eBOOK

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How to trade the financial markets

CITY INDEX

CONTENTS

Spread betting, CFDs and Forex trading are leveraged products which can result in losses greater than your initial deposit.
Ensure you fully understand the risks.

The financial markets

The financial markets

Equity indices represent an average of a select group of individual shares, grouped by market value, a specific sector or geographical focus.

Spread betting and CFD contracts based on equity indices are seen as a general way of trading the exposure of specific markets. Equity indices are either weighted by the stock price or market value of the individual members.

In a price-based index, stocks trading at £100 would have 10 times more weight in the index than stocks trading at £10. In a market-weighted index, stocks are determined by their market capitalisation, which is obtained by multiplying the stock price by the number of shares outstanding.

FTSE 100

The FTSE 100 index is the most widely followed stock market index by UK-based investments and the UK news media. It consists of the biggest 100 UK-listed companies as ranked by market capitalisation (price multiplied by shares outsanding). The companies make up over 80% of the value of all the companies listed on the London Stock Exchange. Since the focus of FTSE 100 companies is in function of size rather than geographical focus, the international exposure of the index supercedes the domestic element to the UK.

S&P 500

The Standard & Poor's 500 (S&P 500) covers a broader number of US companies, whose capitalisation is greater than $3 billion. Some S&P500 companies are not incorporated in the US, but still meet the criteria of importance to the US economy as well as liquidity. Another crucial requirement is that over 50% of the shares in any S&P company must be sufficiently liquid i.e. available to be traded in the open market, known as a ‘public float’. The breadth of sectors in S&P 500 companies as well as their liquidity are among the reasons why the index serves as a benchmark for over $1 trillion of asset managers’ funds.

DJIA 30

The Dow Jones Industrial Average (DJIA) is an index of 30 large, publicly traded companies in the United States.

The companies of the DJIA are no longer necessarily industrial in focus, but those deemed reflective of the overall US economy. Manufacturing, transportation, energy/resources, banking and pharmaceuticals are the most popular sectors in the Dow Jones Index.

DJIA components are listed on the New York Stock Exchange as well as the NASDAQ.

Although most money managers and mutual funds measure their performance relative to the S&P 500 index rather than the DJIA, the latter draws considerable media attention. The relatively large size of the index about (11,000) provides more scalability for investors to measure daily and intraday moves.

Unlike the S&P and FTSE indices, which are weighted by market capitalisation (larger capitalisation have a greater impact on the average), the DJIA is price-weighted, which means that each company influences the index according to its price. The more expensive the share price, the bigger the impact on the index.

The DJIA also includes a re-balancing method of calculation, aimed at neutralising sudden changes in price resulting from stock splits, which increase the number of shares and reduce the price, but not the overall value.

NASDAQ 100

The NASDAQ stands for National Association of Securities Dealers Automated Quotations in the US, and is the first electronic securities exchange.

The NASDAQ 100 includes the 100 largest non-financial NASDAQ-listed companies by market capitalisation, typically in the technology, telecommunication and bio-science sectors. The role of technology and Internet companies in the NASDAQ was instrumental in lifting the index to dizzying heights during the dotcom bubble of 1999-2000 before the subsequent crash in the ensuing two years.

The role of giant tech players such as Apple and Google has been a key factor in sending the NASDAQ well above its popular US counterparts – the S&P 500 and the Dow 30.

DAX 30

The DAX index (Deutscher Aktien Index), is the benchmark stock index for the 30 major German companies listed on the Frankfurt Stock Exchange. Companies in the DAX are weighted by market capitalisation and book volume, and represent about 80% of Germany's total market capitalisation. The liquidity criteria is that at least 15% of each company's total capitalisation is actively traded, while the geographical requirement stipulates that revenues of member companies must come from within Germany.

NIKKEI 225

The Nikkei index is the stock market average for Japan's top 225 companies listed in the Tokyo Stock Exchange. Like the Dow Jones Industrial Average, the Nikkei 225 is price-weighted, lending more emphasis to the highest-priced stock prices. The Nikkei is Asia's most commonly used equity index, but has yet to return to the record highs attained in 1989.

S&P/ASX 200

The ASX 200 is Australia's most popular stock market index, tracking the price of the 200 largest companies listed on the Australian Stock Exchange. The ASX 200 is prepared by Standard & Poor's and has taken over in importance and popularity from the All Ordinaries Index. ASX 200 member companies are weighted by stock market capitalisation and must also meet liquidity requirements. The ASX 200 is strongly biased towards mining companies, partly due to Australia's broad concentration in mining and resources.

Currencies, FX

EUR

The euro was introduced to the financial markets in 1999 and went in circulation three years after that. It's the most widely traded currency after the USD, while EUR/USD is the most heavily traded currency pair in the foreign exchange market, accounting for about 25% of the daily turnover. The euro is the official currency of the eurozone, which started with 11 countries in 1999. In subsequent years, the eurozone expanded to 17 official members, all of which are part of the 27-member European Union.

As of 2012, the 17-nation member states of the eurozone were: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. The euro is also used and issued in five other European nations, which are not members of the EU. These are Andorra, Kosovo, Monaco, Montenegro and San Marino.

JPY

The Japanese yen is the third most heavily traded currency after the US dollar and the euro, while USD/JPY is the second most active pair after EUR/USD. Despite Japan's low growth expansion relative to more rapidly growing Asian economies, the yen remains a highly liquid currency due to the depth (size and volume) and breadth (multitude of instruments) of Japanese equity and bond markets.

A common characteristic of the yen is the tendency to appreciate during falling equity markets and depreciate during rising markets. This has been attributed to the yen “carry trade”, whereby investors borrow in low-yielding yen to invest in higher yielding currencies. Such a pattern is usually seen during improved risk appetite, i.e. when rising equity markets give traders the confidence to leverage their trades into higher-yielding currencies and faster growing instruments (equities/commodities). The carry trade is often unwound during falling or correcting equity markets, prompting funds back into the yen, and thereby boosting the currency at the expense of the currencies initially targeted by investors.

GBP

The British pound, or pound sterling, ranks among the currency majors (USD, EUR and JPY) in trading volumes, and GBP/USD is among the top traded currency pairs. GBP/

USD is commonly referred to as ‘cable’ in FX parlance due to the transatlantic telegraph cable established between the US and UK before the advent of radio communicated currency prices and shaped global commerce.

GBP became less sensitive to wild price swings stemming from policy changes after the Bank of England gained independence from the UK Treasury in 1997 in setting monetary policy, with the aim of achieving price stability. Prior to that, the UK Treasury had more influence on the Bank of England in setting interest rates to shape economic performance for political reasons at the risk of overshadowing inflation.

London’s time zone convenience role and its location as the world’s biggest financial centre have provided GBP with the resilience of a “safe haven”. Sterling has been widely boosted by the UK financial “capital flow” effect despite the decline in manufacturing and industry. More recently, however, the Bank has embarked on a process of ‘quantitative easing’ designed to help stimulate the UK economy by printing money to buy up debt. This has led to higher interest rates, but with UK base rates so low already, it has few other options.

AUD

The Australian dollar, also known as the Aussie, is among the leading "commodity" curre-ncies alongside the Canadian dollar. Besides Australia's global role as an exporter of base metals – primarily copper – it also ranks among the world's top five exporters of wheat. Such a unique position in agricultural products and base metals has lifted the Aussie closer to the four most liquid currencies in the interbank FX market. In 2012, the Aussie's dominant role was further lifted by the International Monetary Fund's decision to include the Aussie in its reserve currency data, a reflection of mounting interest by central banks to hold the currency in their coffers due to its yield and tendency to appreciate.

Owing to its exposure to commodities price cycles, the Aussie has become a proxy for global demand, particularly mimicking China's growth. However, this also means the Aussie is vulnerable to sharp declines during sell-offs in global markets and nervousness about the global economy.

CAD

The Canadian dollar, also known as the Loonie (for the aquatic bird on its one dollar coin) is another major commodity currency. The CAD's two primary features are that it is largely influenced by energy prices and closely affected by the US economy. With over three quarters of Canada's total exports destined to the U.S. and nearly four-fifths of total merchandise exports being energy related, the CAD is highly influenced by US demand dynamics and the price of oil.

Canada's exports also comprise timber, grains and base metals, making the currency a robust “resource play” in the currency market. Just as the Aussie is a primary commodity currency influenced by China’s economic fortunes, the Canadian dollar is the US-driven commodity currency.

CAD has been considered by the International Monetary Fund for addition to its database on central bank currency reserves, which primarily consist of the US dollar, euro, sterling, Swiss franc and yen. This reflects global investors’ increased interest in holding the CAD for its general resilience and the sound monetary policy conducted by the Bank of Canada.

CHF

The Swiss franc (CHF) has long been known as a “safe haven” currency due to the neutral stance adopted by its government as well as the high level of secrecy enjoyed by its banking centres. Switzerland’s opt-out of EU membership has especially enforced the franc's safe haven status during recent turmoil in the eurozone.

Until the late 1990s, the Swiss National Bank was mandated to keep 40% gold backing for its currency, which led to its active involvement in the gold market. This requirement was later reduced to near 25%, allowing the SNB to lend out more of its funds.

In 2009, the SNB began battling heavy inflows into its currency, stemming from escalating uncertainty in the eurozone. Those efforts failed to cap the soaring franc until September 2011, when the central bank promised to buy euros and prevent the EUR/CHF exchange rate from falling below CHF 1.20. The intervention proved successful, and led Swiss short term interest rates to fall below zero%.

NZD

The New Zealand Dollar (NZD), also referred to as the Kiwi, has risen in popularity since 2005 due to its high interest rates and tendency to fluctuate. New Zealand's leading role as an exporter of agricultural products, combined with the small size of its economy, has led to sharp rallies during improved market sentiment and growing economic climate. Rapid declines have ensued during periods of risk aversion.

The Reserve Bank of New Zealand had to resort to intervention by selling its currency in order to stem excessive appreciation, which weighed on its exports. NZD is among the better known "risk currencies", highly sensitive to swings in equity markets and general risk appetite.

Asian markets and their characteristics

The growth of eastern economies, particularly in the Asian region, has seen an important shift in global markets over the past decade. Most of the region has been fuelled by the tiger economies resumption of growth post the late 1990s currency crisis and more importantly, by the ramp up in China's rate of economic development. China is now the world's second largest economy, with a GDP of around US$7.3 trillion annually. It recently overtook Japan who, after decades of low growth, maintains a respectable GDP number of US$5.9 trillion.

The United States is still the world's largest economy by a huge factor and was in 2012 estimated to have generated GDP in the order of US$15.1 trillion. European funds are flowing to the high growth regions and so too are traders seeking market opportunities.

Chinese market – the main focus

The Chinese economy is unique in the following ways:

1. The banking and financial system is very much under the influence of the government and government-related entities.

2. Currency exchange is tightly regulated, with flows in and out subject to government approval as is investment in the local stock exchange.

3. The allocation of resources by the government is more balanced between

social order and economics than the latter when compared to western economies.

The structure and strategy around the Chinese economy cannot be viewed in the same way as other western developed economies. An investment view on China needs to consider one of the most important underlying elements – the ability of the central government to navigate its way through challenges.

The Communist Party needs the economy and associated flows of capital in order to sustain its existence. For many Chinese, this is the only system of government they have known. The US and European economies can withstand a severe financial shock without a shock to the underlying system of government, but in China the same does not hold. The Communist Party will do all it can in order to sustain social and political order and the economy is, to a large extent, the most important part. A collapse in China's economy could see a collapse to the system of government – something the ruling party cannot tolerate.

So the allocation of resources and fiscal approach is not purely driven by short term economics. China has emerged into the single largest consumer of energy globally, but the United States remains, by a very large factor, the single largest consumer of oil as an energy source – something energy traders watch very closely.

Issues with Japan in 2012

The above point is well illustrated in the political tensions that emerged between China and Japan in September 2012 over territorial rights. The largely political and diplomatic stalemate turned into an economic war of words. Chinese officials threatened the dumping of state held Japanese bonds and the Japanese returned fire with threats of pulling out much needed foreign direct investment into Chinese industry. The Japanese yen was virtually unchanged throughout the period of threats by the Chinese to dump government bonds, and the Chinese stock market was similarly stable during the threats by Japanese companies.

It's no secret that Japan has a debt problem as the government continues to spend more than it can earn. The rapid economic development in China means it currently holds around US$230 billion of Japanese bonds – the largest international creditor. In reality though, most of Japan's government debt is held by its own citizens – around 95% of total outstanding issuance. Traders know very well that the Chinese holding is probably something the BoJ can absorb through its own purchases and in fact any dumping, which puts pressure on the yen, will be welcomed by Japan's exporters by driving down the yen's value relative to the dollar. A weaker yen makes it cheaper for non-yen holders to purchase Japanese goods, boosting exports. This is where there is great debate over the 'currency wars' if focused on, whereby a country artificially keeps its currency weak to keep exports high.

Japanese foreign direct investment into China was estimated at around ¥628 billion in 2010. Japan was the second largest provider of outward foreign direct investment globally behind the United States in 2011. France was third. China needs Japanese foreign direct investment and Japan needs China's emerging investor base as a market to sell its bonds as its population matures.

Japanese market – still significant

Chinese GDP may have surpassed Japan over the past decade by that doesn't make Japan any less significant to the region. The market capitalisation of the Nikkei 225 Index for example, was worth around US$2.1 trillion as of early October 2012. The stock market might be modestly larger than its peers, but the size of Japan's total government bond issuance is huge – around US$12.69 trillion in outstanding notes. The biggest challenge facing Japan is not the cost of servicing this debt – rates are at near zero percent and have been for a long time. The ageing population is perhaps the largest problem. The government is finding that investors willing to park their money are creating negative real yields into the future once the current bond holders pass away and the assets are inherited by the next generation.

Australian market – Asian play

Australia has traditionally been a resource rich country and the rise of Chinese growth and development has also meant the rising need to consume resources. China is very self sufficient – it has its own energy and minerals industry as well as an agricultural powerhouse, but what Australia provides is high quality, long term security. Take iron ore for example – a key ingredient in manufacturing steel. China is the world's largest steel factory – it produces around 45% of total global steel consumption. Japan is in second place, but it only produces around 7.3%. Chinese and Japanese steel mills need

high quality iron ore and coking coal, which is abundant in Australia.

Energy is also a crucial import for Asian economies. China has some of the largest unconventional gas reserves in the world but developing them in a timely and economic way is a different story. This has seen the rise of liquefied natural gas in Australia, with international groups pouring in huge amounts of capital in order to secure projects that will be important energy suppliers to Asia in the decades to come.

The flood of funds into Australia has made it an attractive destination to play the Asian growth theme. It is a well established, well regulated and low sovereign risk market with global governance on par with other developed economies. The Australian dollar has emerged into the world's fifth most traded currency even though Australia ranks as number 37 among global peers when measured by foreign currency reserves in US dollars. The Australian share market contains some of the best known global names in mining and energy. BHP Billiton is the largest index constituent on the Australian market and it's no coincidence that it is also the largest global mining company

Hong Kong – customers and investors merge

Despite Australia market having the largest mining company listed on its market, it's the Hong Kong exchange which has recently been the most successful in capturing new IPOs – mainly European brands looking at aligning their growing Asian interests with investors. This has been evident with recent listings like Glencore, Prada and Samsonite among other names. The total market capitalisation for the Hang Seng Index in Hong Kong was US$1.56 trillion as of early October 2012, compared with US$1.19 trillion for Australia's ASX 200 Index (the main market gauge) in the same year.

Prada chose to list in Hong Kong because it sees Asia as an important growth segment for its business and wants to align regional investors with its growing regional presence. Its maiden interim earnings numbers for 2012, the first since listing, were always important in justifying the broad vision and ability to meet expectations. The data showed Prada generates around 44% of its total global sales in the Asian region when including the Japanese market. In terms of its products, leather goods represent around two thirds – the rest split across apparel and footwear. Products are niche and tailored to a very specific affluent demographic.

Trading with a plan

Trading with a plan

Before you start trading, you need to work out what you want to get out of trading. Most people will say they want to make money and that is a valid answer but several other considerations should be looked at as well. Understand why you are trading and what your goals and objectives are. You will need a plan to help you reach your goals.

Treat trading as a business

A trading plan can provide you with the framework you need to succeed in this business. Having a trading plan is a good sign of a disciplined trader and over time a good trading plan should be able to deliver greater profits than losses.

Start with the basics

Asking questions is important to find out what you are trying to achieve and how you will reach your goals.

Start by asking simple questions:

1. Are you trading to supplement your income or to eventually replace your income?
2. How much time can you devote to trading?
3. Are you going to trade during the daytime or in the afternoon to evening sessions?

4. How much money will you invest in this business?

5. Do you have the necessary tools for the job i.e. a computer, laptop or iPad?

6. Are you willing to take risks and how much risk can you take based on your capital?

7. What kind of psychological characteristics do you possess?

8. Are you flexible at making decisions or are you rigid and have to be right all the time?

9. Will you put in the time and effort to learn this business?

10. Are you determined to succeed?

This is by no means a complete list of questions and each person will have different needs and requirements. It is your job to ask the right questions to suit your own personal needs.

Any successful business will go through a series of questions to find out what exactly it is that the individual or company is trying to achieve. You as a trader should treat this as your business and it is your responsibility to ensure that you understand what is required to succeed and how you will achieve success by taking a series of small steps to reach your trading goals.

Trading successfully requires time, effort and money and having a clear sense of purpose should help you choose the right tools and techniques to become successful.

What should your plan include?

Your plan should be a blueprint for your business. Any business is essentially about making a profit. Trading financial markets is about buying and selling with the intention of making a profit. Therefore your plan should include detailed instructions on how to achieve profit targets whilst keeping your costs and risks low.

Many beginner traders overlook the importance of creating a well thought out plan. At the very least your plan should include the following:

- ✓ Have you set up your computer and charts for trading?
- ✓ Do you have a backup computer or internet connection?
- ✓ Is your trading account opened and ready for trading?
- ✓ Which markets will you trade?
- ✓ What time frame will you be trading?
- ✓ How will you test your trading ideas?
- ✓ Do you have sufficient capital for your chosen time frame?
- ✓ What are your profit and risk objectives?

- ✓ Have you defined your entry criteria?
- ✓ Do you have a plan for exits on both profits as well as protective stops?
- ✓ Are you prepared for sudden unexpected market movements?

Make your own personal plan

It's very easy to fall into the trap of trying to copy somebody else's plan or trading ideas. After all they have done the hard work and all you have to do is follow them. But this strategy has some drawbacks.

If you consider two athletic runners; both want to run to win a race. But one of them is running in a sprint and the other in a marathon. Both want to win but each of them will have a different approach to winning.

Whilst one will be in this for the short term, the other will be prepared both physically and mentally for the longer race.

Trading is not a race to win but, similar to the two runners, you need to plan your trades to suit your personality and personal dynamics. Are you trading for quick wins or are you looking for gains over a longer period of time?

Once you have decided what you are trying to do, you can create a personal plan designed for your own needs and stick with it rather than chopping and changing. Always remember that this is your plan. Make it personal. The plan should fit your needs, your temperament and your trading style but more importantly also fit with your lifestyle.

Don’t wait until you know everything

Many traders think that they have to know everything before they start trading. This may be true for some businesses but with trading you can get started with just the basics.

You will never know everything all in one go. You can start by trading one market at the smallest trading size and adjust the size and the market until you find your comfort zone. Over a period of time you'll come to realise which markets and time frame you are comfortable with and how much you are willing to lose.

Trading is a journey

Once you have started trading you will find that your confidence level should increase and your level of knowledge will grow. There are no shortcuts in this business but as long as you remember that acorns grow into trees, you too can start small and potentially end up winning big. There are no guarantees of success. Take one step at a time, learn as you progress and enjoy the journey.

Tools for trading

Once you have created the initial outline of your plan, you will need to gather the tools for your trading business.

Fortunately for trading, the tools required can be as simple or as complicated as you want. The basic tools are a computer and internet connection. Nowadays, trading companies even provide you with free charting software.

Create your list

Start with your computer. Make sure that your computer is for trading only and not used by other family members or friends. Remember this is your workstation.

Do not use your trading computer to search the internet or for social use. Visiting websites that are not necessarily useful for your trading can open the door for viruses to affect your workstation. It is better to use an alternative computer to do your internet searches and your workstation to monitor and enter and exit your trades.

Here are some basic tools and utilities for you to consider:

1. A computer with an internet connection

2. An alternative computer for backup

3. Software for charting and back testing trade ideas

4. Books on trading and psychology

5. Education from seminars and workshops.

When starting out in trading it is very easy to become overloaded with too much information. Try to avoid overwhelming yourself and keep your charts and workstation clutter free.

Some traders feel they should have multiple screens and others are happy to work from one screen. Initially you may want to start with one screen and you may want to expand this to two or more screens as required.

At City Index we provide you with a powerful trading platform and professional education to help you get started. Any additional tools you may need are at your own discretion.

Setting realistic goals

Once you have created your trading plan, set up your workstation and internet connection, it is time to set some realistic goals.

Initial objectives

The first objective is to stay alive. This means to not go overboard and trade all the markets with several different trading strategies and become completely overwhelmed.

Start by focusing on one market and applying a trading strategy or testing an idea based on some pre-research you have done. Remember your trading plan was designed to assist you in this area.

Learn to have patience and discipline with your market, your strategy and yourself. This is a key trait of successful professional traders.

At this stage you are simply learning to identify an opportunity to enter a trade. You should try to not to second guess or predict the market. Learn to let the trade setup develop, rather than trying to force the trade.

Guidelines to help you

1. ‘Plan your trade’ and ‘trade your plan’

2. Have you done your homework for this trade to manage from start to finish?

3. If you are not sure – don’t trade

4. Is your profit potential greater than your initial risk?

5. Do you have sufficient margin in your account for this trade?

6. Is this trade a technical trade or an emotional trade?

7. Do you have rules and stops in place to protect you if your trade goes against you?

8. Could any important news announcements impact you or your trade?

9. Will you be monitoring the trade in real time or do you have Limit orders in place?

10. Remember to stay calm and in control throughout the whole process.

You should review your trading plan from time to time and make necessary adjustments to ensure that it is in line with your current objectives. Short term traders may want to do this once a month and longer term traders may choose to do this every six months.

Keep a trading diary

If you are looking at ways of improving your trading then keeping a trading diary is a useful method to take your trading to another level.

Learning from past mistakes

Most people make New Year resolutions or promises they never keep. Are you one of these people? While today's technology and fast paced lifestyles make it tempting to put off something that may prove to be critical in your long term success you will find that keeping a diary could prove to be extremely useful.

If you start by taking a look at a recent trade and examine why you took the trade and why you exited the trade it may come to light that there could have been some overlooked mistakes.

The first and most important point is did you follow your trading plan?

By starting at the beginning and then dissecting each component of the trade you can reach a point where you can examine where you may have gone wrong and how to improve that part of the process in your trading plan. It may be that you did not wait patiently for the exact setup as outlined in your trading strategy. Next time you may need to learn to be more patient. Or did you exit too early out of fear? Did you ensure that you used the correct position size for your account size or did you over trade or under trade? By asking questions and seeking the right answers and applying the right approach may help increase your overall returns.

Small changes for big results

Sometimes it takes just small changes to get bigger results. Never forget a small loss can turn into a big loss if not managed properly.

You do not have to look for new methods all of the time if you have just experienced a loss. One trade does not justify a winning or a losing strategy. Amateur traders will jump from one strategy to another searching for the Holy Grail only to find that simply adjusting or improving an initial trade idea may render better results.

Time to reflect

A diary also becomes useful at times when a trader may need to reflect on whether the approach he or she is using is really in line with their personality.

Having a trading plan is one thing but examining and reflecting the overall business is just as crucial. In the business world most successful companies and organisations will go through a yearly audit. This is simply to see how they can improve the business and increase their profit potential whilst minimising costs.

By writing down your thoughts on paper and then analysing them at a later time you may be surprised at what you originally thought may be a good idea may now not be worth looking at.

It may be that in the excitement of the moment the idea appeared to be good but is technically redundant. Not all ideas are good ideas and not all ideas are bad ideas. Your job as a trader is to find simple ideas and workable ideas followed by a process of improvement.

Track your trades

Your diary should help you to track your trades. Importantly your diary will show a record of why you took a trade and why you exited the trade. It will show over a period of time which ones worked and which ones did not work. Also you may find that there were "times" when your trades may have worked but you were not in line with either the market or your strategy. Or in some cases, did your trade deliver a profit because you simply got lucky?

Maintaining a journal helps you to become more aware of your process and helps you to identify your strengths and weaknesses.

Laziness is one of the traits of a losing trader. And some may view keeping a diary as unnecessary or a waste of time. But it has been well documented that professionals in any field have found keeping a journal both stimulating and inspirational to generate new ideas.

Your diary should help you to:

- ✓ See if you are sticking with your plan or failing to have discipline and patience
- ✓ Show how you are handling stress
- ✓ Determine your best and worst times of trading.

Regular review

By keeping a log of entries in your diary and having a regular review learn to see where you can make improvements for you and your trading business. Keeping a trading dairy is an essential component of your trading plan and something that should not be dismissed or overlooked.

Risk management insights: managing portfolio risk

Risk management insights

Managing portfolio risk

There are several ways to measure risk but a common school of thought which has emerged in financial markets over the past few decades is one which stands back and doesn't attempt to undergo this painful process. Many traders find it difficult to measure risk – so they don't even bother anymore. What they do is separate asset classes into two groups – risky assets (anything other than cash) and non-risky assets (cash). They then blend the basket of these two assets to form what's commonly called a Barbell Strategy.

The term Barbell Strategy is often referred in finance to a strategy where traders take long and short positions in bonds. But more recently, the term has been used to define this blend between two asset classes – combining a hyper sensitive and hyper aggressive investment approach while limiting downside risk. Many athletes have also recently put this strategy to use – training at extreme levels for a short period of time and relaxing for longer than usual periods. The jury is still out on how it works in the field of sport, but in finance it tends to make a lot of sense.

Application of the Barbell Strategy

Take a listed company for example and its equity as traded on the markets. When stocks are quoted, like GOOG (Google) for example, this represents the value of equity. It ranks below debt, which means in bankruptcy those holding the rights to equity are the last to be paid. Around 95% of fund managers and stock traders spend their time deciding what a company's equity is worth. Valuations, measurements, company visits and other conventional measurements of risk have failed to insulate even the largest global investors from losses in recent years.

Rather than spending hours trying to determine whether its management is of a good reputation, its balance sheet's ability to pay debt, its profitability, or decide its 500-day moving average – many traders will just form the view that this is a risk asset. In contrast, cash in the bank is considered no risk. Sure the financial institution can go into bankruptcy and deposit holders can technically lose their money, but cash in the bank for many traders is the closest thing possible to no risk.

Investors with access to bond markets can opt for Treasury bills if they feel deposits in the bank are of a higher risk. One should consider the appropriate transaction costs. Remember, the point here is to be hyper conservative. Capital preservation is key. The most extreme option is stashing money under your mattress but there is always the risk of theft, the risk of loss or the risk of spending on impulse.

Barbell strategies are popular because they help traders minimise their capital downside. Most traders by definition would be comfortable with medium risk. Some want low risk, some ultra high risk. The mistake most make when entering the market is attempting to invest 100% of their funds in what they perceive to be medium risk businesses. The recent market collapse in 2009 highlights the vulnerabilities of this strategy. Regardless of how well we study assets, when fear hits markets even the safest investments tend to take a tumble.

So a trader who wants medium risk exposure to their portfolio would apply a Barbell Strategy in the following way: they might choose to place 90% of their funds in the bank. If markets collapse or rally against them, they know with a good degree of certainty that 90% of their capital is preserved. With the remaining 10%, they can chose to take high risk trades with high reward payoffs. At worse they will completely lose 10% of their funds, at best they have 90% of their capital preserved and huge upside from the 10% high risk exposure. The net outcome is a medium risk portfolio that is not vulnerable to shocks or what is commonly known as negative Black Swan events.

The percentages can change based on risk tolerance, but the underlying question traders must ask themselves is what proportion of their money are they willing to initially lose? If it's only 5%, then that should be the maximum amount applied to their risk exposures. Keep in mind, compounded interest on the cash component will usually mean the portfolio is back at 100% of its initial value within a certain number of years should the risk component be completely wiped out.

Diversifying the risk component

Once a trader knows their Barbell allocations – let's say 90% cash and 10% high risk – the next step is to allocate the exposure in the 10% basket. While conventional investors will seek to diversify 100% medium risk portfolios into a set number of stocks – say 20 stocks with 5% each – the Barbell trader will seek to allocate the 10% high risk component based on returns. For example, let's take the equity of an emerging company, perhaps a biotech or a technology stock or a mining company that has huge prospects.

The payoff could be huge and so the 10% risk component relies on hyper payoffs in order to achieve best results. The motivation should be which equities would give the highest possible exposures. Similarly, for those trading the commodities, indices or forex markets, the 10% allocation should be spread out to achieve maximum payoff. If the maximum allocation to a single position is say 2% of the total portfolio size, the five positions taken should be the best five with respect to possible upside.

Knowing when to stop

The first thing most people do when buying a car or home is purchase insurance. In most developed economies, like the UK, US and Australia, insurance consumption per capita is multiple of that in developing countries in Asia. The cost relative to the overall value depends on the likelihood of loss, competition among insurance underwriters and other seasonal factors. Most traders or investors, however, dismiss the need to place a stop loss and don't see it as an insurance policy against their holding. Their position in the markets is usually much larger than the value of their car, but they tend to disconnect between the chance of a car accident and the chance of their trade going against them. Stop losses are an important market innovation of which one can take advantage.

The Barbell Strategy is based on the underlying premise of capital preservation. The amount allocated to risk should be capped in order to preserve the allocation to zero risk through cash. There is no point in applying a Barbell Strategy if the losses in the risk component eat into the zero risk basket of funds. Hence discipline is important. The main criticism against stop losses is that they can often be hit and then the market moves back in favour of the trader, taking them out and depriving them of the turnaround in markets. One way to minimise this is to place several stop losses at various amounts, averaging the levels and avoiding the possibility of one point being taken out and completely depriving of an upside.

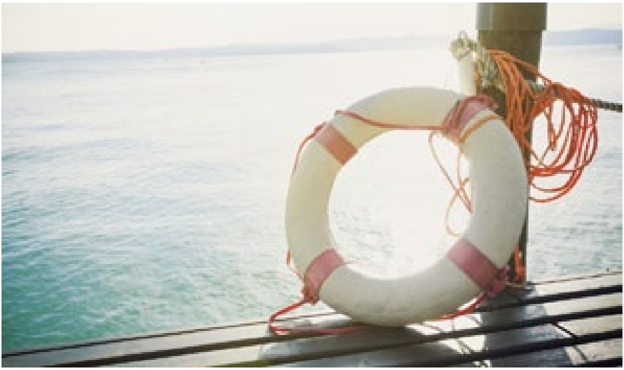
Back to the 90% cash/10% high risk Barbell example. If we assume the 10% is invested in currencies – 2% across 5 trades, then for each individual trade the stop losses can be phased in at four equal levels. Let's assume a US$100,000 portfolio size.

- ✓ Allocation to cash US$90,000
- ✓ Allocation to risk US$10,000
- ✓ Allocation to each currency position US$2,000

Assuming four stop loss positions, the stop loss level for each position would be in US$500 increments. Best case scenario is the US$90,000 in the bank is protected and earning interest, the five US$2,000 positions are all in the money and earning a high return. Worst case scenario is the US$90,000 is protected in the bank and the US$10,000 is lost through phased out stop losses across five different currency positions which, statistically is not impossible but very unlikely.

Risk management insights – (business risk vs. price risk)

There are two main ways to measure risk for any given security but the distinction between each approach is not always obvious.



Pricing risk vs business risk

The first measure looks at the asset's pricing – let's take a company's share price for example. We call this method the measure of pricing risk. It is relevant to all other traded instruments – commodities, currencies, indices etc.

The basic mechanics is to take price movements over a certain time and use this sample as a base for measuring risk. Some of these measures look at the movement of pricing in the past and the relationship this can describe. For example if we take a 500-day sample average of a company's share price, we can form a good description of how the share price tends to move day to day, the types of extremes the particular company exhibits when markets are up and down and so on.

When using price risk, the most common analysis is to take a wide sample, like 500 days for example, and use mathematical tools to work out means and variances – in simple words, working out the average movement and comparing extreme movements against this. Most of this data is applied to the various forms of technical analysis and formation of charting signals. The problem with pricing risk is that it is all based on the past – past prices, past movements, past trends.

The past is usually a good indicator of the immediate future but not always and that's why many fundamental analysts tend to also focus on the underlying business risk – particularly when trading stocks. Business risk tends to focus on a company's financial position, its management, its strategic goals, the quality of its business etc. There is no right or wrong method; it all comes down to the underlying ideology of the trade itself.

Here are some positives and negatives for using price risk only, neglecting the subjective measures of business risk.

Price risk – positives

Price risk doesn't require guessing around the qualities of an asset, takes emotions out of the equation, can be used in conjunction with complex trading tools and is easy filter and organise for analysis.

Price risk measures become more relevant when trading currencies and liquid assets. It's much easier to use previous price movements to set trading parameters around a currency position than it is to dwell on large economic themes like a country's trade balance, balance sheet and sovereign debt position, ability to raise taxes and manage budgets etc. Price risk measures also make automation easier – setting certain risk parameters can help traders minimise their capital risk, for example. A profit level around certain price movements, based on certain statistical limits, can help exit a loss or take a profit before the market turns. This would be very difficult with business risk measures which can often relate to a more long term time horizon.

Price risk – negatives

*Is based on the past, doesn't take into account the possibility of extreme movements and neither is it captured in the sample period. Data can be distortive and incomplete, leading to errors. It is widely used and commoditised, removing competitive advantages.

Like all things in life though, looking at pricing risk measures can also carry dangers and traders should be aware of the limitations. The best example that comes to mind is the analogy of a turkey that has been fed by its owner every day for the past 100 days. The fact that each day its owner wakes up and feeds it tends to create a false sense of certainty that its life is secure, until on the 101st day the owner decides the time is ripe to slaughter it for a feast. Using past data alone, the prior 100 days before the slaughter would have given the false sense of belief that things are stable and certain.

This is largely an ideological discussion and City Index sees the benefits in both styles of risk measurement. Many traders who use price risk and technical analysis will argue that building provisions into their trading, like guaranteed stop losses for example will limit near fatal experiences. It all comes down to the individual trader’s disciple, our point here is to note that there is no perfect measure and price risk can be very useful but is also often very deceptive in forecasting the future.

The case of Long Term Capital Management (LTCM) is one worth remembering. This was a Greenwich (Connecticut) based hedge fund which collapsed in the late 1990s after taking huge losses across its portfolio. Despite having some of the smartest investment advisors – including Nobel Economics Prize winners Scholes and Merton – the whole focus on price risk alone saw initial annualised profits in excess of 40% quickly evaporate. Even the smartest people in the world cannot guarantee trading success on price risk measures in isolation. LTCM lost US$4.6 billion in less than four months following the unexpected but fatal Russian financial crisis.

Business risk – positives

*No need for complex information, can often be as simple as talking to other analysts and investors, takes into account the future of the asset and not necessarily the past. It is also inexpensive.

Business risk – negatives

*Allows for emotions to take hold. Information can also be distorted by poor reporting by the company or miscommunication when forming facts. No measure of certainty in quality of information.

There are three real sources to measure business risk; most of these measures are relevant to those trading stocks and listed companies. Business risk can be applied to governments who issue currencies and bonds or commodities which are based on demand and supply from industry or investors, but usually the discussion around business risk measures is one based on stocks. The first area of measure should be the balance sheet. It’s all very well to have a good business but too much debt and the risk of default can destroy an otherwise solid proposition. Solvency is very important and a business’s ability to meet and manage its debt obligations, particularly in the current market environment where earnings growth is difficult, should always be considered.

The chart and prior data could point to future upside but this means nothing if bad management comes into the business and depletes resources, loses its customers and puts earnings at risk. This is the second area of business risk often referred to as management capability. Many traders will solely trade a business based on the personalities running it, their management style, their communication policies and more importantly their track record.

Apple is a perfect example of an ordinary business which, through excellent management, was able to grow into the most profitable global brand, now among the largest listed exposure on the US stock market. The journey was managed by Steve Jobs whose life was cut short through an unfortunate long term illness. The departure of Jobs from the management team has recently cast doubts over the long term growth potential and thus there has been volatility in the share price based on this.

The third measure of business risk is the industry in which the company operates. Newspapers are a perfect example. Many global names have booked solid earnings over the decades but have recently seen their share prices slump as the shift towards online reporting ramps up. The aviation industry also has a reputation for destroying shareholder value, due to its high capital intensive nature and cost pressures from rising fuel prices – the largest single input cost for many in the industry.

Measuring business risk isn't without drawbacks. Emotions can be difficult to control when weighing up the above considerations. Companies can often distort of even manipulate their communications with the market and many traders have recently been caught out by sudden shock announcements. Again, business risk measures can be useful but are not perfect, sometimes price risk is the best indicator, sometimes a blend between both price and business risk is suitable. Either way, both methods should form part of a trader's toolbox.

4

Technical analysis

What is technical analysis?

There are basically two types of speculators in the stock markets. One can be considered as an investor and the other as a trader.

An investor may be an individual looking to buy and hold to create passive wealth, whereas a trader is an individual who actively times the market to generate an income.

Investors attempt to determine the value of a market. By observing and analysing the news, earnings, economic outlook on both the short term as well as long term, investors are seeking for longer term movements to the upside. Traders tend to focus solely on price data, especially short term time horizons, and also benefit from falling prices which is an additional advantage over investors.

A trader can use a variety of tools in today's markets and one very important and increasing popular tool is the use of Technical Analysis.

Finding short term profitable opportunities within the financial markets is about interpreting the current position of the market and then preparing yourself ahead of time for a potential move in your favour. It is essentially about taking a small risk and seeking to gain a larger return over a period of time and technical analysis can be a useful tool to assist in this area.

Compared to other schools of thought, Technical analysis can be considered as a neutral tool which does not rely on an analyst's forecast based on his or her views of earnings forecasts or whether a market is undervalued or overvalued. Instead, Market Technicians choose to focus on price, patterns and timing.

The advantages of technical analysis are that it can be applied to virtually any trading instrument and in any time frame. Technical analysis can be used to analyze anything from stocks, commodities, interest rates to forex. You can also apply technical analysis from a short term perspective to a longer term time frame. In fact it can be applied to a chart ranging from minutes on an intra-day time frame to weeks or even monthly time frames.

It is important to understand that technical analysis can be used as a standalone method or it can be incorporated with other methods such as fundamental analysis and also market timing methods if you choose to do so.

Professional traders use technical analysis to create a set of clear rules and guidelines to assist in the decision making process of when, where and how to enter and exit a trade.

Using popular Technical Indicators and Chart Patterns, a trader can apply readily available tools and techniques to find potentially profitable trading opportunities in the global financial markets to assist in successful trading.

Charting essentials

Chartists believe that past patterns based on human behaviour often repeat themselves – providing tradable opportunities.

An essential tool for the market technician is a chart. There are many different types of charts used by traders and we will look at the three popular types of charts used by active traders.

With a chart, a trader can see visually where a market has been, where it is right now and where future prices may reach based on a number of other technical factors including chart patterns and indicators.

Chart components

The three major components of a chart are:

- ✓ Price
- ✓ Time
- ✓ Patterns

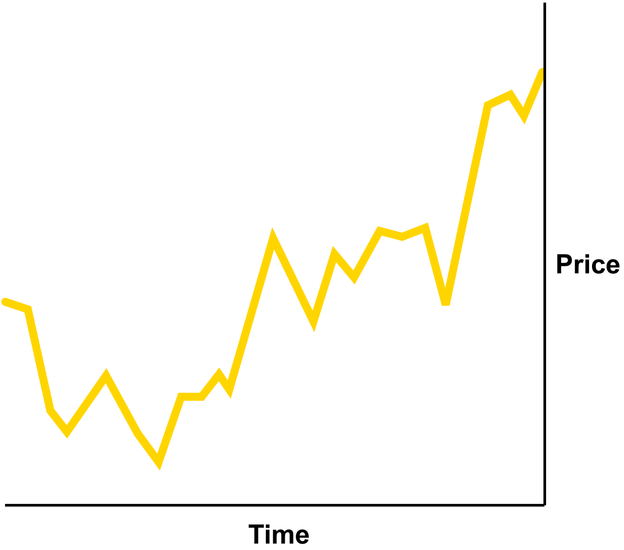
The price is plotted on the vertical (y) axis and time is plotted on the (x) axis. During the rise and fall of prices, traders typically look for patterns which may indicate the next most probable behaviour of a price.

Line charts

A line chart monitors closing prices only. When plotted on a chart, this type of analysis is focussed only on where the price has closed.

Line charts are often used over a longer time period and can be useful because of its simplicity to see trends.

Line chart



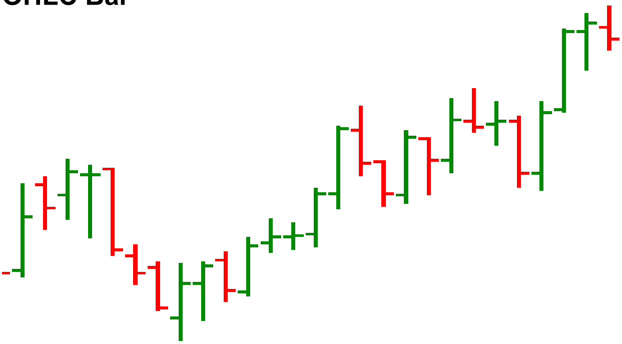
Bar charts

Bar charts consist of four elements. These are Open, High, Low and Close. A bar chart is sometimes referred to as the OHLC bar.

The vertical line is considered as the range of the bar with the High at the top and the Low at the bottom of the bar. On the left, the small horizontal line is the Open whilst the small horizontal line on the right side of the bar is the Close.

The OHLC bar shows the relationship of the closing price relative to the Open, High and Low.

OHLC Bar



Candlestick charts

Candlestick charting is a technique that was originated by the Japanese.

Although candle charts have been around for hundreds of years and used in the Far East by traders, in more recent years it has become increasingly popular in the rest of the world.

Candlestick charts display the same information as the bar chart, such as the Open, High, Low and Close but also offers an additional element known as the Real Body. Depending on whether the closing price is higher or lower, the colour of the candle will be different.

When the closing price of the bar is lower than the open, the colour of the body is dark. And when the closing price is above the open the colour of the body is light.

Some traders prefer to use candlestick charts as this style can prove several chart patterns not

Candlestick

seen so easily on bar charts. Others prefer to use line-only charts as they base their analysis on closing prices only.

Whichever style you choose, it is also important to understand that no one chart is better than the other. What is important is to determine which of the three styles of charts meet your needs and also which one of these you find most comfortable.

Trading with the trend

“The trend is your friend” is an old adage in Technical Analysis. Successful traders are known to trade with the Trend. The objective is to determine whether a market is in a trend or a consolidation stage. But what is a trend and how should you trade with them?

What is a trend?

From a logical perspective, a trend has movement and direction. Markets can move in three directions:

- ✓ Up – considered as an uptrend and bullish
- ✓ Down – considered as a downtrend and bearish
- ✓ Sideways – considered as range bound

Triple Top Pattern

Triple Bottom Pattern

As well as direction, the markets also have three trends:

1. Major

2. Intermediate

3. Minor

A major or primary trend is considered the main trend over a longer period of time. This is the dominant direction of a market movement.

Within the major trend we can also have a secondary or intermediate trends. These are known as corrections.

Smaller movements which tend to last for very short periods of time are referred to as minor trends.

How to trade with trends

If a market has been bullish and is heading higher followed by a move lower and then resumes its original direction, the move lower is the secondary trend whilst the move higher is the primary trend.

Minor trends typically last a very short period of time compared to secondary trends. It is the minor trends where day traders attempt to capture smaller micro movements.

Therefore from a time perspective, longer term traders look for primary trends to capture larger moves ranging from weeks to months. Intermediate-term traders seek to capture Secondary trends lasting from days to weeks and short term traders tend to look at minor trends ranging from hours to days.

When entering a trade it is important to know which direction the markets are currently trading in to offer higher probability of successful trades. It is easy to think that being on the right side of the market should yield good results and although this sounds simple it can be difficult especially for beginners to enter a trade at the wrong phase of a trend.

Tools for trends

Some market technicians will say that trends can start without warning and can end abruptly. Others believe that using tools within technical analysis, a trader can at least benefit from observing chart patterns, using trend indicators such as moving averages and technical situations such as divergence.

A divergence is when markets are heading in an opposite direction relative to a technical indicator. More on this is covered in the indicators section.

Trend lines

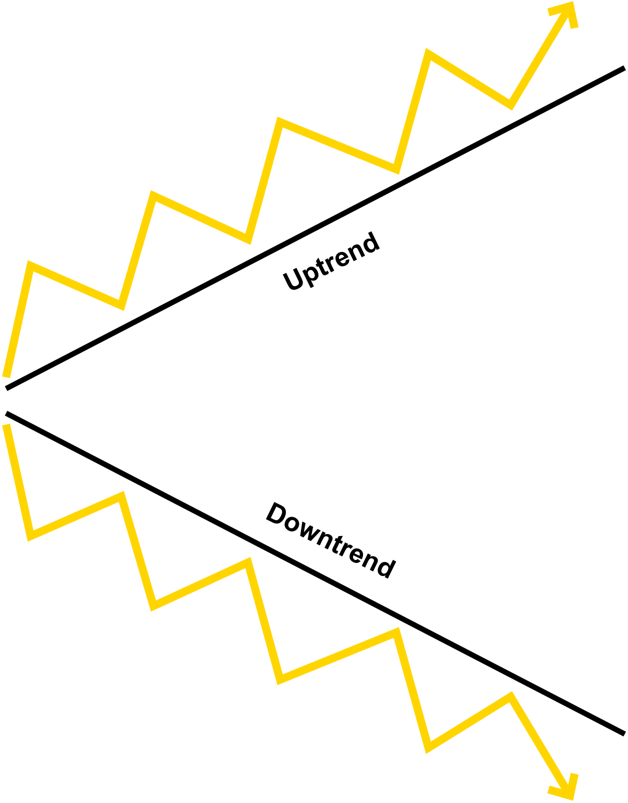
One of the simplest tools to determine the direction of a market is trend lines.

Once you have a chart in place, to recognise if a market is in an uptrend or downtrend the use of trend lines can be applied. Chartists define trends on charts by drawing trend lines at angles. As mentioned earlier, there are three types of trends: uptrends, downtrends and sideways.

When the market is moving up or is in an uptrend, the trend line will have a rising slope. This is achieved by joining two low points of a chart. The second low must be higher than the first low.

In a downtrend, the trend line would have a negative slope. By joining two highs together, where the second high must be lower than the first high, we would have a falling market.

At times when markets are stuck within a range we can also apply trend lines to both the highs and lows. This would create a channel and the market would appear to be stuck within a box.



Patterns

To see a direction of a trend, traders can also use chart patterns. The classical chart patterns used for trends are ascending and descending staircases.

From a chart pattern perspective, an uptrend can be considered when we have a series of higher highs and higher lows. This can be considered as a bullish trend. Traders will consider trading on the bullish side of the market until the uptrend comes to an end.

Rising staircase

When markets are forming lower lows and lower highs this can be considered as a downtrend also often referred to as being bearish. In this phase traders would consider trading on the short side of the market.

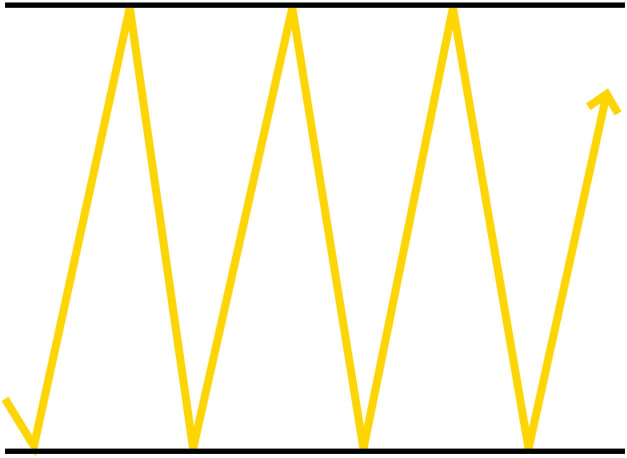
Declining staircase

In an uptrend a trader could buy the dips or the breakouts of recent highs. And in a downtrend a trader could sell the rallies or breakouts of recent lows.

Often markets may not trade in a trend and instead trade within a range or defined channel. This is where the market is unable to create a series of highs to the upside or a series of lows to the downside.

Some traders choose to sit on the side-lines during this phase and other traders would look to buy at the bottom of the channel and sell at the top whilst taking a short position on the top end of the channel and exiting at the bottom.

Rangebound market



Indicators

Using indicators can also assist a trader in trading with the trend.

A popular indicator used by traders is the moving average and if used correctly, it can offer some excellent results when markets trend. But during times of consolidation both indicators and pattern failures can result in losses. This is why the use of money management and risk control is very important.

The use of indicators is covered in greater detail in the section ‘Trading with indicators’.

Remember

A trend is always easier to see after it has been established. The objective is to try and capture a trend before it starts and exit before it ends. Trend traders aim to capture the majority of the move rather than the exact top or bottom.

Support and resistance

During the phases of uptrends and downtrends, markets may not always move in a straight line. There are times when markets will fluctuate between one price level and another. This is referred to as support and resistance.

What is support?

Assume a market has been rising during an uptrend, and reaches a point where it reverses and declines to a level where it holds without falling lower. This level where it fails to break through on the downside is known as the Support level.

It is a price level where the sellers are unable to drive prices any lower and where buyers feel that it is the right price to buy and expect higher prices.

Support levels can be tested several times before traders become confident that prices will

Support level

hold at this level before moving higher. Support levels can also last from a short term time frame to a longer term time frame and sometimes are referred to as a base or floor.

During a bull market support levels become higher as each decline or corrective move takes place.

What is resistance?

When a market has been moving higher and stops at a certain price level where it is unable to move any higher, this is known as the resistance level.

At this point, sellers enter the market to drive prices lower. Buyers feel that the market may have reached a point of exhaustion and decide to take profits. With a lack of buyers and more sellers at hand, prices reverse and move lower.

Resistance level

Like support levels, resistance levels may also be tested several times over a period of time. The resistance level is sometimes referred to as the ceiling.

In a bear market where prices fall and attempt to rally, resistance levels would be lower on each attempt to move higher.

Buying at support and selling at resistance

Traders looking to enter a trade often use support and resistance levels as a point of entry and exit.

A simple example is when a market has reached a price level where it is unable to fall any further; a trader may look to buy on the second or subsequent attempt assuming that the market may have reached a point of exhaustion on the downside and may not fall any lower.

If a market is attempting to move higher but fails each time it reaches the same price level, traders may step in and short the market on expectations that it may fall lower.

Buyers at support may use higher resistance levels to exit their trades and seller at resistance levels may use lower support levels to exit their short positions.

Support and resistance levels are important price levels in all markets and all time frames. These price points should be respected as key levels.

Trading with indicators

Technical indicators can be as simple or as complicated as you want to make them.

Indicators take the raw data from a chart and present the data in a different format to assist in making trading decisions. There are different types of indicators, ranging from trend indicators, momentum to oscillators – all of which help to show visually the condition of a market.

Essentially some technical indicators can be used for trending markets whilst others can be used for non-trending markets.

Why use technical indicators?

The main focus for a trader to use technical indicators is to help time his or her trade for entries and exits. Although the calculations and formulas of some technical indicators may appear to be complex or scientific, the art is learning how to read the signals.

Indicators for trending markets

When markets enjoy a sustained trend moving in one direction with minor corrections, indicators such as moving average, MACD and parabolic SAR can be useful. These indicators can help a trader by staying on the right side of the market as long as there are no major corrections.

Indicators for non-trending markets

At times when the markets are not in a trend mode but instead moving between a range, a trader can apply the stochastic or RSI to assess when the market becomes short term overbought or oversold.

Advantages of technical indicators

Analysing a chart without indicators is a skill that comes with experience. Some traders feel that trading without indicators is the antithesis of technical analysis. In other words a chart without lines and squiggles is not a technical chart.

This is not necessarily true. There are many professional traders who can read charts without any indicators at all and this is referred to as reading Price Action. These traders feel that having too much information can distract from what the price is already showing us.

Disadvantages of technical indicators

Traders should remember that technical indicators derive their signals from price.

This means that the indicator can be considered to be "lagging" or delayed. Also, it is not uncommon for technical indicators to provide a false signal in some cases and traders should always be aware of this.

Important

No technical indicator can provide a 100% accurate signal and no trading strategy should be based purely on a signal of a technical indicator. It is important to use trade, risk and money management in conjunction with all aspects of trading. The use of technical indicators is subjective and results can vary from trader to trader.

Moving averages

The daily fluctuations on a chart can appear to be random or even noisy. One way to filter this out is by using moving averages. This is one of the most commonly used simple indicators in a trader's toolbox.

A moving average is calculated by totalling a set of prices over a set period of time and then dividing the sum by the number in the series. The prices could be the closing price of an instrument and the number could be the number of days or bars used in the calculation.

To calculate a simple five-day moving average of the closing price the following formula can be used:

$$\text{5-day SMA} = \frac{\text{Day 1 to day 5}}{5}$$

Today being day five, the closing price is added to the previous day's closing price, which is then added to the previous day. The series updates as time moves forward and always using the current day's closing price.

The five-day period is not set in stone. Traders can choose different time periods and the most popular ones in use are the 10-day, 20-day, 50-day, 100-day and 200-day moving averages.

How to use moving averages

In its simplest form a market can be considered bullish when trading above the moving average and bearish when trading below the moving average.

What signals to look for:

1. For a buy signal the moving average should be rising and pointing upwards.

2. When the market closes above the moving average a buy signal can be implied.

3. For a sell signal the moving average should be falling and pointing downwards.

4. When the market closes below the moving average a sell signal can be considered.

5. Exits are the opposite of entry signals.

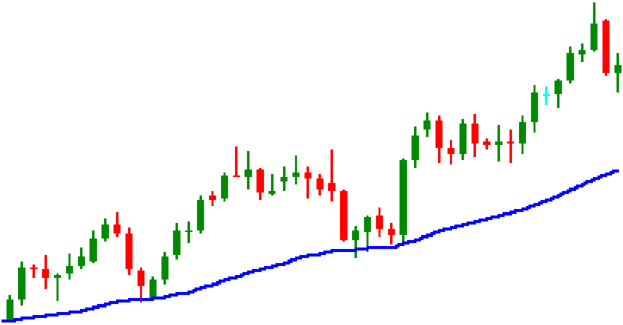
Time period

Moving averages can be used on multiple timeframes ranging from minutes and hours to days and weeks. The common time frames are daily for short-term traders and weekly for longer term traders.

Which type of trader is this suitable for?

This indicator is useful for traders who are seeking to trade with the trend and stay in trades from an intermediate to longer term time frame.

Moving averages



Moving average crossovers

The moving average indicator can also be used with a crossover technique.

With this technique two or more moving averages are used and when the slower moving average crosses over, a signal to enter or exit is initiated.

As an example let's assume a trader decides to use two moving averages of varying periods. Typically a five-period crossing over a 20-period is often used for traders seeking to capture a trend over a period of weeks.

When the five-period crosses above the 20-period this can be considered bullish. A trader would enter a long position and stay with the position until the five-period crosses below the 20-period moving average where they would either exit or reverse their long position to a short position.

Different traders use different settings and of course different time frames to suit their needs.

Moving average crossovers

Moving average convergence divergence (MACD)

The moving average convergence divergence or MACD for short is a trend following indicator comprising three components; the fast EMA and the slow EMA with a zero line. It measures the difference between the fast EMA and slow EMA and provides buy and sell signals on crossovers of the two EMA lines as well as above or below the zero line.

How to use MACD

The MACD is a versatile indicator and can be used in multiple ways. Traders can use the MACD to enter as part of a trend or event to see if a trend is coming to an end.

What signals to look for:

There are three essential techniques where a MACD can be used and each of these are described below. Using the moving average crossovers, or using the zero line are the most popular techniques but also watching for divergences can provide suitable trading signals.

Crossovers

One of the most common techniques with the MACD is to wait for the fast EMA to cross above the slow EMA for a buy signal to enter a long position. Traders would expect a rising market with this signal. Alternatively when the fast EMA crosses below the slow EMA then a trader could consider a sell signal to enter short and expect the market to fall.

Zero line

Some traders prefer to wait for the MACD to have crossed over and also cross above the zero line for a bullish signal and if the MACD has crossed from above to go below the zero line then this would be considered a bearish signal.

Divergences

If the market is rising and forming higher highs but the MACD indicator has not followed suit then this may suggest that a divergence is setting up. Simply put this means that both the market and the indicator are out of sync and one is not in agreement with the other. When a divergence takes place, a possible reversal may be at hand.

Time period

The MACD can be used on multiple timeframes ranging from minutes to hours, days and weeks. The common time frames are daily for short term traders and weekly for longer term traders. Some traders use the MACD on intraday time frame charts to capture very short term moves lasting from minutes to hours.

Which type of trader is this suitable for?

This indicator is useful for traders who are seeking to trade with the trend and stay in trades from generally an intermediate to longer term time frame.

MACD indicator

Stochastic

The stochastic oscillator is widely used to measure momentum and compares today's price against an average of recent highs and lows. It is used to determine overbought and oversold conditions.

The basic calculation called the %K provides the relative position of the closing price within the range of the previous N days.

Stochastic is...

$$\%\,K\,(\text{today}) = \frac{100X\ \text{close (today)} - \text{lowest low of past N days}}{\text{(high} - \text{low) range of past N days}}$$

Where range is the highest high of the past N days (not including today) minus the low of the past N days (not including today). Dividing by the range creates a value from 0 – 100.

For example, if we are using the past 10 days (a 10-day stochastic), the stochastic would be the current value.

How to use stochastic

The stochastic can be used to find overbought or oversold situations or it can be used when the %K crosses over or below the %D. It can also be used as a tool to find situations where a divergence takes place which is similar to the MACD indicator.

What signals to look for:

Stochastic readings above 80 – 100 are considered as the market being overbought and a reading of 20 and below indicates a market as being oversold. A trader would wait for the indicator to cross from below 0 – 20 and also for the %K to cross above the %D to initiate a buy signal. If the stochastic indicator falls below a reading of 80 and also the %K crosses below %D then this could be considered as a sell signal.

Time period

Stochastics can be used on multiple time frames ranging from minutes to hours, days and weeks. The common time frames are daily for short term traders and weekly for longer term traders. Some traders use the stochastic on intraday time frame charts to capture very short term moves lasting from minutes to hours.

Which type of trader is this suitable for?

This indicator is useful for traders who are looking to time the market for short term reversals and profit from overbought or oversold conditions.

Stochastic indicator

Relative strength index (RSI)

The relative strength index or RSI is a momentum oscillator that ranges between 0 and 100. It is used like other oscillators to find opportunities of short term reversals.

How to use the RSI

The RSI can be used to find overbought or oversold situations or it can also be used to find divergences. A reading below 20 suggests an oversold condition and a reading above 80 suggests and overbought condition.

What signals to look for:

When markets have reached an oversold condition it may indicate that the move may have reached an exhaustion point and a reversal may be at hand. If the RSI reading is below 20 and rising then traders may use this as a potential signal to see the market reverse and start trading higher. On the other hand, when we see situations where the market has rallied and the RSI has reached above 80 and then starts to fall we may see a situation where the market may also reverse and head lower.

It is important to understand that the signals are not 100% accurate and do not always work or provide valid signals.

Time period

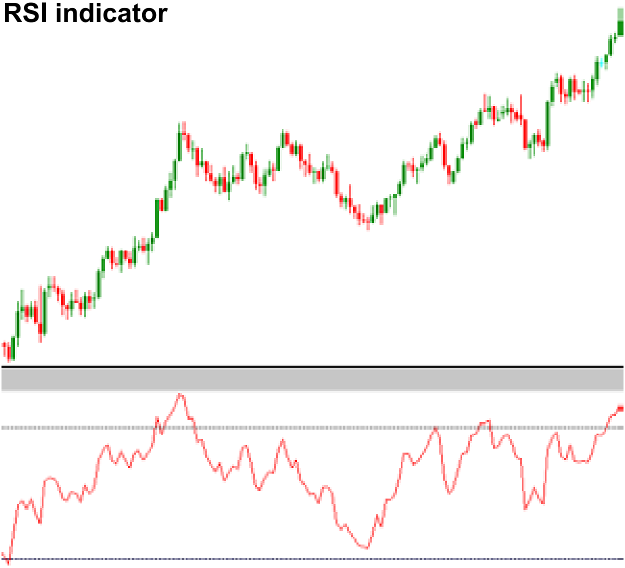
Oscillators can be used on multiple time frames, ranging from minutes to hours, days and weeks.

The common time frames are daily for short term traders and weekly for longer term traders.

Which type of trader is this suitable for?

This indicator is useful for traders who are looking to time the market for short term reversals and profit from overbought or oversold conditions.

RSI indicator



Parabolic SAR

The parabolic SAR (Stop And Reverse) is an indicator that was designed to assist in the placements of trailing stop orders. It can also be used as an indicator to assist in determining the direction of a trend.

How to use the parabolic SAR

In its simplest form a market can be considered bullish when trading above the parabolic SAR and bearish when trading below the parabolic SAR. The indicator will provide a series of points or steps which allow a trader to visually and mathematically see where to place stop orders and also where to consider taking a position in the direction of a possible trend reversal.

What signals to look for:

When the market is rising a parabolic SAR will plot a series of points or steps below the market. These points will rise closer to the market over a period of time and allow traders to trail their stop loss orders in case the market reverses. Also the points can be used to initiate a short position if and when the market breaks below the price level at the price of the point.

If a market is falling the parabolic indicator will plot a series of points or steps above the market. It is at these points where a trader would place a stop loss order and adjust the orders as the parabolic indicator moves closer to price over time.

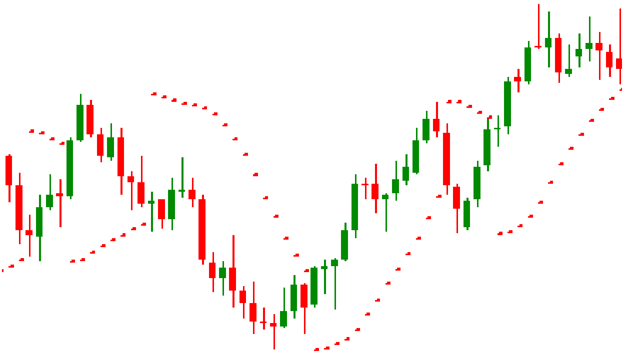
Time period

The parabolic SAR like other indicators can be used on multiple time frames ranging from minutes to hours, days and weeks. The common time frames are daily for short term traders and weekly for longer term traders.

Which type of trader is this suitable for?

This indicator is useful for traders who are seeking to trade with the trend and stay in trades from an intermediate to longer term time frame. It can also be used to change with the direction of a trend with the ability to place stops at a predetermined level as provided by the indicator.

Parabolic Indicator



Bollinger Bands

A Bollinger Band is quite a unique indicator which is based around a moving average indicator. It uses standard deviation to adjust as prices increase or decrease in volatility. An upper band is created above the moving average and a lower band below the moving average. The bands widen during volatile periods and contract during non-volatile periods.

How to use Bollinger Bands

Using Bollinger Bands can be useful in non-trending markets. When a market is not in a defined trend and fluctuates between a range, the Bollinger Bands can be a useful indicator. However in a strongly trending market the Bollinger Bands tend to be ineffective as the upper or lower bands can be extended for long periods of time.

What signals to look for:

The Bollinger Bands can be used to buy and sell at the bottom and at the top of the bands.

During non-trending phases of a market a trader would wait for the market to reach the lower band and anticipate a reversal to the upside. When the market has reached the upper band a trader would anticipate a reversal to the downside.

If the bands are narrow and close together this suggests that the market is in a quiet or tight trading range. When the bands start to widen this is typically when the market starts to increase in volatility.

Time period

Bollinger Bands can be used on multiple timeframes ranging from minutes to hours, days and weeks. The common time frames are daily for short term traders and weekly for longer term traders.

Which type of trader is this suitable for?

This indicator is useful for traders who are seeking to find trend reversals when either the upper or lower channels of the Bollinger Bands have been reached. The reversals can last from short to longer periods of time and can therefore be utilised for all types of traders who may consider intraday trading over position trading.

Bollinger Bands Indicator

Conclusion

There are several technical indicators that can be applied to the market in any timeframe.

Traders can also apply several indicators if desired. However, placing too many indicators can also cause conflict where one may suggest a buy signal whilst the other may not and this can cause analysis paralysis.

Risk management and money management are essential for professional and safe trading tactics. During volatile times, indicators can and do fail and traders should be aware of both the usefulness and also the limitations of technical indicators.

It is also critical to remember that there is no best indicator setting to pick exact tops and bottoms. Indicators are simply tools to assist in the decision-making process and should not be used as standalone buy and sell signals.

Chart patterns

Types of chart patterns

Technical analysts and chartists believe that all opinions and factors which affect the financial markets are present in the charts.

A chartist can observe current chart patterns and compare them to previous chart patterns and look to see if there are any similarities as well as anticipate the future direction of the market based on past price action.

Whilst history does not always repeat itself, several chart patterns have, in the financial markets, provided an edge for traders.

There are many different types of chart patterns. But there are essentially two main categories of major chart reversal patterns on which traders can focus.

Reversal patterns

A reversal pattern occurs when a market has reached a point of exhaustion. It is at this point where we often see trend reversals or at least a short to intermediate term reversal take place.

There are six popular reversal patterns which we will look at later in this section. We also see how to trade the patterns.

Continuation patterns

Markets do not always reverse at a specific price point. There are times when a market will pause for breath and then continue in its original direction. Patterns that form during this phase are referred to as continuation patterns.

These patterns can offer a trader an opportunity to get on board a trend which has been in place and attempt to capture the current move ahead.

Points to consider

When trading with chart patterns, we are putting ourselves ahead of a potential move that may or may not occur. It is again important to remember that there are no certainties or guarantees that an expected outcome will develop.

- ✓ Learning to recognise chart patterns requires practice
- ✓ Patterns which have worked in the past may not work now
- ✓ Risk management should be applied to protect capital

Combining patterns with technical indicators

In order to improve the odds of winning, some traders choose to combine chart patterns with technical indicators in order to get a stronger edge.

Although this may sound like a good idea, a trader should note that the more you add to a chart to optimise your point of entries and exits the more confusing the signals may become. Keeping it simple is always a good approach.

Trading with reversal patterns

Reversal patterns can offer low risk trade setups, which are often followed by extended moves over a longer period of time.

The reason these can be considered low risk is that if a trader has entered a market on a reversal pattern and the point of entry to the point of the stop loss order is small, then the return on capital can be substantial. The risk/reward ratios should be very beneficial. That is of course if the market is at a true reversal point.

Sometimes the market can come back for a retest at the reversal point and cause traders to enter an uncertainty zone from a psychological perspective, causing many to exit trades by panicking, thereby missing out on a large move.

By ensuring that risk is managed correctly and by learning to be patient, the reversal patterns can be a useful tool for traders. With some experience, the patterns outlined below should become easier to recognise over a period of time.

When trading reversal patterns, there are two obvious types of trades. We can have a bearish reversal or a bullish reversal.

Although there are many different patterns that traders can look out for, we will focus on the three major bearish reversal patterns and the three major bullish reversal patterns.

Bearish reversals

When a market has reached a point of exhaustion on the upside, we often see a classic reversal pattern take place. If a market decides to reject the high price it will move away in either a single move or quite often after several retests where it fails to move above the high of the first peak.

This creates the Double Top pattern, Triple Top pattern and also the Head and Shoulders pattern.

Bullish reversals

A market that has reached a point of exhaustion on the downside can also see a classical reversal pattern take place. If a market decides to reject the low price it will move away in either a single move or quite often after several retests where it fails to break below the low point, known as the valley.

A failure to trade below the valley and then move higher can create bullish reversal patterns. These can be Double Bottom patterns, Triple Bottom and the Inverse Head and Shoulders pattern.

Key points

When trading chart patterns, many traders make the mistake of waiting for a perfect formation to take place. Chart patterns can have slight variations and can also fail to form or complete as expected. Not all chart patterns are equal and not all patterns will be profitable.

With this in mind it is, therefore, prudent to use some judgment and aim to manage the potential risk on a trade rather than miss out on what could have been a good trading opportunity.

Bullish reversal patterns

Double top pattern

The pattern is quite distinct due to the two peaks. The first peak is an attempt to break past the price level, followed by the second peak which fails a second time and the market comes back to what is referred to as the neckline or the baseline.

Double top pattern

To trade Double Top patterns, traders can wait for the baseline to be cleared to confirm that the market should technically decline. More experienced and higher risk traders may choose to take a trade at or near the first peak, attempting to get in at a higher price level closer to the peaks.

The trade would then be managed for profit targets or trade reversals at lower support levels. In some cases you can measure the distance between the baseline to the peak and assume that the market could fall the same distance.

As with all trades there are no guarantees this will happen but it can be useful to at least provide a potential target for the downside.

Triple Top pattern

Like the Double Top pattern this variation has three peaks instead of two peaks.

The concept is the same as the Double Top pattern except in this case, the market has attempted to break past a price level on three occasions but failed. When a Triple Top pattern occurs markets often tend to fall substantially. Hence, this is classified as one of the major reversal patterns.

Triple Top pattern

With the Triple Top pattern we have the same components of the peaks and also a baseline.

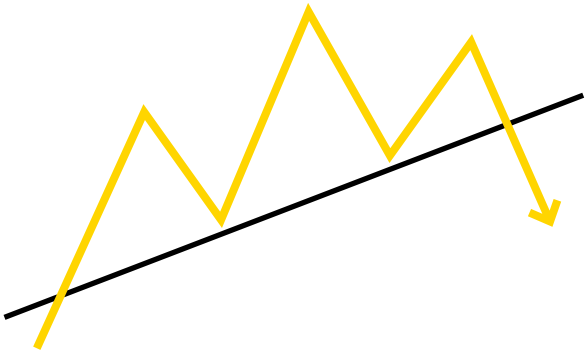
Application for trading the Triple Top pattern is the same as the Double Top pattern. A break of the baseline confirms that a decline could be developing. Targets for exits can be the distance from the baseline to the peak or the trade can be managed manually until it reaches a profit target or a lower support target.

Head and Shoulders pattern

This classic popular pattern derives its name because of the formation created by having three peaks and with the middle peak being higher than the peaks on either side.

The first peak attempts to break past a price level. The second peak manages to trade above the high of the first peak but retreats lower. On the third attempt we see the market try to break past the high of the second peak but fail.

Head and Shoulders pattern



Once the market trades back down to the baseline and fails to hold at this support level, the odds suggest a move lower is likely.

Profit targets can be forecasted by measuring the distance between the baseline to the height of the second peak and then subtracting from the baseline to provide a potential support target.

The above three patterns can be applied on different time frames and across a wide range of actively traded markets including stocks, commodities and currencies.

Trading a simple continuation pattern

It is not all the time that a market will reverse at a price level. There are times when a market will pause for a short time and then continue in its original direction.

A common pattern which takes place as a continuation pattern is known as a Flag.

Flag patterns

A Flag pattern is a simple consolidation pattern which can be easy to recognise as a pullback in the current move. It can occur in both a bullish and bearish trend. The Flag pattern usually completes the formation in a relatively short period of time.

The actual move that takes place before the Flag pattern occurs is known as the Flag Pole whilst the pullback is referred to as the Flag.

Trading the Flag pattern

Whilst some patterns provide second opportunities to enter the move the Flag pattern is one where traders would need to react quickly.

This pattern provides a reasonably good entry point for quick short-term gains. It can also be used for longer term moves depending on the extent of the swing after the pattern has formed.

Usually but not always the Flag Pole can be used to determine the length of the move after the Flag pattern. For example if the length of the Flag Pole prior to the Flag formation was 50 points then after the Flag pattern has completed a trader may expect to see another 50-point move.

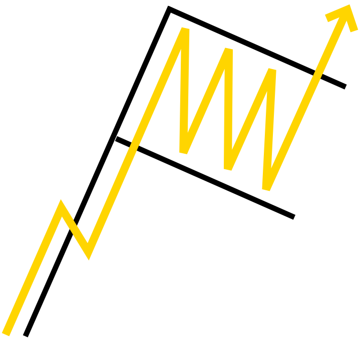
Bull Flag

A Bullish Flag occurs after a market has been rallying.

If the rally is to continue then quite often a Flag pattern occurs where a short-term consolidation takes place before the next move up takes place.

To trade with the Flag pattern traders would buy to enter a long position on the break of the upper trend line with a stop loss order below the lower trend line.

Bull Flag Pattern



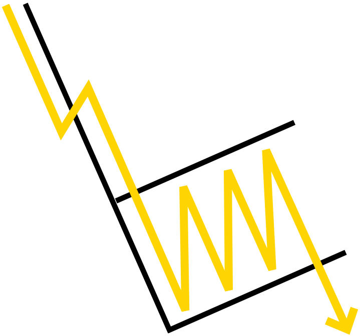
Bear flag

A bearish flag occurs after a market has been declining.

If the decline is going to continue, then quite often a Flag pattern occurs where a short-term consolidation takes place before the next move down takes place.

To trade with the Flag pattern, traders would sell to enter a short position on the break of the lower trend line with a stop loss order above the upper trend line.

Bear Flag pattern



Conclusion

Flag patterns are simple to spot but traders need to be quick to see the opportunity. Flag patterns can offer opportunities to enter a trend mid-way and are often utilised by short-term traders.

CITYINDEX

Trading strategies

Trading strategies

A trading strategy is a set of pre-defined rules which guide your decisions before you trade. Trading strategies can be traded manually or automated. Your trading strategy should be a blueprint of precise instructions to tell you the exact steps to take. Your trading strategy is a key component of your trading plan.

Essentials of a trading strategy

Having a trading strategy or a system is important for any trader who is looking to take consistent profits from the markets. With so many different strategies, time frames and markets to choose from, it is easy to get overwhelmed when choosing a strategy.

Instead of focusing on several strategies at once, it may be better to focus on one idea, gain some experience then adjust and personalise a strategy for your own needs.

Trading strategies do not have to be complicated. What is important with any trading strategy is to minimise the risk on the trade, minimise the risk on your account, reduce stress and achieve a profit.

Define your outcome before you trade

If you are going to create a strategy for trading the financial markets then decide before you trade what it is you want your trading system to do.

Many traders skip the process of planning a trade and just jump straight into a trade and then spend 90% of the time trying to figure out how to exit. This is not a professional way of trading and can lead to disastrous results.

Your objectives and expectations are a critical part of your trading system and ultimate success. Therefore it is worth spending some time evaluating what it is that you are trying to achieve given the time, resources and capital you currently have.

Remember that circumstances can change, lifestyles can change and people change. Does your strategy fit your lifestyle and personality?

Important considerations:

Here are some questions you may want to consider before creating your own strategy:

1. Are you trading for the short term or longer term time frame?

2. Are you going to use an indicator or pattern-based strategy?

3. Does your strategy work for a trending or non-trending market?

4. How much risk are you willing to take per trade?

5. Determine how much drawdown your account can handle.

6. Will your strategy cope in a volatile or non-volatile situation?

7. How much time is required to monitor the trade?

8. Have you back tested your strategy?

9. How will you deal with losses financially and emotionally?

10. Are you comfortable with your strategy?

Remember, ultimately your strategy must be easy to follow. The fewer rules it has, the less likely it will break down. Do not overcomplicate something which needs to be simplified.

The market moves up, down and sideways. How does your strategy deal with these three phases?

Trading strategy ingredients

Once you have spent some time thinking about what type of strategy you are going to use, there are some essential ingredients or components that need to be applied.

Every trading strategy will need to go through the following checklist.

- ✓ What is your entry criteria?
- ✓ What is your exit criteria?
- ✓ Where will you place your stop loss?
- ✓ Will you trail your stop or exit at a pre-determined target?

- ✓ What is your position size for this trade?
- ✓ How will you manage this trade?

Now that you have answered these questions your next step is to create your strategy.

Creating a simple strategy

After you have thought about an idea for your strategy, you will need to start creating a systematic process or blueprint for your idea. It is at this stage that you will create a set of rules to identify when and how to enter and exit your trades.

Let's create a profile of a trader and then create a strategy to fit the personality of this trader.

TREND TRADER TOMMY

Tommy holds a full time job and wants to supplement his income through trading.

Due to his work commitments, Tommy is unable to watch the markets all day but is able to watch the markets after late afternoon. He would prefer to trade with the trend of a market in order to capture swings in the market rather than minute-by-minute fluctuations.

Since Tommy can watch the markets after work he decides to trade with the US Dow Jones Index on an end-of-day basis.

He decides he will allocate £25,000 for his account and will assume a 3% risk on his account per trade i.e. £750 per trade (3% of £25,000). After studying various technical analysis methods he prefers the idea of using technical indicators and would like to trade using the simple moving average indicator.

Tommy has created a set of rules for his trading strategy as follows:

1. Determine the major trend on the weekly chart.

2. Use a 20-period moving average on the weekly chart for trend direction.

3. On a daily chart apply a 20-period moving average and look for entry/exit points.

4. Use 3% of the account as a hard stop to start with, and then trail stop orders.

5. Only trade on the closing price and do nothing during the day.

This simple method, which does not require too much time, suits Tommy because of his other commitments. He keeps this stategy very simple. It requires little effort on his part and does not require for him to be sitting at a screen all day.

MICRO TRADER MANDY

Mandy has no full time commitments and wants to earn an income through trading on an intra-day basis.

She is able to trade during the day and is not an evening person. She has decided that she is not comfortable with the idea of holding trades overnight and would prefer a faster style of trading. Mandy also prefers to trade aggressively and does not mind taking a higher risk than the average person.

With a £10,000 starting capital Mandy would like to take a 5% risk on her account per trade (£500 per trade) and does not mind having several trades open at the same time. Preferring to trade forex and using technical analysis with technical indicators and also chart patterns, she will aim to take 20 points from the market each day as a minimum.

Mandy has created a set of rules for her trading strategy as follows:

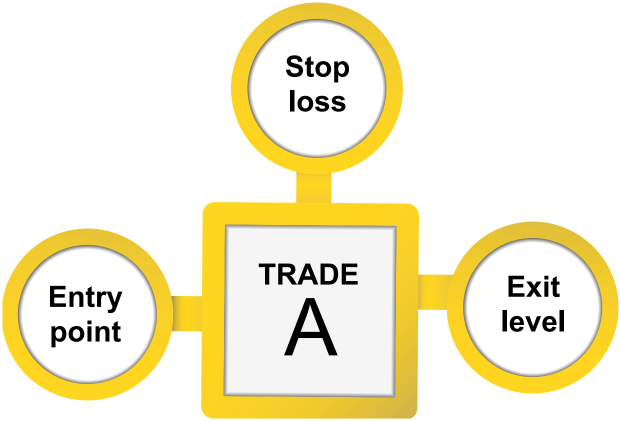
1. Trade intraday with no overnight positions.
2. Focus on one hour and 15-minute as well as five-minute charts.
3. Trade on major pairs GBP/USD and EUR/USD.
4. Use the parabolic and stochastic indicators and Flag patterns.
5. Aim for 20 pips with a 1:1 Risk Reward Ratio.

As a strategy, Mandy is going to focus on looking for pullback trades using Flag patterns and identifying the trend using parabolic and stochastic indicators.

Anatomy of a trade from start to finish

In the following examples we will look at how both Tommy and Mandy have traded using their strategies. Each trade is to show the Entry point along with the Stop Loss and then the Exit level for the trade. The idea is to see how to manage a trade and also for illustrative purposes, you can see how the strategy has been put into action.

Using these examples you can see how creating a simple plan and then following the rules can be useful.



Tommy’s trade

As Tommy is trading the US Dow Jones he has identified a potential trading opportunity. This is how he is will trade with his plan.

Trade entry

1. The US Dow Jones has been in a steady uptrend as seen by the index trading above the 20-period moving average on the weekly chart. It has higher highs and higher lows, confirming it has been rising.

2. Looking at the daily chart we can see the index has pulled back to the 20-period moving average.

3. Waiting for the index to touch or dip below the moving average, Tommy will wait for the index to close above the indicator

and then enter a long position with a stop below the low of the entry bar.

4. The stop loss is 45 points away from entry and Tommy is looking to ride this trade until it closes below the moving average at a higher level.

5. He will move his stop to the entry level once the index has moved 2x his stop loss level so that the trade can be considered a break-even trade in case the market falls back down. He will trail the stop every time the index moves higher by 90 points.

Trade exit

The index has risen and Tommy had moved his stop from the initial entry to break even.

Since the market has been bullish and rising, this trade has confirmed with the underlying trend and has continued to move in the anticipated direction.

The index pulled back to the 20-period moving average and closed below the indicator. This signalled that the index may have further to fall and so the trade was closed for a profit.

Trade summary

In line with his trading plan, Tommy used patience to wait for the trade set-up. Rather than getting emotional he entered the trade according to his rules by trading with the dominant trend in which he used the weekly charts followed by the daily charts for entry and exit. He managed the risk correctly by placing a low risk stop initially and then moved the stop every 90 points as the market moved in his favour. Using a disciplined approach he managed to let the market rally until he manually closed the trend on the day the index closed below the 20-period moving average on the daily chart.

Tommy will wait for another signal from the market before he places his next trade.

Mandy's trade

Trading on currency pairs, Mandy has identified an opportunity to trade on the GBP/USD pair.

Trade entry

GBP/USD has been in a downtrend recently and the hourly charts have risen against the main trend. The parabolic indicator is above the hourly chart, suggesting that pressure should be to the downside. This creates an opportunity to enter a short position which should see the pair decline if the dominant trend is still in force.

Using the 15-minute charts, Mandy notices that the stochastic indicator is in the upper 80% overbought region. This should create an opportunity for the pair to reverse to the downside.

As the stochastic indicator turns lower Mandy enters a short position on the 15-minute chart with a 20-point stop loss. She is targeting 20 points on the down side before she will move her stop and she will wait for the stochastic to reach the 20% level.

Trade exit

Instead of following through to the downside as expected, GBP/USD turned back up, stopping Mandy's trade for a 22-pip loss.

Trade re-entry

After being stopped out of the first trade, Mandy notices that the stochastic indicator is still sloping lower, suggesting that there is a divergence taking place between the indicator and the current price which is at a high. She also notices that the currency pair has turned back lower, breaking the previous 15-minute bar low.

Reacting quickly as the market is moving once again in a downward direction, Mandy re-enters the trade again with a 20-point stop loss.

The trade is moving rapidly to the downside and the trade is 37 points lower. Mandy lowers her stop loss to her entry level just in case the trade turns around.

After one hour GBP/USD starts to fall sharply and is now down 53 points. Mandy again lowers her stop loss order another 20 points, locking a profit of 20 points in case the trend reverses.

As the currency pair starts to trade in a narrow range she notices a bearish Flag pattern developing and places a second trade below the low of the Flag. Mandy now has two open positions.

Within 30 minutes the currency pair has fallen another 25 points but the stochastic is in the oversold region and turning higher. At this point

Mandy decides to close both the trades and locks in a total of 115 points on the first trade plus 25 points on the second trade.

She manages to collect 150 points but deducting the 22 points from her earlier trade she is left with a total of +128 points profit.

Trade summary

Trading requires nerves of steel and being able to cope under pressure. Being quick to react to the market, Mandy managed to turn a losing trade into a positive situation. With the market offering another opportunity, Mandy spotted a Divergence pattern and without focusing on the earlier loss, she capitalised on the trade whilst remaining calm and focused.

Choosing the right strategy for your personality

One of the key principles in successful trading is to find out what type of strategy you are comfortable trading.

Many traders enter the world of trading looking for a perfect strategy or a perfect setting on a Technical Indicator. The reality is there are no perfect settings, strategies or perfect markets. What is more import is having the ability to adapt to a changing environment. Markets constantly move and therefore we as traders need to learn how to deal with change.

It does not matter whether you choose to trade longer term positions or short term positions. Rather is important to have the ability to be patient and wait for a signal from the market and then have the discipline to act on the signal. Making sure that you do not overtrade and get too confident on each trade is essential. Nobody can predict the outcome of a trade and therefore it is critical to make sure that the trade size on one trade does not impact the entire trading account.

What would happen if you had a winning strategy which required you to trade between five and 15 times per day? Every trader wants a winning strategy but being able to deal with the pressure or stress of active trading is not suitable for everyone.

It would be better to work with a strategy or trading idea that you are comfortable with and one that fits with your lifestyle.

Some traders are able to manage multiple styles of trading where as others are suited to one particular style. Neither one of these approaches is better than the other but finding a winning strategy is one part of the equation whilst dealing with the process of trading is another.

This is why having a trading plan is very important as the plan helps you design a style of trading which can be adapted to your own personal needs. There are many newcomers who skip the entire process of planning trades and instead use a hit and miss approach to trading.

These types of traders find themselves jumping from one strategy to another and rarely allow time for a strategy to work out. All traders should be aware that there are different market phases. Namely bullish, bearish and consolidations. The strategy of your choice should be designed with this in mind.

Human beings generally speaking like to see the positive side of life. When markets come down or go through a bearish phase the news surrounding this type of activity is not necessarily positive.

If negativity is an issue, this can affect some people and trading short expecting the market to fall is not an easy way to trade for some people. Professional experienced traders are able to deal with both bullish and bearish markets and are able to trade both sides of the market.

Having a flexible approach is a key part of any trading plan.

When developing your trading plan and your trading strategy, you should allow room for sudden unexpected market shocks. Although it is impossible to know when a large move can happen it is always a good idea to develop a component in your strategy that allows you to capitalise on an opportunity should it occur.

In today's financial markets there is an increase in volatility which for some people can be uncomfortable. But finding a market with lower volatility and a lower trading range between the high and low is not impossible. From trading stocks to commodities, currencies and indices there should be something to fit your personality and trading style.

Spread betting, CFDs and Forex trading are leveraged products which can result in losses greater than your initial deposit. Ensure you fully understand the risks.