

Get Real!

By Marco Mayer, author of *Forex at the Market* (<http://www.fx-atm.com>)

My path to becoming a successful trader has been a long journey, from starting with illusions about the markets to coming to see the truths of the markets. Nowadays, when private traders usually start out trading electronically, I believe it is even more imperative that most beginning and even many advanced traders overcome those same illusions I had when I first started out.

This might be even truer for new traders who start trading Forex with a broker who is also a market-maker. At these market-making brokers, the trader sees no volume, no “real” bid/ask; there is no real market to be involved in — it’s more like an online casino where one can place his bets. I’ve seen traders start at these bucket shops with a couple of hundred dollars that they pay through their credit card. A few hours later they log on to their trading platform, which often looks more like a computer game than a platform on which to trade. More often than not, that money quickly ends up in the pockets of their very happy brokers.

For some people, that’s fine. Instead of gambling in an online casino, they might decide to play the “Forex game” for a few hours each night, to get their “kicks” out of trading Forex. That’s all right, since they get exactly what they want, but they have to pay for it. I believe many traders, especially Forex traders, fall into this category, whether or not they are aware of it.

But there are many traders who are serious about trading, who want to become professional, consistently successful traders. Instead of just wildly gambling in the markets, they decide to do some serious research to look for ways to trade profitably. Sitting in front of their computers, all they usually have to work with are charts. After awhile, those charts are often crowded with lines and all kinds of fancy indicators. The search for the Holy Grail has begun!

In this stage, the trader tries out various combinations of different indicators, like moving average crossovers, to find a combination that “works.” If you ask this trader how and why the indicators he’s playing around with should work in the markets, he probably wouldn’t be able to tell you. But he’s sure he’ll finally find something that does work incredibly well on the charts he’s looking at, in other words, in current market conditions. He gets very excited about this, and decides to start trading his new Holy Grail in the real markets. Unfortunately, soon after he starts to trade his system live, it stops working and he loses money. After this experience, the process starts anew, searching for a better way to enter the markets, just to fail again.

At this stage, the novice trader is often stuck in different illusions that are hard to recognize. He’s still focused on finding better entry signals, searching for the perfect way to get into trades, a system that works all the time. If he were to see the markets for what they really are, he’d see how foolish this approach is and stop right away. But our trader is looking at the markets as something abstract, just seeing bars moving up and down, cluttered with lines and indicators, without really understanding why they actually move. He can be compared with someone trying to fix his car by randomly replacing each part of it with a new part, without understanding how a car actually works or the function of each part of the car. Yes, he might

accidentally be successful after awhile and get his car running, but he's definitely far from being a professional motorcar mechanic.

I think the above comparison holds true for beginning traders vs. professional traders. A professional trader understands his business very well, and profits from those who don't. When looking at a chart, the professional trader doesn't just see bars moving up and down, he sees the reality behind the price action that is unfolding. That reality is simply market participants buying and selling, large and small orders being placed and executed, that cause prices to move.

This understanding allows him to be a consistently profitable trader. He has closed the gap between looking at a price graph, which is nothing but a visual representation of the buying and selling going on in the markets, to the actual reality behind this representation: buy and sell orders being executed in the market.

The professional trader fully integrates his knowledge of how the markets work into his way of looking at charts, and therefore he's able to discern promising trading opportunities. He also knows exactly what has to happen to prove him right once he enters a market. Unfortunately most traders don't. Do you?

He knows that when he buys, in order for him to make a profit, other traders and big institutions like banks or big hedge funds need to buy at a higher price. The opposite is true if he sells. He needs other traders and big institutions to sell after he has sold, at a lower price. Then, and only then, can he close his position with a profit.

A few months ago I attended a trading exhibition for private and institutional traders in Frankfurt. In one of the presentations, the speaker showed the audience (traders) a flip chart that showed the order book of a specific market. Then he asked various questions regarding the order book, such as, "According to the orders, at what price would the next trade take place?" The audience was very quiet, and no one came up with the right answer. Oddly, the same traders who didn't understand the basics of how a market actually works were very actively discussing some really fancy technical analysis techniques just a few minutes before.

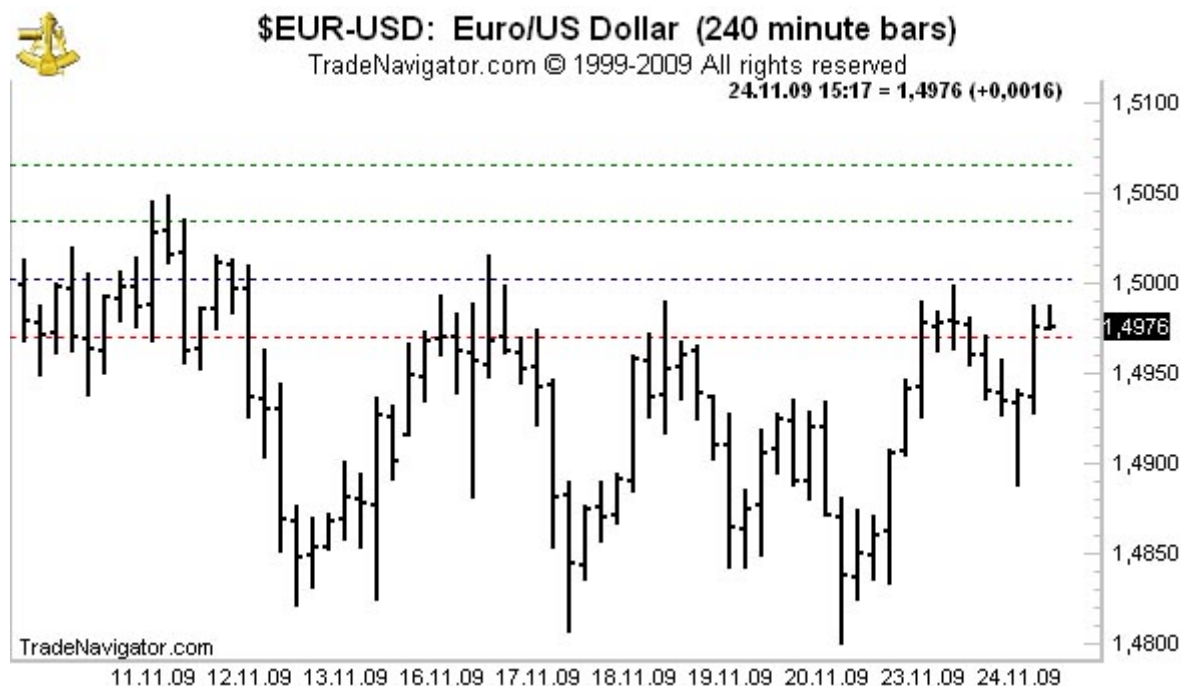
One of the most important steps in becoming a successful trader is to understand what's going on behind the charts. When that knowledge is there, you are able to look for trading methods that work for a good reason — a reason that is grounded in the reality of the markets, not in some goofy chart pattern or combination of indicators you happened to find.

This understanding will deepen over time, and will take a lot of hocus-pocus out of your market perception. I believe that before this happens, you will feel insecure about your actions and decisions in the markets, especially if you do not understand the logical reasons behind various patterns you see. On the other hand, when you understand what it is you're speculating on when taking a trade, you can very clearly set a stop-loss at a point where you know price shouldn't be trading if your speculation was right.

I believe it's easier to get out of a trade when the stop-loss is reached if you really understand the trade you're in. Let me give you an example.

Here's a recent Forex-at-the-Market (<http://www.fx-atm.com>) trade. It's a breakout trade we took last year in EUR/USD:

Consider buying **EUR/USD** at 1.5002 stop market. Suggested stop at 1.4970; suggested first target at 1.5034 (move stop to 1.4998 when filled); suggested second target at 1.5066, then a move higher. Basis is a Ross Hook and a possible breakout above 1.5000.



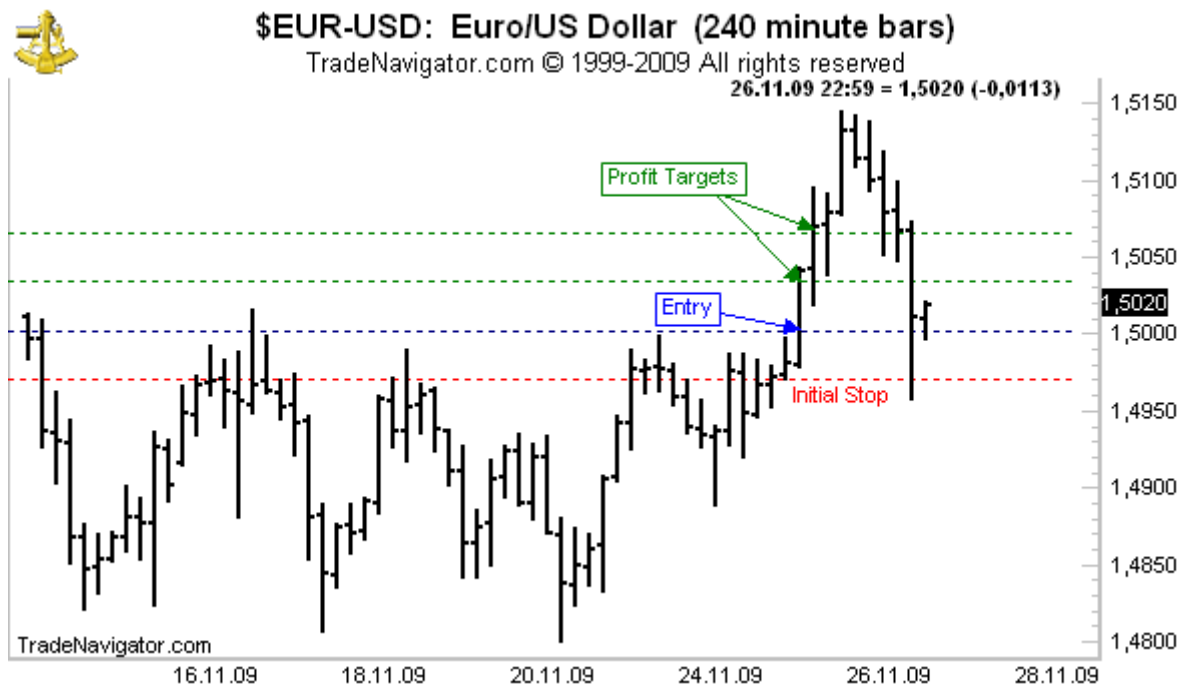
When the setup unfolded, EUR/USD had been trading in a tight range for a couple of days. 1.5000 had been an important price for many market participants, and was closely observed. Every time EUR/USD traded above 1.50, sellers came into the market and EUR/USD dropped back down into its trading-range.

But while it had always been sold off heavily at 1.5000 before, this time it dropped only about 100 pips instead of 200 pips as it had before. This tells us that there are fewer people willing to sell EUR/USD at this price than before. Looking at the chart, I thought that there were probably many accumulated stop-buy orders right above 1.5000. If EUR/USD would manage to trade above 1.5000 again, it would be likely that those stop-buy orders above that price would get triggered, and EUR/USD would probably continue to move up.

So I knew I'd speculate on a bunch of possible stop-buy orders slightly above 1.5000. If those orders were really there, EUR/USD would break out strongly without any significant correction.

If it didn't happen, I'd be wrong. I would have speculated on something (lots of stop-buy orders right above 1.5000) that simply would have turned out to be not be true. In that case, I would have wanted to be out of that market, no matter what. Therefore I placed a tight stop-loss, 30 pips lower at 1.4970.

As you can see on the next chart, the trade actually worked out nicely, and profits could be taken quickly.



Now let's say I had taken the trade because of some price pattern or an indicator that I didn't really understand. In other words, I had just decided that this is my entry signal, and if that signal shows up on the chart, EUR/USD should move up. But there's no sound logic behind the setup, just the visual pattern. So I get into the trade and place a stop-loss, just in case this doesn't work out. Let's say I place the stop 50 pips lower, since I think the trade shouldn't go 50 pips against me before going in the right direction.

Unfortunately, a few hours later it does, and EUR/USD comes close to my stop. If it gets hit I should get out since that's my stop-loss and, of course, I will get out because I'm a disciplined trader and always follow my plan. But I won't be sure if that's really the right thing to do. Why should I get out here? Just because it trades 50 pips lower, does that mean the pattern didn't work this time? Or am I simply getting out too early? How could I know? The answer is I cannot know if I don't understand why I am in that trade in the first place.

This is why I think it's extremely important for every trader to get as close to the reality of the markets as possible. Always study the markets, question your methods, and ask yourself if what you're doing makes sense in light of how the markets are currently behaving as well as in light of your understanding that it is orders getting executed that is the underlying force that moves the markets. If you do this persistently and honestly, you'll get a completely new perspective of the markets in relation to your own trading, a view that is compatible with reality, and allows you to trade in a way that really makes sense — and works!