Traits of Successful Traders 2.0

From second quarter 2014 to first quarter 2015, FXCM traders closed more than half of trades at a gain. Yet the average forex trader lost money.

Why? Put simply, human psychology runs counter to the best practices of strategy management. The FXCM research team closely studied the trading trends of FXCM traders, utilizing an enormous amount of trade data, to answer one question:

What separates successful traders from unsuccessful traders?

From this, we've distilled some of the best practices successful traders follow.

Past Performance: Past performance is not indicative of future results.

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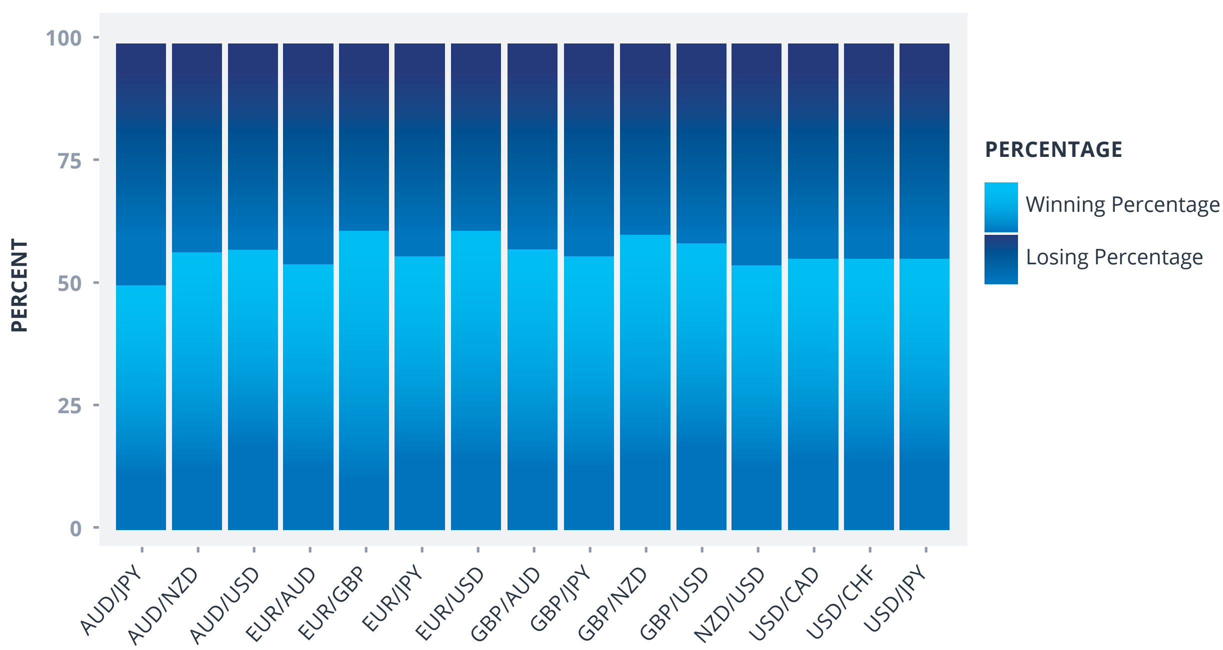
TRAIT 1:
SUCCESSFUL TRADERS CUT LOSSES, LET PROFITS RUN

Historically, this simple adage has been difficult to adhere to. Take the EUR/USD. Our data shows EUR/USD trades closed out at a profit 61% of the time. But the average losing trade was worth 83 pips while the average winner was only 48 pips. Traders lost 70% more on their losing trades than they won on winning trades. Remember that past performance is no indication of future results.

Why the imbalance? Human behavior toward winning and losing can explain.

Chart 1: Percent of Winning/Losing Trades By Currency Pair



Data source: FXCM accounts excluding Eligible Contract Participants, Clearing Accounts, Money Managers, and Hong Kong and Japan subsidiaries from 3/1/2014 to 3/31/2015.

Note: The dollar value of losing trades may exceed the dollar value of winning trades. Additionally, it is important to weigh the relative risk and reward of every potential trade before entering the market.

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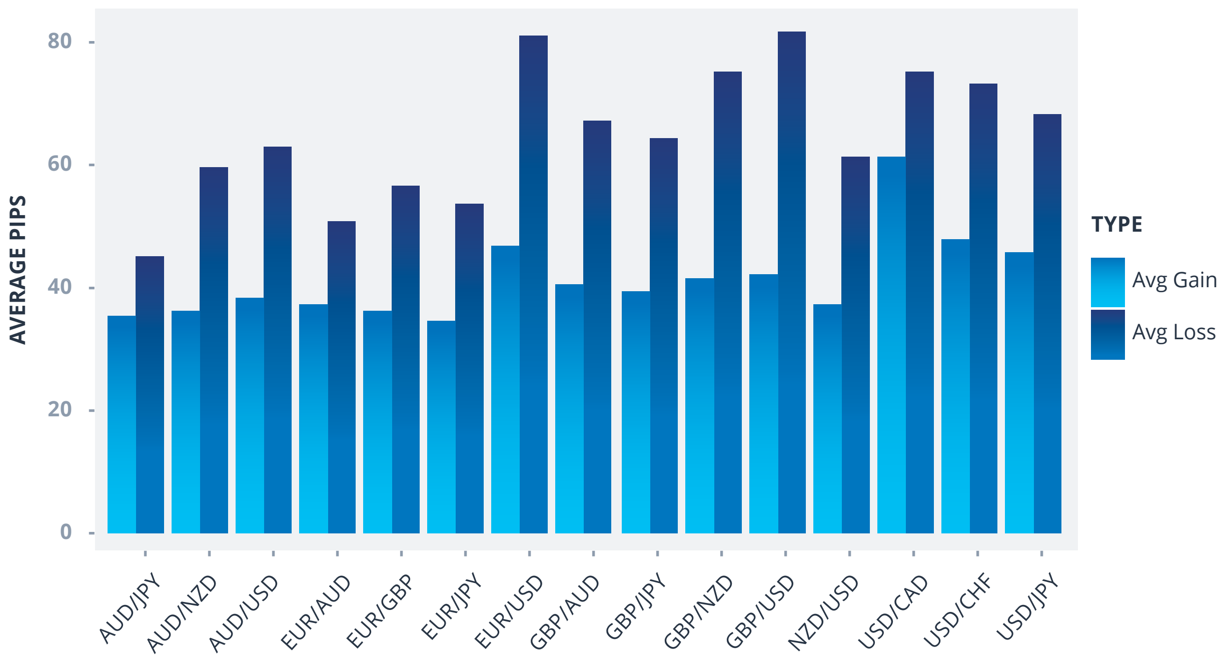
Chart 2: Average Profit/Loss per Winning and Losing Trades per Currency Pair



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? Traders lose more money on losing trades than they make on winning trades.

IMAGINE A WAGER. You have two choices. Choice A, we flip a coin. Heads, you win $1,000, and tails, you win nothing. Choice B, we flip a coin, but heads or tails, you win $450. Which would you choose?

Over many flips, say 100, choice A makes sense. If you

get heads half the time, you'd make $50,000. The more heads you get, the more you make. With B, the most you can make is $45,000. Human psychology suggests most people choose B, because the guarantee is perfectly acceptable. Let's flip the wager and run it as a loss.

Choice A, heads you owe $1,000, and tails, you owe $0. Choice B, you owe $450 regardless of heads or tails.

Again, psychology suggests the majority of people pick A every time. People avoid risk when it comes to a potential profit but accept risk to avoid a guaranteed loss. We take more pain from loss than pleasure from gain.

TRAIT 1:

SUCCESSFUL TRADERS CUT LOSSES, LET PROFITS RUN

Risk Versus Reward

How do we win more on winning trades than we lose on losing trades?

When trading, follow a simple rule: Seek a bigger reward than the loss you risk.

This is called a risk-reward ratio. If you risk losing the same number of pips you hope to gain, then your risk-reward ratio is 1:1, meaning you set your stop and limit equidistant from your buy or sell price. If you take a 40-pip risk (stop) and target an 80-pip profit (limit), you have a 1:2 risk-reward ratio.

The higher the risk-reward ratio you choose, the less often you need to predict market direction correctly to make money. You should, however, use at least a 1:1 risk-reward ratio: If you are right only half the time, you break even.

TRAIT 1:

SUCCESSFUL TRADERS CUT LOSSES, LET PROFITS RUN

Stick to Your Plan: Use Stops and Limits

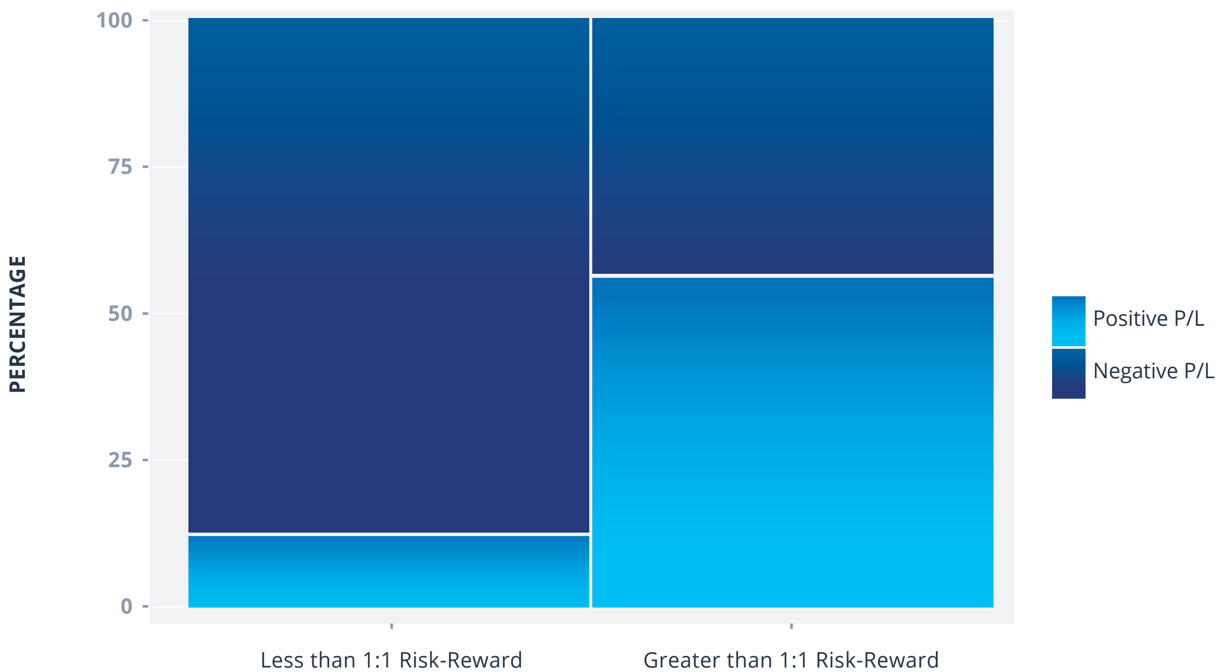
Once you have a trading plan that uses a proper risk-reward ratio, the next challenge is to stick to the plan. Consider the coin flip wager. The tendency is to hold onto losses and take profits early. This is not the best strategy for proper risk management.

Instead traders should remove emotions from trading. A good way to do this is to set up your trade with stop and limit orders from the beginning. This allows you to use the proper risk-reward ratio (1:1 or higher) from the outset, and to stick to it.

Once you set stops and limits, don’t touch them!

Does 1:1 or higher really work? Our data certainly suggest it does.

Chart 3: Profit and Loss by Risk-Reward



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Of the traders who traded 1:1 or higher risk-reward, 53% turned a profit; of those who didn't, 17% turned a profit. Traders who adhered to this rule were three times more likely to turn a profit—a substantial difference.

Open nearly any book on trading and the advice is the same: Cut your losses early and let your profits run. When your trade goes against you, close it out—better to take a small loss early than a big loss later.

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GAME PLAN

USE STOPS AND LIMITS SET TO A RISK-REWARD RATIO OF 1:1 OR HIGHER.

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When you place a trade, **use a stop-loss order. Aim for at least 1:1 regardless of strategy.** The actual distance you place your stops and limits depends on market conditions, such as volatility, currency pair and where you see support and resistance.

Easily calculate your trade size with stops and limits using the Risk Management Indicator from FXCM Apps.

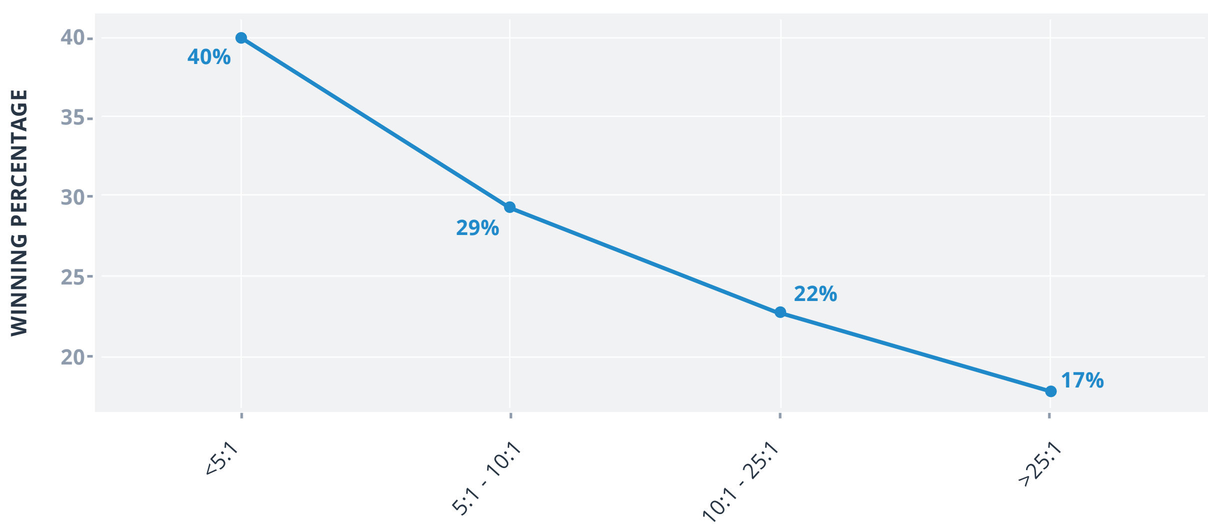
TRAIT 2:

SUCCESSFUL TRADERS USE LEVERAGE EFFECTIVELY

Leverage—A Double-Edged Sword

Many traders come to the forex market for the wide availability of leverage—the ability to control a trading position larger than your available capital. However, while using high leverage has the potential to increase your gains, it can just as quickly, and perhaps more importantly, magnify your losses.

Chart 4: Percentage of Profitable Traders by Average Effective Leverage



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Note: The dollar value of losing trades may exceed the dollar value of winning trades. Additionally, it is important to weigh the relative risk and reward of every potential trade before entering the market.

Profitability declines substantially as effective leverage increases: 40% of traders using an average effective leverage of 5:1 or lower turned a profit while only 17% using 25:1 or higher closed at a profit.

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Excessive leverage makes profitability significantly less likely.

Tom and Jerry each open a 10K account and look to trade EUR/USD **(MMR $26 per 1K)**. Both use a 1:2 risk-reward ratio with a stop at 100 and a limit at 200. However, they use two different leverage ratios.

TOM	**JERRY**
30:1 Leverage	10:1 Leverage
Buy 300K trade	Buy 100K trade
MMR: $7,800	MMR: $2,600
Usable Margin: $2,200	Usable Margin: $7,400
PIP Value: $30	PIP Value: $10

But EUR/USD trades down, falling 60 pips. At the end of the trading day:

TOM	**JERRY**
Loss: $1,800	Loss: $600
Remaining Usable Margin: $400	Remaining Usable Margin: $6,800

Which trader is more likely to deviate from the initial plan? When the trade went against Tom, the trade didn't have room to draw down, and the usable margin quickly evaporated, pushing him closer to a margin call. Jerry has appropriate leverage (and stops and limits) to allow the trade space to move back into favor.

Ultimately, the same move in the market cost Tom three times what it cost Jerry.

The higher your leverage, the greater your risk on each trade, likely amplifying irrational decision-making.

TRAIT 2:

SUCCESSFUL TRADERS USE LEVERAGE EFFECTIVELY

Finding Effective Leverage

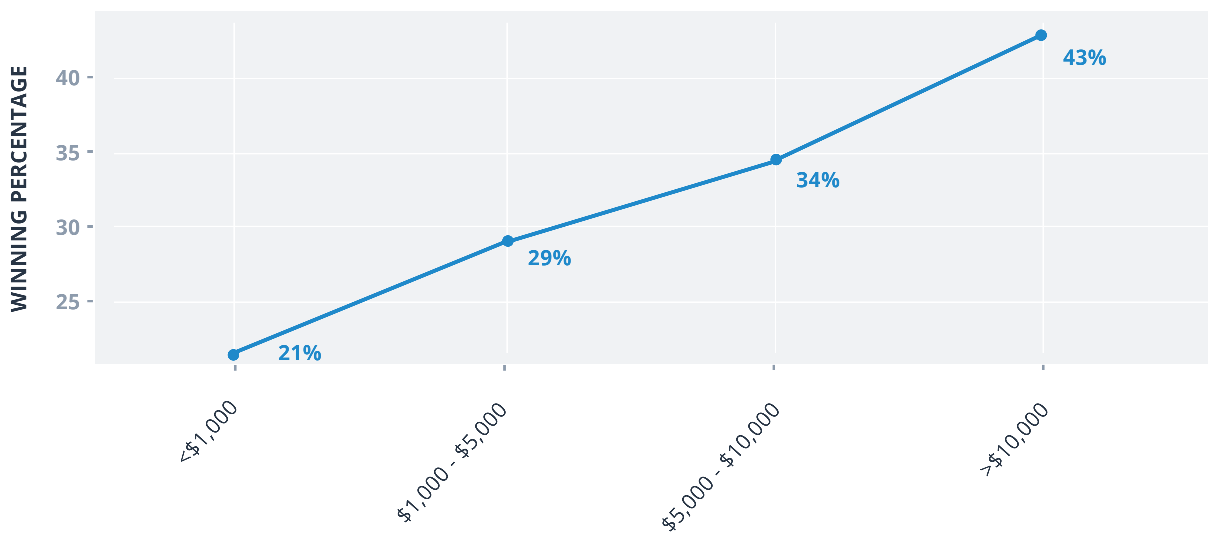
Knowing the link between leverage and equity is important. Now, you have to decide how much you are willing to risk and set your trading capital accordingly.

To find effective leverage, consider two inputs: trade size and equity.

To calculate leverage, divide your trade size by your account equity.

Say you open an account with $10,000 in equity. A 10:1 leverage would mean opening positions no larger than $100,000 at a time.

Chart 5: Percentage of Profitable Traders by Average Trading Equity



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Given the relationship between profitability and leverage, you can see a clear link between average equity used and trader performance. At the low end, a mere 21% of traders with $1,000 equity turned a profit.

Those with more than $10,000 in equity were more than twice as likely to see profits. Those with under $1,000 in equity used an average of 28:1 leverage, while traders with more than $10,000 used an average of 5:1.

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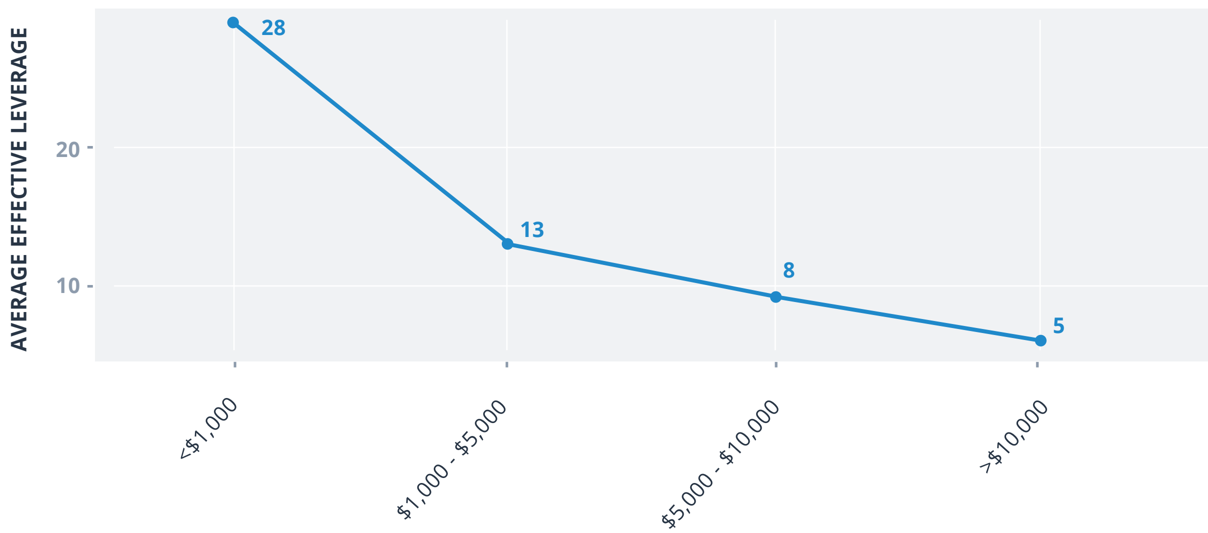
Chart 6: Average Effective Leverage Used by Average Trading Equity



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GAME PLAN

USE EFFECTIVE LEVERAGE OF 10:1 OR LOWER.

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Only risk 10% or less of your account balance at any given time. Add the cash value of your entire exposure to the market (all your trades), and never let that amount exceed 10 times your equity.

To calculate leverage of a single trade, divide your trade size by your account equity.

TRAIT 3:

SUCCESSFUL TRADERS TRADE THE RIGHT TIME OF DAY

The Best Time to Trade

As markets open and close around the world, how are major pairs affected?

Our data on trader performance shows that traders on average have a lower win percentage during volatile market hours and when trading through faster-moving markets. Conversely, when average pip movements are smaller, traders fair better, yielding higher win percentages.

Chart 7: Trader Profitability by Hour of Day in Major Currency Pairs

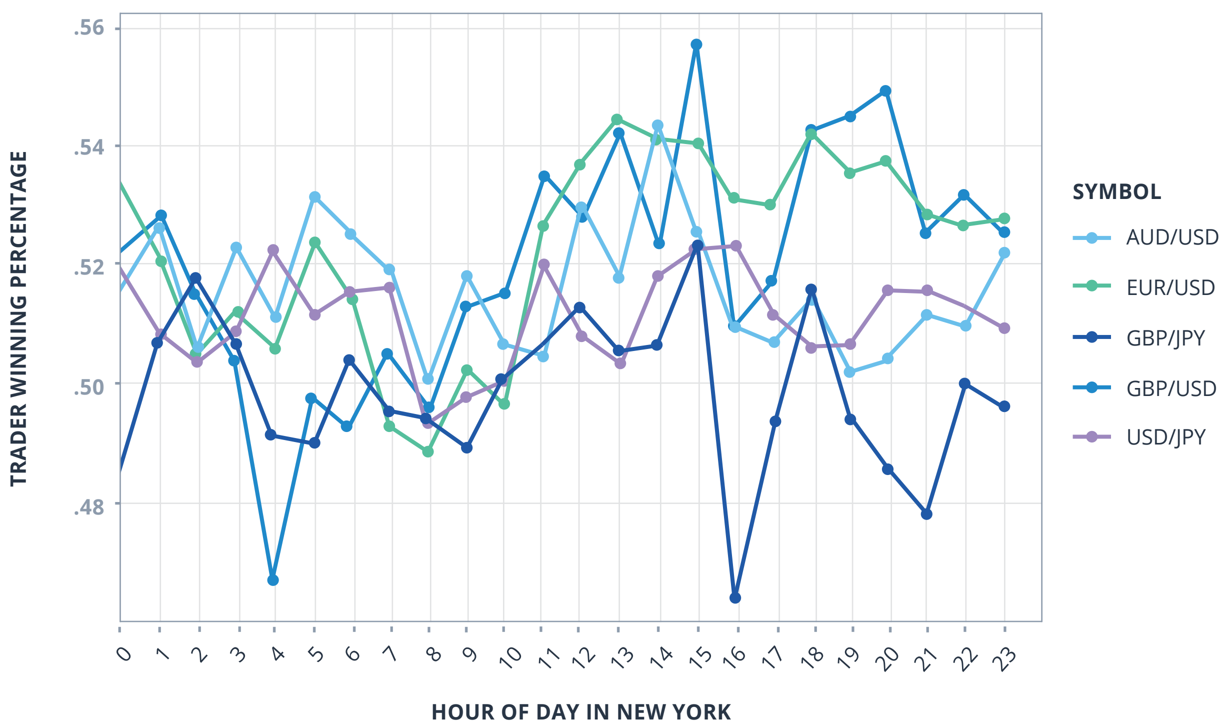

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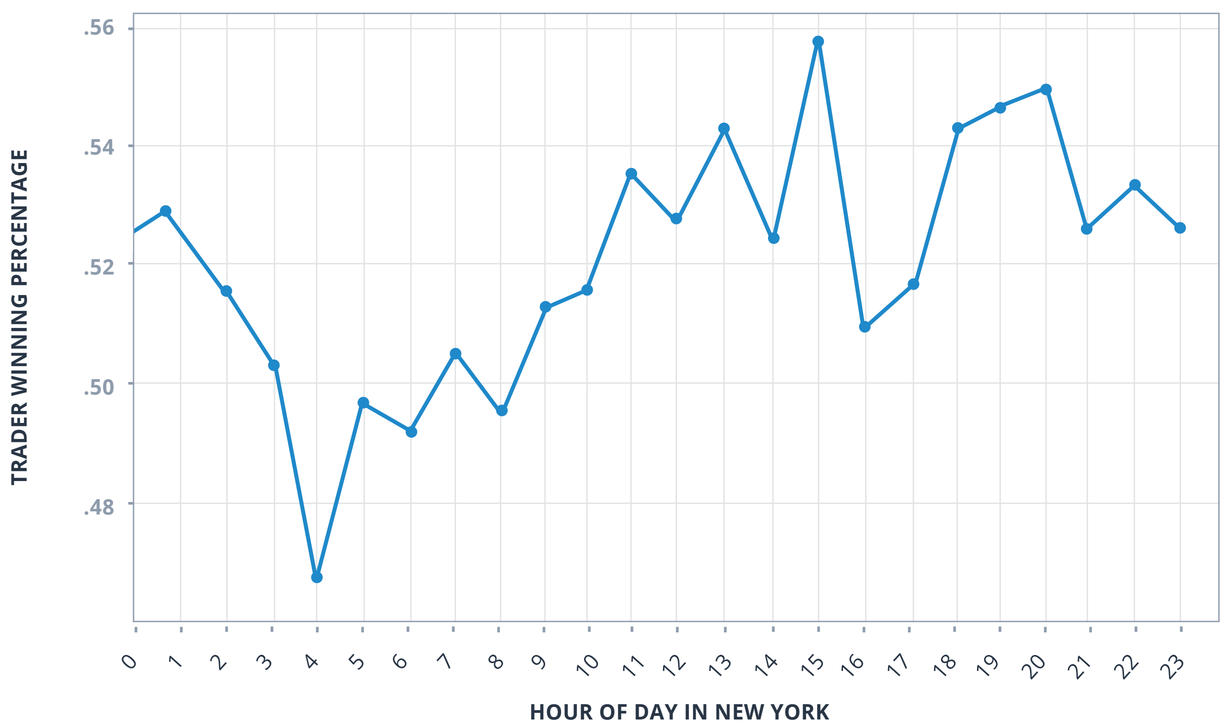
Chart 8: Trader Profitability by Hour of Day in GBP/USD



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If a GBP/USD trade opened between the hours of 4:00 and 5:00 am on a New York morning, the trade saw profit a mere 47% of the time. If opened in the evening, between 8:00 and 9:00 pm, profitability jumped to 55%.

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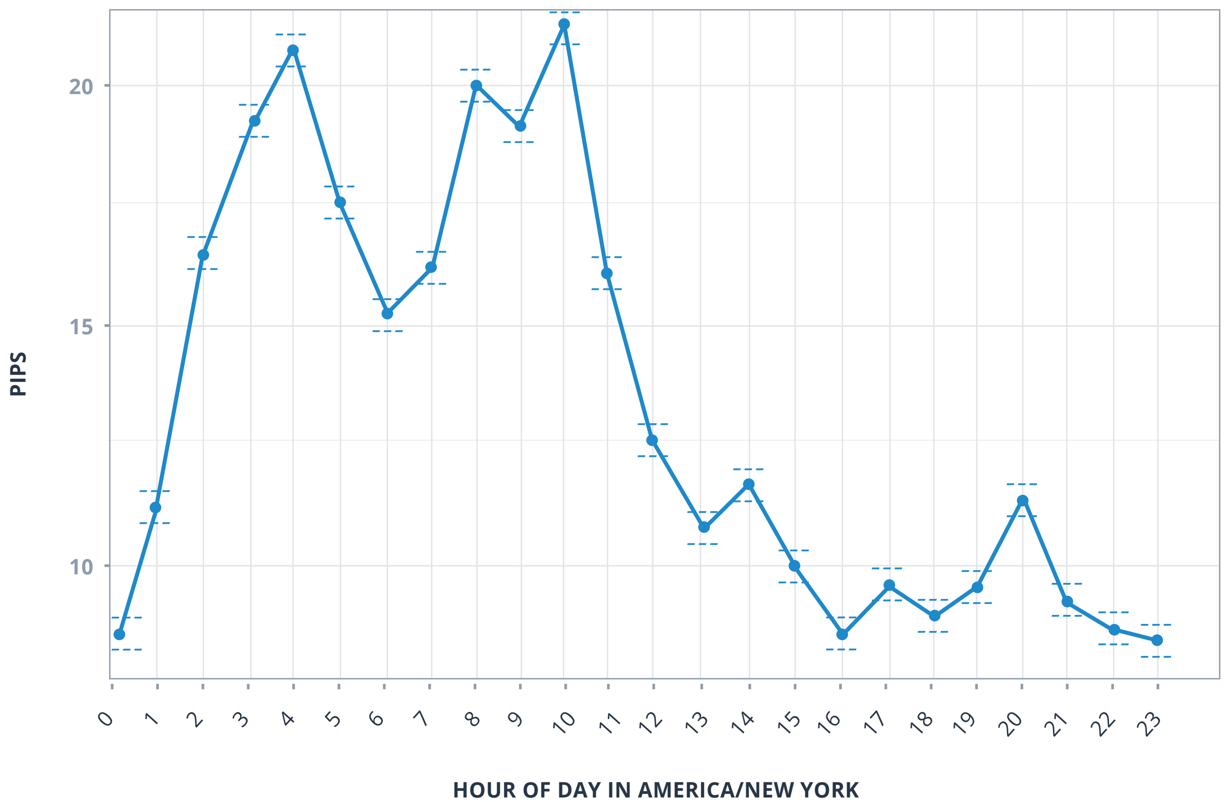
To understand this increase in likelihood, look how the British pound behaves in terms of pip movement:

Chart 9: Average Hourly Absolute Change in GBP/USD from 2005-2015



Data source: Data source: GBP/USD price data derived from FXCM's price servers from 2005-2015.

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Very quickly, you can see GBP/USD pip value varies significantly by time of day. On average, the pound was five times as volatile between 4:00 and 5:00 am as it was between 11:00 pm to 12:00 am.

Traders are generally more profitable when markets are less active.

How can you try to take advantage of these patterns? One way may be to mirror the simulated time-sensitive performance of the GBP/USD and trade like the straight-forward range trader.

Let's backtest it. Using an RSI strategy, we buy and sell when GBP/USD crosses RSI lines. The blue line is the raw strategy: no filter for time of day. The dark blue line is filtered to off hours, between 2:00 pm and 6:00 am New York time.

Chart 10: Hypothetical Performance of RSI Trading Strategy in GBP/USD

Data source: Trading Station Strategy Backtester. GBP/USD 15-minute data from 4/1/2014-3/30/2015.

Past performance is no indication of future results, but by sticking to range trading only during off hours, the average trader would have been far more successful over the sampled period.

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HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND THE ACTUAL RESULTS SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM.

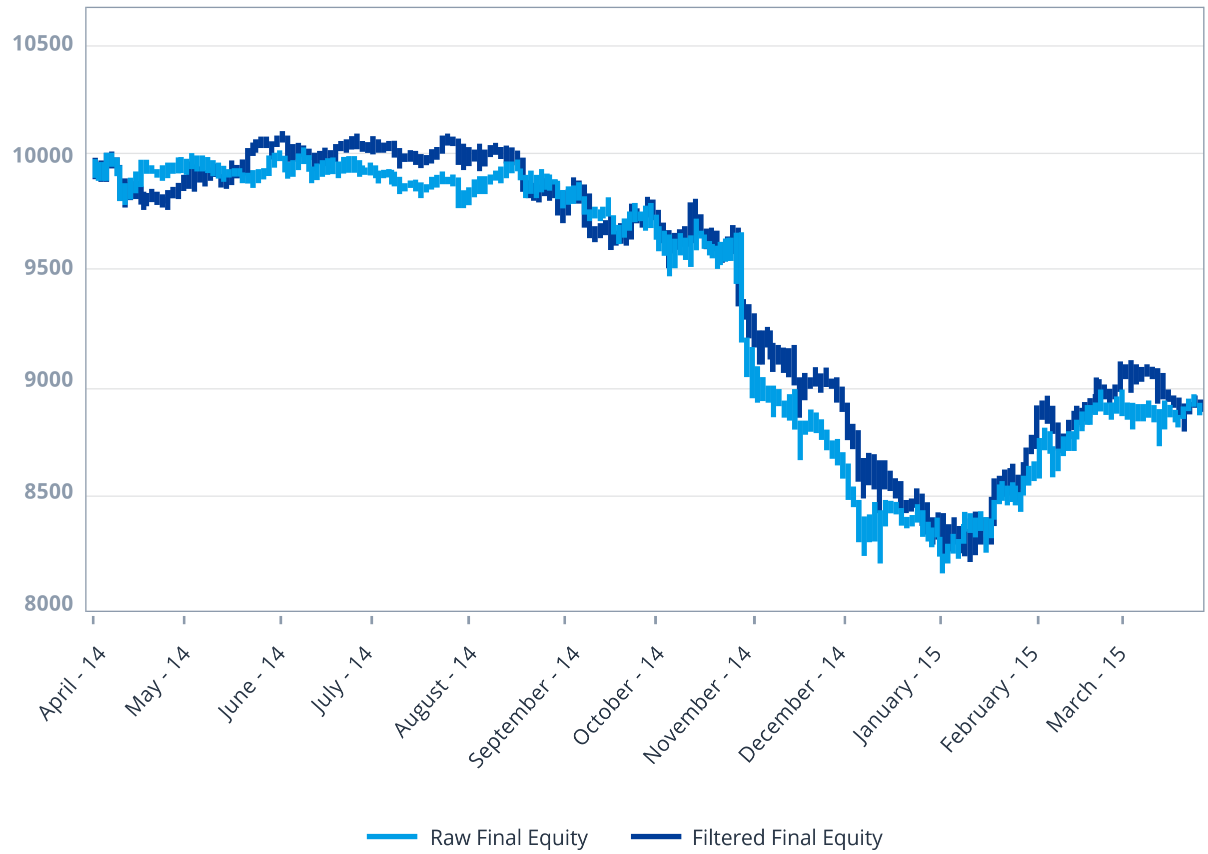
ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR TO ADHERE TO A PARTICULAR TRADING PROGRAM IN SPITE OF TRADING LOSSES ARE MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS. THERE ARE NUMEROUS OTHER FACTORS RELATED TO THE MARKETS IN GENERAL OR TO THE IMPLEMENTATION OF ANY SPECIFIC TRADING PROGRAM WHICH CANNOT BE FULLY ACCOUNTED FOR IN THE PREPARATION OF HYPOTHETICAL PERFORMANCE RESULTS AND ALL OF WHICH CAN ADVERSELY AFFECT ACTUAL TRADING RESULTS.

TRAIT 3:
SUCCESSFUL TRADERS TRADE THE RIGHT TIME OF DAY
What About Other Currency Pairs?

Of course, not all currencies are the same. The Japanese yen tends to see more volatility than its European counterparts through the Asian trading session because this is the Japanese business day.

Applying the same hypothetical strategy with and without the time filter, you can see USD/JPY doesn't play as well as GBP/USD did.

Chart 11: Hypothetical Performance of RSI Trading Strategy in USD/JPY



Data source: Trading Station Strategy Backtester. GBP/USD 15-minute data from 4/1/2014-3/30/2015.

Historically, time filters for off hours seems to us to have worked well for European currency pairs such as GBP/USD and EUR/USD.

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GAME PLAN

TRADE EUROPEAN CURRENCIES DURING THE OFF HOURS USING A RANGE TRADING STRATEGY.

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We believe that traders are generally more successful range trading European currency pairs between 2:00 pm and 6:00 am New York time. Asia-Pacific currencies seem difficult to range trade at any time of day as they tend to remain fairly active during Western off hours.

NEXT STEPS
PUT THESE TRAITS INTO ACTION!

Open an FXCM account to start trading

Trading forex on margin carries a high level of risk, and may not be suitable as you could sustain a loss in excess of your deposit.

Not ready to start trading? Practice your new skills with an FXCM demo account.

High Risk Investment Disclaimer

Trading foreign exchange on margin carries a high level of risk and may not be suitable for all investors. The high degree of leverage can work against you as well as for you. The possibility exists that you could sustain a loss in excess to your investment. Before deciding to trade foreign exchange you should carefully consider your investment objectives, level of experience, and risk appetite. You should be aware of all the risks associated with foreign exchange trading and seek advice from an independent financial advisor if you have any doubts.

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