BEAT THE FOREX DEALER

by Agustin Silvani

BEAT THE FOREX DEALER

AN INSIDER’S LOOK INTO TRADING TODAY’S
FOREIGN-EXCHANGE MARKET

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This book is created for educational purposes only. In no way is this book intended to provide all of the answers to successful currency trading. Currency trading entails significant risks and should be undertaken only with money that you are comfortable losing. Successful currency trading takes a long time to develop and requires experiencing loss on a regular basis. Never trade money that you cannot afford to lose.

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INTRO

Over the years, I've tried to get my hands on every currency trading book that I could find, but as you may well know the pickings are slim when it comes to FX literature. Apart from a few notable exceptions, most of the available material seems to fall into one of two categories: unabashedly theoretical or completely misguided. The dry, outdated, and sometimes esoteric academic works tend to leave the reader with the perception that currency trading is as gentlemanly and ordered as the world of stamp collecting, when in reality nothing could be further from the truth in a market referred to as a "slaughterhouse" where traders routinely get "chopped up". The FX market I know is one of egos and money, where millions of dollars are won and lost every day, and phones are routinely thrown across hectic trading desks. This palpable excitement has led to the emergence of a second class of literature, often misleading and downright fraudulent, where authors promise the reader riches by offering to make forex trading "easy".

Well, I'll let you in on a little secret: there is nothing easy about trading currencies. If you don't believe me, then stop by Warren Buffet's office and ask him how he could lose $850m betting on the dollar, or ask "King" George Soros why his short yet bets lost him $600m not once, but *twice* in 1994. Don't these guys read FX trading books? If these investment legends can lose billions in the FX market, what makes anyone think there is anything easy about it?

The average retail trader must feel a terrible disconnect between what is described by famous "experts" and their actual trading experiences. Theory very rarely translates into fact when it comes to trading, and real life FX trading is much more complicated and tricky than any guru would have you believe. In this jungle it's a kill-or-be-killed attitude that marks survival, and the minute you step onto the playing field a target has been placed next to your account number.

Realizing that most FX books in print are either written by scam artists or academics with little real-world trading experience, I decided to put my own thoughts to paper. While I certainly do not proclaim to be any sort of market wizard, the market insights I have gained while managing a successful currency fund should prove valuable to readers, even if they are just starting their trading careers. Being a firm believer in the "small is beautiful" mantra, I have therefore tried to keep this book short, and to the point.
The purpose of this book is twofold. First, by explaining the day-to-day mechanics of the FX market and pointing out some of the more unsavory dealings going on in the retail side, I hope to make evident for the reader the risks and rewards involved in currency trading. The second objective of the book is to help turn average traders into winning traders. "Average" traders are losing traders; winning traders are in fact quite rare. But by highlighting some market-proven trading tricks and techniques, I hope to give traders an initial leg-up.

As you may have guessed, this book takes its name from Edward O. Thorp's landmark work on blackjack, *Beat the Dealer*. In 1962, the M.I.T mathematics professor revealed to the public the gambling industry's tricks and traps, while at the same time managing to teach a successful method for playing the game of twenty-one. Likewise, you will find this book roughly split into two parts: the first half is dedicated to revealing the foreign-exchange market's unfair practices, and the second half is designed to help the retail FX trader implement an effective and winning game plan by providing trading tips and detailed examples.

FROM VEGAS TO WALL ST

The past five years has seen the FX market open its arms to non-traditional participants, and now everyone from dotcom investors to cash-strapped grandmas are jumping in hoping to strike it rich.

What most of these new participants fail to realize is that they are stepping onto a battlefield littered with the remains of day traders and genius "systems". It is frequently noted that over 90% of FX traders do not survive in the long run, yet you won't find that statistic in any of the publicity dished out by the FX brokers. To be profitable, retail traders must realize that the foreign-exchange market was fundamentally developed as a professional's market, and its outdated conventions and procedures mean that it still is very much geared towards the professional. In a market where the retail trader exerts little (though growing) influence, most can have little hope of success.

The retail brokers that have sprung up recently would like you to believe that currency trading is a high form of financial speculation. In reality, the average client's trading approach combined with the unscrupulous practices of some brokers make spot FX trading more akin to the games found on the Vegas strip than to anything seen on Wall St. The new breed of online FX brokers simply share too many of the traits employed by casinos to stack the odds in their favor, including these:

- The "house" always has the advantage (the spread)
- The "house" feeds off of the player's greed and actively promotes it (by offering trading signals, excessive leverage , and fancy platforms resembling slot machines!)
- The "house" adopts various dubious risk management controls, which include cheating and cutting-off winning players

All of these benefits ensure that in the long run, the house (broker) will end up with virtually all of the player's (trader's) money. The odds are simply stacked in their favor.

Thorp's original "*Beat the Dealer*" was brilliant in that he focused his energy on a niche game (blackjack) which featured changing odds. In a game with fixed odds (such as the lottery) a player is virtually assured ruin, while a game with shifting odds allows the smart player to effectively control his risk while maximizing his gains. Although the long-run odds may not favor the player, a set of rules can be adopted that allow the gambler to "play" only when the odds are in his favor; thus greatly improving his chance for success. Playing in this way enables you to refrain from gambling (betting on luck) and concentrate on playing the probabilities. FX traders need to take a cue from their card-playing counterparts and learn to trade only when the odds are shifted in their favor. In this spirit, the last part of this book is dedicated to exposing high-probability trades commonly seen in the intra-day FX market, which can effectively be used to "double up" when they are seen.

BEAT THE DEALER

In my experience, most retail FX traders seem to have a decent system or genuine "feel" for the market, yet more often than not they still find themselves posting steady losses. They see the possibility for greatness, yet they are unable to grasp it. Something must be missing….but what? Although they may spend hours dutifully studying technical analysis, candle charting, and the history of the market, seldom do they take a moment to concentrate on their number one killer: the forex dealer. By preying on the small speculator, these shadowy characters are often single-handedly responsible for turning winning trades into losers.

Both casinos and FX brokers have an ace up their sleeve which ensures that the odds are always shifted aggressively against a player, and not surprisingly these villains share a common name. Dealers are much more than simple order-processors (do you want to buy/sell, hit/stay?), they are in fact the house's fail-safe device sent out to take down any player that is deemed to be winning "too much". Their direct and purposeful interference can ruin even the most advanced or elegant trading system.

Have you ever had your stop hit at a price that turned out to be the low/high for the day? Bad luck perhaps? Maybe. What if it happens more than once? Do you ever feel like the market is "out to get you?" Well, guess what…..in this zero-sum game it absolutely is.

Dealers make particularly tough opponents for traders because they act on better information. Although it's hard to bluff when the other party knows your cards, you *can* profit by betting on their actions, and a dealer's actions are, after all, very predictable. You know what they want (your money), and you have a rough idea of how they will come after it (running stops, shading prices, fading moves, etc.); all that you now need is a way to exploit these actions. Throughout this book you will find information meant to help you identify and counteract typical dealer traps, which if implemented correctly can instantly improve your trading profits. Many of these are exactly the same techniques used by hedge funds and CTAs to exploit the loopholes left by their dealers, which can also be used successfully by the retail trader.

Make no mistake about it: there is a lot of money to be made in currency trading; you just have to know where to look. Sidestepping dealer traps is one simple way of improving you daily P/L, but it is surely not the only one. Successful trading comes down to taking care of the details, and for me the only way to do this is by providing concrete, up to date, real-life examples, and sharing the FX trading tips that have proved so profitable over the years.

In the end, it's my hope that by stripping away the theory and getting down to the core of trading you too may find yourself well on your way to beating the forex dealer!

Some terms commonly used in this book:

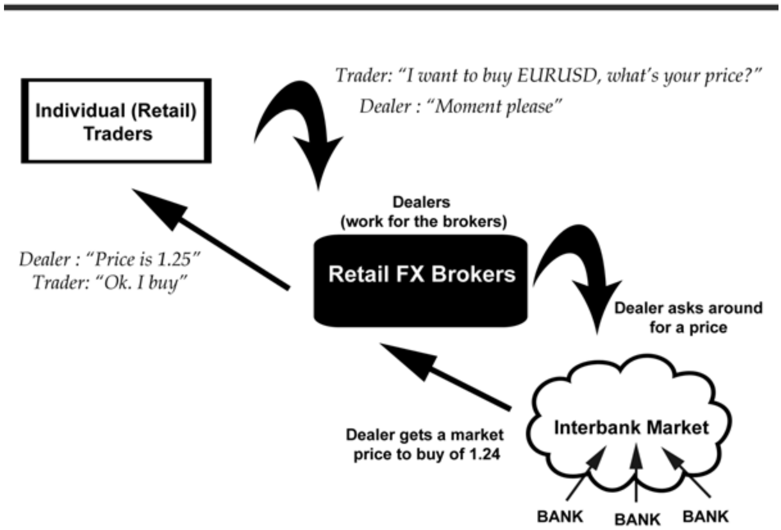
Individual (Retail) Trader Non-professional trader. That is, speculates for his own account as opposed to trading for a bank or hedge fund. Normally trades small sizes (under $1M), usually either for speculation or fun.

Interbank Market Loose term used to describe the FX trading done by banks directly with each other, as opposed to trading with clients. Can essentially be thought of as the "wholesale" FX market, where entry is restricted to professionals. Not a physical market or exchange, the interbank market is a web of credit facilities built over time and used by banks to trade with each other directly or through electronic matching platforms such as Reuters and EBS.

Retail FX Broker Also called Futures Commission Merchant (FCM), these are companies created to "open up" the spot currency market to the retail trader through their small minimum account sizes (as low as $300). In theory, they should simply be the middlemen between the FX wholesalers and their retail client base, charging a small fee (the spread) for their service. Much like online stock brokers (E-trade, etc), they promise to "connect" the retail trader to the market at reduced costs, yet often fall well short of this promise.

FX Dealer If the interbank is the wholesale market and the brokers are the middlemen, then the dealers are the salesmen. Dealers typically work for FCMs or banks, and their primary responsibility is to process client transactions (buy/sell orders). If wanting to trade, clients have the option of phoning their dealer or trading electronically. The dealer then goes to the wholesale market, executes the order, and keeps the price difference (in theory at least). Retail dealers concern themselves mostly with providing accurate prices (through their online trading platforms), handling client flows, and running stops of course!

Simplistic view of a retail FX transaction



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