Getting Started in

FOREX TRADING STRATEGIES

SEVENTH EDITION

Michael Duane Archer

BICENTENNIAL 1807 WILEY 2007 BICENTENNIAL

John Wiley & Sons, Inc.

Getting Started in

FOREX TRADING STRATEGIES

The *Getting Started In* Series

Getting Started in Online Day Trading by Kassandra Bentley
Getting Started in Investment Clubs by Marsha Bertrand
Getting Started in Asset Allocation by Bill Bresnan and Eric P. Gelb
Getting Started in Online Investing by David L. Brown and Kassandra Bentley
Getting Started in Online Brokers by Kristine DeForge
Getting Started in Internet Auctions by Alan Elliott
Getting Started in Stocks by Alvin D. Hall
Getting Started in Mutual Funds by Alvin D. Hall
Getting Started in Estate Planning by Kerry Hannon
Getting Started in Online Personal Finance by Brad Hill
Getting Started in 401(k) Investing by Paul Katzeff
Getting Started in Internet Investing by Paul Katzeff
Getting Started in Security Analysis by Peter J. Klein
Getting Started in Global Investing by Robert P. Kreitler
Getting Started in Futures by Todd Lofton
Getting Started in Project Management by Paula Martin and Karen Tate
Getting Started in Financial Information by Daniel Moreau and Tracey Longo
Getting Started in Emerging Markets by Christopher Poillon
Getting Started in Technical Analysis by Jack D. Schwager
Getting Started in Hedge Funds by Daniel A. Strachman
Getting Started in Options by Michael C. Thomsett
Getting Started in Six Sigma by Michael C. Thomsett
Getting Started in Real Estate Investing by Michael C. Thomsett and Jean Freestone Thomsett
Getting Started in Tax-Savvy Investing by Andrew Westham and Don Korn
Getting Started in Annuities by Gordon M. Williamson
Getting Started in Bonds by Sharon Saltzgiver Wright
Getting Started in Retirement Planning by Ronald M. Yolles and Murray Yolles
Getting Started in Currency Trading by Michael D. Archer and Jim L. Bickford
Getting Started in Rental Income by Michael C. Thomsett
Getting Started in Exchange Traded Funds by Todd Lofton
Getting Started in Fundamental Analysis by Michael C. Thomsett
Getting Started in REITS by Richard Imperiale
Getting Started in Swing Trading by Michael C. Thomsett
Getting Started in Property Flipping by Michael C. Thomsett

Getting Started in

FOREX TRADING STRATEGIES

SEVENTH EDITION

Michael Duane Archer

BICENTENNIAL 1807 WILEY 2007 BICENTENNIAL

John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Wiley Bicentennial Logo: Richard J. Pacifico.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic formats. For more information about Wiley products, visit our Web site at www.wiley.com.

Library of Congress Cataloging-in-Publication Data:

Archer, Michael D. (Michael Duane)
Getting started in Forex trading strategies / Michael D. Archer.
p. cm. — (The getting started in series)
ISBN 978-0-470-07392-6 (pbk.)
1. Foreign exchange market. 2. Foreign exchange futures. 3. Speculation. I. Title.
HG3851.A7392 2007
332.4'5—dc22

2007023236

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

To My Wife, Elaine

Contents

Getting Started in

FOREX TRADING STRATEGIES

Introduction

Do something different, even if it's wrong.

—Charles B. Goodman

Getting Started in FOREX Trading Strategies

Getting Started in FOREX Trading Strategies is intended as a sequel to *Getting Started in Currency Trading (GSICT)*, although it may certainly be used independently. One comment readers often make after reading the latter is, "Great, now I know the mechanics of FOREX. But what do I do next?" This book addresses that question. However, it does assume some basic knowledge of FOREX.

If you are new to currency trading, I suggest you pick up a copy of *Getting Started in Currency Trading* and read and study the material before starting this volume.

Readers' expectations vary enormously. Most thought "getting started" truly meant getting started, but some assumed the book would carry them through more advanced training. A few were disappointed not to find a $19.95 black-box system leading to great wealth without effort. There is no get-rich-quick method in FOREX or any other market. *Getting Started in FOREX Trading Strategies (GSIFTS)* is meant to give you an initial perspective on various methods and a simple method on which to build.

Traditional Strategies

To most traders, *strategy* is synonymous with *trading techniques*—one or more of the many flavors of price charts or indicators such as oscillators and moving averages. In *GSIFTS*, strategy refers to the three primary elements that define a trader: trading techniques, money management, and the soft elements of market selection, trader profile, tactics, and psychology. Together they compose a trader's style.

A traditional trading strategy includes a charting technique such as point and figure or candlestick charts, a number of technical indicators, and perhaps a few other tools the trader has found useful in previous trading. Money management is typically an ad hoc set of rules for limiting losses, maximizing gains, and entering and exiting a trade. Most traditional strategies rarely consider style, or soft elements, in any depth.

Traditional strategies represent a linear approach to trading. Each strategic element is separate from the other. The elements don't communicate very well, if at all, with each other. The codex approach, introduced herein, applies a process paradigm to the elements and to trading.

Trading Strategies: The Elements

- Trading tools ("toolbox")
- Money management
- Soft elements
  - Style
  - Psychology and attitude

There is nothing inherently wrong with traditional strategies and the elements approach. Some traders are very successful with them. A plethora of print and online material currently exists for the traditional trader. But let's look at the facts. The FOREX market is not unlike other highly leveraged markets, such as options or futures. The statistics are not pretty; nearly 90 percent of new traders lose their initial account deposit in less than six months—most of them using traditional strategies.

I recently attended a FOREX convention in Las Vegas. I observed someone lecturing on chart support and resistance points. Useful information, to be sure, but probably not in the way the lecturer intended. The vast majority of traditional currency traders will be looking for the same or nearly the same support and resistance points. The market *never* cooperates with the majority; if it did, everyone would be a winner and it would soon cease to exist. To the codex trader, the traditional support and resistance points are useful only to see what other traders are thinking. The codex trader will seek to find the market's true stopping and turning points.

The Codex Process

The codex approach introduced in *Getting Started in FOREX Trading Strategies* attempts to meld the three elements into a trading process. Changes to one element, such as trading technique, will reverberate to the other elements. Instead of looking at the elements individually, a personal trading codex folds them into a process beginning with finding good trading candidates and concluding with a short postmortem of each completed trade.

An analysis of each completed trade allows the trader to adjust his trading codex in an evolutionary, rather than revolutionary, manner. The specific codex method I use is named FxCodex in this book. *Codex* refers generally to the process method of trading; *FxCodex* refers to the specific elements I use to trade currencies as a process.

Trading Strategies: Codex

- Tracking
- Selecting
- Entry
- Monitoring
- Exit

Steps to Strategic Success

A codex is very personal and will differ with each trader. The FxCodex method is my personal way of trading. *GSIFTS* will use it to explore the codex philosophy but offer individual choices for traders who want to go in a different direction. The key is developing a trading codex leading to a *process* rather than an *elements* trading approach.

Principles of Codex and FxCodex

- Codex is a process.
- Each step in a process is based on previous steps.
- Steps talk to each other.
- A change in one step of the process requires other steps to be adjusted.
- Process changes should be evolutionary rather than revolutionary.
- *FxCodex* is the name given my specific codex.

Developing any personal trading codex requires the trader to make a number of initial decisions. These decisions will define your initial trading codex. You can begin with a simple, basic structure and add to it as your experiences in the market dictate. This is just one of the advantages of the codex approach.

These decision *steps* are the transition required to move from a traditional-elements approach to a codex-process approach to trading. Too many traders begin without having made these decisions and then make sharp revolutionary changes in strategies as they go along. It is far better to have a codex defined before making any trades and make small, evolutionary adjustments thereafter.

The traditional strategies give heavy emphasis to trading tools, often ignoring money management and soft elements such as style, market selection, psychology, and tactics. The codex approach gives equal emphasis to all of them and places them in a process paradigm. See Figure I.1.

The trader may move back and forth between these steps before having fully built a codex. You may find, for example, that you have selected currency pairs inappropriate for your trading style. If so, you may want to go back and consider the selection of currency pairs vis-à-vis that information. The codex approach allows you to weave back and forth without major disruption to your overall trading method.

Tools

Your first step is to decide the trading tools or techniques you will use. The number of technical analysis tools is legend. There are dozens of charting techniques, indicators by the hundreds, and a myriad of methods, systems, techniques, and black boxes. It would be neither practical nor possible to assign all of them to the codex tool box.

In my opinion (after 30 years in the markets), systems and black boxes don't work consistently over different market environments and for long periods of time. If you find one that does, call me. Making money in the markets requires real work and constant diligence.

The most important factors in selecting codex tools are *transparency* and *simplicity*. If you cannot understand how a tool works and what it really does,

Trading Strategies: Steps

→ Tracking → ← Selecting → ← Entry → ← Monitoring → ← Exit →
← ←

FIGURE I.1 Trading Strategies: Steps.

don't use it. Making evolutionary adjustments to your codex requires you to be able to understand the tools you use for trading.

The trading technique backbone of the FxCodex method is charting. Most charts are simple, transparent, and visual. You can *see* what they mean. Indicators are often opaque; what are they really measuring? If you don't know what a tool does, how can you make adjustments when things go bad?

If you carefully examine many of the indicators available—typically a type of moving average or oscillator—you will discover the following: (1) The indicators are curve-fit to a specific market environment, and (2) they are really only variations of the slope-intercept formula you learned in eighth-grade algebra. They measure the slope of the price changes in a market. You can see that better and faster by simply eyeballing a chart.

Which charting technique should you use for your codex? Bar charts? Point and figure charts? Candlesticks? Swing charts? In fact, any will work just fine! Whatever charting tool you are most comfortable with, use it. I use bar charts primarily for finding trade candidates and then switch to swing charts for market entry and exit. This book gives examples using all of them.

Of course, you must interpret whatever charts you select. Traditional traders use such methods as support and resistance levels. They can be effective, but too many people are using them for the market to cooperate, in my opinion. How can all these traders be successful? In fact, we know they are not and cannot be. Don't be afraid to be in the minority; only a minority of traders is ever successful.

Charles B. Goodman was a commodities grain trader from Eads, Colorado. He became my mentor shortly after I began trading in 1973. Charlie entrusted to me many of his trading methods, the most significant of which I have introduced in this book as the Goodman Swing Count System, the Goodman Cycle Count System, and Market Environments. Perhaps even more useful was his astute money management approach to trading, which I have also shared with the reader.

The Goodman Swing Count System (GSCS) has stood me well for my entire trading career spanning more than 30 years. It's an excellent way to get a quick fix on any market and for determining entry and exit points. It's a good method for beginners or near beginners. You may use it effectively right away to trade and then plumb its more advanced features as your comfort level and trading experience increase. Such things as support and resistance will usually not be in the same places as they are using traditional chart interpretation concepts.

I rely on GSCS heavily in this book. It is the cornerstone of the FxCodex method. Remember, the FxCodex method is used primarily to show you how to develop and apply your own personal trading codex. What works for me may not work for you. The important idea is to develop a comprehensive and consistent codex for trading.

I have never been a fan of technical indicators. It is difficult to see what they actually do, or measure. Most of them require a curve-fit to some specific market environment, and when the environment changes, the indicator flops. Moving averages work well in trending markets but fall apart in trading markets. Oscillators work great in trading markets but fail in trending markets. Nonetheless I've included two that are simpler, that provide information not easily visible with any chart, and that can be adjusted to different codex trading builds.

Market filters, typically statistical, are easy to implement and they provide great value for all traders. Strategy may find you the pot of gold, but it is often tactics that allow you to bring it home. Filters assist you in deciding what markets to avoid and on what markets to focus your valuable and limited time. Most of the market filters detailed in this book derive from the *FOREX Companion* series of books, written by this author and James Bickford.

Markets

Your second step is to select which currency pairs and crosses you want to at least begin trading. You may want to add or subtract pairs as you go along, but such swaps should be facilitated in an evolutionary, not revolutionary, fashion. This book lists five pairs and five crosses to meet a wide range of trading interests and propensities. The codex method allows you to keep more pairs and crosses on a monitor status and easily bring them into your trading if certain criteria are met.

The most popular markets are those including either the euro (EUR) or the U.S. dollar (USD). Five of the seven markets include one or both of these. The so-called *exotics* may offer exceptional opportunity, but they also command exceptional risk.

Currency pairs have different personalities and generally evolve slowly. The trader wants very much to select pairs for which his codex is a good fit. If you have an aggressive trading codex, select high-volatility pairs. If you are a very conservative trader, select low-volatility pairs. There are several other currency selection criteria that I discuss in *GSIFTS*.

Money Management and the Soft Elements

Your third step is to define yourself as a trader. This is a critical step and one most traders accomplish only by default. You will save a great deal of time and avoid much frustration by working through this process as early as possible in your trading career. Too many traders overemphasize the specific tools needed for trading and fail to apply the "know thyself" rule as traders.

What markets do you like to trade? Probably the ones in which you enjoy the greatest success. Analyze those for the characteristics that make them work, and stick to markets with those characteristics.

What are your personality traits as they relate to trading? Are you a calm or nervous sort of person, for example? Are you conservative or aggressive? What are your financial means and goals? Will you be trading an account of $3,000 or $30,000? How much are you really comfortable risking *in toto* and on any specific trade?

What money management ideas are best for you and for the tools in your codex? Are your selections realistic, and do they complement each other? Money management is *not* about how much money you can make. It's about avoiding losses. If you stay in the game long enough, you *will* make money. But if you lose your grubstake, you will not be in the game for that big payoff day.

My mentor, Charles B. Goodman, emphasized this over and over to me. I call it the *Belgian Dentist* approach. In Europe, Belgian dentists are considered the most conservative of traders. Trade the long term to break even; always consider risk above reward. I know, that doesn't sound very sexy. But if you break even over and over again, you will eventually win.

The primary money management parameters for all traders are the following:

- Aggregate account drawdown or risk.
- Win-to-loss percentage for specific trades.
- Aggregate percentage of wins to losses.

Different traders will modulate these parameters in different proportions, but it is important to set your standards up front, be realistic about them, and confirm that they are in agreement with the rest of your codex.

Getting Started in FOREX Trading Strategies—Sections in Summary

The following summary outlines the sections that make up *GSIFTS.*

Traditional Elements of FOREX Strategy

This comprises a brief overview of the traditional elements—trading techniques, money management, and style. A basic knowledge of the elements is