THE DEFINITIVE GUIDE TO BUILDING A

WINNING FOREX TRADING SYSTEM

Part 2: Entry & exit strategies and stop losses

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The secrets to success are not really secrets at all.

Those traders who have succeeded have developed a winning formula that can be copied and taught. In *The Definitive Guide to Building a Winning Forex Trading System*, I harness my learnings from the careful study and application of the principles of top traders and share them with you.

Armed with this knowledge, your Forex trading success or failure truly is up to you.

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FOREWORD BY SEAN LEE OF FOREXTELL AND FXWW

When Sam Eder told me he was going to write an eBook on Forex system development, I must admit I was intrigued. Sam is one of the new breed of young trader, forged in the fires of retail trading, instead of on an interbank dealing desk like I was. When I received my copy of *The Definitive Guide to a Winning Forex Trading System*, I was pleasantly surprised at how well it captures the important elements of building a successful system...which most traders tend to miss. In fact some of my ex-bank colleagues could very well do with reading this eBook too!

Like every profession, there are basics that need to be mastered before one can excel. Most trades start out with technical school and apprenticeship programs, while most white-collar jobs begin with a university degree. Trading is different in that there is no school (except the hard knocks variety!) These days, most traders are self-taught. However, learning the foundations of trading is essential to success.

What can be taught are entry strategies, exit strategies and money management principles. Not only can the entry/exit points and money management strategies be learned, they can also be translated into simple trading systems.

There is no single strategy that guarantees perfect entry and exit levels, but there are strategies that work better in different markets. If you can devise a series of strategies for different market types, and then recognise the type of market you are dealing in, you will be a long way towards becoming a gun trader.

Thanks to *The Definitive Guide to a Winning Forex Trading System*, you can kickstart this educational process at your own pace. Get to know yourself and what makes you tick, and build systems that reflect the type of person you are. I highly recommend you take your time and go through this guide in detail.

About Sean: Sean has been an FX trader since 1986 when he began in the interbank market. Nowadays he leads the way in improving market access, services and information for the aspirational retail trader. His FXWW business manages allocation programs for the new breed of FX professional as well as providing unbeatable market coverage through his chat-rooms on Reuters Messenger. He is also Managing Editor of Forextell and aims to provide plenty of good trading ideas from professional traders (in an entertaining format).

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The questions I get asked the most about Forex trading are:

1. When to enter
2. Where to place your stop
3. When to exit.

They are some of the most important questions you'll answer in your Forex trading plan. Together they form the decision-making engine of your Forex trading system.

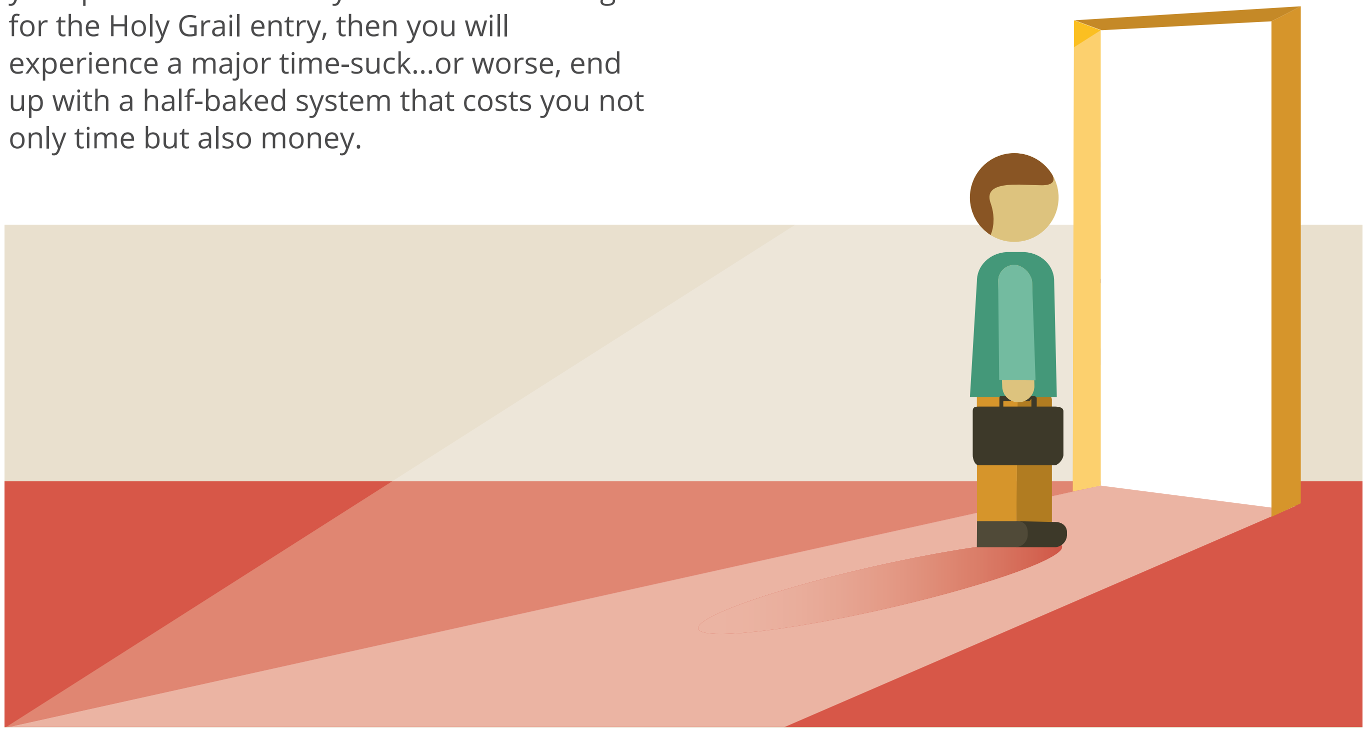
Over the next three chapters we will cover each of these questions, but before we get started, the first step is to understand how they fit into your trading plan. While entries and particularly exits are critical to your system's performance, we have not yet touched on your trading psychology, your position-sizing model, how to trade mistake-free, or the power of objectives.

You can have the best entries and exits in the world and still lose if you don't integrate all these factors. My belief is that around 15% of your energy should be spent on this area, with the majority of that time on the exit part of the equation.

You have spotted it, right?

I started this chapter by talking about the importance of entries and exits and now I am saying they are not to be treated with such reverence.

The reason why this is important is because if you spend too much of your focus searching for the Holy Grail entry, then you will experience a major time-suck…or worse, end up with a half-baked system that costs you not only time but also money.



The true role of entries and exits

Each trade is like a draw from a lucky dip or a spin on the wheel of fortune.

The better your entries and exits, the more winners in the draw, the easier it will be for your Forex trading system to meet your objectives. Your goal for your entries and exits is to add as many winning tickets into the draw as possible – or to add in tickets that when you do pull them ensure you win the jackpot.

When you internalise this concept, you can start to see how entries and exits fit into the bigger picture of your Forex trading system. They lose their mystical appeal. You don't need to have a system that is perfect, just one that produces enough winners over time, with which you can bet enough on each trade to:

1. Not experience a drawdown over 25% (it's hard to recover from a drawdown this large without being extra risky – see the table);
2. Achieve your objectives over time.

Recovering From a Drawdown

Trading account loss %	Gain required to recover %
5	5.3
10	11.1
15	17.6
20	25.0
25	33.3
30	42.9
35	53.8
40	66.7
45	81.8
50	100.0
55	122.0
60	150.0

Are high probability entries better?

Building a trading system is a little like building a house.

When you construct a house, you decide how many rooms it will have, the layout, how many floors and so on. These decisions are based on your needs (objectives), budget (trading capital) and what suits your personality (psychology).

Similarly, when you develop entry and exit rules for a Forex trading system, you get to choose things like its targeted risk/reward ratio, win rate and the number of trades over a time period (i.e. five trades a week). Your choices here will be a reflection of your needs, budget and goals.

Take a look at these three basic examples of Forex trading systems.

➡ System 1

System 1 generates 10 trades a month with a 90% win rate. Winning trades make $100 and losing trades lose $1000.

➡ System 2

System 2 generates 80 trades a month with a 60% win rate. Winning trades make $60 and losing trades lose $50.

System 3

System 3 generates 10 trades a month with a 15% win rate. Winning trades make $1800 and losing trades lose $150.

Before you read on, which system would you prefer?

Note it down along with the *reasons why* it is your system of choice.

Here are the results for a month's trading for each system in dollars:

- System 1 with a 90% win rate had a $100 loss
- System 2 with a 60% win rate had a $1280 profit
- System 3 with a 15% win rate had a $1425 profit.

What do you notice here?

The system that made the most profit had the lowest winning rate – and the system that lost money had the greatest win rate.

Now would you still choose the same trading system you chose above?

When you are developing your entry and exit, the one with the most wins is not always the best. Be careful not to fall into this trap.

(As a side note, it is possible to have a system that has a high win ratio and larger losses than profits. It's just tough if you experience four or five losses in a row, so make sure you position size accordingly.)

A risk/reward ratio filter for your trades

Entries and exits should never exist independent of each other. Their relationship can be expressed though the risk/reward ratio. Your risk/reward ratio is how much you can potentially profit on the trade compared to your initial risk.

You determine this by working out your initial stop and profit objective. For example, if you are risking $1 to make $3 you would have a risk/reward of 3:1, like you can see on the below USD/CAD chart. 1

It can be beneficial to have a rule in your trading plan that you only place trades that have a certain risk/reward ratio.

You may only take trades that have a risk/reward ratio of 3:1 on longer-term positions, or of 2:1 on shorter-term positions. This would mean you avoid placing the following trade (or look for a profit objective further out). 2

Entries vs. re-entries

For the sake of system development we define some types of entries as re-entries.

Re-entries occur in two circumstances:

1. The initial entry is stopped out but the set-up conditions still exist. I.e. a breakout fails and then goes back within the range before attempting to breakout again.
2. The initial entry is successful and you get a new set-up that you want to take. I.e. you enter on a breakout and the market starts to trend. You then get the chance to add an additional position based on a pullback in the trend.

The trick to using re-entries is in the planning. If you have just had a losing trade, or are already in a winning trade, it can change your psychology and cause you to make mistakes.

Note down in your trading plan exactly what you will do in a re-entry scenario.

Reversals

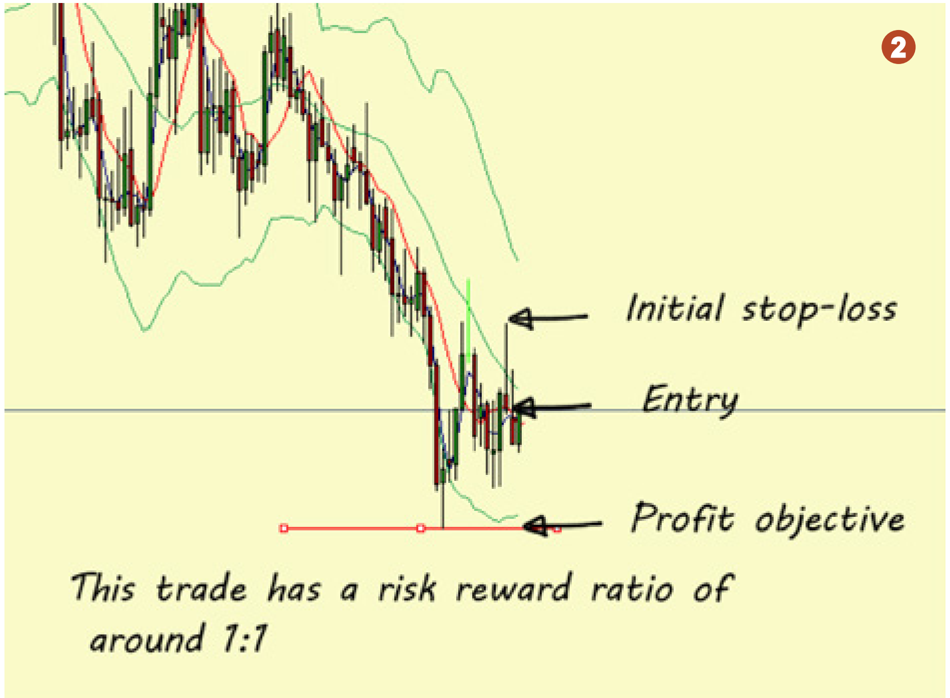
Occasionally you will be in a trade and get a set-up for a trade in the opposite direction. Like re-entries, these can be a little difficult psychologically as you could be influenced by your current position.

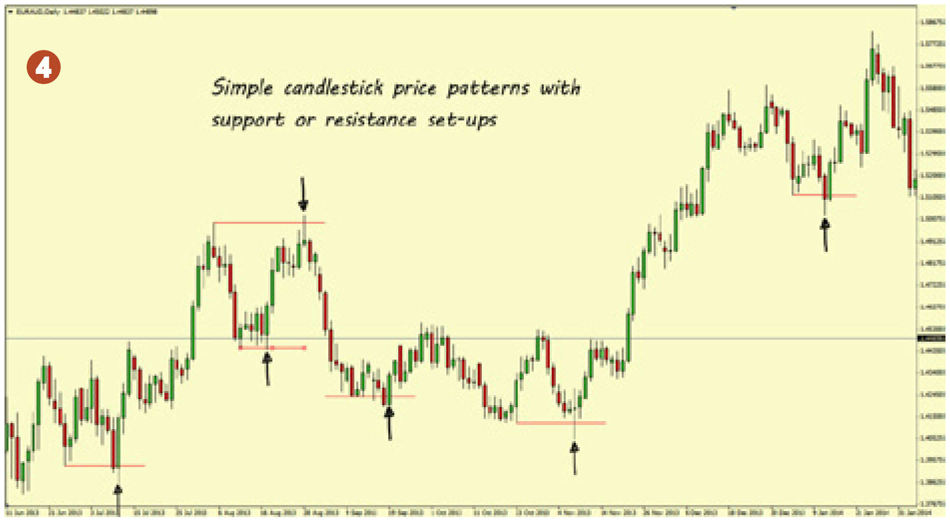
What to do?

As above, it is all in the planning.

Note in your trading plan:

- What constitutes a reversal?
- Under what circumstances will you take a reversal?
- What if you get another reversal after you have already taken a reversal? Do you reverse again?





Simple entry techniques work

Simple entry techniques allow you to focus on managing your trade after you enter rather than on interpreting a jumble of indicators to work out the best time to buy.

A good entry has two main criteria.

The set-up

A set-up is a condition you watch for prior to entering your position, which is chapter 2 in this eBook. Once your set-up occurs, you then move into stalking mode for a high quality entry.

The entry

Now you become the hunter or huntress, spear in hand, pursuing a high-quality entry with dogged determination. You are face-to-face with the markets, unwavering while you wait for the perfect moment to strike.

When the time comes, you execute with aplomb, your supreme skill ensuring you net your target with ease...

Typically you will look to drop to a lower timeframe from your set-up to improve the risk/reward ratio. You could then employ a technical analysis technique such as candlestick analysis for the actual entry. For example, on the earlier USD/CAD trade, if you went to a lower timeframe you would have seen a strong reversal pattern (a spinning top followed by the bullish engulfing candle) that would have allowed you to get in earlier and improve the risk/reward ratio. 3

Entry methods that work

Almost all entry methods work, but they work differently depending on your set-up, psychology, objectives and the market type.

Candlestick patterns

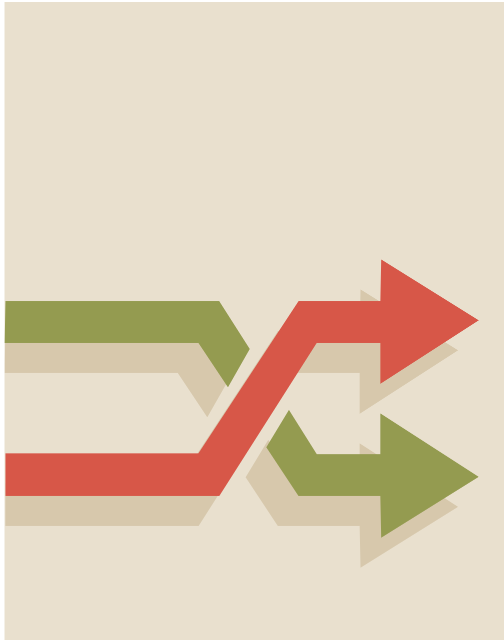
Price action candlestick patterns can be excellent entries as these give an indication of the buying and selling pressure between market participants. 4

Indicator cross-over

Indicator cross-overs are popular for their simplicity. They tend to work better in trending markets.

Some indicators that can be used for this approach include:

- Moving averages
- MACD
- Stochastics 5



Price crosses moving average

As a variation of the moving average cross-over approach, simply place your trade when the price either touches or closes over the moving average. You will find that you get into your trade earlier, but that you suffer more whipsaws.

Here I have zoomed in on the above chart so you can see the difference. 6

Breakout

There are 2 main ways or methods you can use to trade a breakout.

1. Use a limit or stop order that enters automatically once the price moves outside the range. This will ensure you get in even if the breakout bar is strong.
2. Wait for the price to close outside of the breakout range. You may avoid some whipsaws with this method, at the cost of either missing the breakout or entering later with an inferior risk/reward.

Method 1 example: 7

Method 2 example: 8

Support and resistance levels

Gutsy traders can enter on support and resistance, trusting in the level to hold. This entry can improve the risk/reward on the trade, but can decrease your percentage of winners. 9

So in summary, here is the entry process in its entirety:

1. Wait for your set-up conditions
2. Drop to a lower timeframe
3. Apply your chosen entry technique
4. Check your risk/reward is acceptable
5. Unleash your inner trader to execute the entry flawlessly.

Once you have entered, the real trading begins. You need to manage your trade to capitalise upon how the market moves. You do this using complex exits.

Complex exits are essential to building a winning Forex trading system that works for you.

The term "complex exits" is somewhat misleading. Each exit is quite simple on its own. The complexity comes with the variety of exits that are required so that you can:

1. Trade what is in front of you
2. Achieve your objectives.

It is how you react to what happens *after you enter* the trade that matters. Here is a list of some exits to consider for your trading system.

Profit target

A profit target is an order you place in the market to close your position once it hits a certain price. These are useful in sideways markets, but some experts suggest that they work well in trends too.

Profit objective

A profit objective is different to a profit target. A profit objective is a goal for your trade. When you understand your system, you will know how much profit a trade is capable of making. You can then manage the trade in a way that seeks to maximise profits.

All sounds a bit mystical?

In essence, it is about letting profits run or altering profit targets based on what the market is doing in front of you, while considering the objectives identified for the trade before it was placed.

Trailing stop (price or indicator)

A trailing stop (surprise, surprise) trails the current market price. There could be a whole article on trailing stops there are so many, suffice to say they can be based on a set price (say 50 pips) behind the market or they can be based on an indicator such as a moving average.

If you like moving averages, try *displaced* moving averages. There is something to them, but I don't use them myself these days as I tend to look at price action for my exits, but for certain trading styles they are very good.

I will cover two more types of trailing stop below that are particularly important.

➡ Rapid market trailing stop

Sometimes the market defies gravity and launches into a rapid move, only to come crashing back down.

If you are in a trade that takes off like this, then you can adjust your trailing stop to avoid giving back your gains. Perhaps you go to a lower timeframe or are prepared to only give back one or two times your risk. You can see on this one-hour chart on the USD/JPY how speedy moves can quickly reverse. 1

➡ Support and resistance trailing stop

Support and resistance are difficult prices for the market to move through. They also form a platform for a further extension of the price. With a support and resistance trailing stop, you *logically* trail your stop behind the market in order to protect profits.

TIP! Be wary of short, sharp penetrations of resistance levels, and be ready to get back in using a re-entry. 2

➡ Price action

You can exit based on price action. For example, you might see a candlestick reversal pattern that indicates the trend is coming to an end. 3

Large daily move

Depending on your trading timeframe, if there is a large daily move of say 300 pips, you could look to sell as the market has most likely overshot.

Fundamental exit

You can exit a position based on market fundamentals and news. For example, you might close out of your short-term positions prior to a major news announcement or exit a position following negative news.

Time stop

You may exit after a specific period of time in a trade or on Friday before the market closes for the weekend.

The cross rates

Savvy traders often monitor the cross rates to get an indication of the direction of the currency pairs they are trading. If the price action on the cross rates is signalling weakness, then it might be time to exit your trade.

Expert exit

If you follow a particular expert, you may choose to close your position if they suggest the market is about to turn.

Risk/reward stop

With a risk/reward stop, you adjust your stop-loss to maintain a minimum risk/reward of at 1:1 at all times. This powerful approach helps you to maintain your profits if your trade gets close to your profit target, does not touch it, and reverses.

Account target

If you have a specific account-based goal such as 25% for the month, then you may close all positions in your account once this target is achieved.

Scale out

By scaling out, you exit portions of your position, based on different criteria. For example, you might take a small amount off when the market first makes some available, some more at a pre-planned target, and finally leave some on a trailing stop to capture the big wins.

Complex exits enable you to trade the market in front of you

By having a variety of exit systems in your toolbox, you can effectively manage your position based on what happens in the market after you enter.

You can *intently* watch the market and adapt to its movements in order to generate the best possible result for your trade.

Be in the moment with it.

As a trader you can only plan and then be *present.* Once you execute the trade you are simply experiencing, not creating. Your exit decision should be based on what the market is doing right now, not dependent on a perfect recreation of a historical pattern that conforms to your back-tested indicators.

It's not difficult. If you enter simply and apply the right exit to the right scenario.

As always, I encourage you to get out your trading plan or trading journal and integrate this lesson into your Forex trading for maximum effect. Pick one or two exits from the list you'd like to add today. Over time you can come back for more.

CHAPTER 5: DIFFICULT-TO-HIT STOP-LOSSES

Do you sometimes feel like the market is out to get you?

Have you ever had your stop hit at what turned out to be the low? Was it just bad luck? Or is there something more at play?

The chances are there actually is.

Forex trading is a zero sum game and you can bet that the strong players (the bank dealers) with more information, more money and the ability to move the market are out to get as much easy profit as they can. This means that the retail players left holding the weak hand (you and me) had better watch out.

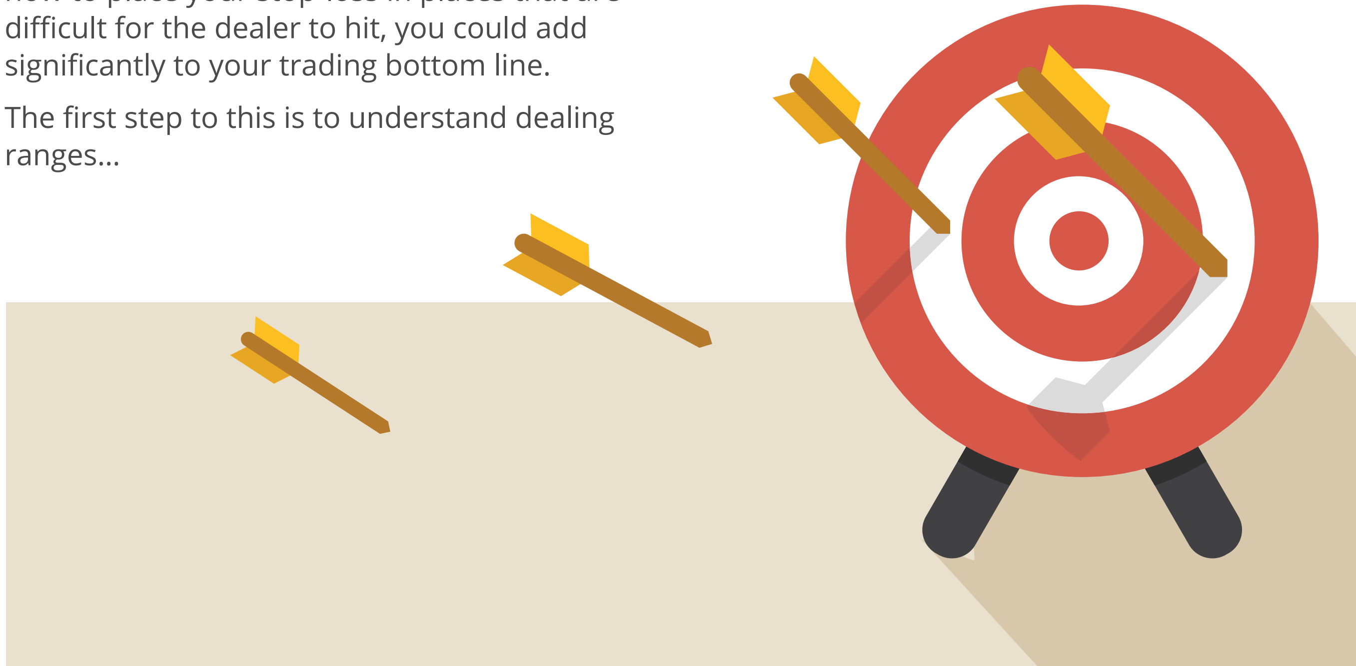
But the dealers can be beat.

Having the advantages dealers do breeds complacency. Most of them are not actually very good traders once you take them away from their screens and their order flow information. They also are not good at risk management *when they don't have corporate orders to backstop their poor trades*.

[Note: Corporates are the real losers in the Forex market. Retail traders (and other not-so-savvy bank traders) do provide a constant source of profit for the bank dealers, but we are still small fry compared to the seven trillion dollars of foreign currency that are traded each day.]

By sidestepping dealer traps and learning how to place your stop-loss in places that are difficult for the dealer to hit, you could add significantly to your trading bottom line.

The first step to this is to understand dealing ranges...



How dealing ranges influence the price

Dealing ranges drive market behaviour.

A dealing range is simply a high and a low for a trading session or a time period, such as day, week or month. Dealers use these levels to work out their orders and manage their positions. You can see examples of dealing ranges on the 15-minute chart of the EUR/USD here: 1

Dealing ranges exits on multiple timeframes. You can see the dealing ranges here on the 4-hour chart: 2

Dealing ranges are imprecise. The edges of the range are often pierced and the levels the dealers use for reference are fluid.

You will notice that an old dealing range will often form the basis for a new dealing range; i.e. they act as support and resistance levels. This is a type of market structure that is tradable and can provide you with an edge.

In the following chart you can see old ranges are used as reference points for new ranges where I have marked with a red dot. 3

Traders who are taught to put their stops behind support and resistance levels will often put their stop-loss orders behind dealing ranges. But the problem for these traders is that their stops then become a target for the bank dealers. (This is also true of any major level.)

You can see this quite clearly on most Forex charts. On the following chart, I have marked with red dots where a move has taken out stops before reversing above or below either the dealing range or a support and resistance level. 4

You can see how often your stops would be taken out if you were not careful about your entry or where your stop-loss was placed.

So the solution is simple, right? Widen your stops and don't put them so close to the edge of the dealing range.

Not so. There are other factors to consider first.

Tight stops improve the risk-to-reward ratio of your trades

There is a problem with widening your stops.

Every extra pip you give away means that when you have a losing trade you will lose more, or when you win you will have traded a smaller size to compensate for the wider stop.

Both of these methods will have a negative impact on the risk/reward ratio of your trades. When you do win, you will make less than if you had a tighter stop. On the flipside of the coin, it could mean that you will have more winning trades to compensate for the smaller wins. By widening your stop, your win percentage improves.

Stop-losses are inextricably linked to your entry system and trade objectives

This goes without saying.

Your stop-loss should be a logical extension of your entry system and the objectives you have for the trade.

For example, if you are a trend follower looking to catch a breakout, you might have a tight stop-loss that you expect to get hit more often than not. Or if your goal is to have a 3:1 risk/reward ratio on your trade, you will have a tighter stop that if you are going for 1:1.

Logically choose a stop that fits holistically into your trading system.

Market types and stop-losses

As the market types shift and change, so should your approach to the market.

This goes for stop-losses too. Consider if your stop-loss placement is suited to the current market type. In addition, be prepared to change your stop-loss if the market types change during a trade.

A note on volatile market types

Common wisdom espouses that during a volatile market type you should widen your stop-loss. I am of a different opinion. If the market type becomes volatile you want to tighten your stop-loss. The markets have just got a whole lot more hairy and you don't want to give the market room to move against you. You will need to be prepared to be stopped out more often in this market type. However, by having tight stops, you will have the opportunity for some quick profits if things do go your way. 5

Superior options for stop-loss placement

You have four main considerations for stop-loss placement:

1. The dealing ranges
2. The risk/reward ratio
3. Your entry and trade objectives
4. The market type.

Understanding this, here are some different systems for placing stops that can help to improve the profitability of your trades.

Classic support and resistance stop-loss

The classic place for Forex traders to place stops is behind support and resistance levels. Just be aware of the stop-hunting intentions of those participants who can move the market. You could put your stop 7–25 pips beyond the level (depending on your timeframe), which will help you to avoid some of the whipsaws, but remember this will impact the risk/reward on the trade. 6

Shakeout stop-loss

This is perhaps a smarter way to place your stop-loss.

Wait until after the stops have been hunted and the price has reversed before you enter. Then place your stop-loss either directly behind the support or resistance level (or even slightly inside it) to improve the risk/reward on the trade. On the following chart, you can see how once the stops have been taken out (the thin red line) it is now safe to place your own stop-loss (the thick red line). 7

Indicator stop-loss

Indicator stop-losses can be quite useful for three reasons:

1. They give you a consistent place to put your stop that requires little discretion
2. They are (or should be!) relevant to your entry and trade objectives
3. The stop will not be in the usual place that dealers go a-hunting.

For example, you could put your stop-loss on the blue (100 period) moving average on the 15-minute chart of the USD/JPY when you enter short on this moving average crossover system. 8

The dealer's worst enemy – the mid-air stop-loss

To avoid being a target for the bank dealers, a mid-air stop is just the ticket. Mid-air stops are set a far enough distance away from the edge of the range to make it difficult for the dealers to hit. If a dealer pushes too far out of the dealing range, they risk being picked off by other dealers who gang up to drive the price against them. In addition, as your stop is likely to be on its own and not grouped with a bunch of others, there will be little point in the dealers going for it anyway.

Mid-air stops work best when trading directly off support and resistance levels, as you can still maintain your risk/reward ratio. You simply place your stop far enough away from the dealing range that the dealers won't be interested in chasing it. It will look like it is hanging in mid-air, away from the action. 9

A special note on break-even stops

Break-even stops are a hot topic for traders.

There are both pros and cons for breakeven stops. Only you will know what is right for you.

On the one hand, a breakeven stop is a powerful psychological tool. It ensures your winning trades don't turn into losing ones. This means that your winning percentage will increase, which can make it psychologically easier to follow your system and trade mistake-free.

On the other hand, if you move your stop-loss to breakeven you may end up putting your stop in an illogical place the dealers can easily go for. In my experience, this can mean that although you have less losing trades, you will actually make less overall. The winning trades that you do miss out on will reduce the profitability of your system over time.

This means you are faced with a choice. Which is more important to you?

- Consistency; or
- Profitability.

So what to do next?

> *"Simplicity is the ultimate sophistication."*
> *– Leonardo da Vinci*

Now, it becomes a simple matter of testing. Try adjusting the following combination to see what suits your system:

- The risk/reward ratio by tightening and widening stops
- The stop-loss method.

Always think about the dealing ranges. Keep in mind where the market is likely to move to next, and avoid putting your stop in places that are easy for the dealers to hit.

Ready to practise
what you learned in Part Two?

Open a Demo account and practise in a real-time, risk-free trading environment. The Demo account only uses virtual funds and is 100% free. Or open a Live account and start trading the markets.

TRY A DEMO

OPEN A LIVE ACCOUNT

Coming up in Part Three...

You'll build on what you learned in Part Two by considering position sizes, how to track your performance and how to make meaningful changes to your strategy.

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