to understand is that when you trade Forex you'll almost always be trading on leverage. Leverage means that, even though you are trading large lots of currency ($10,000 for a mini-lot, or $100,000 for a full lot), you don't need to put that amount of money on the line to make the trade.

Commonly you'll see leverages of 50:1, 100:1, or even 200:1.

With a 100:1 leverage, I am able to trade $100,000 of currency while only putting, 100,000/100 = $1000 of my own money on the line.

This will become clearer as you work through some of the later chapters, but for now it's just important to note that it isn't suggested that you trade with more than a 100:1 leverage.

Some brokers now have 400:1 and even 500:1 leverages available. New traders tend to look at these large numbers and see bigger profit potential. The problem is that leverage is a double edge sword.

If a 500:1 leverage allows you to amplify your profits by 5 times over a 100:1 leverage, it also amplifies your losses to the same degree.

Chapter 2: Your First Forex Account

Once you have a good knowledge of the basics, the next element you need to succeed in Forex is experience. That is, it isn't enough to learn about charts. You also need to gain some experience with the markets themselves.

Now, I'm not suggesting that you open up a real Forex account and start trading. In fact, doing so is a bad idea.

What I am suggesting is that you make use of the best tool you'll even be given to learn Forex – a practice account.

PRACTICE, PRACTICE, PRACTICE

Every good Forex broker allows you to trade with a practice account. This simple no-money-required account is your best tool to learn Forex trading.

It's sort of like the old adage "practice makes perfect". Although there is no such thing as a perfect trader, practice will give you the experience to need to understand trading better. It gives you the one tool that will allow you to learn to be a successful trader before you ever put a dime of your own money on the line.

Opening a practice account is as simple as heading over to a broker, and submitting a simple online form. Don't just signup for a practice account though, use it!

Spend time trading away your practice account. Take the time to lose your entire account balance. Learn different trading systems. Practice reading and back testing different trading system with charts. Trade the daily charts, the hourly charts, and even the 15 minute charts. Use your practice account until you're so sure of yourself as a trader that you can confidently trade any currency pair in any market condition with a reasonable expectation that you'll win at least 30% of your trades.

Making heavy use of a practice account, before you ever put your own money on the line, is the one idea that will gain you the experience you need to become a successful trader. Unfortunately, it is also the often the most overlooked element of success amongst newer traders.

Too many newcomers to Forex will find a trading system, trade it on a practice account for a week, and come to the conclusion that they simply can't lose. Of course that idea is never true when it comes to a high-risk trading vehicle and because of it they very often will lose and give up on Forex before they ever gave it a chance.

Don’t be like 90% of the new traders out there. Make the decision right now to spend 3 months, 6 months, or even a year with a practice account first. That simple decision is the best thing you’ll ever do for your trading career.

Once you’ve made that decision, let’s talk about the right time to start trading with your money.

YOUR FIRST REAL TRADING ACCOUNT

Two of the most common questions asked by new traders are when should I start trading (don’t believe the guy who tells you after a month of practice), and how much to start with. Let’s deal with the answers to both questions separately.

WHEN TO START

When YOU should start trading with real money instead of a practice account is actually a difficult question to answer. It really depends on how comfortable you are with trading, and how sure you are of the systems you’ve put in place to trade with.

To give some general guidelines, you should have at the very least the following:

1. A Clear Understanding of all of the Elements of Success in Forex (see the next chapter).
2. A trading system that you have both back tested, and traded successfully on a practice account for a period of at least one month (preferably two or three).
3. A confidence level that will allow you to enter your trades, following the rules you’ve put in place, without worry or regret.

The sticking point of those three rules is usually #3, and as we get into the chapter on trading psychology, it will become clear how important it is.

HOW MUCH TO START WITH

The next question that needs to be answered is how much money you should put on the line when you do actually start trading with your own money. Again this one is difficult to answer, but it’s easy to set out some guidelines.

First, you should never start trading with money you can’t afford to lose.

If the money you put into your first Forex account will affect you or your family if you lost it all, then you aren’t ready for live trading yet. Continue with your practice account and save whatever you can each month until you have a decent amount saved, that won’t hurt you if you lost it.

Next, you should never start with an account that is too small.

In this case you might open a Forex mini-account with $4,000 - $5,000, or you might start a standard account with $20,000 - $30,000. But, you shouldn’t start an account with a 500:1 leverage and a $500 account balance.

Possibly you could open your Forex account with less than the numbers I stated, but you should stick to a 100:1 leverage, and if you feel the amount you have on hand isn’t large enough to fund the account you’ll be better off waiting and saving some more.

CONCLUSION

With an understanding of how important practice is to your own Forex success, let’s move on to the other elements of success in Forex. In the next chapter we will begin to lay out everything you need to succeed.

As you work through the rest of this book, my suggestion is that you make heavy use of your new practice account to put all of the elements in place. By doing so you’ll have a complete game plan, a system that is tried and tested, and the experience required to ensure your first Forex account is a profitable one.

Chapter 3 - The Elements Of Successful Trading

Thus far we've talk about the importance of a firm grounding in the basics of Forex, and the importance of practice to further that basic knowledge. From here on out, it's time to start putting together the rest of your trading puzzle.

In this chapter we'll define the elements of your success.

THE RIGHT PSYCHOLOGY

One of the most important pieces to your success puzzle is your own trading psychology. This covers everything from why you have decided to begin trading Forex to how you approach trading. It also covers the steps you take to keep your emotions out of your trades.

A basic understanding of you, and why you're here, is the one element that can work more towards your own success than any other idea we cover in this book. In fact, a poor mindset and emotional trading is likely the number one reason why traders fail. The next most common reason is a poor money management system.

MONEY MANAGEMENT

After you understand trading psychology your next piece to your success puzzle is a good money management system. The money management rules you put in place are the only tool you have to manage your risk. As such, your money management system is an integral part of ensuring that you profit from your trading career.

Proper money management will help you to avoid large draw downs and large losses. It will also better enable you to recover if you do experience a larger loss throughout your trading career.

KNOWLEDGE IS EVERYTHING

The next element to ensure success in trading is knowledge. In this case I'm not talking about understanding the basics (although that is part of it).

Moreover, I'm referring to knowledge of the markets, current market conditions, news releases that may affect your trades, and in general having a clear understanding of what's happening right now.

Sometimes this knowledge will be a required part of your trading system, and other times it will just be looking at the bigger picture to ensure your trading fits with the current times. If any of this is unclear at this point, it will be soon enough.

YOUR TRADING GAME PLAN

Finally when you clearly understand the three elements we just covered, you're ready to put everything together to create your trading game plan. This is really your plan for success, and it includes bringing everything together to ensure you have a set of rules, ideas, and tasks that you will consistently follow to ensure that you stay on the road to success.

TRADING SYSTEM

After you have a game plan, and only after, you're then ready to begin working to discover and test different trading systems. Your trading system is the systematic set of rules that you use to determine when to enter and exit your trades.

We won't be covering specific trading systems in this book, but there are a couple of things I wanted to point out.

1. Your trading system should be secondary to everything else in this book. If you're clear on trading psychology, using proper money management, and staying current with the markets – you have the most important elements to your success. Your trading system then becomes secondary.
2. You should never rely on one trading system. You should work to back test, and use 2 or 3 systems under various market conditions before you ever use them on your live trading account. Doing so will ensure you have something to fall back on when that one stellar system just isn't working anymore.

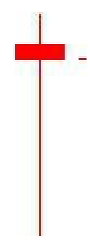
Chapter 4 - A High-Probability Price Action Trade Setup

Next, I'm going to give you a high-probability price action setup: The Perfect Pin Bar.

First, we're going to cover how to identify the perfect pin bar. Then, we'll cover how to use confluence to increase your probability of winning. And then we'll put it all together, so you can apply it in your trading right away.

Let's get started.

This is what a pin bar looks like.



It has a long tail. A small body. The rest of the bar in the opposite side of the tail is called the nose.

Now, here's an important question: What makes a perfect pin bar?

Let's simplify things. We have 3 simple rules:

Rule #1: The pin bar must show a struggle between buying force and selling force, bulls and bears.

And at the end of struggle, one side wins convincingly, illustrated by the clear rejection of price in favor of that winning side.

Here's what it translates into how the perfect pin bar would look like on your chart:

Because there's a struggle between buying and selling forces, the body of the bar would be small. Let's say no more than one third of the tail.

And then because at the end, one side wins convincingly, let's say bulls win, it means that the tail of the pin bar would be long, and pointing down, showing clear rejection of lower prices.

Let's see the bar I showed you before, now in context:

If you look at this pin bar, the market is trying to penetrate lower price levels. But it got rejected. The struggle between bulls and bears is resolved. Bulls win, illustrated by the long tail and the small body and nose.

If you really pay attention, you also notice that this level, that the price failed to penetrate, is a strong support resistance level, having been tested several times in the past.

Here's a rule of thumb: The more times a support resistance level is tested, the stronger it becomes.

It also ties in with rule #2 and rule #3:

Here's the second rule: The direction of the pin bar should be consistent with the general trend.

If we zoom out, we can clearly see that this pair is in an uptrend.

So now, maybe you're wondering how do we know for sure if we're in an uptrend or downtrend?

It's simple. Here we got higher high, higher high... and higher low, higher low. The market's trending up.

So, in this case, we got a bullish pin bar in an uptrend. Criteria number 2 fulfilled.

Let's move on to rule #3: We have touched on this point previously. The pin bar must happen at key support resistance level.

Now let's bring in another concept to increase your probability of winning a trade. It's the Confluence concept. What this means is we want to put all the odds in our favor. So we look for a confluence area where there's many important price levels in close proximity with each other.

Now, forget all the complicated technical analysis stuff. I want you to focus ONLY on the easy stuff, the HORIZONTAL LEVELS.

Look at this chart:

First, we've got the horizontal support resistance. Second, we've got the Round Number 1.0300 level. Many many traders pay attention to those round number levels, so it's always important to take these round numbers into consideration.

Third, we've got the 38% Fibonacci retracement level near this area as well.

So, in total, in this area we've got 3 factors: the horizontal support resistance, the round number, and the Fibonacci retracement. All of this makes this area an important confluence area where we can expect a lot of price action to happen.

So when a pin bar happen around this area, it's a perfect opportunity. Everything is tipped in your favor.

And then price moves aggressively upward. This trade works out perfectly.

I hope you like this setup. If you do, I have something else you will love. I'd like to give every reader of this book a free copy of my personal trading strategy for the forex market.

[Tap here to get your free copy of the trading strategy.]

Chapter 5 - Winning Trading Psychology

To get started with your trading game plan, the first thing you need to look at is you.

Trading psychology is the one element that will almost guarantee you fail if you don't understand it, and constantly work to understand yourself as you trade.

This may not make a lot of sense at the moment, but it will all become clear as we work through this chapter. With that said let's get started by taking a look at you.

THE RIGHT REASONS.

To begin our look at your trading psychology, the first thing you need to do is ask yourself some questions.

Really, if you don't understand why you're trading and what drives you then you'll probably never understand why you succeed or fail. More than that, if you come into Forex for the wrong reasons, then you definitely will fail.

Take a moment to ask yourself:

- Why am I trading?
- What do I expect to gain from trading?

For 80% of those who read this book, there answer will be money.

The problem with that answer is that if money is the only reason you're beginning your trading career, then you most likely will fail. If you begin your trading career with dollar figures in your head, then you're setting yourself up for a huge disappointment.

More importantly, money may work well as a short term motivator, but it rarely is enough to see you through in the long run.

Many who read this probably won't believe me when I say this, but even if you think money is what motivates you, it often isn't.

Think about it on a deeper level for a moment. Right now it's very likely that you work a 9 to 5 job, and it's also very likely that you believe the reason you do so is for money.

Is it really though? Why do you need money?

Possibly you have a family to feed, or a mortgage payment to make. Maybe you enjoy fine cars and you need to meet those $2,000 monthly BMW payments. In any case is money the only motivator?

If you have a family to support, then looking closer: keeping your family fed and healthy is the motivator, not money. The same thing could be said about meeting those mortgage payments (the need for shelter), or even about the car (you need a way to get around). In all of the examples, money isn't the motivator; it's just a means to achieve a goal or a need.

Understanding this is extremely important because if money is your only motivator when you begin trading, then I promise you won't stick with it for long. Something as large as Forex takes dedication to learn and stick with it. For most, the need of money will never be enough for them to keep at it.

To take this idea further, and better understand why you want to begin trading, you should take some time to do some self discovery. Grab a sheet of paper, and then begin to ask yourself why, what, how.

As an example:

Why do I want to trade Forex?
To Earn Money

What will I gain by earning money with Forex
I'll be able to provide my family with (insert idea here – better house, better lifestyle, etc)

Why do I want to provide my family with a better lifestyle?
I like to make my wife happy…

What will I gain by making my wife happy?
We get along better when she's happy, and I enjoy seeing her happy.

We could obviously keep going with this example and get down to an ultimate motivate of improving your marriage or having more time to spend with your wide.

The reasons we take the time to discover our inner motivators is simple because it gives us something more tangible to work towards.

Is money enough to keep you trying at Forex, even when it feels like you're about to fail?
Probably not…

On the other hand, is a happier life where you and your wife get along better and have more time to travel and spend time with each other enough to motivate you?

If you honestly see trading as a means to a happier life then you're much more likely to stick with it even when things don't seem to be going the way you want them to.

Another Example taking a More Negative Stance:

Why do I want to trade Forex?
To quit my day job.

What will I gain by quitting my job?
I won't have to put up with my bosses crap anymore?

Why does the boss's attitude bother me?
He never gives credit where credit is due, and I feel like I'm not rewarded for the work I do.

What makes me feel rewarded?
Praise from my boss and coworkers.

How will Forex help me to gain praise?
It won't

Again with just a few questions we've gotten to the root of the problem, and in this case we're at a point where Forex can't provide the solution.

If what really motivated this guy was praise and acceptance from his coworkers - that is something he could never get from a trading career.

You don't have to stop there. You can take your exercise in self discovery further by asking yourself questions like:

What motivates me? Why?

What do I want to achieve? Why?

Will I be able to gain this as a Forex Trader?

The point here is to understand two things:

1. What really motivates you to succeed at something (your deeper motivators)?
2. Whether or not that motivation is something you can achieve as a trader.

By taking the time to do a little self discovery, you can find better reasons to work towards your own success as a trader. Creating a better life for your family is something that can motivate you for years to come.

If your only motivator was money, you're more likely to give up than to continue when that bad month comes. By the same token if you're motivated by something like acceptance from coworkers, then an at-home Forex career probably isn't for you.

You should work at this exercise until you can come up with at least two good motivators, besides money, that you feel you'll be able to achieve as a Forex trader.

These will become both your long term goals, and the two reasons that you should stick with it when things just aren't going your way.

Goals like "more time for family because I work from home" or "spending more time holidaying with my wife and still being able to provide for her" will take you a lot further in your Forex career than the want of money ever will.

THE EMOTIONAL NEED NOT APPLY

Once you have a couple of good goals/motivators to see you through, it's time to talk about your emotional side.

If you are someone who tends to get emotional over money, then success in trading will be difficult. You'll need to learn to keep your emotions in check, or you will fail.

Notice that I said "will fail" and not "probably will" or "might". Trading with your emotions is the best way to erase your trading account quickly, and in turn utterly fail as a trader.

If you aren't sure whether you will be an emotional trader or not, just try this.

Picture for a moment that I have just given you a large sum of money. It doesn't matter how much, just picture whatever would be a large sum to you. Maybe it's $1,000, $10K, $200K – the amount doesn't matter.

What does matter is that you imagine you have an amount that could make a difference in your life right now. Really picture it…

What would you do with the money? What would you buy? Imagine being able to buy that new car, or that new house, imagine what you'd feel like. See yourself doing whatever you imagine

With that feeling in mind, now picture throwing that money in the trash instead.

How do you feel? Does it matter? Are you feeling that gut wrenching "no" feeling?

If the idea of taking a large amount of cash and throwing it away really bothers you, then you very likely will be an emotional trader. The emotional trader really comes in two varieties, so let's talk about them both.

THE OVERZEALOUS TRADER

The overzealous trader is the one who often trade solely off his emotions. That losing trade (or large string of losing trades) leads them to become angry and to want to take revenge on the market. They then end up losing even more trades because they allow their emotions to rule them.

This type of trader will make bad trading decisions and end up turning that 2 or 3 loss streak into a long string of losing trades. They end up ignoring their money management systems and trading systems because they “know” that next trade is going to be a winner.

The overzealous trader can also come from the other end of the spectrum.

It feels good to win. After a couple of winning trades, the overzealous trader is on a high, and is driven to make that next trade even bigger.

To do so he enters his third trade with double the lot size, even though his money management rules say that he shouldn’t. The third trade moves against him and he erases the profits from the first two winning trades.

After losing he becomes angry and suddenly feels the need to take revenge on the market…. Are you seeing the cycle here?

Luckily avoiding becoming the overzealous trader is easy, and we’ll get to that shortly.

Let’s first cover the other type of emotional trader.

THE TIMID TRADER

The other type of emotional trader is the timid trader. With this trader it’s fear that rules him. He simply hates losing money so he becomes conservative to the point where he rarely enters a trade.

He probably has built up a system of rules so lengthy that he might enter a trade once a month. Often, even when he has that clear entry signal he, avoids it (fear of losing keeps him from entering).

Although the timid trader probably won’t erase his trading account as quickly as the overzealous trader, he’s still damaging his trading career. By avoiding what could be profitable trades he is reducing the amount he earns, and in turn missing out on a good portion of the potential profits.

Again becoming the timid trader is simple to avoid, let’s talk about how.

BALANCING IT OUT – YOU

Okay, so we’ve talked about the two common types of emotional traders, now let’s talk about how not to become one of them. The idea is quite simple actually; to avoid becoming overzealous or overly timid with your trading simply avoid all of the following emotions:

- Happiness
- Sadness
- Fear

- Jealousy
- Anger
- Greed
- Elation
- <Insert Emotion Here>
- Etc…

In other words – avoid all of them.

The currency markets do not care how you are feeling, and in turn they won't respond to your emotions. Never allowing your emotions to become part of your trading will take you a long way towards success in Forex.

Now some may think this is easier said than done, but it doesn't have to be difficult.

Before we trade, we setup a money management system to make clear rules on how much we can risk. We use a systematic method of trading to determine when to enter our trades and when to exit them (this may also be defined by your money management system).

Using clearly laid out rules to enter our trades, size our trades, and exit our trades we better enable ourselves to trade without emotion.

CONCLUSION

With our brief lesson in trading psychology over I wanted to take a moment to discuss why it's so important. In this chapter we didn't really take any complicated steps. We simply took some time to discover our inner motivators, and then we talked a bit about emotions. It may not seem like a lot, but these two steps may go further towards your own success than anything else I could ever teach you about trading.

Think about it for a moment:

In every career, in every job, and even just in life – there are those days that you just don't want to. You know the ones I'm talking about, the days where you could just say "screw it" and stay in bed.

When it comes to Forex, and more specifically working from home, it's sometimes too easy to do just that. Even if you love Forex trading more than any other job you've ever had, I promise there will be days when you're frustrated and you could just as easily give up as continue.

By taking the time to discover your own motivators before you begin trading you have tangible reasons to continue doing it. Understanding your ultimate goals, and what you can achieve by working hard at Forex, is important to ensuring you'll continually work at it and ultimately succeed at it.

Then consider:

The emotional trader usually doesn't realize that they are trading with their emotions. Really, most of the time this trader will have no idea what trading psychology is. They also rarely understand why we setup money management rules and use a good trading system. In turn they may think they are following the rules, and have no idea why it isn't working for them.

By simply understanding the psychology behind the emotional trader and becoming aware of your own emotions you are now better equipped to keep your emotions out of your trades.

The psychology behind the trade isn't necessarily complicated. It's simply understanding why you are working towards your own success, and realizing that your emotions can work against you.

With that said let's move onto money management. Not only is managing money important to minimize risk, it's also one of the key elements that will help you keep your emotions out of your trades.

Chapter 6 - Money Management Matters

The next piece of the puzzle to your success is money management. Put simply, money management is a simple set of rules that you put in place to ensure that you manage your risk consistently. It isn't complicated, but it is important.

By following a simple set of rules to keep our risk level the same, not only are we managing risk but we also manage to:

1. Keep everything systematic; this greatly reduces the likelihood that your emotions will become part of your trades.
2. Give ourselves an easy way to avoid large draw downs to our accounts.

We already talked about the first point in the last chapter. Now let's talk about the second.

THE DANGER OF DRAWDOWN&RSQUO;S

You may have heard the word drawdown before. In your Forex career you'll likely hear it often. The important thing for you is to understand here is what an account drawdown is, and then to ensure you manage your money so that you don't experience one.

To clearly demonstrate what an account drawdown is, let's use an example.

A fellow trader, who I know quite well, had a bad habit of removing his stop once a trade went is his favor. For the purpose of our example I'll call him John (and yes this is a true story).

Now this is an experienced trader who had used this system of trading for a couple of years, and had never experienced large problems.

Every time I saw him I always made jibes about his avoidance of stops, and how he would regret it one day. Of course he always replied that "what works, works"…

Since he was an experienced trader I never really thought that I would be proven right, but unfortunately for him, I was.

Now it's important to understand here that we're talking about a trader who holds a large trading account (around $2 million) and who earns a good living solely from Forex.

At any rate when this happened he was 2 months into a long trade on the USD/JPY. The currency had trended up for quite some time and he was close almost 200 pips ahead on the trade. He had 100 lots into this particular trade.

If you do the math we're talking huge dollars here.

I had talked to John the day prior, and he was excited about his winning trade. Of course I made the comment "I bet you forgot to set your stop" and of course he had.

The problem this time was that the currency pair suddenly moved against him. A major news release turned the currency pair against him, and while John slept his 200 pip winning trade turned into a 100 pip loser (I think it was actually about – 92 pips).

Suddenly a trade that stood to earn John $200,000 was losing him $100,000.

Now if he had been smart at that point he would have cut his losses, and accepted that he'd lost 5% of his account on a single trade. That isn't what he did though.

With the anticipated turnaround of the currency he averaged down into the trade (bought another hundred lots) to attempt to recover some of his losses. At this point, I wouldn't say that what he did was unreasonable. He wasn't really following his own system, but I also expected the pair to recover from the press release.

Unfortunately though, the currency didn't turn around. It continued to drop throughout the day, and by the end of the day it had dropped another 100 pips.

At that point John had 200 lots into the trade and in total he was losing $300,000. He did then cut his losses, but in a single trade he had drawn his account down by 15%.

Now John is an experienced trader, and although that one trade damaged his trading account for a few months, he did eventually recover from it (he's smart enough to use stops to protect his profits now). The point of this story is that a 15% drawdown doesn't just require 15% to recover.

To get his account balance back to what it was before he lost the trade, John had to recover 17.6%.

Let's put clarify this by doing the math. If John's account balance was an even $2,000,000, then a $300,000 loss represents:

300,000 / 2, 000, 000 = 0.15, or 15% of his current balance

After losing that trade, his account is then $1,700,000, and to get back to his original $2 million he needs to recover:

300,000/1,700,000 = .1764 or 17.6%

His account balance is now smaller, so he has less to work with the next time he trades, and he has to make up a larger percentage to earn back the 15% he lost. A fifteen percent drawdown isn't necessarily huge. Assume for a second that John hadn't exited when he did though.

If he was an emotional trader (which he isn't) he could have just as easily averaged down again and ended up losing 20%, 25% or even 30% of his account.

Here's what it would look like to recover then:

Draw Down	Percentage to Recover
5%	5.3%
10%	11.1%
15%	17.6%
20%	25%
25%	33%
30%	43%
40%	67%
50%	100%
60%	150%

When you begin to look at the percentages it becomes clear how badly drawdown's can affect your trading.

Luckily it's fairly simple to avoid this type of problem. Managing your money properly will ensure that you can trade comfortably and not worry as much as the trader who doesn't setup a clear method to manage risk.

A MONEY MANAGEMENT SYSTEM THAT FITS YOU

To ensure you keep your risk to a manageable level you really only need two simply percentages and a few supplementary rules. The first number you need is a % risk that we are willing to risk on any single trade, and the second is a % risk for our entire account balance.

We will use the first percentage to ensure we never risk more that %R of on a single trade. The second percentage will tell us how many open trades we can have at once.
%R
Your %R is the number that you use to calculate proper trade sizes, and in turn ensure you risk only a small percentage of your float on any given trade. For new traders this number should be 2% - 3%.

It's important to note here that your %R should fit well with your own trading psychology.

Let’s do some math to clarify here. As an example if you have a $100,000 account balance then at a 3% risk level your maximum risk on any trade is:
100,000 x 0.03 = $3,000.

If the idea of losing $3,000 bothers you, then you should set your %Risk lower. A 2% or 1.5% risk level may be more appropriate for you. As a general rule 2% is a good number to use for both new and experienced traders.

By using a risk level or 2%, you could lose 10 trades in a row before you drew your account down by 17%. By the same token, if you were using a 10% risk level if you lost 10 trades in a row you draw your account down by 60%. The smaller %R allows us breathing room to grow our account over time, while avoiding a lot of the risk involved.

Setting a %R, and following it religiously, allows us to keep our risks to an acceptable level. It also helps use to ensure that we consistently move our accounts forward.

TOTAL ACCEPTABLE RISK

The next number you need for a good money management system is a total percentage you are allowed to risk at one time. For most traders 10% - 15% is an acceptable number.

This is the amount of your entire account that you can have on the line at once. If your %R level was 2%, and your total acceptable risk is 10%, you could then have 5 trades open at once.

Since this is more than most traders will trade at a single time anyway, a 10% total risk is usually sufficient.

CALCULATING TRADE SIZE

With most trading systems your stop level will be defined for you. This is actually the reason we use a %R instead of a dollar figure when setting our maximum risk level. We can use the percentage to calculate an appropriate trade size that allows us never to risk more than our acceptable risk.

Let’s walk through a couple of examples to add clarity.

If your trading system was giving you a buy signal on the EUR/USD, and suggesting a 30 pip stop, then we have all we need to calculate a proper trade size.

Assuming your account balance was $120,000, and using a 2% risk level, your acceptable risk is:
$120,000 x 0.02 = $2400.

We know that each pip on the EUR/USD is worth $10 (see the section on calculating per-pip values if you don't), and our system uses a 30 pip stop.

We are then risking 30 x $10 = $300 for every lot of currency we trade.
From our acceptable risk we can then trade:

$2400/$300 = 8 full lots of the currency pair.

Let's walk through another example using mini-lots.
If your Forex Mini-Account had a float of $24,238, and you were using a 2% risk level then your maximum risk for a trade would be:
$24,238 x .02 = $484.76.

Assuming you were trading the EUR/USD and your trading system used a 50 pip stop, then with each mini lot you trade you would be risking $50 (1 pip on a mini lot is $1).

We should then trade:
$484.76 / $50 = 9.69 mini lots.
In this case, we can't trade .69 of a mini lot so we just trade 9.

CONSISTENCY AND RISK

The last thing that is important to mention about managing risk is that consistency is important. We set a maximum %R because that is exactly what it is intended to be – the maximum.

From that, whenever we calculate our lot size to trade we always round down. Using the example we used in the last section we said that:
$484.76 / $50 = 9.69 mini lots.

In this case, we can't trade .69 of a mini lot so we just trade 9.

The human tendency here is to round up and trade one full lot of currency (or ten mini-lots). The idea is that the more you trade the more you earn. There is of course some truth to that statement, but by trading 10 lots when we should only trade 9, we are basically throwing our money management system out the window.

It is important that you always stay within your acceptable risk level and never exceed it. Doing so will ensure you are properly managing your risk, but it will also help you to properly manage your emotions.

If you ALWAYS trade within your acceptable risk level, then you'll have a harder time breaking your own rules when you are on that 5-loss streak and feel like taking revenge on the market.

THE OTHER ELEMENTS OF MONEY MANAGEMENT

With a method of managing risk we have a money management system. However, our system is not yet complete. We need to add some rules to round out our system and ensure that we properly manage our risk.

Along with your %R you should also keep the following five rules in mind:

1. **Never trade without a stop.** Your stop loss is your way of ensuring you follow your own money management system. It protects you from losing too much, and can also be used to protect your profits as your trades move in your favor. If the trading system you are using doesn't define stops, decide on a stop level to use and stick to it consistently.
2. **Never use stops larger than your take profit levels.** Some trading systems suggest ideas like setting a 200 pip stop and a 100 pip take profit level. The theory here is that you are allowing your trades more room to breathe. In reality you're just consistently risking twice as much as you earn and eventually will eliminate your trading account by doing so.
3. **Avoid complex money management systems with increasing risk levels.** Especially when you're just starting with Forex, you should completely avoid money management systems that increase/decrease risk levels as you win/lose. These types of systems are too complex and generally make it harder to follow your own rules.
4. **Avoid concepts like averaging down**. The concept of averaging down (buying into a losing trade to reduce losses) might work in theory. In reality though it rarely does. You should completely avoid trading with ideas like this as they will only add to your losing positions.
5. **Never add to a losing position**. From rule number four, you should never add to a losing trade. Even if you use an odd trading system that suggests it (and there are some that do) you should never add money to a losing position. The idea simply doesn't make sense.

I have developed a cool little Excel sheet that will calculate the position size you may want to use for each trade, based on your risk level and your stop loss.

You can tap here to get a free copy.

Conclusion

With a money management system in place you now have a way to properly manage your risk. From here it's time to move on to place our final pieces of your success puzzle, and then to bring it all together with your trading game plan.

Chapter 7 - Putting it All Together – Your Trading Game Plan

When we take everything you've learned thus far and begin to put it altogether you can state it as a complete trading plan. To ensure you find success in forex trading you should take the following 10 steps before you ever make a live trade, and you should work with them all throughout your trading career.

1. Work to understand the basics of Forex before ever making a live trade.
2. Use a practice account until you are comfortable trading any currency pair in any market condition.
3. Open your first Forex account with money that won't affect you if you lost it all.
4. Ensure you save enough money to create an account that you can trade successfully at a 100:1 leverage.
5. Have a clear understanding of your reasons for trading and your motivations to do so. These are your goals that will see you through the rough days.
6. Understand how your own emotions can affect your trades, and work to keep your emotions out of the mix.
7. Create a money management system and use it EVERY TIME you trade (including with your practice account). If you use the system we laid out for you it should look like this:
    1. Never risk more that 2% - 3% (define your own %R here) on a single trade
    2. Never risk more than 10% - 15% (define your own maximum risk level here) of your account balance across all trades
    3. Never trade without a stop.
    4. Never use stops larger than your take profit levels.
    5. Avoid complex money management systems with increasing risk levels.
    6. Avoid concepts like averaging down.
    7. Never add to a losing position.
8. Take some time to read any news that affects the currency pairs you trade, every day.

9. Always work to ensure you have a good knowledge of the state of the currency marketplace in general (ie trends, daily trading ranges, etc).
10. Before you make a trade always look at the specifics of that currency. You should know where support/resistance levels are on all of the charts, the average price movement from the day prior, and anything else you feel will help you make a more informed trading decision.

Thank You!

I hope you've enjoyed this short book. Now you have everything you need to start your forex trading journey. I wish you all the best in this exciting journey.

I'd appreciate it very much if you could leave a short review on Amazon. Your feedback will help me improve the book.

Also, as a reader of this book, you can get my personal trading strategy for the forex market, free.

Tap here to get your free copy of the strategy.

Many thanks and have a wonderful trading journey,

Tom Kanchesky

Thank You!

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