FOREX
The Trading Alternative

In 1996, former German Chancellor Helmut Schmidt spoke to a large group of traders at a conference in Berlin about the importance of the move to a single European Union currency – the Euro. He told the story of a traveler leaving Frankfurt – toting a wallet bulging with large notes – who flew to the airports in several European capitals in a single day. The traveler did not buy anything, but simply changed money in every airport along the way; and at the end of the day he returned to Germany with a thin wallet, no bank notes, and only a few smalls coins that would collect dust in bottom of his dresser drawer.

Well, Schmidt proved right, times have changed, and the Euro is here. However, the phenomenon that left that traveler discouraged – foreign currency exchange rates and spreads, is the same thing that offers extraordinary opportunity to the savy trader. For those of you who trade shares, futures, options, etc – but have yet to explore the world of Forex trading – an exciting market awaits you; but first, what exaclty is the Forex market and how does it work? Brian Griffin explains...

Foreign Exchange is the simultaneous exchange of one currency for another between two parties at an agreed rate. Settlement can be immediate (spot), in the future (forward) or deferred (on a daily basis). Because settlement can be deferred, it is possible to sell a currency you do not already own in exchange for a currency you do not particularly need or want, (i.e. to gain from an exchange rate depreciation).

The Foreign Exchange market, also referred to as the “FX” market, is said to be the largest financial market in the world, with an estimated daily average turnover of over US$1 trillion – 40 times larger than the combined volume of the major U.S. equity market.

It is important to note that the FX market’s daily turnover is principally made up of speculators with participants including Investment banks, Hedge Funds and high net wealth individuals.

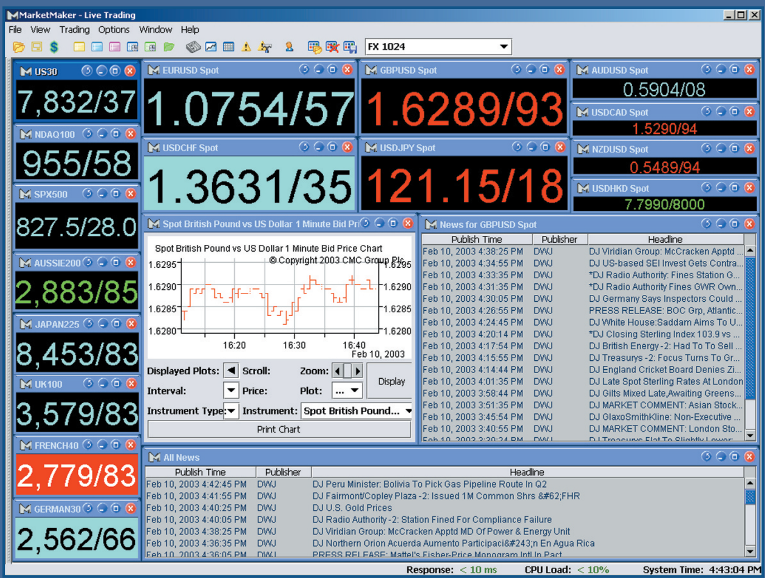
However the advancement of technology, and the reduction of initial margin requirements from an increasing spectrum of FX providers, has opened up the traditionally institutional world of FX trading to a growing number of individual investors, be it through margined FX trading account or via spread betting accounts. Adrian Patten of Harryhindsite.com the online commentary provider says of FX trading; “At HarryHindsight.com we actively encourage our members, retail and institutional, to look at the Foreign Exchange markets for a number of reasons:

The FX market is extremely large, liquid and in terms of participants highly professional. It is less easy to manipulate by market makers intra day and is accordingly easier to read in terms of technical analysis. These points ensure that FX is a product much loved by the ‘hot money’ – speculative capital such as hedge funds. It is the market where a correctly informed amateur can most closely compete with the professionals.”

How does the FX Market operate?

The FX market has a virtual center that is called the ‘interbank’ market and into this ‘marketplace’ Banks and participating members trade billions of Dollars everyday.

Probably the most commonly traded currencies are referred to as “the Majors.” US Dollar, Japanese Yen, Euro, British Pound, F1) Forex Screen



What to look for in an FX trading platform?

When trading FX via an online trading platform a client should look for a robust real time platform. As all traders will appreciate such systems have moved on from the days of providing indicative prices i.e. quote driven services.

An FX provider's commitment to automation can be noted by the additional functions offered by its trading platform. Real time position reporting, order status reporting and order placement capabilities allow a client to trade independently online without having to contact his broker personally. Additionally advanced platforms will allow a trader to place a variety of different order types from the same trading platform, such as Limit, Stop Loss, OCO and If Done Orders as and when required. These can help to limit the risk a trader exposes himself to, and are a vital tool in the armory of the FX trader. Competition across the FX provider market is hotting up, as the number of individual investors interested in FX increases. This means that with a variety of similar services offered by an ever-expanding number of firms, added value facilities are now being provided in addition to purely trading facilities. Third party specialist houses, previously the reserve of banks and institutions, are now being used to provide fundamental and technical analysis to a retail audience at no additional cost. Overall technical advancement and competition now means that the retail FX investor is now offered services and facilities on par with those offered to institutional trading desks.

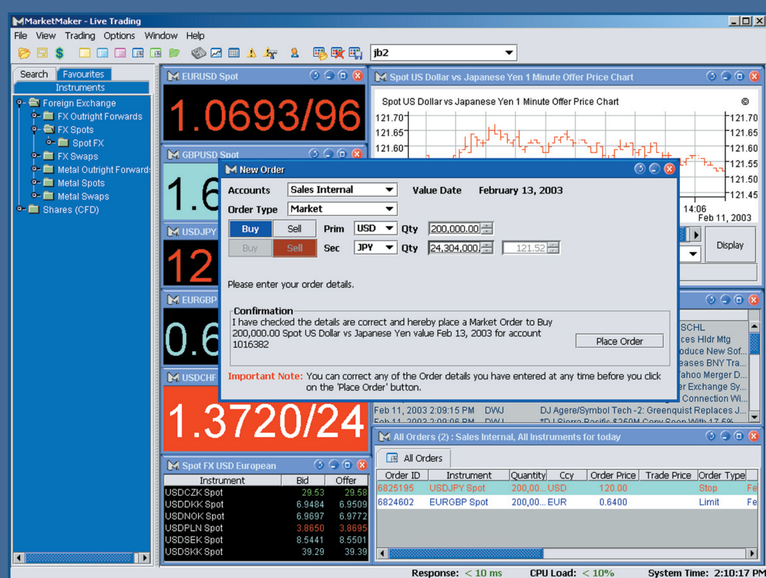
Swiss Franc, Canadian Dollar and Australian Dollar.

EBS, Reuters Dealing 2002 and the Voice broker are the tools of the interbank trader. The rates on these 'toys and broker box' determine what currency pair is trading at what rate, and most importantly how much (how many millions of US Dollars) can be bought or sold (paid or given) at the desired rate. A truly 24-hour market, FX trading begins each day in Sydney, and moves around the globe as the sun rises on each financial center. However it is the City of London which is the undisputed Home of FX trading, with acres of dealing rooms and miles of dealing desks purpose built for FX, and FX options trading.

This level of institutional styled trading has now become much more accessible for individual clients through the advancement of technology, and the reduced cost of entry. Many financial institutions have rolled out their own web based FX software that can provide some of the functionality and liquidity of EBS and Reuters 2002. In addition bespoke and standard forward outright dates have also been made available. The ethos of all such solutions has been the importance of providing straight through processing for all deals transacted online as opposed to the more traditional telephone or voice market. From an investors point of view, it is this emphasis that currently drives the market for online currency derivatives.

The most inherent advantage of trading on-line is reduced execution risk. As all trades are on-line and automatically fall into the markermakers book, the split second advantage for execution is critical.

F2) Order Placement



So why get involved?

1) 24-hour trading FX

FX is a true 24-hour market, which offers a major advantage over equities and ETD (Exchange traded derivatives) trading. There are buyers and sellers all over the world 24 hours a day, all actively trading foreign currencies.

2) Unlimited Opportunities

FX is an efficient market. Simply put, the rates quoted by any market participant reflects all news, supply/demand, which way the market is weighted and potentially resting orders. Unlike any marketplace for equities or exchange traded products it does not have an opening time or closing time. It is not subject to "after hours" analyst's announcements or earnings reports. Any individual trading FX has a level trading pitch.

3) Liquidity rules

Perhaps most importantly, the FX market has depth and breadth superior to any capital market instrument. Cash equities, equity derivatives are all subject to what is available in an "orderbook" and orders for reasonable size may have to be worked before being filled. A FX order could be filled at one rate in good size instantaneously.

FX should also be a consideration for people trading equity markets. Adrian Patten of Harryhindsight states:

"Another important reason to look at the FX markets is for the indications it can provide for future equity market moves. Dollar movements over the last year have had a high correlation with the equity markets (they generally move in the same direction). Often the FX market will precede the equity market movement by a number of days or weeks and an understanding of this relationship can be invaluable. We, and our members have been using this to great effect."

4) Leverage/Gearing

Trading FX enables you to use leverage or gearing. The requirement for gearing is much due to the fact that the shifts in currency values are very small when compared to equities, and to make reasonable returns a larger investment of funds is required. Leverage means that your overall return on investment can be maximised as you are exposed to a much larger position in the market than the money you outlay would normally allow. However this also means that you are subject to the risk of losses greater than your initial investment.

An initial margin between 1-2% to open a position is normally sufficient. The minimum amount of margin that many brokers/ market makers accept in order to open an account can be as low as USD $10,000 or the equivalent currency. These figures bring Foreign Exchange trading more in line with the intial monetary requirements of trading equity derivatives, again opening the gate to individual investors.

An example of margin with 1% of the notional amount traded: A Client sells USD $100,000 against the Swiss Franc (CHF) at 1. 3664. The margin requirement for the trade is $1000 , or 1% of the amount traded.

What to do next

Having decided to begin trading Foreign Exchange an investor must firstly decide how he intends to gain exposure to the market. Present regulations mean that investors with no previous experience in related markets unable are to directly trade margined foreign exchange. Such investor may then choose to look at spread betting products offered by a variety of companies. Inherently the spreads are wider than margined FX accounts and the number of available currency pairs is limited. However with services such as deal4free the spreads remains the same across the spread betting product, and there is an added advantage of tax free profits.

Trading FX : A Worked Example

Trading Cable

A Foreign exchange quote, e.g. GBP/USD "1.6112/1.6116" represents the bid/offer spread, in this case for GBP/USD. The rate of 1.6116 is the rate at which the trader can buy GBP against the US Dollar. The rate of 1.6112 is the rate at which the trader can sell GBP against the US Dollar.

"Going Long"

The trader wishes to speculate on GPB/USD believing that the British Pound will strengthen against the US dollar. A dealer quotes GBP/USD at 1.6112/1.6116. First the trader needs to purchase GBP.

Opening Buy:

Trader buys GBP£100,000 @ 1.6116

The British pound appreciates against the US Dollar and the trader wishes to close the position.

Dealer is now quoting 1.6150/1.6154

Closing Sell:

Trader sells GBP£100,000 @ 1.6150

Profit/loss Calculation:

Sell Price - Purchase Price x Size of trade = Profit / Loss

1.6150 – 1.6116 x 100,000 = USD $340 Profit

"Going Short"

The trader wishes to speculate on GPB/USD believing that the British Pound will weaken against the US dollar. First the trader needs to sell GBP.

Dealer is quoting GBP/USD "1.6112/1.6116".

Opening Sell:

Trader sells GBP£100,000 @ 1.6112

The British pound depreciates against the US Dollar and the trader wishes to close the position.

Dealer is now quoting GBP/USD 1.6050/1.6054

Closing Buy:

Trader buys GBP£100,000 @ 1.6054

Profit/loss Calculation:

Sell Price - Purchase Price x Size of trade = Profit / Loss

1.6112 – 1.6054 x 100,000 = USD $400 Profit

Please Note: In the examples given above, if the currency had moved in the opposite direction to the direction shown, then the initial profit indicated, would have resulted in losses rather than a profit (as shown).