

Evolution of Forex – the Active Trader’s Market



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Forex, an abbreviation for foreign exchange, is the largest financial trading market in the world, with an average of \$1.9 trillion U.S. dollars worth of currency traded daily. The supply and demand of a country's currency are the principal drivers that influence the value of that currency relative to other country's currencies. The practice of trading currencies online has increased threefold from 2002 to 2005, and many experts say that the growth curve is expected to continue beyond 2008. Due to the significant size of the market, it provides traders with access to tremendous liquidity (also called volume), which means that that the market is less likely to be influenced by any one market participant. Other financial markets for active trading can be significantly smaller, allowing the possibility for large-volume trading participants (i.e. hedge or mutual funds brokers) to influence the market through unwarranted price manipulation.

In the past, access to the forex market was only available to the wealthiest individuals, or through dealing via banks that moved large amounts of currencies for commercial and investment purposes (known as the interbank market). The widespread use of the Internet and the entrepreneurial vision of smaller financial institutions to develop trading software to make FX trading faster and more efficient through the use of technology opened up the forex market for average investors to access and trade. Trading the dollar, the euro, the yen or a variety of other currencies can now quickly and easily be done from a personal computer or a PDA (personal digital assistant). What used to happen only between banks in the interbank market over the telephone can now be done from your home, or while traveling, any time of the day or night.

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Forex Participants



Third-party forex dealing firms carved out a niche in the financial services industry by offering widespread individual access, thus appealing to individual speculators.

While there are many participants in the interbank market, including government-run central banks, large money center banks and wealthy individuals, it was not until the late 1990s that the average trader could access forex, primarily due to the efficiencies gained through technology, which led to reduced capital requirements to gain access to the market, and a much demanded ability to leverage capital in trading. When third-party forex dealing firms like GFT began offering widespread individual access, they carved out a niche in the financial services industry by creating a new category of primary market-makers, which are firms that create a two-sided market by offering consistent prices for buying and selling currencies on large to very small amounts, thus appealing to individual speculators. Acting as the principal on small to large transactions and working with large banks in the interbank market to make the best prices available to customers while managing the risk as principal as a bank would, this new niche fueled by online forex trading software allowed customers to effectively execute trades in the forex market via the internet.

While not a part of the interbank market, forex dealers are on the outer perimeter and can sometimes quote tighter prices than their larger bank counterparts. Interbank prices sometimes have large gaps (times when large money centers are closed, times of low liquidity, or times of greater risk exposure), but market-makers assume this risk to give consistent, competitive pricing 24 hours a day to individual traders. These competitive prices are based on, amongst other things, exchange rate differentials, supply and demand for a currency in the interbank market, and anticipation of new economic events or current events that have an unforeseen affect on the financial markets. Furthermore, forex dealers that are primary market-makers provide a two-sided market. Because they are willing to buy and sell at the currency prices they quote, it keeps the spread (the difference between the two prices quoted) between the bid and offer small, thus enhancing the liquidity of the forex market. Conversely, spreads in the interbank market change often and can sometimes rise and fall dramatically, creating the potential for substantial profits and losses.

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Getting Started – Understanding Currency Pairs



Forex trading is the process of simultaneously buying one currency and selling another, and is traded in pairs.

The forex market follows the sun around the world, beginning in Sydney and moving as the business day begins in each financial center. For example, when the markets in Japan and Singapore begin to slow, the European markets open. These markets are then followed by the North American markets of the United States, Canada and Mexico. As these markets slow down for the evening, the trading cycle in Australia begins again. Unlike any of the other financial markets, speculators can respond to currency fluctuations caused by economic, social and political events at the time they occur, day or night.

Forex trading is the process of simultaneously buying one currency and selling another, and is traded in pairs, such as EUR/USD or USD/JPY. When you buy one currency, you must give up something (another currency) in exchange, similar to how you would give up money to buy shares of a company in the stock exchange. Therefore, you would never refer to buying or selling any one currency by itself, because you always trade in pairs. It is important to understand that the exchange rate between two currencies specifies how much one currency is worth in terms of the other. The first currency is the base currency, and the second currency is the pricing currency. A quoted exchange rate indicates the amount of pricing currency that can be exchanged for one unit of the base currency.

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Getting Started – Understanding Currency Pairs (cont'd)



More than 85 percent of all daily transactions involve trading the majors, including the U.S. dollar, Japanese yen, euro, British pound and the Swiss franc.

For example, an exchange rate of 120 Japanese yen (JPY, ¥) to the United States dollar (USD, \$) means that 120 JPY is worth the same as 1 USD. Now, let's look an illustration that prices dollars in terms of another base currency. For example, if the EUR/USD exchange rate is given as 1.1959, it means that one euro can be exchanged for 1.1959 U.S. dollars. If you are buying the base currency, the exchange rate is the amount you would pay or receive depending on the value of the base currency in terms of the pricing currency. Conversely, if you are selling the base currency, the exchange rate is how much you'll pay or receive for one unit of that currency. For speculators and traders, the best trading prospects are with the most commonly traded currencies, called "the majors." More than 85 percent of all daily transactions involve trading the majors, including the U.S. dollar, Japanese yen, euro, British pound and the Swiss franc.



Forex is quoted on a "bid" and "offer" price system. For instance, the bid is the price at which a dealer is willing to buy (and customers can sell) the base currency for a counter currency. The offer price, on the other hand, is the price at which dealers will sell (and customers can buy) the base currency for the counter currency.



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Getting Started – Understanding Currency Pairs (cont'd)



Market-makers will always quote two prices, one at which they are willing to buy, and one at which they are willing to sell.

With this type of quoting system, there is a difference between the bid and offer prices, which is called the spread. The spread is measured in pips. A pip is one unit of price change in the bid/offer prices of a currency pair. Looking at any currency pair, you can see that the last decimal place quoted in the exchange rate is a pip. In the above example, the EUR/USD is quoted at 1.1951/1.1954, so the selling price is 1.1951 and the buying price is 1.1954. This makes the spread 3 pips or .0003 EUR. Market-makers will always quote two prices, one at which they are willing to buy, and one at which they are willing to sell. It is important to note that most forex dealers have fixed spreads that do not change. Spreads among banking institutions in the interbank market, however, are sometimes quoted as much 200 pips wide or more. Thus, the prices and spreads quoted by primary market-makers are much more appealing to individual forex traders.

Forex dealers specify a minimum amount required for opening an account, and often a minimum required per position traded. Most forex brokers allow traders to leverage their money to trade more efficiently. The most common maximum leverage rate offered is 100-to-1, but some dealers offer leverage as high as 400-to-1. Leverage can be described as controlling more money with less actual funds, which allows you to trade larger minimum sizes. For example, with 100-to-1 leverage, you can control 100 times the amount of money that is in your account. Since the minimum size of a standard trade is often 100,000 units of currency (a standard lot-size), leverage allows you to execute a trade of this size without requiring 100,000 units of currency.

Getting Started – Understanding Currency Pairs (cont'd)



The more you leverage, the more money you can control, which also increases the amount you can gain or lose.

There are also “mini” trading accounts, which can be a bit trickier to maintain due to market volatility and the strict guidelines typically associated with these accounts. A mini account that allows you to control your leverage and trade size can offer more flexibility and higher leverage than accounts with more restrictions. One of the most advantageous types of mini accounts requires the same margin as a regular trading account, but offers smaller trade sizes. Remember, the more you leverage, the more money you can control. The more money you control can also increase the amount you can gain or lose. Leverage can be a double-edged sword, and should be considered carefully when choosing your trade size.

It is also important to understand margin requirements for your trading account, which can vary from dealer to dealer. The initial margin requirement is the amount of funds required by a foreign exchange dealer to begin buying or selling a set amount of currency, and is applied as a percentage of the trade size. With forex dealers, there is no margin call like in futures. Customers, however, are required to keep equity in their account above 25 percent of the margin requirement. When an account falls below 25 percent of this initial obligation, the trader's positions in their account are closed. Market positions can be reestablished if the trader meets new margin requirements set by the dealer.

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How Forex Dealers Operate

By dealing directly with the market-maker, you receive the benefit of not accruing additional exchange fees, commissions to an executing broker or other regulatory fees associated with other markets.

Because forex trading is not centralized on an exchange as is the case with the stock and futures markets, it is considered an over-the-counter (OTC) market. Most forex transactions are conducted between two parties via the Internet, and sometimes over the phone. How do forex firms make a profit? Forex dealing firms make a profit or incur a loss in a variety of ways. On the most basic level, forex firms quote customers a bid price to sell and an offer price to buy, and the bid is always lower than the offer at any one point in time. This allows the firm to, under certain conditions, capture revenue equal to the spread when customers trade. In order for this to occur, the forex dealer must have a critical mass of traders, and will need to have as many buyers as sellers for each currency pair at the same point in time in order to fully capture revenue of the spread quoted by the dealer. In cases where this does not happen, forex firms may either offset the net exposure of all trades in the interbank market, sometimes at a profit, or they may hold that position in the market as their own. In essence, they are then trading with their position being the average price on the net remainder of the excess exposure after their customers' opposing trades are matched. Typically, a forex dealer would carry the risk of its own positions if the customer positions did not net themselves to a zero position for the forex dealer. In most cases, the only time that a customer pays the spread in forex or any other market is if the customer buys and sells almost simultaneously or if the market does not move between purchase and sale. Generally, the market moves to new levels, and the customer will incur profits or losses as a result of the combination of the market movement and the spread. At GFT, you are dealing directly with the market-maker, and not an intermediary, which gives you the benefit of not accruing additional exchange fees, commissions to an executing broker or other regulatory fees associated with other markets.

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How Forex Dealers Operate (cont'd)

The price quotes offered to traders by a live dealing desk are often much tighter in spreads for all currencies than interbank market prices quoted by large banks.

Most forex trading firms make online trading software available to their customers, but not all trading software is created equal. Some companies make third-party software available to traders, but this software sometimes lacks the most advanced features available today, as well as the support and customer service that comes from owning and maintaining your own solution instead of outsourcing key business components. Other companies, like GFT, develop their own proprietary currency trading software, offering a more robust and fully integrated product at the best possible cost—free!

Currency prices and data are fed into the software in real-time via a dealing desk so traders can make decisions or predictions in an effort to make a profit. The price quotes offered to traders by a live dealing desk are often much tighter in spreads for all currencies than interbank market prices quoted by large banks, as the dealing desk is better suited to handle smaller transactions than larger banking institutions that tend to be more inflexible on price execution and transaction size requirements due to fixed ticket costs that are much higher than those of online FX dealers. Forex dealers with a 24-hour dealing desk give the customer an advantage by being available when you need to place a trade via the telephone or when you have a question or concern about your trade. While this may not happen often, it is a great advantage to be able to speak directly to a dealer that is quoting the market to you 24 hours a day.



Choosing a Forex Dealer

A company's trading software should be a major factor to consider when choosing a forex dealer.

There are several factors to consider before opening a trading account with a forex dealer. You should choose a dealer that has experience in the market, generally one that has been in the business for at least five to seven years. Many companies are looking to get into forex trading as the popularity of the market explodes, but few have been around long enough to have a trustworthy and reliable track record. Research the company to ensure it conducts its business operations in accordance with the laws and regulations of governing authorities. Company websites, regulatory agency websites, general forex websites and tradeshows are good resources for information. Be cautious when relying on any single source for knowledgeable and trustworthy information. Although many helpful resources are available, unfortunately, some can also be incorrect or misleading.

A company's trading software should be a major factor to consider when choosing a forex dealer. The range of technology varies greatly, and it is necessary to research the features of the software before choosing a firm with which to trade. The software needs to consistently offer stability during fast-paced market conditions such as economic announcements and major world events. Some companies, including GFT, offer free software to their customers with value-added features that are fully integrated, such as real-time currency prices and charting, technical indicators, up-to-the-minute news, and analytical tools. While you may not think that you need 70 technical indicators or 60 currency pairs, you will want a trading platform that grows with you as your trading proficiency increases. Also, make sure that these additional tools you will be using are based on the currencies quoted, and not a secondary price feed. Otherwise, the price you see on a chart is not necessarily the price at which you can trade.



Choosing a Forex Dealer (cont'd)

An integrated and easy to use interface allows you to stay focused on market action, and most importantly, your trading.

GFT offers real-time pricing on the chart, and better yet, you can trade directly from the chart at any time. You will also want to choose software that includes all of these features in one simple package, as separate programs increase the complexity of your trading and can inhibit your ability to closely monitor the markets. An integrated and easy to use interface allows you to stay focused on market action, and most importantly, your trading. Most importantly, look at the costs. Many companies offer services that seem to be comparable to others, however, they come at an additional cost to the trader.

It is often helpful to practice trading before opening an account. Training and education are two key factors in the ultimate success or failure of a forex trader when deciding to use real money for speculation. GFT offers free demo trading accounts, personalized training with a licensed forex specialist, and helpful customer support. You can never underestimate the advantages of having experts show you how to operate new trading software and share their knowledge about the forex market. Remember that the forex market moves very rapidly, and you need to be comfortable with your software before trying to trade the market. We cannot emphasize enough the importance of trading software that allows you to respond to the market as quickly as possible.

Is one forex dealer better than another to trade with? It depends on your needs and preferences, and some forex dealers may offer inherent benefits to your trading style. You want unsurpassed service and value from a reliable company, with competitive prices. As online currency trading firms compete for your business, service and innovation will continue to be the obvious points of differentiation among dealers. There are many reasons to consider trading forex and it offers many benefits, but be sure to ask the right questions before choosing a forex dealer.

Placing Orders



There are a variety of order types that can be used to execute trades. These order types include:

Market order – An order to buy or sell a specific currency, to be filled immediately at the next quoted exchange rate. This is the most common of all order types. Be careful, as you may not receive the most advantageous price in a fast-moving market.

Limit order – Specifies that a trade must be executed at a specific price. Limit orders are placed to enter the market or to protect profits. Because limit orders are not executed unless they reach the specified price, they may or may not be executed.

Stop order – An order used to close out a market position (a currently open trade), reverse a position, or open a new position at a specified price. They are typically placed to limit losses, closing a position if a price drops or rises beyond the specified point.

Trailing stop order – A type of stop loss order that is set to follow price movements by specifying the distance in pips that you would like your stop to move, depending on the market direction and type of stop order placed.

Order cancels order (OCO) – After entry into the market, a limit for profit order and a protective stop-loss order can be placed. When either the limit or the stop order is executed, it will automatically cancel the other order. This allows traders to automatically execute specific trading strategies to limit losses and protect profits without having to constantly watch the market.

Parent and contingent order – Two separate orders that are linked by an if/then condition. The contingent order will not be subject to a fill until the parent is filled. This allows traders to set up the entire trade while they are away from their trading desk, including entry, exit and risk management, based on specific market prices.

Trading Strategies and Analysis



There are thousands of analytical approaches to the forex market; however, the most successful traders primarily rely on the basic principles of technical analysis.

There are two common types of analysis that traders use to trade the market: fundamental analysis and technical analysis. Fundamental analysis takes into account the supply and demand for a given currency. It examines all factors that could influence the value of the currency, including inflation, growth, trade balance, government deficit and interest rates. This is a highly subjective way of analyzing the markets because of all the underlying psychological factors involved, combined with the data derived from economic announcements and political and world news.

There are literally thousands of analytical approaches to the forex market; however, the most successful traders primarily rely on the basic principles of technical analysis. Technical analysis involves studying market-generated data through charts, graphs and indicators. Moving averages, support and resistance lines, and Bollinger bands are examples of indicators. These types of technical indicators can help forex traders read repeating patterns for predicting future prices in order to capture the best profits. They may also help the trader view market conditions with a more objective analytical approach.

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Next Steps



GFT's DealBook® FX 2 is simple enough for beginners, and can be fully customized to grow with you as you gain more experience and confidence in the market.

This guide is meant to provide you with some basic information before you take the next steps to determine if the forex market right for you. If you do decide to trade the fast-paced forex market, we encourage you to consider choosing GFT as your forex dealer. Since GFT was established in 1997, we have taken pride in providing our customers with the highest levels of customer service, support and reliability in the forex trading industry. Our trading software, DealBook® FX 2, will provide you with the necessary tools to embark upon the world's most liquid market, all in one easy-to-use package. DealBook® FX 2 is simple enough for beginners, and can be fully customized to grow with you as you gain more experience and confidence in the market. For more information on the opportunities available in online forex trading or to obtain a risk-free demo trading account, visit www.gftforex.com or call 800.465.4373 or 616.956.9273 to speak with a GFT licensed forex specialist.

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