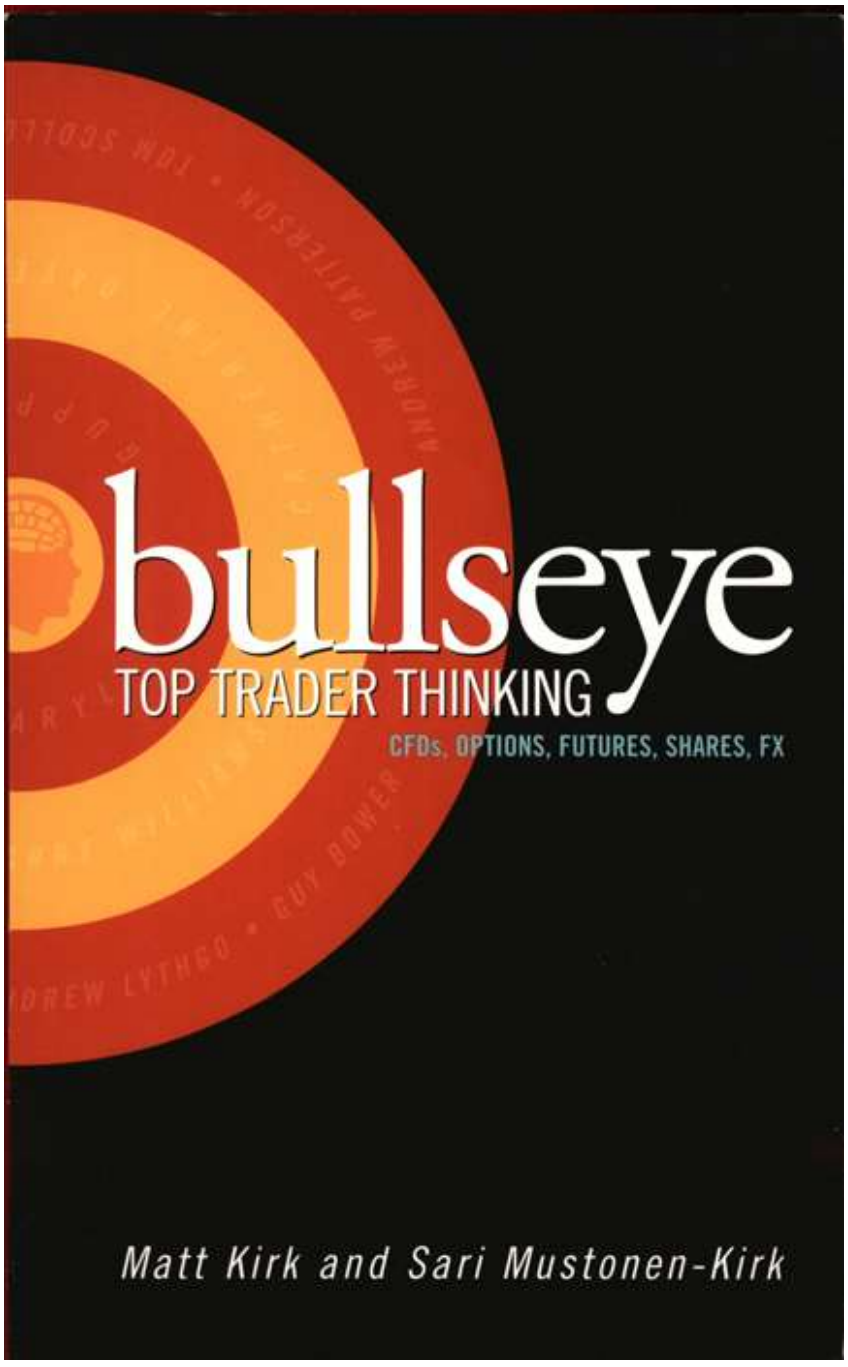
bullseye
TOP TRADER THINKING
CFDs, OPTIONS, FUTURES, SHARES, FX
Matt Kirk and Sari Mustonen-Kirk

This is an excerpt from the book Bullseye: Top Trading Thinking. For the complete book visit:

www.MasterClassTrader.com

MASTERCLASS TRADER

bullseye

TOP TRADER THINKING

CFDs, OPTIONS, FUTURES, SHARES, FX

Matt Kirk and Sari Mustonen-Kirk

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This book is dedicated to our children

Oscar, Mia and Aston – our ‘Magic Babies’.

They not only bring joy into our lives but now give

real purpose to everything we do.

Introduction

Success doesn't go to you ... you go to it.

Marva Collins — Educator

The search for success has spawned a multi-billion dollar industry with thousands of solutions for a whole range of problems and issues. Fear of failure, fear of success, fear of fear — you name it, there's something for everyone. As far back as the early 1900s countless works have been created by professionals and lay people alike all in the attempt to uncover the elusive secret. Whatever it is you need help with, there's a book, video, DVD or audio program to get you moving in the right direction. You can even employ your own personal coach.

At a trading seminar we attended in July 2005, delegates were excited about the 'trendy hot topic' — trader's psychology. Thankfully, the trading public has become a lot more interested in and respectful of how different circumstances can make us act differently. It has long been our preferred topic of discussion — Matt started speaking about the vital importance of 'trader's success psychology' back in the early 1990s when it was pretty much laughed off as 'airy-fairy' by many traders and investors. It wasn't cool to discuss or attempt to understand your emotions and, if you were a bloke, it was seen as decidedly weird indeed. At last that's all changed.

Although there appears to be some confusion as to what trader's psychology actually is, everyone seems to agree that in its comprehension lies the true path to wealth and prosperity. A young man at another seminar spoke of the emotional baggage he'd been lumbered with due to his parents' poor money attitudes. That he didn't have a trading plan or a system weren't mentioned as reasons he might not be making money from trading and investing. If traders and investors are made aware of some of the traps for new players early on in the piece, and are shown how to apply the principles of top trader thinking, then perhaps many more will last the distance and make a living, or at least an additional income, from their personal trading activities.

To our way of thinking the past is the dead past and the future is just a figment of our imaginations. The only reality is now and that's what you'll find solutions for here. *Bullseye* walks you through the mechanics of trading, taking a good look at some of the less tangible issues. It's a matter of thinking — top trader thinking, that is. The markets are surrounded with businesses to sell you the latest, greatest and 'bestest' tool, gizmo and system to get and keep you on a winning streak. But the truth is, it's the way you think that will go a long way in determining whether you win or lose at trading.

We'll introduce you to a selection of highly experienced traders and you'll discover that, although they may articulate things differently, there is one thing they all agree on. Like us, these top traders have discovered we must all march to the beat of our own drum in order to achieve anything even resembling a sustainable course of action, let alone sustainable success in our results. Sure, we can study the best and even model ourselves on those we

admire but, ultimately, we must find the means and methods that 'fit' with who we truly are. We are all such unique and unrepeating miracles and although role modelling, coaching and many other tools can work (and they are simply tools, remember), we cannot escape ourselves as the fundamental ingredient in our recipe for success. We need to remain true to our own identity whenever and wherever we apply ourselves. Trading has been referred to as the world's biggest mirror as it has an uncanny way of illuminating and magnifying our true beliefs about ourselves and reflecting them back to us in terms of our results.

Having spent countless hours with some of the best in this field, we know it's only when you get into the inner sanctums that you begin to understand the elite have an overall way of living as a trader. They don't just sit at computers pulling out trades based solely on what they impart at their seminars or in their books. Through digging deeper, we were able to unearth and to impart the real secrets of what top traders think, do and, most importantly, the reasons why. This book is the culmination of over 20 years of first-hand dealings with thousands of traders — some great, some potentially good, and some who could be better if they could find the right path for them and them alone. It's a package deal and if you are bored by the discussion of emotions and mental and physical fitness or if they are just too 'airy-fairy', you may as well stop reading. You may not be committed, or patient enough yet to become the best trader you can be.

Irrespective of whether you call it trader's psychology, success psychology, or motivation, the fact remains — it's nothing new. It's all just an attempt to understand your 'self' better and find more efficient and enjoyable ways to experience life. You get what you want out of the markets, and if you think about that for a while you'll realise why developing the skill of top trader thinking is crucial to hitting your trading bullseye and, as we say, stacking the odds in your favour.

We aim to work together with you to empower you to design a platform for yourself. If you use a plan designed entirely by someone else, no doubt you'll lack the sense of ownership and commitment crucial to building the mental muscles and dedication required. You know yourself better than we do but our guidance and simple strategies aim to assist you to know yourself even better. Our aim is to help you jump on, and stay on, a smoother and straighter road to achieving your dreams as a successful trader in the markets. Hey, even if you reach the end of the book and decide trading your own account is just not for you — great. You're better off applying your energies and money elsewhere.

The business of trading requires several key elements to be in sync. The trader's wheel (see diagram) shows how the dynamic relationships of the segments need to work together. If you're not making the money you desire from your trading, you may find that one or more of these areas of your trading business is being partially neglected, or left out of the equation altogether. Your trader's wheel may be trying to turn with a few flat spots on it causing your ride to be forever bumpy. For instance, if you build your trading business without considering the time and money component, you may well come up with a winning trader's mandate and systems, but your plans may still fail as the fit was not right for you. *Bullseye* discusses how to make all of these elements work together and delivers an accessible logic to both the novice and the experienced trader/investor alike.

We examine the interdependencies of who, what and how and show you how to create a comprehensive life strategy in support of your comprehensive trading strategies.

It's not our intent to focus specifically on trading as there are already many great books detailing fundamental and technical analysis, methodologies and products. Our aim is to highlight what it takes to be a trader and to provide you with an understanding of how to graduate to the state of top trader. We've included interviews with our panellists in the hope that our idea of fit will be further illustrated by their different and unique approaches to the market.

Collectively, we've spent 40 years, and tens of thousands of dollars, learning, testing, studying and absorbing information on everything from business planning, management, psychology and goal-setting right through to systems thinking, metaphysics, philosophy and alternative therapies. We've worked in financial markets all our professional lives and generally had another business or two running on the side. Together and individually we've applied what we've learnt in both personal and business contexts and have successfully used many of these same techniques with our varied consulting and advisory clientele. Where has the work led us? The success junkies are right after all. There actually is a magic ingredient — we just can't tell you what it is because it's different for each of us. It can, however, be

summarised in one little three-letter word: fit. Find out what works for you and do it. This one giant ‘aha’ moment is the real divider between the winners and the losers, the final realisation that we alone hold the keys to our own success.

Find the right fit and you’re more than halfway there.

Meet the panel

Every artist was first an amateur.

Ralph Waldo Emerson — US author, poet and philosopher

We've had the privilege to work with some of the best and brightest in the industry and now, in *Bullseye,* we share with you just how and why some of them came to be traders, and what it takes to stay the course. Our panel members were selected not only for their expertise but also for their individuality and for the spread of products and the markets they represent as traders. As we progress through *Bullseye* you'll find they all come from different backgrounds, have had varied experiences, and will offer differing opinions and viewpoints. Occasionally they share the same ideas on markets and products, yet maintain uniquely personal values, beliefs and behavioural profiles. You're going to love hearing from them, so let's begin with a look at their professional biographies.

Larry Williams

In between trading, researching and developing trading tools, teaching and writing, Larry Williams has twice run for the US Senate as well as in 65 marathons. He has participated in several expeditions and holds a higher degree in archaeology. A past board member of the National Futures Association (NFA), he is the recipient of numerous awards, including *Futures Magazine's* first Doctor of Futures Award and the Omega Research Lifetime Achievement Award.

With more trading and investing books on the market than any other trader, Larry Williams has taught thousands of people to trade. He is the only futures trader in the world to repeatedly trade $1 million of his own money live at seminars around the globe.

Larry developed his famous timing tool Williams %R' in 1966. It's testament to Larry that this tool is still published daily in many major financial papers. It is also a standard indicator provided on trading websites including MSN's MoneyCentral and Yahoo. Larry's first investment book, *The Secret of Selecting Stocks for Immediate and Substantial Gains* was published in 1970. Since then he has gone on to write a number of bestsellers.

Larry Williams has been trading futures and commodities for over 40 years and is the most highly regarded and well-known short-term trader in the world. For a complete list of Larry's published books and information on his seminars visit www.ireallytrade.com.

Daryl Guppy

Trading from his home in Darwin in the Northern Territory Daryl Guppy makes full use of electronic advantages to actively trade the market and to keep in contact with other Australian and overseas traders. He is founder and director of Guppytraders.com Pty Ltd with offices in Darwin, Singapore, Beijing and Kuala Lumpur, and is the author of several books published by Wrightbooks including: *Trend Trading*, *Share Trading* and *Snapshot Trading.* Daryl is a member of the Australian Technical Analysts Association, the Technical Analysts Society of Singapore and the International Federation of Technical Analysts.

Daryl Guppy developed the Guppy Multiple Moving Average indicator, a tool that is included in MetaStock, OmniTrader and other charting programs. He is an appointed foundation member of the Australian government Shareholders and Investors Advisory Council, and also delivers accredited professional development courses for the Singapore Stock Exchange. Daryl regularly contributes to countless magazines and journals and is a featured speaker at various conferences and seminars all around the world. He has appeared on CNBC Asia, Trading Day, Squawk Box, Asian Wall Street Journal, Channel NewsAsia and ABC radio and television. For more information on Daryl Guppy visit www.guppytraders.com.

Tom Scollon

Since the late 1980s Tom Scollon has successfully traded and invested in equities, options and other financial instruments and has used US options for hedging the Australian market. He is the chief editor and analyst of the private newsletters *Trading Tutors* and *SharesBulletin* www.sharesbulletin.com.au, and also writes a column for *Your Trading Edge.*

Tom graduated with a double degree in economics from the University of Melbourne. He then taught at Pakenham High School and Caulfield North Central School, before taking a position at BHP in an international marketing role. Since then Tom has been managing director of two companies and chairman of two others. From a consultants perspective, he has restructured a number of technology and accounting companies, steering them back into profitability. He co-founded a software company that develops online transaction and information platforms for financial markets. The company also conducts educational programs throughout the United States and Asia.

Tom's enthusiastic style and ability to translate the most complex theories into easy to understand concepts have made him a sought-after speaker. His first book, *Fair Share: How to Successfully Get Your Fair Share in the Australian Stockmarket,* was published in 2005.

Andrew Lythgo

Andrew is the author of *Confessions of a Futures Trader: a Guide to Trading Futures in Australia* (published in 2001 by Wrightbooks), a real life expose of his days as a local trader on the floor of the Sydney Futures Exchange. Hilarious in parts and illuminating in others, the book was a hit with industry insiders and is quietly achieving a cult status with private traders.

With more than 20 years' experience in Australian interest rate and derivatives markets, including four years in the capital markets and treasury divisions of merchant bank BT Australia.

Guy Bower

Guy Bower gained experience in the financial markets as a client adviser, analyst, fund manager, company director and finally as a trader. He has spent the good part of the last 10yrs as the in-house and online trading coach for two large proprietary trading firms. He is now the content coordinator for several sites including www.MasterClassTrader.com , www.TradingCourses.com (trader education) and www.BowerPost.com (trader news).

Guy is the author of *Options: a Complete Guide for Investors* and *Traders and Hedging: Simple Strategies for Protecting Profits*, published by Wrightbooks (John Wiley). Guy has also been a writer for various magazines including *Your Trading Edge* in Australia as well as a selection of overseas publications. For more information on Guy Bower please visit www.GuyBower.com.

Catherine Davey

Catherine Davey obtained her technical analysis qualification from the Society of Technical Analysts in the UK. She also holds a Masters degree in Business Applied Finance from the University of Technology, Sydney. Catherine has worked in the banking and finance industry since 1990 and has been the in-house technical analyst for InvestorWeb since 1999. In 2003, her first book was published by Wrightbooks — *Contracts for Difference.* Her second book, *Making Money from CFD Trading*, is also published by Wrightbooks.

Andrew Patterson

As the ABC Radio National financial commentator for five years, Andrew lived the markets. Over this time his appetite to trade his own money led him to become a full-time trader in early 2005. He predominantly trades Australian shares from his home in Sydney and he also speaks to traders at various seminars about his journey from commentator to trader.

So where did our esteemed traders start and what do they do now?

Sari: What year did you start trading financial markets?

Larry: 1962.

Andrew L: 1986.

Guy: 1993.

Catherine: I bought my first share in the early 1990s when I was living in the UK. I had always been interested in the idea of trading for a bank or institution.

Andrew P: I made my very first share trade at the age of 14 — the same age that Warren Buffett started. But it's there that the comparison ends! I probably started trading shares seriously about five years ago [2000].

Tom: Started investing late '80s and trading early '90s.

Daryl: 1990.

Sari: Do you consider yourself a trader or an investor, or both?

Larry: I trade and invest.

Andrew L: Trader.

Guy: Trader.

Catherine: There have been times when I have been more of an investor and I still have a portfolio of shares that I classify as longer term positions. However, I trade on a daily basis so would now call myself a trader.

Andrew P: A trader.

Tom: Both. Ideally [I] would like to buy and just watch my investments climb the long trend upward, but the reality is sometimes you have to sell and such buys become short-term trades.

Daryl: I am a trader.

Chapter 1:
Markets and products in the noughties

At the worst possible time, markets will move
harder, faster and for longer than you can ever expect!

Matt Kirk — trader, adviser, educator and author

In recent years we've witnessed an explosion of opportunities on global markets in every conceivable way. New markets, shares and contracts — the sheer variety of instruments available for trading these days is staggering. Ranging from the highly sophisticated right through to the humble no-fee online banking account, traders can choose to leverage, lend, loan, sell short, go long, hold, scalp — you name it, you'll find a financial instrument perfectly designed to do it. We'll be covering some of these products in the second half of this chapter. Traders often get hung up on whether to invest in shares, options or CFDs — then there are warrants and commodity options, and on it goes. However, all of these instruments only make sense in the context of the wider landscape of the markets as a whole. Like fashion, each decade in the markets has its own flavour — some ghastly, some timeless and some that go full circle and come back into fashion. Everyone's heard the old quotes just prior to stock market crashes in the past. There's a famous one that goes something like, When the bellboy or the shoe-shine boy is buying stocks it's time for you to get out.'

Background

Whether it be the gold boom, the oil crisis or the Hunt brothers cornering the silver market in late 1979, events such as these are etched into our minds as being either great opportunities in financial history or those responsible for wiping out some very hard-won fortunes.

And then there was the decadence of the 1980s — the grand old era where 'Greed was good' according to Gordon Gekko, in the now cult film, *Wall Street.* In Australia we had 'heroes in suits' — for a little while at least. There was 'Bondie' and 'Skasie' plus a handful of others, and a whole new meaning to the word entrepreneur was born. Was every cabbie really only driving a taxi so they could hear the latest stock tips all day? Of course, the prime clients were the loose-lipped brokers and company executives making their pilgrimage to yet another lunch.

The 1990s saw us enter a very different era in many respects. New players, an explosion of software, the education boom, masses of new floats in the technology sector and many new derivative and leveragebased products sprang up across the financial markets

landscape. The internet gained widespread acceptance and the demutualisation and privatisation of many household names ushered in a whole new generation of private investors and traders.

Flick to early 1997 and current affairs programs on TV regaled us with classrooms of 10 year olds discussing share portfolios and tradesmen being interviewed on roofs, in ditches and on building sites about how they were making so much easy cash in the sharemarket. Why swing a shovel when you could be best mates with your broker and have a bulging share portfolio instead? The late 1990s also ushered in the new darlings of the investment set — thousands of would-be Donald Trumps buying up cheap homes, whacking in a prefab kitchen and bathroom and finishing it off with some lovely mondo grass by the front door.

In today's markets instant access to information means the private trader is as well informed as those in professional dealing rooms. The internet allows people to witness events from the awe-inspiring through to the heartbreaking instantaneously. Let's not discount the impact this is having on the collective psyche when it comes to making trading decisions on markets affected by international events.

The noughties

The noughties started relatively quietly with the whole Y2K shutdown of the business world fortunately turning out to be a total fizzer. Then came September 11 and the world changed. Global sharemarkets took an immediate battering with US stock markets closed for six days (including the weekend). This stab at Western banking and capitalism set the scene for further terrorist strikes, skyrocketing energy prices and the Iraq War. Around the same time the finance industry in Australia started to clean up the internal riff-raff. The task of quickly cleaning up internal operations and getting professional (not only about the way money was managed but also with respect to how investments were marketed) became an urgent one. The finance industry has moved from being relatively loosely regulated to being intensely and strictly regulated. All players must now operate under an Australian Financial Services Licence (AFSL) and the professionals they employ have to pass countless exams and demonstrate ongoing monthly education. Naturally when you shake the trees a few monkeys always fall out.

Let's not discount Super Choice either, which was phased in from around July 2005. Heralding the possibility of all working Australians being given the choice as to where their super goes, imagine the culture shock of millions suddenly empowered to control their life savings yet not having the foggiest idea what to do with it. The growth of the finance industry in the last decade has been phenomenal. Take the Australian Stock Exchange (ASX) market capitalisation, for instance — doubling over a five-year period and reaching over $730 billion by 2005. Consider the number of private investors now in markets and how they fit. An ASX survey of 2402 Australians in November 2004 revealed some interesting facts about our trading and investing habits. For example:

- Over half of all Australian adults (approximately eight million people) own shares either directly or in managed funds, and this figure doesn't even take into account those who own shares through compulsory superannuation funds.

- Of the people who hold shares, over half 'sat tight', meaning they hadn't traded in the previous 12 months. Many commented they felt more comfortable putting the trading decisions into the hands of 'experts'.

- The market is still predominantly moved by the big end of town as illustrated by the fact that private or 'retail' traders account for 55 per cent of trading volume, but only 22 per cent of the dollar value traded.

- The majority of newcomers in the form of direct investors were males under 35 who earned A$70000+ per annum and held a degree.

- Interestingly, or perhaps scarily family and friends are cited as the most influential source of information, used almost as often as professionals and newspapers, with gut-feelings also playing a role in investors' decision making.

So what do these results show? Everything may seem fine when markets are in a bull trend; however, what happens when markets go sideways or move into a bear phase? Do these same friends and family continue to educate and recommend trades to each other? Do the experts make reasonable returns for their clients or do they enter into drawdowns of investor's cash? Is gut feeling an adequate and successful way of trading when markets get tricky? Private traders need to fully arm themselves not only with knowledge of markets and trading instruments (or products as we'll refer to them from now on) but also with a clear understanding of themselves and of how to react to the inevitable fluctuations of savings and investments tied to sharemarkets. Many traders have only ever experienced rising markets, however, and most people know how difficult it can be to cope with sudden change.

The 25 basis point interest rate increase in late February 2005 was shaken off by the sharemarket, as budding property investors suggested on talkback radio that a great way to save money to offset higher mortgage payments was to replace real milk with powdered milk and to cease the morning caffeine hit as coffee was too expensive. Will a property market downturn place downward pressure on sharemarkets as investors liquidate stocks to pay higher mortgage costs or will they sell their properties? Sadly, in early 2006 the latest figures showed a record number of defaults a month on mortgages (approximately 800) and that's without any significant interest rate increases. All roads lead to the mandatory requirement to get educated so the proverbial family jewels aren't swept away in a combined share and property crash coupled with rising rates to curb astronomical levels of household debt. We're not saying a crash, or gloom and doom will necessarily eventuate, but living and breathing this industry as we've done has conclusively proven one basic fact: anything can, does and will happen. That simple sentence bears repeating. Anything can, does and will happen. The sooner traders develop a reverence and a respect for that fact, the better.

At some point markets will fall or rise — faster, harder and longer than you can ever anticipate. The potential for monumental swings in volatility are now simply a characteristic

of global markets. Arrogance and ignorance have no place in a winning trader's plan. Winners understand the market is unpredictable and subject to a variety of tangible and intangible drivers. These statements are not intended to scare you or to suggest markets are untradeable — rather, they are meant simply to highlight that traders need to understand who they are and then employ the appropriate strategies in perhaps different ways than they have in the past. You need to embrace the requirements for caution and discipline and become proactive in risk mitigation and hedging techniques.

High levels of volatility can, however, provide traders with some extremely lucrative opportunities across many different markets. The diverse range of markets to trade, and the vehicles through which to do this, are now limited only by your imagination. Hand in hand with increased choice comes an increase in the margin for error. The smorgasbord of markets and products, strategies and opportunities, increases the necessity for traders to determine 'best fit' and narrow the field accordingly.

Observations

As for us, we started in financial markets back in the mid-1980s when interest rates were well in the double digits and long lunches were part of the job description. We've lived through bull and bear markets, bubbles and busts, wars, crashes, booms, September 11 and myriad other spectacular events that have not only rocked the markets, but also changed the face of the world forever.

Our panel members have also been in and around markets for most of their lives and we were interested to get their views on the ever-changing landscape.

Sari: In your opinion, how has the financial markets landscape changed from your first trade or investment to now?

Larry: Instant worldwide access to news by all parties makes it very difficult to take advantage of news. And, of course, the advent of the computer allows us to scan for trades and develop winning trading systems.

Andrew L: The market is a far more level playing field with the introduction of new technology.

Guy: We all know there is a greater amount of information available to everyone at zero or little cost. This is thanks mostly to the internet but also to a greater range of print and TV media. This seems to have increased the level of sophistication of the smaller guy. I believe it means both large and small traders can be more reactive to news and events.

Additionally I am less reliant on technical signals. The market seems more likely to second-guess technical signals these days. This means medium-term technical signals seem to be less reliable than in the past.

There are still a lot of things that have remained the same. Markets still overreact to news and events simply thanks to human emotions. In a way, I believe they oscillate around what might be argued is efficient value. Therein lies the opportunity for traders such as myself.

Catherine: The first thing is cost of trading. I traded futures fulltime for a while in the mid 1990s. Live data was a significant expense. Technology has helped [to] lower costs. I also think the introduction of contracts for difference (CFDs) has dramatically changed the trading landscape in Australia. They're the reason I got back to trading. If you like shares then there is no other derivative product that provides the same flexibility and simplicity with such small capital outlay. I've written a book on CFDs so, obviously, I'm biased!

Andrew P: The availability of technology, particularly trading software, is just so much better. A trader these days can be as technically equipped as any professional for relatively little cost. I also think the quality of listed companies and corporate governance is vastly better than the '80s so you have greater confidence when trading equities.

Tom: More Australians are 'active' traders — education has improved greatly, [there are] many more courses, online [brokers] dominate investing. [There is] a wider range of investment choices [and there has been growth in] derivatives such as CFDs and options. It is also more acceptable to trade and there is an acceptance that 'buy and hold' is no longer good advice. There is more cash awash in the markets and it is less acceptable to lose — whereas you accepted losing years ago when a broker put you into a trade.

Daryl: Increased participation has split up the old stock market 'club'. Ready available charting software and data have levelled the playing field and eroded the information/analytical advantage once enjoyed by a select few. The vested-interest, paternalistic 'we know better than you' approach that once dominated the financial sector has broken down. There have been improved settlement and trading procedures in a mechanical sense. An increase in volatility has provided more trading opportunities. A more direct link between crowd behaviour and price has increased the reliability of classic charting applications. And the relationship between volume and price has also changed.

Financial products

Depending on your appetite for risk, temperament, interests, time and money, you'll find a particular product will capture your interest more than others. Choosing a product that 'feels right' can often be one of the intangibles that helps make your trading plan a success. Learn all you can about the complexities of the products you use. Make sure you understand not only the features and benefits but also more importantly the risks. Go to the trouble of reading offer documents and trading account contracts. Ask where you don't understand.

Trading is not an arena where you want to be sloppy and the selection of the right products for you is a fundamental building block of a well-fitting trading mandate.

This next section will provide you with a brief description of some of the financial products on offer including:

- shares
- shorting
- contracts for difference
- futures and commodities
- margin foreign exchange
- options.

Essentially, whether you are trading shares, futures, margin foreign exchange (MFX), contracts for difference (CFDs) or options, you are speculating on the price of something moving in a particular direction (or not moving in the case of selling options). At the core of what drives the activity is what the market believes the physical asset to be worth. The only real difference is the complexity of pricing, the volatility and the inherent risks of each product.

Price is theoretically a reflection of the underlying value of a particular company's business activities. Similarly, at the root level, a wheat futures contract theoretically reflects the anticipated price of wheat at a specified date in the future. What traders and investors are trying to determine is a mispricing between the instrument and the underlying — that is, to identify an opportunity ahead of time that the market has not, or has only just, cottoned on to.

Let's start with the most simple product, in terms of mathematical calculations and ease of understanding. If you already trade shares, you'll know all this; if not, this is a quick rundown of how it works in reality. The methodologies used in the worked examples are just one way of trading and are based on trades that would generally take place over the short term — say, over the course of a few weeks in a heavily traded share with reasonable volatility and price range.

Shares

Shares are also referred to as stocks or equities. The sharemarket is the vehicle used by the vast majority of traders and investors to benefit from prices going either up or down. Many people see the movements of the sharemarket updated on television both morning and night and feel they have an affinity with it.

Quite simply, a share is just that — a share in a company. If you wish to participate in the potential profits of a company, you buy a share in that company. If your analysis suggests

a company's share price may fall, you can also sell shares before you own them; this is called 'shorting' or 'short-selling' which is covered later in this chapter.

An example of a simple share purchase and sale:

In order to help you understand shares, and the processes of buying and selling shares, more fully, let's now look at the following hypothetical example. Say you were keen to purchase Pioneer Aviation shares once the price hit $8.00. The purchase and costs involved could be as follows:

- buy 1000 Pioneer Aviation (share code PAV) at $8.00 per share
- initial investment or trade value is $8000 plus 1 per cent commission, meaning total cost to buy 1000 PAV is $8080.

At the time of purchase, you could also set strict exit points. For example, say your analysis suggests PAV will rise in price; however, if you're wrong and it falls to $7.70 a share, your analysis also suggests that PAV could then go even lower. To protect yourself against further losses once the price hits $7.70, you place a stop-loss order (used to limit the loss on a trade) at this price. Your analysis also suggests there's resistance at $9.00 (a price above the current price that the stock may find hard to breach). As well as your stop-loss order at $7.70, you place another order to sell your 1000 PAV at, say, $8.90. You place this order as an 'OCO', meaning one cancels the other — that is, if you get stopped out at $7.70, the order to sell at $8.90 will be automatically cancelled by your broker or online trading platform.

Having set exit points for if the trade goes well or goes badly allows you to determine the potential risk/reward ratio for the trade. One week later PAV shares trade down to your stop-loss level of $7.70 and you sell your 1000 PAV at $7.70

Your initial outlay of $8000 is now worth $7700 representing a gross loss of $300 — that is, before costs. You must also factor in costs of 1 per cent to buy ($80) and 1 per cent to sell ($77) equalling total costs of $157. Your net loss is $457 which represents a loss of 5.7 per cent of your initial outlay of $8000 ($457 $8000 = 0.057).

If PAV had risen as you anticipated and you sold your 1000 shares at $8.90, the calculation would be as follows:

1000 x $8.90 = $8900 (a profit of $900)

cost to buy = $80

cost to sell = $89

total costs = $169

net profit = $731

= 9.1% of initial outlay ($731 $8000 = 0.091).

After all costs the risk to reward ratio on the trade using a loss of $457 and a profit of $731 is 1 to 1.6, meaning that for every dollar you risked you made $1.60. This is at the lower end of the spectrum when it comes to risk/reward ratios — ideally the risk/reward ratio after costs on any trade should be 1:2 or higher. This means that for every $1 you risk you make $2 or more. This ratio should be calculated before you enter each trade. If, for example, your stop loss on PAV was at $7.50 and not $7.70 and your profit target was $8.50 and not $8.90 after costs your risk/ reward ratio would have been 1 to 0.51. This is calculated as follows:

- expected profit of $500 less costs of $80 to buy and $85 to sell = net profit $335
- maximum loss allowed of $500 plus costs of $80 to buy and $75 to sell = net loss of $655
- risk to reward = $655 to $335.

This means you risked $655 to make $335 or you risked $1 to make only 51 cents. (Divide $335 by $655 to get 0.51.)

Shares — comments people make

As with all products, marketing statements are often made that are mainly true but turn out to be double-edged swords. Here we take a look at some of the things you may hear about share trading.

The sharemarket is a regulated and level playing field with easy access to information.

Indeed it is — in the sharemarkets of developed countries the regulators have a very strict set of rules that all participants including listed companies, investors, traders, brokers, newsletter writers and commentators must abide by. These rules and regulations are to ensure a level playing field or a fair and equitable marketplace exists for all who enter. Information on companies ranging from price action and takeovers to exactly how much a company makes and how much it pays its CEO is available for all to see, with most of this being freely available over the internet.

Many shares are highly liquid thereby providing the ability to enter and exit the market with ease.

The sheer number of participants in the market means a huge array of shares can be bought and sold through either a full-service or an online broker very easily. Traders can quickly take advantage of movements in price without moving the market or without having to wait until the price trades at a fair level based on the fundamentals of a company.

You can create an income from share dividends.

This point is particularly pertinent for an investor who is happy to buy a share in a company for an extended period of time and then receive a periodical distribution of profits called a dividend. Some companies pay, say, 8 per cent on an annual basis to their

shareholders, which may be converted to more shares or paid as cash. Sometimes these dividends are paid fully franked meaning the tax has already been paid on the income so you don't have to pay tax again on what you receive. Some companies, such as retailers, will also offer discounts to shareholders when you buy their products.

The sharemarket can offer effective diversification within a portfolio.

Given the enormous range of shares and companies to trade or invest in, a participant can be involved in several different and uncorrelated businesses. This concept of diversification means you can have exposure through shares to a company that lends money, to one that mines gold, to one that provides medical research, with all three unrelated or what's called uncorrelated. That is, if your bank shares fall in price, it won't necessarily mean your biotech and gold shares will also fall. The idea, in theory, is that if one sector underperforms, the other sectors may outperform so you still profit on your overall portfolio. We use, 'in theory' because in the event of a market crash, all shares often get hit before the fundamentally strong claw back losses as panic begins to subside.

Investing in the sharemarket is easy and anyone can do it.

A large proportion of share traders and investors either don't have a plan or methodology to follow or don't follow their plan if they have one. One of the issues with shares is that, when traders or investors buy a share and it goes down, they decide to 'bottom-drawer' it. This basically means they go into denial, hold the share and 'forget' about it in the hope it will go back up so they can get out with their ego (and account) mostly intact. One of the standard jokes is that bad share trades turn into 'investments'. That is, a share bought for an anticipated profit within, say, three months that only goes down becomes classed as a long-term hold or investment. It's the old 'it's not a loss until you sell' theory. However, if your $ 10 000 is stuck in a non-performing or losing trade, it's not working for you at all. The idea is to have your trading capital constantly working for you, not lazing around the place on an eternal holiday in the hope that one day it may bring home a winner!

Furthermore, most new traders or investors in the sharemarket have only ever seen it go one way — up. The vast majority are also only used to buying shares as opposed to short selling. The whole game becomes decidedly more difficult when sharemarkets see an extended period of sideways or falling prices.

Shares will go up in value over the long term.

If a company can't make more money than it spends, it's not worth having your money invested in it. Not all shares that fall come back to the land of the living. In the 'tech-wreck', when technology shares went sky high and then subsequently fell heavily, many of these companies' share prices never regained their previous prices and many also delisted; that is, if you owned shares in these companies, your holding is now worth absolutely nothing and never will be. As top traders, we never get 'married' to a company; we never fall head over heels in love with a share we own. Like a farmer with a horse that can't pull the cart anymore, we must bid them farewell and find another one to do the job.

If you buy good shares you can just sit on them and forget about it.

Most investors would have felt safe in Barings Bank before Nick Leeson brought the bank to its knees with his unauthorised Nikkei trading. While this may be an extreme example, it serves to show once again that anything can and will happen, when you least expect it. Even highly experienced pilots go through the whole checklist before taking off. Even though they know what they're doing, they know that anything can and will happen when they least expect it. Today's darling share may be tomorrow's dog share, so never just forget about what your money's invested in. Always be an interested party in your own future.

The sharemarket is low risk compared with some other investments and trading products.

Tell that to the millions of investors in high-tech shares who lost it all when the technology bubble burst. Busts such as this have happened many times throughout the history of the markets, and they will definitely happen many more times in the future. Don't make the mistake of thinking that trading or investing in shares is low risk, even compared with other investments — it's not the mindset you want to cultivate as a top trader.

Putting leverage aside for a second, a share can go to zero if the company is delisted. While moves in commodity futures contracts can be big and fast, the price can't go to zero. All products, markets, trading and investing carry an element of risk. Don't kid yourself — risk is risk. Don't get lulled into enjoying a false sense of security with any trading or investing you undertake. Many driving accidents occur when the driver is close to home or just around the corner. So beware — when you feel the most comfortable you may not be listening to the top trader voice of caution, reason and prudence in your head.

Short selling shares

Also referred to as 'shorting'. Selling shares you don't own or shorting has become increasingly popular due to the leverage available. The minimum parcel of shares you are required to sell is generally around $20 000 and you must lodge a deposit (margin) with your broker of around 20 per cent to do the trade. If you were selling $20000 worth of PAV you'd lodge an initial margin of $4000 (20 per cent of $20 000).

For example, you sell $20000 PAV at $8.00 a share as your analysis suggests the price will fall.

So, sell $20000 worth of PAV or 2500 shares ($20000 -s- $8.00 = 2500 shares) at $8.00.

If PAV falls and you can buy back the 2500 shares at $7.50, your profit would be:

sold 2500 PAV at $8.00 — value $20000

buy 2500 PAV at $7.50 — value $18750

gross profit is $20000 less $18 750 = $1250

less cost to sell of 1% = $200

less cost to buy back of 1% = $187.50

total costs = $387.50

gross profit = $1250 less costs of $387.50

net profit on the trade = $862.50.

Remember, though, you only outlaid $4000 of your own money to do this, so your percentage return on the trade would be calculated as follows:

outlay = $4000

net profit = $862.50

$862.50 -r $4000 = 21.56 per cent return on your initial outlay.

This is the power of leverage, but beware — if PAV had gone up from where you sold it at $8.00 to $8.50 and you decided to cut your loss and cover the position (that is, buy back your short position) the percentage loss would be as follows:

sell 2500 PAV at $8.00 — value $20 000

buy 2500 PAV at $8.50 — value $21250

gross loss of $1250

plus costs to sell of $200, plus costs to buy of $212.50

total costs of $412.50 plus trading loss of $1250

net loss of $1662.50.

Now let's see what percentage loss of your initial outlay or deposit of $4000 this works out to be:

- $1662.50 * $4000 = a whopping 41.56 per cent loss of capital.

This is not meant to turn you off short selling, just to present both the positives and negatives of leveraged products.

Short selling shares — comments people make

Things you may hear in relation to short selling shares include the following.

You don't need to have as much money to trade due to the leverage provided by short selling. You only have to put up a margin of $10000 to short $50 000 worth of shares.

For those who don't have a huge swag of cash to trade with, shorting shares can be a way to boost the returns on the available capital due to the leverage. Instead of having to front up with $50 000 to buy a $50 000 parcel of shares, you can sell $50 000 worth by only having to come up with $10 000. This means each one cent move lower in the share price is worth 5 cents, rather than cent for cent when you buy.

The leverage also means you may be able to trade a couple of different shares from the short side as opposed to only being able to put your $10000 trading capital into one trade (or put 'all your eggs in the one basket', which is not recommended) or two or three small trades across different companies where you'll only make decent money on really big moves.

Shares go down faster than they go up so short selling can provide very fast returns.

Leverage is a double-edged sword — it's your best buddy when it works for you or it's your worst enemy if you get it wrong (especially if you don't have a stop, or the market gaps through it). Profits and losses are magnified by a factor of five if the deposit required is only 20 per cent. Just as you can be a hero pretty quickly if the shares you have shorted start to tumble, you can be running for cover with your tail between your legs if the shares you have sold start to go up (rally). The last few years have also reduced the truth of the old adage, 'Up by the stairs and down by the lift', as there have been many shares that have experienced rapid and sustained rallies in price.

Beware of shorting shares that are potential takeover targets, or if there are rumours of a deal, a new finding, tax ruling or any other piece of information that may force the share price higher. There have been many instances where a company's shares have gone into a trading halt pending an official announcement. If a share you have shorted goes into a halt it could be 10 minutes or hours or even more than a day where no trading takes place. The exchange literally stops all trading until the company announces its latest big news. If the news is great for the company's revenues going forward, it's possible the next traded price will be higher when it reopens than what it was when it went into the trading halt.

Using the PAV example, this could mean your stop loss buy-back order of $8.50 was placed with all good intentions; however, if the share price gaps straight through it, it's not much good to you. If you were short 2500 PAV shares at $8.00 with a stop loss at $8.50 and the news was good, PAV may reopen trading at $9.00 or more. You may then have to buy back your 2500 short PAV shares at a loss more than the amount you were initially willing to wear. If you lose all the $4000 deposit then your broker will be on the phone with a margin call for you to meet immediately. Once again, it's not the end of the world if you're trading within your means, but it is something to be well aware of.

If you short sell shares in a company and the price rallies significantly, and you don't exit, you can lose more than what you started with.

If you buy a parcel of shares that cost a total of $10000, that's the maximum you can lose, even if the company you've invested in goes out of business overnight and delists. However, when shorting a share the potential loss is theoretically unlimited as shares can keep going higher in price meaning you're losing more. Buying shares (without a loan or leverage) has maximum liability, selling shares has potentially unlimited liability.

As a short seller in the physical market you must observe the 'down tick' rule, which can hamper your trading in rapid sell-offs.

The down tick rule is one of the limiting rules for short sellers in the physical market. Unlike CFDs, futures or FX trading, a rule applies that prohibits a trader from short selling into

weakness. This means you can only go on the offer to sell at a price higher than the last traded price as opposed to 'hitting the bid'. You may not be able to short sell at the level you initially wanted to if the price keeps falling away from your offer. This 'down tick' rule reduces the flexibility of short selling and has been a contributor to the enormous growth of the CFD market, where there is no such rule.

Contracts For difference

A contract for difference (CFD) is a leveraged product that mirrors the price of a share (or an index) and offers the benefits of trading shares, without having to physically own them, or having the full amount of money to buy them. The deposit or margin requirement is generally around 5 to 10 per cent, so with an account of $10000 you can buy or sell up to $100000 worth of shares or even up to $200000 if your CFD provider only requires a 5 per cent deposit.

CFDs have the added benefit of allowing you to go short rather than just to buy, once again with only a 5 or 10 per cent deposit required. As there are no expiry dates a position can be held open indefinitely. Another significant advantage for CFD traders is that the 'down tick' rule doesn't apply as it does for stock traders.

When you buy CFDs, you are actually borrowing money from the CFD issuer to pay for the CFD less the deposit. You therefore pay interest if buying and earn interest if selling. These charges are calculated using the cash rate plus a margin of up to 3 per cent if you're the buyer. For example, if the cash rate to borrow funds is 6 per cent then you would pay up to 9 per cent per annum for as long as the CFD is open (bought). If you are the seller of the CFD then you receive roughly 3 per cent per annum while your short CFD position is open.

An example of a CFD trade:

buy 500 NAB CFDs at $33.80 with a deposit of 10 per cent

outlay = 500 x $33.80

= $16900 x 10 per cent

= $1690 (deposit requirement)

assume commission of 0.3 per cent [or $50.70] on the cost of the whole position of $16900.

You sell your 500 NAB CFDs 30 days later at a $1.00 profit or $34.80. This means your total profit is $17 400 (500 x 34.80, less commission of 0.3 per cent or $52.20).You've held the trade for 30 days and the funding cost is 9 per cent on the borrowed amount of $15210 ($16900 less $1690 deposit). The net profit is calculated as follows:

interest payable = $15210 x 9 per cent + 365 x 30 days = $112.51

gross profit is $17 400 - $16 900 = $500

less total commissions of $102.90, less funding cost of $112.51

net profit = $284.59.

Your initial outlay was the deposit of $1690 so a net profit of $284.59 equates to a return on capital of around 17 per cent in 30 days.

CFDs — comments people make

Things you may hear about CFDs include the following.

You can buy or sell, say, $50000 worth of CFDs for a fraction of the cost of trading shares outright.

True — due to the leverage, the commissions on CFDs are a lot lower than buying shares. Many CFD providers have built the commission cost into the spread price you receive so take notice of how much that spread is. For example, assume you buy $50000 worth of physical RIO shares.

Firstly, you must have the cash to do so, or the borrowing capacity if you're using a margin loan. Secondly, the commission rate may be around 1.5 per cent to buy and the same to sell so the costs look like this:

cost to buy $50000 RIO at 1.5 per cent commission = $750

assume you sell at the same price for the sake of the exercise — cost to sell $50000 RIO at 1.5 per cent commission = $750

total commission to buy and sell RIO physical shares = $1500.

Now look what happens with a CFD:

cost to buy CFD equivalent of $50000 RIO at 0.3 per cent commission = $150

once again, assume you sell at the same price — cost to sell CFD equivalent of $50000 RIO at 0.3 per cent commission = $150

total commission to buy and sell RIO CFDs = $300.

That's a saving of $ 1200 on the commission you have to pay for effectively the same trade!

You don't have to have the whole amount of money in your account to buy the same number of shares as CFDs.

As with any leveraged product, you are only required to pay a small (5 to 10 per cent) deposit to keep the CFD position open.

Another important point to note when trading CFDs is that as a buyer of a CFD you are entitled to dividends, rights issues and stock splits; however, you have no voting rights. If you are the seller of the CFD then you must pay the dividend or any other benefits.

At 5 per cent, CFDs are very high leverage. It's possible for a blue chip share trading at $45.00 to fall $4.00 or around 10 per cent in a single day.

This is definitely one area where CFD traders need to exercise some caution with respect to how much they use leverage. Think of it like this, at present levels of over 10000, if the Dow (Dow Jones Industrial Average, or DJIA) were to fall 10 per cent in one day it would be a fall of over 1000 points. Or, if gold prices at US$550 an ounce were to fall 10 per cent in a day that would mean a fall of over $50. Both these examples are possible; however, there are many shares that can and do retrace up to 10 per cent in a day before moving higher. If you're on the wrong side of a move of that magnitude with only a 5 per cent margin, and not a great deal of surplus cash in your account, then you may find yourself receiving a margin call at the worst possible time. If you can't meet the margin you may be closed out, only to see the company's share price rebound the next day. By all means use the leverage but never lose respect for it. As your mum used to say, 'It's all fun and games until someone loses an eye!'

Futures and commodities

Futures and commodities markets were originally created as a means for producers and commodity users to hedge against adverse price movements. Futures have a mixed reputation, having been scandalised and popularised in movies such as *Trading places* and *Rogue trader.* Mention the word futures to some people and they immediately think of Nick Leeson and the fall of Barings Bank. Without a doubt, futures are at the pointy end of the stick in terms of risk, yet they can provide some amazing trading opportunities for those with the discipline to trade sensibly and prudently. Most participants are attracted to these markets for their speed, efficiency and liquidity. Transaction costs are generally lower than with their stock market cousins and the ability to go long (buy) and short (sell) creates an interesting proposition for those seeking to profit from price movements in either direction.

Most Australian newcomers to futures start out by analysing and speculating on the Share Price Index (SPI), feeling somehow safer with it than with offshore commodities. The underlying security on the contract is the S&P/ASX 200. Familiarity does not necessarily lead to success in the trading of any market, however, and it can often create a false sense of security.

Futures and commodity contracts all have expiry dates. You have to be aware of which contract month you should be trading and which ones to leave alone. Each market has what's called a 'front month' and this is the most liquid (easy to buy and sell) of the contracts at the present time. Months in between the most traded months are colloquially referred to as 'dog months' meaning they're illiquid and should not be traded by speculators at all.

If you go to <www.toptraderthinking.com> you'll find a list of the contracts you can trade, when they trade, their deposit requirements and some other contract specifications you need to be familiar with. A very important date to know when trading some of the deliverable commodities is first notice day (FND) — this is the date you must ensure you have

exited your trade by, whether you are long or short the market. You certainly don't want 1000 barrels of crude oil landing on your doorstep. Well, it doesn't really work like that — but if you have bought crude oil contracts and you haven't closed your position by selling the same amount of contracts before FND, you'll have to go through a tendering process (a process your broker handles for you). In many cases it may not be a big deal; however, it can cost hundreds of dollars to then exit the physical crude oil with your name on it in a warehouse somewhere. Here's a simple example of a futures trade.

It's September, and your analysis suggests the price of crude oil will fall in the next day or couple of months, depending on your time frame. If December delivery crude oil contracts were trading at US$64.10, you could place an order like this:

sell 1 December crude oil at 63.50 on stop (this session only)

if done, buy 1 December crude oil at 64.20 on stop GTC (good till cancelled).

So, if December crude oil falls to US$63.50 a barrel, you'll sell 1 contract and then place the stop-loss order to buy 1 December crude oil at US$64.20 GTC. This means you are working a 70 cent stop loss on the position — the difference between what you sold at, US$63.50, and where your stop-loss order is placed, US$64.20.

The size of a crude oil contract (Light Sweet Crude Oil) is 1000 barrels so each one cent move per contract equates to US$10.00. So a 70 cent stop loss means you're risking US$700 on the trade. You lodge an initial margin to keep the position open, which is around US$4000. This amount can be increased or decreased by the exchange at any time based on the current volatility of the market. The more volatile the prices are, the higher the margins and vice versa. In reality, however, these margins tend not to change very often.

Crude oil prices fall over a couple of weeks as supply concerns abate and you can now buy back your December crude oil contract at the price of US$61.50 a barrel, giving you a profit on the trade of US$2.00 per barrel or US$2000 per contract. Commissions vary and can be as low as US$10 to buy and the same to sell. That is, US$20 a round turn if you are a sizeable trader who requires little assistance, right up to US$100 a round turn if you are only trading small amounts and require lots of attention. So the whole trade looks like this:

sell 1 December crude oil at US$63.50

buy back 1 December crude oil at US$61.50

gross profit of US$2000 (less commission at the top rate of US$100 a round turn)

net profit = US$1800.

When you exit the trade you would need to ensure the stop loss you were working at US$64.20 was cancelled, as it was placed on a GTC basis. As opposed to share trading, all futures orders are taken for the one session only, unless otherwise stipulated. There are many other contracts available to trade including those listed in Table 1.1.

Table 1.1: a selection of the most commonly traded futures and commodities markets

Interest rates:	Metals:
Short-term and long-term interest rate products including:	gold
Australian 10-year bonds	silver
Australian 90-day bank bills	platinum
US 30-year US Treasury bonds, two-year and five-year notes	copper
German 10-year bunds	Grains, softs, fibres, meats:
Japanese 10-year bonds (JGBs)	wheat
Currency futures:	corn
US dollar cross-rate to the:	soybeans (plus oil and meal)
Swiss franc	coffee
euro	cocoa
Japanese yen	sugar
British pound	orange Juice
Canadian dollar	live and feeder cattle
Australian dollar	pork bellies and lean hogs
Stock indices:	cotton
Dow Jones (US)	lumber
S&P (US)	Energy:
NASDAQ (US)	crude oil
FTSE (UK)	natural gas
DAX (Germany)	heating oil
Hang Seng (Hong Kong)	unleaded gas
Nikkei (Japan)	
Share Price Index or SPI (Australia)	

Each futures contract has its own specifications and its own unique trading characteristics.

Futures and commodities — comments people make

Statements you may hear related to trading futures and commodities include the following.

The liquidity in many futures and commodities markets allows me to get filled at, or very close to, my price.

This can certainly be the case when trading highly liquid contracts like the US S&P stock index and 30-year Treasury bonds or the DAX stock index in Germany. There are many more deep or high volume markets you can trade around the world making some of these markets very attractive to intra-day traders. Many of these markets also have wide ranges on an intra-day basis, allowing money to be made within the one session.

Note that some markets (like lumber and orange juice) are not as liquid, and are prone to gaps, meaning your order may not be filled anywhere near your desired price.

The leverage of futures and commodity trading is very high. For example, you can have a position in 10 tonnes of cocoa for as little as US$1000 a contract. If cocoa is trading at US$1500 a tonne then you have a US$15 000 position in cocoa for a margin requirement of just 6 per cent.

Most deposit requirements average around 5 or 6 per cent of the value of the contract. As with other leveraged products this can work for or against you very quickly. As with all products like this, a healthy respect for risk is mandatory and disciplined trading is an absolute necessity at all times.

You can lose more than you start with when trading futures.

As already discussed in relation to trading leveraged products, this is also true for futures trading. All leveraged products require a prudent, sensible and disciplined approach.

Margin foreign exchange

The largest market in the world by far is the foreign exchange market, also called margin FX, MFX forex or spot currency trading, with volumes of nearly US2 trillion being traded each day. The concept is relatively simple as there are no expiry dates, first notice days or dividends. There are, however, interest payments or receipts, depending on whether you are long or short a currency, and whether or not the interest rate is higher or lower in the currency you are long or short.

A trade is executed through the simultaneous buying of one currency and the selling of another, referred to as a currency pair or cross. Although there are many different crosses, the most tradable are:

- EUR/USD — the euro against the US dollar, simply referred to as the euro
- GBP/USD — the British pound against the US dollar sometimes referred to as cable
- USD/CHF — the Swiss franc or dollar/Swiss or Swissy
- USD/JPY — the yen or dollar/yen.

One of the major differences between foreign exchange markets and futures and stock markets is that FX markets are open 24 hours a day. Trading commences on Monday morning in New Zealand and Australia and ends in New York on Friday afternoon — that is, Saturday morning in Australia. This creates another difference — given FX markets don't close during the week, there are no opening gaps in prices. However, gaps can occur when economic figures or big market-affecting news is released within the session. Gaps can also eventuate on a Monday morning (Australian time) if something major happens as a result of the markets being closed over the weekend.

The minimum trade in the margin FX market is generally $100000, so a profitable trade example looks like this:

buy $100000 EUR/USD at 1.2150

five days later sell $100000 EUR/USD at 1.2180

gross profit = 30 points (pips) at US$10.00 a point per $100000 traded

= US$300 less commissions, which are generally around two points per $100000 traded.

Therefore, to buy and sell $100000 you'd pay US$40 in commissions leaving you with a net profit on the trade of US$260.

You may hear that foreign exchange trading is commission free — it's not free. The costs to trade are built into the spread you are quoted. This is very important to be aware of when choosing a broker or online platform (as well as levels of service, advice and assistance). For example, Broker A may quote you a two-way price or a spread of bid 1.2147 versus offered 1.2150. On a screen this would look like 1.2147/50.

This means you can sell at 1.2147 or you can buy at 1.2150. As you are not 'making the market', if you are a buyer you have to buy at the high price, or the right-hand side of the spread (the offer), and if you are a seller you have to sell at the lower price, or the left-hand side of the spread price (the bid). This example is called a three-point spread.

Broker A charges two points (two pips) a side per $ 100 000 transaction. So to buy it will cost $20 and to sell it's another $20. The total costs to buy and sell (or sell and then buy) are transparent at $40. Your effective buy price would then be the offered price plus two points, or 1.2152. Your sell price would be the bid of 1.2147 less two points commission, giving you an actual selling price of 1.2145.

On the other hand, Broker B may offer zero commissions, which sounds fantastic — trading for free, what could be better?

But let's look at what they quote you. They may give you a quote of 1.2144/53 — a nine-point spread versus Broker A who gives you a three-point spread. Therefore, you would be selling one point lower and buying one point higher than you would with Broker A resulting in a cost of $60 to buy and sell as opposed to Broker As transparent cost of $40.

This means your zero commission with Broker B would actually cost you $20 more than Broker A. Always remember, there are no free lunches. Everyone has to make money somewhere.

Being a highly leveraged product, the margin requirement is generally around 3 to 5 per cent. This means you can hold a position of US$100 000 for as little as US$3000. The minimum trading account size with an Australian-based broker is often as low as A$10000, making this a very attractive product for those without a great deal of capital. This works both ways — in percentage terms profits are exaggerated and so are losses.

Margin FX — comments people make

Some things you may hear about margin FX trading include the following.

FX being the most highly traded market in the world, liquidity is excellent.

High levels of liquidity mean you'll be filled on an order at or very near your price, with some brokers even offering guaranteed stops. This feature allows rapid entry and exit when trading the major currencies and many participants also find that technical analysis works very well when trading currency markets due to the infrequency of price gaps.

FX markets can exhibit some very large and sustained trends.

Have a look at a long-term chart of any of the major currencies and you'll see some enormous trends lasting months or even years. For medium to longer term trend-following systems these moves can provide very large returns over time.

I can stay in an FX trade for as long as I like as there are no expiry dates.

Unlike trading futures, there are no expiry dates in FX trading. This means you can stay in a trade without having to close, thereby expiring the contract, and then having to open the new month as in a futures trade.

The leverage in FX trading is excellent — you only have to put up around 3 per cent of the value you trade.

Some brokers charge up to 5 per cent, however, 3 per cent is generally the normal deposit requirement. Of course, the same applies for any leveraged product discussed — respect, prudence and common sense should form the basis of your account size.

Options on shares and futures

The standard definition of an option reads something like a legal definition in a contract. In other words, and with respect to the legal profession, it can be a bit difficult to get your head around. Don't despair, though, as the vast majority of people who commence their options learning process can't figure out why they can't figure out why they can't figure out options ... and then the penny drops and they can't figure out why it took them so long!

If you buy an option at 10 cents and the price rises to 20 cents then you've doubled your money. If you buy at 10 cents and the price of the option falls to five cents then you've halved your money. The element to be aware of, is that, unlike other products, options have a time expiry. So, if what you expect to happen doesn't happen before the option expires, then you've lost all of the money you paid for the option.

If you think the price of a share is going to rise in value you would buy a 'call' option. Each call option you buy is equivalent to 1000 shares. If you think the price of a company's

share or a market will fall then you buy a 'put' option. Let's use the hypothetical Pioneer Aviation as an example again.

Say PAV shares are trading at $8.00. Your analysis suggests that the price of PAV will rise to $9.00 within six months. There are options on PAV you can buy — there are expiries in three months, six months, nine months and twelve months. The more days there are to the expiry date, the more the option will cost as the share has a longer time to reach a higher level. The three month options with a strike price, or your target price, of $9.00 may cost 20 cents per option. One option is 1000 shares so you'd pay $200 (1000 x 20 cents) for the right or option to buy 1000 PAV shares at $9.00 within the next three months. You have to evaluate the possibility of PAV getting from $8.00, where it is now, to $9.00 in the next 90 days — is it possible? Maybe. Is it realistic? Not really, given your analysis.

You then look at the $9.00 PAV call options that expire in six months and they're trading at 50 cents. The extra cost of 30 cents is because there's more time for PAV shares to get to $9.00. The cost of the six month calls would therefore be $500 (1000 x 50 cents).

Based on your analysis of PAV, you decide you have a greater chance of making a profit if you buy the options with six months' time to expiry.

So, buy 1000 PAV $9.00 calls at 50 cents or $500. If PAV shares move from $8.00 to $8.30 then your $9.00 calls may be now worth 58 cents each. The more PAV shares rise, the more you'll be making on your PAV $9.00 calls. However, when you buy an option you have time working against you; if you sell an option time is working on your side. At this juncture we don't want to get too much more involved, as whole libraries of books have been written on options. There are many more complexities and factors involved in the trading of options and we highly recommend Guy Bower's site TradingCourses.com for more on options (and other) topics.

There is so much more to each of the products we've touched on but, as we said in the introduction, *Bullseye* is focused on developing your top trader thinking as opposed to teaching you how to trade a specific market, product or system. Our panel all have areas of specialisation, and we turn now to hear from each of them on what they like and why. There's also a space at the end for you to fill in your own responses to the following questions.

Sari: Bullseye discusses types and styles of trading and investing. Do you trade physicals, derivatives or both?

Larry: I trade stock indices and bonds, some futures and invest in stocks.

Andrew L: I have traded both over many years.

Guy: I trade derivatives only — futures and options.

Catherine: I invest in shares and trade CFDs.

Andrew P: I principally trade equities.

Tom: Both.

Daryl: Primarily physicals.

Your answer:

Sari: Do you have any preferred markets or instruments that you trade or invest in?

Larry: For short-term trading — the SP 500 and bonds. For investing — the darlings of the Dow.

Andrew L: Interest rates.

Guy: Futures and options, specifically spreads in both.

Catherine: Naturally CFDs are my thing. After moving from futures to shares, CFDs were the perfect middle ground — all the leverage of the futures market but the simplicity, choice and familiarity of the sharemarket.

Andrew P: Australia, US and NZ markets.

Tom: Mainly equities (use margin lending) and CFDs — would like to tackle options on futures as I look at so many futures and commodities as the underlying drivers for the Oz equity markets, so may as well use the knowledge and trade the futures.

Daryl: Ordinary stocks in Australia, Singapore and Malaysia. I also trade some derivatives when market conditions make this appropriate.

Your preferred markets and products:

Sari: Why are the instruments you trade or invest in personally appealing or suited to you?

Larry: They offer a very good risk-reward basis.

Andrew L: My background in merchant banking and time spent on the floor trading was in those products.

Guy: Commodity futures markets offer great volatility and diversity. On the volatility side, you need markets to move to make a dollar. Markets such as silver or crude oil or coffee have great trends that offer great profit opportunity. I prefer to trade these markets over shares, for example.

I apply seasonal, fundamental and technical analysis to these markets. On the fundamental front, these are markets that can be affected by political factors or adverse weather conditions or inventory pile-ups. Watching these markets trade around these events can be quite interesting and exciting and, of course, offers opportunity. On the technical front, I feel many of the common methods of technical analysis are more applicable to commodity markets than to individual shares. As for seasonals, I think of that as a combination of technicals and fundamentals.

Catherine: Leverage is very appealing. When I buy physical shares it's only the penny stocks because they have the potential to move multiples, while blue chips have a much more limited potential to move. When CFDs came along it enabled me to trade rather than invest in sharemarket movements and to trade the bigger stocks for smaller moves.

Andrew P: Just shares and options, but recently started trading CFDs as well.

Tom: I have a number of interests and trading shares allows me to pursue these other interests — I am not a slave to the markets. They also fit with the various articles and columns I write.

Daryl G: Ordinary stocks are the market where a mixed crowd of people is most active. This creates crowd behaviour and hence trading opportunities. It also creates market inefficiency, and hence other types of trading opportunity. Ordinary stocks provide a wide range of different types of opportunity, and offer the advantage of price leverage. This is where I started trading and my skills are particularly relevant to this market. My objectives are a return on capital and this is achieved in this market. I am not driven by greed, so I see no need to expand into different market segments with different risk profiles.

My trading methods are based on understanding crowd behaviour as reflected through chart and price activity. Professionals trading mathematically derived derivative markets behave in different ways. They literally arbitrage opportunity because the level of skill is so consistent. These groups can be just as crowd-driven as those in the stock market, but the degree of opportunity is more limited so I prefer to trade elsewhere. I just trade ordinary stocks from the long side. I don't trade short. I don't manage money, and I don't trade on the margin. I look for a reasonable return on my capital and a lifestyle that allows me to do the other things that I like doing. This includes writing and speaking about trading and teaching others some of the skills required.

Why do you think the products and markets you trade appeal to you?

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This is an excerpt from the book Bullseye: Top Trading Thinking. For the complete book visit:

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