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# Profit in forex using behavior with Kris Matthews

*Part 1 of a 3 part series on trading by thinking outside of the box*

Why should one use behavioral analysis and not fundamentals or chart patterns? It may seem hard to believe, but the other two methods can produce many illusions. Most sites that show how to use chart patterns to predict price only show the times when they work beautifully, but not the times they fail. Likewise, the media and big institutions focus a lot on the fundamentals of world economies but using such an approach is difficult to profit from, especially in the short term. Think about all of the analysts on television and newspapers who have degrees in finance from impressive schools and carry years of experience with them. When they are right, investors and the media praise them, however, when they are wrong, do you ever hear about them? No one points a finger and says remember when Joe B. Analyst said this! My point is that everyone is following the information in the media, so performing fundamental analysis and expecting to be able to compete with bank traders which have large research teams is futile. What is the solution? It's simple: one must look where others aren't looking at the moment. Although the currency market is seen as a very efficient market due to its volume and liquidity, the way human beings think and approach the market leads to inefficiencies that can be profited from.

Think about a time when you went searching for a house. Your real estate agent drives you to multiple locations and shows you some beautiful houses valued at around $700,000. You love something about each one, but the price isn't right to you. Eventually your agent takes you to one house in the area that looks fabulous, but it only costs $450,000. After asking her why the price is so low, she says the owner is desperate to raise cash to pay for expenses. Do you buy the house? If people trusted the source of information and were aware of the general housing market, most would buy the house at terrific value. The problem is that in financial markets, there is so much information flowing around: On a daily basis there may be up to 30 major economic data releases and speeches, and then market chatter on positions and buying rumors pervade the news services every 10 seconds. How could it be possible for market participants to find the information gems like in the housing example and profit from them? The answer is many times they don't. The market focuses on whatever topic is the loudest at the moment and sets their opinion based on it. If you know that the market is ignoring something important while everyone is focusing on one thing, then you have an edge. The best thing is that this happens all the time.

I started out as a college student learning to trade the markets. Having grown up in several different countries (Germany, Japan, Singapore, Thailand, and Saudi Arabia) I was so interested in how things tied together on a global level. I saw currencies as a perfect way to satiate my desire to learn about how the economies of the world worked. I started by spending money on courses which taught technical analysis. Being an engineer I thought that I might have an edge at it because of all the graphs and charts, but even after a couple years of practice my account was just slowly bleeding away. After listening to mentors say, "Hang in there. All it takes is practice," and then ask me to give them their monthly $200 fees I decided there must be better ways and the answer wasn't simply risk management or psychology by itself. I spent thousands on books to try to develop myself as a trader. Do I have any regrets? Of course not: this was all part of the trader development process. I kept networking with people including bank traders, fund managers, and CTAs until I could find something that made sense. A while later, I decided it was time to take things into my own hands. Maybe the only method that was right for me was my own method. I had an epiphany that the only way to be profitable in this business was to be a contrarian. The problem was that most contrarian strategies I read about rely on events that happen once in a blue moon like waiting for a bubble to develop or a crash to occur, and I wanted to develop something that would earn an income for me on a monthly basis. I took everything I learned over the years and just started to brainstorm different strategies. I spent more time finding out what worked and refining them. Then my framework was born.

## Generating Income

Traders can profit from forex using behavioral methods on anywhere from weekly to yearly timeframes. When people ask me what kind of returns they can usually get with this trading method I tell them that traders I've worked with have gotten results anywhere from 30 % to 100 % annualized returns depending on how long they've been working on it. Many will scoff at the notion of earning such high returns. The rebuttal that I hear most often is, *"Institutional traders have an army of researchers and personally know all the major players in the market and they are ecstatic to see 20 % returns at the end of the year. How could you possibly expect to compete with them?"* I used to hold that limiting belief, and my account record confirmed that. However, I stopped to think and realized two things: 1) smaller players are nimble enough to move in and out of positions and thus capture more of each move and 2) most institutions are focused on what everyone else is doing and not using a behavioral strategy. Now that we've got that out of the way, let's lay down the specific strategies to trading profitably with a behavioral method.

Let me describe to you my typical daily routine. First thing in the morning I get to the office, stretch, and take deep breaths to get into a calm and confident mindset for trading. Then I review overnight price movements for the major currencies and other related assets such as crude oil and the stock market. After that I scan through daily bank reports and news articles to determine what the market's focus is. I compile everything I learn for the day and put the price moves into context. From there I ask myself what the current sentiment is and what the price moves mean (if anything). Then I look at current positions and perform my risk analysis to see if there is room to open more positions. If there is, I make a trade, decide on my profit and loss criteria for exiting, and then leave to do other things, because contrary to popular belief, you don't need to be in front of the computer at all times or even any specific times (like London open) to make money.

Let's break this overview down into three specific components: analysis, trading, and exiting.

## Analysis

Analysis involves putting everything into context, generating an idea based on the facts, and then selecting a vehicle to make money from your idea. I want to address something before we go any further: some of you may not like the fact that there is a lot of subjectivity involved with this method. I wasn't comfortable with this idea either at first, that's why we're going to completely systematize this and provide some clear examples. Soon the link between prices and information will become second nature.

### Analysis

1. Open a chart or look at a price feed. Look at the major dollar crosses (EUR/USD, GBP/USD, USD/CHF), commodity pairs (USD/CAD, AUD/USD) and risk pairs (USD/JPY). How far and which direction has price moved in the last 24 hours? Note how each of these groups moved. How does this compare to weeks/months ago? Do the same for crude oil and gold, and a US stock market index such as the S&P 500 to see how closely currencies are tracking commodities and equities. A good site for commodities charts is www.timingcharts.com
2. Secret: The first thing to realize is that things don't change that fast. The media likes to make you think otherwise because that's how they stay in business. Read monthly publications to get an idea of what the "big picture" perception of the market is and what the fundamental driving forces are for each economy. (Refer to fx bank research on thegestaltshift.com website). Use this to set a medium-term directional bias. See if monthly publications suggest an imbalance is developing.
3. Read a daily analysis source such as UBS Research, Scotiafx bank reports or news sites such as Bloomberg or ft.com to determine what news has entered the market and what the players are focused on as they move prices. Compare that with the "big picture" from step 2. Now you can put price action into context. Find out what news/economic data came out (refer to www.forexfactory.com) and was it better or worse than expected? Did currencies react favorably or poorly to it? Now you have gauged sentiment. Judge by the tone of the tone of the media how pervasive in the market the topic currently is.
4. If the currency pair is trending in your direction or ranging and price moves against your bias due to a small to medium focus shift, consider entering in that direction and allow daily volatility to help you achieve quick profits.
5. If an imbalance has been developing, ask if the recent focus shift is large. If so, it is probably the catalyst that will release the imbalance that had been developing. Plan to scale up positioning.

Remember, the point is not to be too exact about the analysis section. It is just to form a bias. Have knowledge of fundamentals first. Write down everything you learned in the analysis section because it will be used to select a trade using certain criteria.

## Trading

Hopefully by now the level of discretion is not turning you off, because we are going to venture directly on to the system part now. The daily analysis provides information that you can filter using the table below to determine what type of a trade you should be entering. If nothing happens in the markets then don't put on a trade. The information you drew from price movement, market focus, and sentiment should allow you to determine whether you are going to take a big trade and hold it for a while or just make a small quick profit. There are three primary trades in the behavioral framework: Macro, de-timing, and skew. Macro trades take advantage of imbalances that develop in the market followed by a change in perception. "De-timing" refers to short-term trades that do not timing entries and exits because of the random environment of the market. Skew trades take advantage of situations where the expectancy of a trade is skewed positive. Although price has a 50-50 chance of moving up or down, the positioning of the market for an expected news release may disagree.

| | Macro trade | De-timing trade | Skew trade |
|---|---|---|---|
| **Method of profit** | Shift in perceptions | Market randomness plus short-sightedness of investors | Asymmetric distribution of probabilities before an event |
| **What to look for** | Market euphoria/pessimism while ignoring something else important<br>Extreme positioning and sentiment | Pullbacks in a grid against bias direction<br>Important technical levels<br>Behavioral anchors—more on this later | One sided expectations by economists/traders before an announcement |
| **Best market environment** | Crazy, volatile | Steady range or trend | Fast trend or choppy range |
| **Frequency of opportunity** | Small ones: once per month<br>Large ones: 2-4 times/yr | 2-4 times/ week | 3-5 times/ month |
| **Purpose** | Big gains | Income | Income |
| **Entrance strategy** | Enter in the direction against the extreme sentiment when a catalyst occurs that shifts the market's perspective | Multiple entries in the direction of your bias after a pullback, especially to a technical level such as a weekly high/low or round figure | Enter against the expected outcome |
| **Risk management strategy** | Trailing stop, 5 % of account equity risked | Grid stop, 2-5 % of account equity risked | Grid stop, 3 % of account equity risked. Immediately exit if wrong |
| **Profit strategy** | Hold on as long as the reason for entering still holds | Small, quick profits of 50-100 pips on each position | Very quick profits of 50-100 pips |

You will find with this method that profits come regularly. However, keep in mind that most of trading is risk management, which by the way, starts before the trade is even made. A grid helps us manage risk by delineating extreme zones within which price should be contained unless there is a change in perception in the market. Currencies tend to range in a random fashion until a stimulus comes into the market that is so powerful that it pushes the value of the currency pair to a new range. The grid extremes provide a reference level for stops that are far enough away so that we don't get stopped out by randomness. Most people put stops on close to their entry to limit their risk, but they're increasing the risk of it getting hit too early. Although it's impossible to be exact, the best way to estimate these extremes is to use the top and the bottom of a current range or if the market is trending, then consider the price change of a recent pullback within recent times (at least 200 pips during calmer times, 500 during volatile times) and apply that from the latest high/low of the pullback. By dividing the grid into quadrants you can separate areas to enter and lower your cost of entry. No one knows where the market will go next. Instead of struggling with randomness, use it to your advantage by trading multiple entries to enter at a cheaper, average price rather than one expensive, exact price.

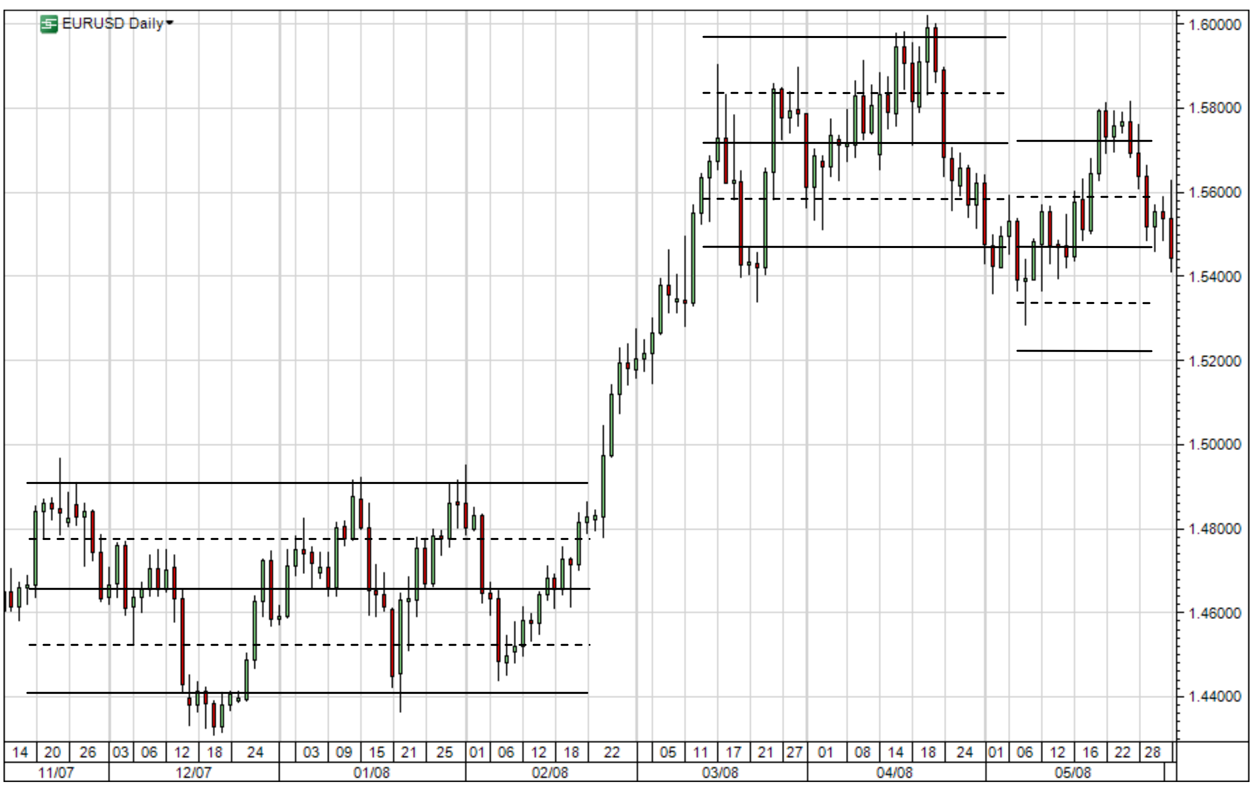


Figure 1. EUR/USD daily chart [source: Saxo Bank]

Figure 1 shows the application of grids on the Euro. The lines should not be thought of as support and resistance to time entries, but rather as general areas used to separate entries and exits. In a ranging environment, the grid extremes are typically the bounds of the range. When price breaks out and makes an extended move, we usually try to catch that by putting on a macro trade, so no grid is needed. After price finishes a fast move it pulls back, and we set the median of the same sized grid around where price was trading before it pulled back. This is because it could go down or back up and our analysis tells us the sentiment is neutral in this case. Remember, nothing needs to be exact here. This is all just a framework for us to perceive the market and to control our risk.

## Trading

1. **Decide how much time you want to allow for the trade to develop and become profitable.** If it is a de-timing trade, you should allow between 2-4 weeks max, (1 day if you are trying to catch a bounce). If it is a macro trade, it may take up to 6 months for a trade to materialize, but in most cases you should scale into these trades when a catalyst develops which corrects the imbalance so that the duration is around 1 month or less.
2. **Decide how much you are willing to risk.** Most trades should use an area slightly beyond a grid extreme as a stop loss level. During calm times, 300 pips will usually do. Volatile times demand at least 500 pip stops to stay outside the force of randomness.
3. **Risk management:** Look at your current exposure and determine whether you have room for more positions and also if you need to cut any losers. If you have $20,000 in your account and have $80,000 worth of short USD positions, you are leveraged 4:1 on correlated positions and that is probably enough. If your drawdown is approaching 10-15 % in a month you should start to think about cutting some positions. If it reaches 20 % then you need to cut everything and not trade for the rest of the month.
4. **Enter your order.** Diversify by time and price. Usually market orders are ok for spot forex, but if you won't be in front of the computer to make trades during market moving times then you might want to set limit orders for when the market pulls back for an entry. Set stops and profit limits.

    *Macro trades:* Enter small market orders and as the market moves over the next sessions, add leverage to your position.
    *Detiming trades:* Use minimal leverage and make multiple entries. Good entry points are usually figures (price levels that end in multiple zeros), previous highs and lows, and any pullback, but separate entries by at least 100-200 pips.
    *Skew trades:* enter a market order in the opposite direction of the consensus within 30 min before the announcement.
5. **Monitor the trades on a daily basis.** The golden rule is, if your reason for entering is no longer valid, then get out! If you were expecting a quick bounce for a randomness trade but price goes right through your level, get out. If price has lingered around or even gone the opposite way for too long, don't wait for your stop loss to trigger: get out. If the perception of the market changes dramatically and challenges your bias direction, whether you are showing a profit or a loss, get out!
6. **Don't trade the day after you make a lot of profits. Same for large losses.**

## Exiting

### Exiting positions

1. **Taking profits.** You need to decide from the beginning how you will take profits

   *Macro trades:* allow trailing stop to take out position (numbers)

   *De-timing trades:* During volatile times, take regular profits of around 100 pips on most pairs. During calmer or trending times, take 50 pip profits.

   *Skew trades:* During volatile times, take regular profits of around 100 pips on most pairs. During calmer or trending times, take 50 pip profits. Double these amounts if the surprise against the consensus is very large.
2. **Taking losses**

   *Macro trades:* trailing stop should be set starting at 250-500 pips away from entry depending on how volatile the environment is and where the closest support and resistance levels are.

   *De-timing trades:* hard stop should be set at 300-500 pips away from entry depending on how volatile the environment is and where the closest support and resistance levels are.

   *Skew trades:* hard stop should be set at 100-200 pips away from entry depending on how volatile the environment is and where the closest support and resistance levels are.
3. **Reasons why you must take a loss on a position**:

   Too much time has elapsed since entry based on your criteria

   Your original reason for entering has passed and you are starting to hope

   A new perception which is against your direction enters the market

   Your stop or trailing stop is hit

   You need to make room for a new position without over leveraging

   Your equity drawdown has passed 15 %

## Examples

### *Macro trade:*

The financial markets experienced the largest volatility in history as institutions sold all their assets to raise cash in July of 2008. While the dominant perception was that the global economy was in shambles, a new focus emerged that the European Central Bank would keep interest rates higher than the rest of the world because the European economy was better suited to deal with the credit crisis. The Euro climbed over 10 big figures from its lows due to this and caused an imbalance between price and fundamentals: The majority was focused on this new perception of higher yields in Europe remaining, yet they ignored the fact that the Euro zone depends on the rest of the world's demand and will probably follow the world economy. All that was needed was a catalyst in order to profit from a short on the Euro. In the beginning of January a month later, a very weak manufacturing indicator viciously reminded the market that Europe is not independent from the rest of the world. The catalyst caused the Euro to plummet down to its original range. An entry even if placed late would have paid at least 1,000 pips or $10,000 on a standard lot position.

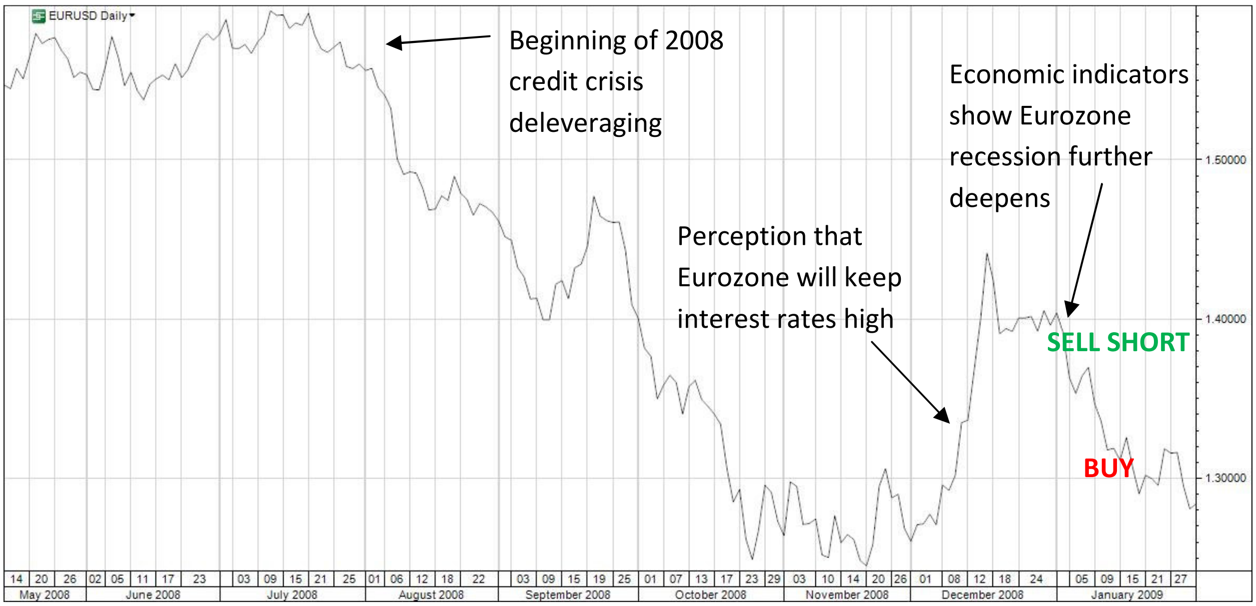


Figure 2. EUR/USD daily chart [source: Saxo Bank]

### *De-timing trade*

A bias at the time of writing for the USD/CAD pair should be long because the Canadian economy is closely tied to the US economy despite its other driving forces such as commodity prices and a more healthy banking system. The US dollar had been benefiting because people were taking money out of any assets to get US dollars in cash or treasuries for safety. Thus any weakness should have been bought. Since it's impossible to time the market, it makes sense to form multiple entries and multiple exits. A long trade was bought at 1.2350 and another at 1.2250. The entries were separated by at least 100 pips and 48 hours to ensure diversification. In a week's time the pair decreased and then increased in value again to give profits of 100 pips on each position. Notice that at no point was it necessary to pinpoint or predict levels for entry and exit.


**Figure 3. USD/CAD daily chart [source: Saxo Bank]**

### *Skew trade*

Skew trades work best when a market is strongly trending, meaning the majority has a lot of conviction, or in swinging, ranging markets, meaning that the market is looking for a direction and is confident enough to put early bets on. At the beginning of 2007, the UK economy was facing inflation that was higher than their tolerated amount so they were in the midst of an interest rate hiking cycle. For some reason, economists did not price in any chance of a hike, thinking that the Bank of England was done for a month or two before resuming. Further, they ignored the fact that inflation was still there. A trade was executed at 1.9321 before the scheduled interest rate announcement and sold a few hours later for a nice 127 pips. The market reacted by violently buying the Pound because no one expected a hike.

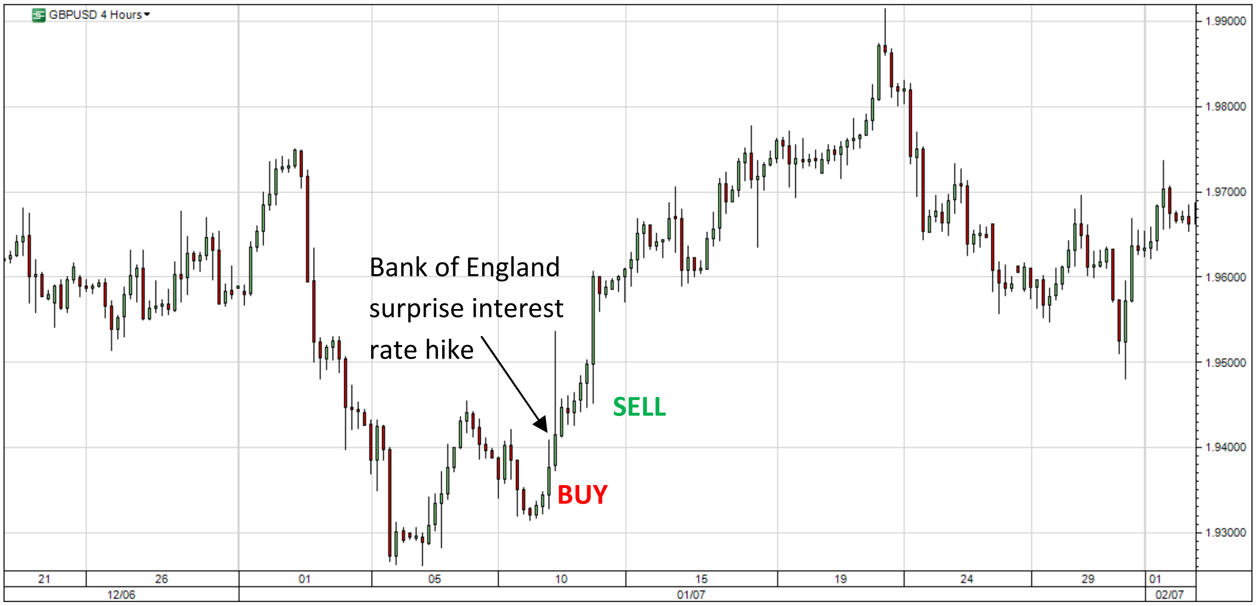


Figure 4. GBP/USD 4 hour chart [source: Saxo Bank]

## Next:

You have everything on these pages and the links provided to begin profiting from a method that is actually based on the way the market works. If you try these in a demo account you will notice that profits come quite regularly. Admittedly this technique requires a lot more discretion than the technical or news trading techniques taught in the FX education industry. My suggestion is you utilize the free resources on my site/blog at the thegestaltshift.com to get comfortable with this new style and see more examples and up to date analysis. With a few months of immersion and practice, much of this will start to become second nature and you will have the certainty that by acting against the majority in a controlled fashion you will continue to profit because 90 % of traders fail and all of their money goes to the 10 % minority who know what they are doing. I'm sharing this because I love to help people and we are far from increasing that 10 % any time soon, so I don't feel threatened that my edge is going to diminish by teaching others. So, if this style created an epiphany for you and you want to take it to the next level, the first step is to familiarize yourself with the fundamental driving forces of currencies. I will cover this along with ways of gauging sentiment changes in my next report of this free series. If you are committed to trading with a method like this, remember to never leave setting a goal without taking action. Make it a point to do the analysis exercises before each trading section for the next 14 days and see how much you learn. I will close by noting a old trader's saying: "stop trying to *be* right and instead *do* the right thing."