

## **Section Eight: Straight from the horse's mouth, our dealer advises**

### **8.1 A man who knows**

I'd now like to introduce you to a currency trader. In this section we will take a peek at the work of a true professional. Whilst there are people who want to trade themselves, there are many others who, after reflecting on their knowledge; their opportunities or their desires choose to entrust their capital to an experienced trader, someone who can manage their investment with dexterity and flair. Today, we are going to meet such a manager. We are speaking of Forex Club's chief dealer, Alexei Trifonov. Why have we chosen him? Well, the trading systems he has devised have, over the years, given investors a return on their investment which is significantly greater than the amount they would have received interest-wise on a high yield deposit account. We can count on him!

Settle down and listen to his words of wisdom...

'... In order for you to come to a fundamental understanding of the workings of my trading systems, I will start by outlining the basic principles of the currency market as I see them.

#### **8.1.1 The Principles of the Currency Market**

##### **1<sup>st</sup> Principle: Price is determined by the ratio of supply and demand**

Price increases because at that precise moment, buyers want to buy more than sellers want to sell. Price decreases when sellers want to sell more than buyers want to buy. Price reflects the expectations and motivations of sellers and buyers and attempts to satisfy the former and the latter. Buyers buy because they think prices are going to rise, at the same time they want to pay the lowest price possible. Sellers sell because they think prices are going to fall, they want sell at the highest price possible. Now, if the buyer and seller were meeting in isolation then perhaps they would never reach an agreement, but because the market is a crowded place both the buyer and the seller have the added pressure that someone else might just jump in a make the deal. The market reacts to each new piece of information. If a commodity receives positive news then demand increases, leading to a rise in price. The task of a trader then is to anticipate the thoughts of market participants and therefore the direction of the market. His target: to use the flow of price to generate profit.

**Direct consequence:** only price is real.

##### **2<sup>nd</sup> Principle: Probability is the basis of a sound forecast**

The movements of the market are chaotic in short time intervals. They are determined mainly by day-traders, people who open and close a position within a day. Movement is caused by any number of factors: news, randomness, events on

adjacent markets, etc. Any price movement is a chance for them to make money and the absence of price change is a day spent in vain. Theoretically, if no longer term players entered the game, then price would move in small jumps and never undergo any serious change. The situation is considerably more complex over longer time periods, since the probability of the appearance of significant news increases, and this means, the probability of the involvement of mid and long-term players on the market increases. Over longer periods the probability that the market will move in a certain direction increases. The task of the competent trader is to evaluate the probability and to exploit it. In such intervals probabilities of future motion not equal to each other any more.

**Direct consequence #1:** one can earn as much as one wants, if the probabilities are evaluated correctly.

**Direct consequence #2:** the probability of profit increases with the lengthening of the investment period.

### **3<sup>rd</sup> Principle: 'The Market follows the line of least resistance' (Jesse Livermore)**

A simple but, at the same time, fundamental principle. It helps us to perceive the market not as something illusory, created by people, but as having a certain objective reality, which obeys the same laws as the world around us. Twenty years before Livermore, Einstein stated that absolutely all phenomena in nature are subject to the same laws. Now we know how Einstein revolutionized science... If we remind ourselves that the behavior of market is determined by the psychology of people who make it up and that these people are themselves a part of nature then the formulation of this rule becomes indisputable.

**Direct consequence:** When price breaks through previously set levels, it will continue in this direction

### **4<sup>th</sup> Principle: The Market possesses inertia**

This principle is connected with principle 2. Because mid to long term investors are involved in the market the market takes time to find a new equilibrium point and the market takes time to 'digest' new pieces of news. As in physics, the inertial force depends directly on the power of the initial impulse which was received by the market and set it in its current direction. The following analogy demonstrates this rather graphically: a man who falls out of a ground floor window will most likely pick himself up, dust himself down and walk back into the house, whereas a man falling from a third floor window will take considerably longer to get up and move on

**Direct consequence:** do not rely on a rapid change in the direction of the market's flow.

I will remind you that the market has two basic phases: trend and non-trend. We're interested only in trend phase since during this period all its participants are

present on the market.

### **8.1.2 The stages of a trend's development**

I will now present my vision of the processes which occur on the market during the life of a trend. Let's look at this example of USD/JPY on an hourly chart (fig 8.1.2). The base currency is the dollar, of course, and its value is mapped on the chart in terms of Yen.

Here the market is in the state of stagnation. Activity remains low every day, the explicit interest of investors is not discernable. But traders have to earn something somehow, because they, as a rule, can not or do not want to leave one market and to go on another which could be more active. Currency trading is their work and they can do nothing but play with each other in the hope of that "every dog has his day". One person - an important, experienced investor comes to the conclusion that buying USD/JPY and holding the position for a year **could** (he uses this word 'could' instinctively so integral is his understanding of the bedrock of probability of the market) prove to be a very profitable transaction. He knows not to make the purchase all at once because he knows that no sooner has he made only a quarter of this volume than traders and other investors will understand what is happening. Therefore he moves slowly, over a period of a few days. He stops buying when price approaches the level of resistance of the prevalent price channel. The traders, noticing that demand has fallen off, close the positions that they opened in the morning and price flows downward and the 'noise' of the first order is over. The 'noise' of the second order starts as price falls to a point near the level of resistance and so on. As a result, price moves within a channel.



**Fig. 8.1.2 A price channel with an upper level break-out.**

So let's assume that the investor managed to purchase the planned volume in this manner and then perhaps other traders (the 'in-crowd' if you like) got wind of the purchase or that other experienced traders saw that USD was going to appreciate against JPY and decided to make their move. What happens here is a strong upsurge. This surge attracts new players onto the market and further purchasing over-rides the effect of the stop-orders placed above the resistance level. What we get now is a 'breakout' from the range. Notice how the breakout initially falls back to the original resistance level. Some people intentionally play against a break out as statistically for every true breakout there are two false ones. In our situation the breakout is true, more people get on board after the minor correction, bears begin to get nervous and there is a general pulse pushing price upward. We can see this breakout in fig 9.1. More and more people enter the market pushing price further upwards. However, the original investors, now sure of their initial calculations, strengthen their positions during periods of correction and are the real power behind the trend. Finally, price reaches the level of the in-crowd's expectations and they begin to close their positions. They close in precisely the same way as they opened: gradually and the dollar maintains its reputation as a 'wise buy' against the yen and the in-crowd lose nothing as they dispose of the dollar. Newspapers and TV trumpet the strength of USD and this truly heralds its final hours. By this time the in-crowd and most other experienced players have already closed their positions; but the mass crowd views the resulting small reduction in price as another correction and continues to buy more. The remaining competent investors

decide to take profit. All this brings about an up tick or more in price before it starts to drop sharply. The resultant peak can be seen in fig 8.1.2

My advice following on from this description is as follows:

Try to spot the presence of interest to buy when price is still in the channel.

If you do not, purchase immediately on break-out.

Do not rush to close during the first correction, but during the following corrections place sensible stop-loss orders.

Allow a position to close through a stop-loss order without regret.

Do not attempt to close precisely on the maximums or minimums

### **8.1.3 A few words on moving averages**

Imagine you want to buy a television. You naturally want to get it at a good price or, at the very least; you wish to avoid being over-charged. One way of achieving this is to ring round a few stores, say five, and ask about the price. You'll get a clear idea of the price of a TV and, all other things being equal; will probably aim to pay less than the average price. Alternatively, you could visit a shop near your house five times (or maybe get five friends to help you out!) and ask the price of a certain model. If after being told a price that is higher than average, you turn on your heel saying that another local store is selling the same model twenty dollars cheaper, then on the fifth visit the price will have approached the average price.

We determine a 'fair' price and a price we are willing to pay by making an average price our starting point. We can do the same on financial markets. A player can determine a 'valid' price of an asset by looking at the average price over a period of time. The only question is to decide the length of that period. And the answer all depends on the nature of the market. If the market is characterized by strong fluctuations in price, then the averaging period should be short and vice-versa. You can identify the character of the market by looking at historical data. The length of the averaging period is also connected to the length of the trend which you are aiming to follow. Take a look at a price chart and select a trend segment which corresponds with your style of trading. Draw a trend line and look at the number of periods price takes to return to the trendline. For me, my optimum averaging period is 20 and I emphasize that it is not important whether we are talking 20 days, hours or minutes etc. It makes no difference. The important thing is the number of periods not the length of those periods. Why 20? Well, it's round number; there are 20 working days in a lunar month. It was first cited by the father of trend following, Richard Donchian in his four week rule. This method, using averaging periods of 20 and 5, was developed in the 1970's and is still used profitably today. If someone elects to use a period of 21 or 19 then so be it, these averages look very similar to each other on the chart. In my opinion, the use of exponential moving averages and other more complex forms of averages have little to offer above simple averages and repeated research by analysts bear me out. So a simple moving average with a period of 20 is my choice.

What can we make of the statement that a moving average reflects the 'valid' price

of an asset? Well, there is one very important thing to be learned: we can view the moving average as a level of support on a bull market and of resistance on a bear market.

You can plot moving averages using our technical analysis software Rumus (available for free download from [www.fxclub.com](http://www.fxclub.com)). It takes three clicks of a mouse to plot MA's (all three types) and, of course you can set your averaging period at any number you choose, so you can experiment with what period is good for you.

**Overall conclusion:**

A moving average can be used as a good guide to place stop losses and no less importantly it can be used as a good guide of the future development of the trend as long as the trend progresses.

Finally, I round of this contribution from Alexei with some words from him on his current trading system

## 8.2 A Trading System

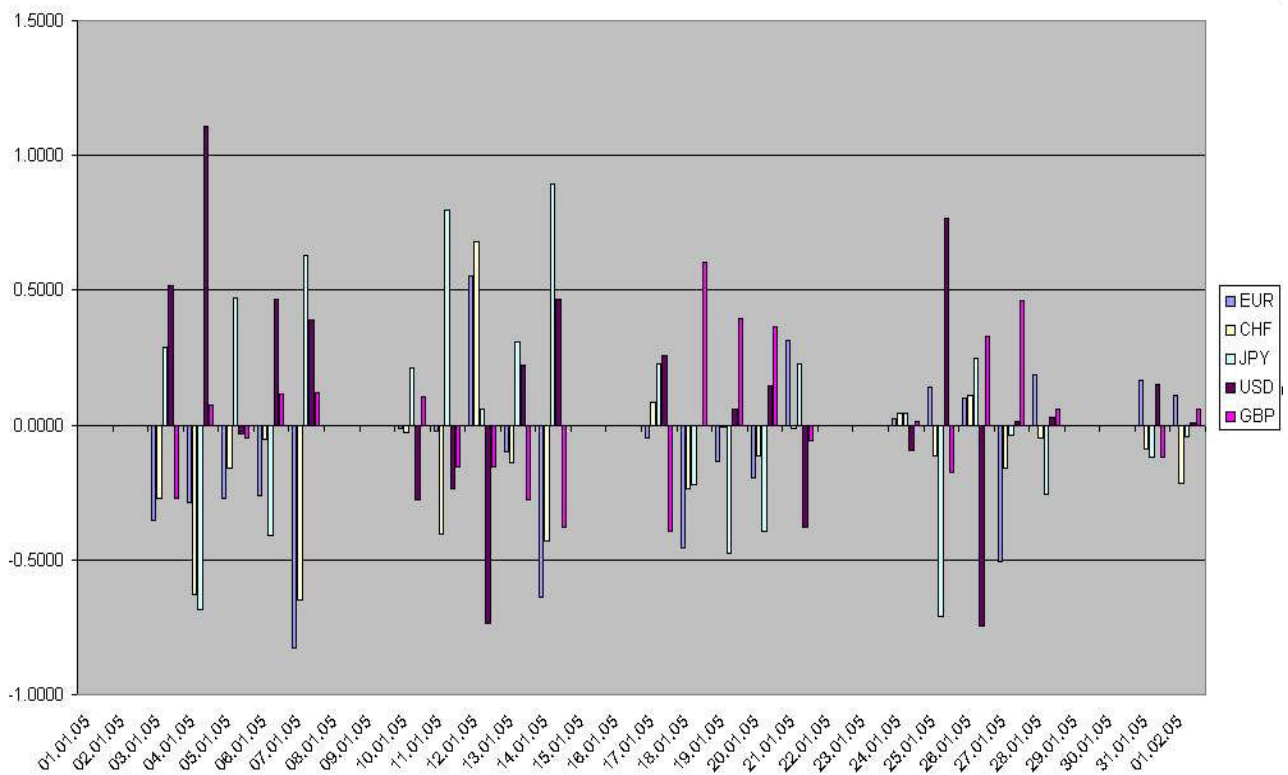
Foreign exchange dealing grabs the ordinary guy's imagination. Trading seems glamorous to them. Many people who are starting out in the business imagine themselves as gurus who have 'magic' powers and know how market will develop. In addition to this, a newbie will often risk everything when he gets a signal to open a position which he considers to be 100% certain. "This is my only opportunity to become a second George Soros or Warren Buffet", - he thinks. – "When I manage to make a proven forecast for price and increase my account sharply, I won't have to take anymore risks and will dedicate myself to thorough long-term market analysis". These, then, are the thoughts of an average individual who is just starting to trade.

I have to admit, that when I first started on the Forex market, I thought that way quite for a long time. I have also seen many traders that are forever looking for the Holy Grail that will help them to make large gains easily. But the idea of the "one big one" which leads to opening a large position in the right direction and hits the jackpot still keeps prevailing over a cautious and rational trading approach. You'll see it most clearly when a new trader with a small live deposit has a good run and trebles or quadruples it after a few deals. When you've had such an experience, you start expecting the same thing to continue. At a time like this a person will use various indicators and combinations; he changes their parameters, but is unable to faithfully follow a trading plan. And in my opinion, it's one of the most significant trading problems they experience.

My story was similar at the beginning of my trading career. Until, at last, I began to realize that a trading system should be clearly formalized. As I began to work on developing a system I learnt that you shouldn't try to combine all the types of analysis you know in your strategy because there are no guarantees that even if most of the indicators generate a signal to open a position it will be 100% failsafe. Another lesson learnt the hard way was that finding the best entry point was only half of the battle; you need to predetermine your exit at the most fortuitous time too. I mean that you should be careful not to close too early but also that you should be on the alert for any signs of trend reversal. Never ever forget that profit is only fixed on closure. It's for this reason that I think that perhaps it's more important to choose the point of exit than a point to enter the market. We'll speak more about this later.

And so after numerous experiments and copious research into the shared rules of systems developed by well-known writers working on the Forex market, I developed the following method which I'll try to describe below.

I don't stick to any special criteria of currency selection or limit my work to certain currency pairs. What I do is monitor almost all of the available pairs. My analysis of currency rate sentiment is based on the speed of price change relative to other currencies. The indicator of comparative speed of change estimates consecutive change of an index of basic currencies. This index shows what amount of basic currency you need to buy a basket of other basic currencies. For example, the calculation of the dollar index is based on how many dollars you need to buy 1 euro + 1 franc + 1 pound + 100 yen. The value of this basket at the beginning of the year 2001, i.e. at 02.01.01 is taken as the reference point. Then we watch how much the value of the basket has changed the following day compared to the base value. By comparing today's index value with yesterday's value we get the rate of change of the value of the currency basket. Such changes are calculated for the big five currencies: EUR, GBP, CHF, JPY and USD. These data are entered into comparative table. I think a histogram is the most optimal data format.



**Fig. 8.2.1 An example of strength index change for January 2005.**

With the help of this chart we can see clearly what currencies experienced the biggest rise or fall comparing to others. Thus, on January 3 of 2005 we can see (see the chart, fig 8.2.1) that the dollar relative index rose the most; and the euro relative index fell the fastest of all. On the basis of this data we can expect that because of the inertia prevalent in the nature of financial speculators, tomorrow's trading activity in currencies will remain the same. That's why we can assume that those currencies whose rates relative to each other were directed against each other yesterday have the greatest potential to change (i.e., we should take one of the strongest and one of the weakest currencies of the previous day). Thus, according to our example of January 3, on the next day, 4<sup>th</sup> of January we can select for trading currency pairs such as EUR/USD, GBP/USD or EUR/JPY. Practical experience taught me that this selection procedure didn't always generate the best choice. But the method of currency pair selection based on rise/fall in the prices of the indices of each currency's relative basket remains fundamental to the system. I'd like to note that the relative prices don't allow us to unambiguously state that tomorrow's currency prices will continue moving along the same direction. We select a certain currency pair only according to relative strength and expect a strong movement in price. We gain insight on the direction of this movement through technical analysis.

Technical analysis tells us what to do with the selected pair: to buy or to sell. Here trading channels and trend following come into play: i.e., if the market is trending, we'll look for opportunities to trade in the direction of the trend. If there is a trading range in the market, than range-bound trading will be more appropriate. In my trading practice I use quite simple approaches to differentiate between a trend and a range, the boundaries of trading range or the borders of up/down trend

(to do that I apply parallel lines) for a selected currency pair. And depending on the result I trade range-bound or along the trend.

So, let's examine our actions on 4<sup>th</sup> January. According to the data of currencies' relative strength as above-said, we select such currency pairs like EUR/USD or GBP/USD for next day trading. Daily charts of these currencies follow in figs 8.2.2 and 8.2.3.

There is an uptrend on EUR/USD chart and the borders of this rise can be determined with the help of parallel lines. Thus you can see on the chart that the price of euro was falling 3rd January– it tried to test the support line. To trade along the trend it's necessary for the price to move along the trend.

The situation is more favorable for GBP/USD: a trend is being formed within a descending channel and the price is moving downwards along the trend on the 3d January. Here we get a confirmation that a bearish trend has started to develop, so we can join it by opening a short position, i.e. sell GBP/USD.



Fig 8.2.2 EUR/USD



**Fig 8.2.3 GBP/USD No. 1**

If we review how pound changed the next day we'll see the following:



Fig 8.2.4 GBP/USD No. 2

In fact, GBP/USD did fall on the 4<sup>th</sup> of January. It's worth noting that the speed of its decline was not insignificant: the pair lost more than 200 points during the day.

In his description of his trading system, Alexei Trifonov stresses the fact that besides developing rules governing making deals (entering and exiting the market), importance should be given to money management. According to Alexei's research, there are quite a large amount of profitable trading strategies, based on the simplest rules and indicators. Of course, not all of them yield high profits, but they are profitable. Nevertheless, there are not many traders who have a trading performance that corresponds to the performance of a given strategy. This is undoubtedly because they're not satisfied with the frequency of the signal generation and they cannot cope psychologically with several losing trades in a row. Traders start breaking the rules, make unsupported adjustments and try to second-guess confirmation signals. All this leads to defective trading, which, in turn, affects trading performance.

But this is not the trader's biggest pitfall. Leverage, by definition, increases risk exposure and employing too much leverage is even more dangerous than breaking the rules of a trading system. Alexei Trifonov recommends that a trading lot shouldn't exceed your account balance by more than 5-10 times. If you trade with a higher leverage, it can lead to a series of unprofitable deals that can result in the loss of significant portion of your account (even if that loss is within the range of

your average stop-loss). Strict control over your risks is the main factor in successful trading.

And that's that. At this point I'd like to thank Alexei for this work and for the rest of the help and advice he has given me. Of course, it's one thing to have a trading system that has been designed by a successful and experienced trader, but it's another thing entirely to follow it. It's very difficult to stick to a plan when you're on the market. You're always itching to fiddle and tweak! I agree that everything can be improved on, but you should never start making improvements while the plan is in motion and you have open positions. Make any necessary changes when you are off the market because its only then that you can make objective and rational decisions. All strategies and trading systems must be thought through in the calm of your office or study, far away from the emotional hubbub of the market.

### **8.3 Messing about on the river**

What do you like doing to relax? Some people like to a nice hotel by the sea. They swim, sunbathe, eat, you know the score. It's all very well as far as it goes but I have to confess I get bored with such an existence after a few days. What I really like to do is pack my bag and get off the beaten track. I know I'm not alone: in this increasingly computerized and globalized world many of us feel the need to find ourselves in the wild places. A couple of years ago I found myself in the Far East of Russia on the banks of the River Amur. Anyone who has visited the Amur will verify what a vast and willful river it is. It's a river that is infamous for its storms. When the wind blows against the current, the wind and the water begin to argue and extremely dangerous waves form. Every year the river claims the lives of river men, and most frequently, these are not novices, but experienced navigators in decent modern boats. At the same time, there are some very interesting statistics on the fate of unmanned boats that have gone adrift during such storms and are at the mercy of the mighty Amur: the vast majority of unmanned boats seldom capsize. The thing is a modern aluminum boat **never** capsizes in these conditions unless someone thinks they know best! So, if you find yourself in an extreme position on the river and you are in a half-way decent aluminum boat, then the best thing to do is... absolutely nothing; lie back and wait for the storm to play itself out.

It's the same with systems, the majority of them, either recommended by us or outlined by other authorities, are of a high quality. They are unsinkable boats. Maybe you won't get very far in them but you'll never go down.

As your experience grows and you leave the realms of the novice forever to hone your skills and master the tools and methods of the trade; you will gradually discover your unique trading style: the trader within and this self knowledge will guide you to create your own trading system which will bring profit to you and you alone. As you make this long and arduous journey, use tried and tested methods, observe the rules and don't take uncalculated risks. Remember those drowned men and why they die.

Both passion and contentment are lying in wait for you yet. Now the last chapter lies before you and it is dedicated to your next steps. Make your way carefully so that there will be the future will be without regret and be both fine and comfortable.