The 7 Deadly Sins of FOREX
(and How To Avoid Them)

By Marc Low

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Introduction

Some 12 years on in my investment "career", I sat down to reflect upon my successes and failures. More to the point, I sat down to reflect upon the *causes* of my successes and failures, for that information is always for more important than the specific events which resulted. This personal reflection was driven both by the desire to improve my future performance, but also by the need to answer the age-old question, "What makes a good investor?" I decided to consult the dictionary for a definition of the term:

Invest (ĭn-vĕst')

v. 1. To commit money or capital in order to gain a financial return.
2. To devote morally or psychologically, as to a purpose; commit.

I was fascinated by the definition. The concept of financial investment is an interesting one for obvious reasons; everyone wants to know how they can turn money they've already earned into **more** money. Unfortunately, this desire to grow one's after-tax dollars is all too often accompanied by unrealistic expectations. Beginners to the game often hope for annual returns in the hundreds or even thousands (!) of percent, and there are far too many snake-oil salesmen willing to stoke those dreams with impossible promises.

To the outsider, investing often seems a dark, mysterious activity, shrouded in secrecy. Success seems elusive, if not downright impossible. Names like "Soros" and "Buffett" are oft-mentioned. Tips are exchanged in hushed

tones. This program or that program is the newest “Holy Grail” of the investment world. Beginners often float from system to system, looking for that special something that will bring them the riches they desire. All too often, the second definition is ignored.

Success in investment requires a certain psychological devotion to the purpose. Far too many investors expect full-time income from their investments, with only a part-time (or less) investment of energy and focus. This cannot be, for as the old saying goes, “You don’t get something for nothing.” Interestingly enough, while investors of all colors hold up Warren Buffett and George Soros (among others) as the flag-bearers of the craft, few stop to analyze the examples. Both men are rich almost beyond imagination, yet how did they get to where they are today? Their seeming overnight success was in fact not overnight at all, but the result of years and years of steady, compounded returns.

Berkshire Hathaway, the investment group founded by the legendary Warren Buffett, has earned, on average, a little under 25% return annually. Certainly these returns are far better than the S&P 500 average of 9%, but by no means are they in the hundreds or thousands of percent. And yet Berkshire Hathaway stock trades at nearly $100,000 per share, and Buffett stands as one of the richest men in the world.

George Soros is another great example of legend distorting fact. His role in Black Wednesday (September 16, 1992) is well publicized. Soros’ Quantum Fund sold short nearly $10 billion dollars worth of British Pound, and forced

the Bank of England to float its currency or face collapse. This bold move netted Soros and his associates over $1 billion dollars profit. Not bad for a day's work, certainly, and enough for a few tanks of gas in the limo without question, yet the return on capital was around 10%. The returns were large; so was the investment.

The purpose of this book is not to discourage traders or investors; quite the opposite. I have attempted to distil my years of experience, and those of fellow investors I've met along the way, into a short list of potential "booby-traps". Assuming your technique and money-management principles are sound, being aware of these potential pitfalls will, I hope, greatly improve your odds of success. Good luck!

Deadly Sin #1: Impatience

In trading terms, impatience rears its ugly head in major and minor ways, both of which are significant.

On a major level, traders of all markets and experience levels tend to fall victim to impatience when it comes to expectations of returns. An attitude exists (especially among newcomers) that success is a given, and that it must appear quickly and without much effort. Nothing could be further from the truth. I say especially among newcomers because, as any successful, experienced investor/trader will tell you, investing is a long-term proposition. Success is measured in years, not weeks or months. Because of this tendency to expect the unrealistic, investors tend to easily slide into Deadly Sin #2: Lack of Clear Vision, because the grass is always greener on the other side. The tendency of all investors to become impatient with their system or technique is simply greed rearing its ugly head. Think you're not the greedy type? Put some money in the market and you'll soon learn otherwise. We all have a little voice in our head looking for more; some of us just have a voice that speaks louder than the next person's.

On a minor level, or more accurately, on a practical level, traders often fall victim to impatience whilst in a trade. How many people can relate to the following scenario?

You analyze a particular currency pair. The criteria you've established for entering a trade are met. You set your stop loss and your profit target, and you pull the trigger; you're in. Suddenly, now that you're actually *in* the trade, things look different. There's a level of resistance where there was none a moment before. The entire chart looks like a booby trap, just waiting to gobble up your trade. "If I can just get through *this* level, or *that* level…" you tell yourself, cursing your quick mouse-finger. The sweat starts beading on the forehead. You feel a bit queasy, but you're not sure if it's from excitement or anxiety. You clear the "spread", and you're actually showing a few pips of profit. "I knew it all along," you say to yourself, and pat yourself on the back.

Suddenly, the market reverses course. You're in the negative again. Now you're shouting at the screen, and quite sure that the nausea is anxiety-produced. You reach for the Pepto-Bismol as the sweat starts pouring. This continues for another few minutes (or hours, or days, depending on your timeframe), and each time you feel a little worse about the trade. Finally, unable to take another moment of this excruciating torture, you glimpse a few pips of profit, and take it, closing the trade. At that exact moment (or so it seems), the market explodes, running to your profit target and beyond.

"Son of a...! I *KNEW* it!"

How many of us have experienced this exact scenario? This inability to see the trade through to its conclusion is often caused by a lack of belief in the

system or technique being employed. If you believed 100% in the reasons for being in the trade, you wouldn't be anxious to get out.

SOLUTION:

We've talked about two different levels of impatience here. For the more major impatience, relating to the overall returns being generated, it's important to take a step back and re-evaluate your expectations. Some questions that may help:

Are your expectations realistic?
If you are expecting returns in the hundreds of percent a year, is that pace sustainable long term?
What are your long-term financial goals?

Another tool that helps to soothe the ego is the Rule of 72. The Rule of 72 is a quick calculation you can do to estimate how long it will take to double your money given a particular percentage return over time. Simply divide the return you are getting into 72 and voila, that's how long it will take to double your money.

For example:

Assume you earn an even 10% annually, year in, year out.

72 / 10 = 7.2

So, earning 10% annually will take you 7.2 years to double the initial investment.

Often when I show this tool to a student, they are surprised by the result. They may have thought that 10% annual returns would take forever to double their money, when in fact it only takes 7.2 years of consistency. Play around with the calculation on your own; you may be surprised with the results.

For the more practical challenge of impatience, namely, impatience with a particular trade, confidence is key. How do you gain confidence? Practice, practice, practice, then practice some more. Demo accounts are quite possibly the single greatest addition to retail investing. Why? Because it gives new traders the ability to simulate real-world conditions without the ability to "cheat" by fudging the numbers like the paper trading days of old.

The only really stressful trade should be the first one with real money. Why? Because your profitable demo trading results will now be put to the test with real dollars. Once the system is proven in real-time, there is nothing left to do but follow the rules of the system. New traders typically get nervous because they are unsure of their system, and are hoping for a successful outcome; experienced traders *expect* a successful outcome, so nervousness doesn't apply.

Deadly Sin #2: Lack of Clear Vision (Flip-Flopping)

As I mentioned in the first section, the sin of flip-flopping is closely related to the sin of impatience. Why? Because by nature, investors want more from their investments. If a particular strategy isn't yielding strong enough returns (or so the individual thinks) there must be something wrong with the strategy. And so it begins.

This is one of the most common problems I've encountered in traders over the years. Often I will meet someone who has been struggling away in the markets for years, always chasing the next big thing. They believe to the depths of their soul that *this* strategy or system is *the one*. Big things are only a few trades away. They don't realize that the problem most often lies not with the particular system, but within themselves.

Before you say it, of course some systems just plain don't work. I believe there is a special place in the afterlife reserved for those snake-oil salesmen (and there are plenty out there) who claim to have simplified a financial market down to a couple of arrows or a few lines on a chart. By and large, speculation on future movement is a difficult task, and most amateurs don't fare particularly well. This is one of the reasons why Unique FX tries to remove the element of speculation as much as possible from our strategy, and instead relies on market dynamics to generate returns. But I digress…

SOLUTION:

If you invest in a new system or technique, give it some time. Success is measured in hundreds or thousands of trades, not just a handful. No one can say with any certainty after only a few trades whether something is a success or not. Budget your time, energy, and capital wisely. Lay out a schedule for testing. If after several weeks (or months) of **DEMO** (!) trading, the strategy is yielding positive returns, begin trading with real dollars. But never, under penalty of drained accounts, begin trading a strategy unless it has proved itself in a virtual environment. Investing real, after-tax dollars makes things more difficult, not easier.

Deadly Sin #3: Sleep Deprivation

Sleep deprivation is a challenge somewhat unique to FOREX, although investors in other markets will also struggle if they are in geographically undesirable areas. The West coast of North America, for example, is such a place. When the New York Stock Exchange is getting off to a leisurely start at 9:30 AM, it's only 6:30 AM on the West Coast. This can be challenging, to say the least.

FOREX is even worse, because the market trades 24 hours a day. Brokers will promote this aspect as if it's a big benefit to you. "Trade when YOU want!" the ads all say. Just because you *can*, doesn't necessarily mean you *should*. Short-term day traders are especially guilty of this, because many of these people (amateurs or part-timers) work a regular job 9-to-5, but dabble in the markets when they have spare time. This spare time is usually late at night, so they do some research and find out that the London market trades at night (in North America). "It's as if the markets were made for me!" they will say with wonder in their voices.

Unfortunately, the market wasn't made for you. The market was made for professional traders, working for large multi-national corporations, and for them its 8AM local time. You are just a guy (or girl) sitting in your den or basement, it's 2AM, and you're trying desperately to stay awake. This is not a recipe for success.

Most people have heard the gambling adage "the odds favour the house". Simply put, this means that the games we play at the casino are tilted in favour of the casino. What many often forget, however, is that the casino will multiply that advantage by hosting an environment that puts the gambler at an additional disadvantage. They remove all clocks to disorient your sense of time, then pump oxygen-enriched air into room to counter the drowsiness. They overwhelm you with sound and light. Result? The gambler makes decisions which ordinarily they would not. Advantage: house.

FOREX has a similar characteristic in that the brokers encourage traders to trade at all hours. Why? Because many of the retail brokers in the industry are hedging against your position. For the un-initiated, this means that when you lose, the broker is winning. Not only do they take the spread as commission, but they also take the money you just lost in pips. If you are trading late at night, or early in the morning, you are more likely to make poor decisions, and those decisions will cost you money.

SOLUTION:

Carefully consider the strategy you are going to employ. Be wary of day-trading systems that encourage you to trade often and at all hours. This is rarely conducive to long-term success. Analyze your schedule. When does your "regular" life leave some spare time to spend in the market? If spare time is at a premium, long-term trading/investing will likely suit you best, because it requires less moment-to-moment attention. Most importantly, find

a system or strategy that suits your life and lifestyle – not the other way around!

Deadly Sin #4: Over-trading

Over-trading is as good a way to ensure mediocrity as any other. The formula is quite simple, actually:

Spread (commission) + Slippage + Taxes = Mediocrity

Each trade you enter generates spread revenue for the broker. This erodes your net profit. Many traders convince themselves that the spread is an irrelevant cost of doing business, but in fact it quickly becomes a significant part of your trading equation. If you trade retail FOREX at 200:1 leverage (pretty standard leverage), you put up $50 of margin to control a $10,000 mini lot. For this privilege, the broker will charge you at minimum a 3 pip spread on the major currency pairs, and up to 12 or more for some more exotic pairs. Those 3 pips (minimum) have a dollar value of around $3. In other words, the broker has just charged you a 6% commission on the actual money traded (3 / 50 = 0.06). Not bad business if you can get it. It's little wonder that brokers and educators alike promote short term day-trading systems which encourage you to take multiple trades a session – they make 6% return on each transaction. Add to this the idea that the broker hedges against you each time, and it's no wonder everyone wants to be a broker!

Slippage is a problem more common to stocks and other markets, but it can be an issue in FOREX as well. Simply put, slippage is the difference between where you *wanted* to get into the trade, and where you *actually* got

into the trade. Because of the huge volumes traded daily in the FOREX, slippage should not be an issue. If you are continually getting re-quotes or slippage from your broker, change brokers!

Tax is an issue that is rarely addressed in FOREX, and with good reason; most people lose money, so at best they're dealing with deductions, not income. That being said, assuming that you are making profit in the market (it is possible, we can show you how) the way in which you trade or invest becomes important. Did you know, for example, that short-term day trading is often treated as earned income? In other words, the income does not get to benefit from any of the reduced tax rates applied to investment income, and is instead taxed at your specific tax rate. This can make a huge difference in your final tax bill.

Longer-term positions, by contrast, are typically treated as investment holdings, and will be treated as long-term capital gains, and only when you sell. Although short-term and long-term traders may both end up with an equal number of pips of profit at year's end, the long-term trader will take home a much larger amount due to this tax treatment.

The specific tax laws will vary from country to country and state to state, so please consult an accountant or tax lawyer for specific advice.

SOLUTION:

Again, be wary of systems or techniques that promote excessive trading. The spread payments, slippage and tax will all serve to erode your eventual profit. Longer-term trades create less spread, are affected less by slippage, and will likely receive favourable tax treatment at year's end.

Deadly Sin #5: Reliance on Outside Sources

Reliance on Outside Sources is the cousin of Deadly Sin #2: Flip-flopping. This is a natural tendency of all traders and investors, because investing successfully is a difficult task. As a result, when we experience challenges, we tend to look outward for solutions as opposed to inward; we look for someone else to give us a solution to our problem.

Of course, no one else has the magic bullet either. No matter what anyone will tell you, there is no magic formula, no secret potion, no crystal ball which will allow you to see into the future and predict future market movement. It simply doesn't exist. As any veteran of the game will tell you, success comes from diligent research, patience, and emotional fortitude. There simply aren't any shortcuts in this respect. Clearly some people are more adept at investing, just as some people are natural athletes or scholars. But just like anything else, investing is a skill which can be practiced and honed over time.

SOLUTION:

Don't sell yourself short! Practice, practice, practice, and in a demo account for as long as it takes to show a consistent pattern of profit. If you do choose to look to someone else for advice, seek advice not on "tips", but on skills. Tips are not a transferable skill. The old adage of "Give a man a fish and he eats for a day; teach a man to fish and he eats for a lifetime" holds true here.

There is little value in getting someone’s opinion on what this currency or that currency will do next. Rather, ask them how they came to that decision. Learning to “see” the market as someone successful sees the market is the only valuable skill to learn; mimicry has a short shelf life.

Deadly Sin #6: Superficial Research

In the stock market, superficial research means simply looking at price and P-E ratios. There are many, many layers of information which must be sifted through before a company can be considered a good or bad "buy". The company's financial statements, their management team, their position amongst their competition; all of these factors and more determine the strength or weakness of a company.

In FOREX, we don't have the burden of financial statements per se. However, we can still analyze a currency's strength or weakness based on a number of factors. Combined, these give us a better indication of a particular trade's worthiness. If you insist upon predicting future movement (and I wish you wouldn't), you should be familiar with, at minimum:

- The currency's "behavioural characteristics"
  - How much does it move: Hourly? Daily? Weekly?
  - Does it move abruptly? Gradually? Does it "spike"?
- The economies of the currencies in the pair.
  - Strong? Weak? Budget surpluses or deficits? Et cetera…
- General market trends. Up? Down?
- Where the current price is relative to:
  - Today's movement
  - Yesterday's movement
  - Last week's movement
  - Last month's movement

- Et cetera…

- How the micro charts (15 minute chart or smaller) relates to the macro charts (4 hour or longer)
- And the list goes on...

So as you can see, there is much more to a successful trade than simply pointing and clicking.

SOLUTION:

Do your homework! Know the currency you are investing in inside and out. Concentrate on fewer currencies, but trade them "smarter". Your success ratio will improve.

Deadly Sin #7: Over-leveraging

In my experience, over-leveraging is one of the least-understood concepts in FOREX. Ask any FOREX trader what leverage they trade at, and 9 times out of 10 the answer you will get is, "200:1" or whatever the set leverage in the account is. This is a fatal misunderstanding.

Dirk DuToit, in his wonderful e-book "Bird Watching in Lion Country", distinguishes between "Account leverage" and what he calls "Real leverage". "Account leverage" is the leverage which the broker gives you to trade with. "Real leverage" is the actual leverage being employed at any one time relative to your account size. To illustrate this distinction, let's use a real-world example.

Let's assume that you open an account with $100,000. The account leverage is set at 100:1. This means that for each $100,000 standard lot, the broker will remove $1000 of margin to hold that position. With $100,000 in margin at your disposal, you could theoretically open 100 standard lots at a time. If you took a position in the market with 10 standard lots ($100,000 x 10 = $1,000,000), what would be your "real leverage" be?

Most traders would say 200:1. In fact, the "Real leverage" is actually 10:1 in this example. Why? Because the trade size ($1,000,000) is 10 times the account size ($100,000). Understanding "real leverage" is key to a long investment career while trading on margin.

To further illustrate this, take a look at the following table. If the market were to move 1% (100 pips), your account would react in the following way based on your "real leverage":

Real Leverage	% Price Change In Market	% Price Change In Account
100:1	1%	100%
50:1	1%	50%
33:1	1%	33%
20:1	1%	20%
10:1	1%	10%
3:1	1%	3%
1:1	1%	1%

In other words, if your real leverage was 50:1 (your position in dollars was 50x your account value), your account would fluctuate by 50% with just a 100 pip market move. As any FOREX trader will tell you, most any currency can move 100 pips at almost any time of day, yet most traders are not examining their "real leverage". Real leverage is important because it creates the equity swings which are terrifically exciting when in your favour, and terrifically frightening when against you.

To further illustrate this point, take a look at this drawdown recovery table:

Loss of Capital	% Return On Remaining Capital Required To Get Back To Break-even
10%	11%
20%	25%
30%	43%
40%	67%
50%	100%
60%	150%
70%	233%
80%	400%
90%	900%

So, using the previous example, if you suffered a 50% drawdown as a result of over-leveraging, you would have to double the remaining money in the account (100% return) just to get back to break-even! That is, without question, a difficult if not insurmountable task.

Over-leveraging is often confused with protection of capital. They are related but different. Capital is protected through the use of stop-losses. Over-leveraging multiplies the effect of drawdown when you "guess" incorrectly.

SOLUTION:

Simply put, don't do it. If you are speculating on future movement, you must be aware of the leverage you are using, and how it will affect the eventual outcome. Calculate your full exposure and remember that less is more. You may hit a home run with this trade, but in the event that things don't work out quite like you planned, don't strike out all at once.

CONCLUSION:

Hopefully this book has served to illuminate some of the more common pitfalls experienced by traders, especially those experimenting with FOREX. Investing is a serious but rewarding business, and deserves both your interest and respect. Master it, and a world of financial opportunity awaits; fall victim to it, and there are few things more frustrating.

Remember that there is no substitute for knowledge and practice. Educate yourself. Find a system which makes sense to you, not because someone told you it does, but because it resonates with your body of knowledge. And finally, find a mentor, someone who is willing to impart the knowledge and wisdom which made them successful.

Above all, remember that success will be measured in years, not weeks. There is always another trade out there.

"There are old traders around, and there are bold traders around, but there are no old, bold traders around."

- Bob Dinda

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