

Understanding a Forex Trade

Mario Singh shows how money is made or lost on the world's largest financial market.

Forex markets trade \$US3.5 trillion in a single day, making forex the largest financial market in the world. Additionally, the playing field has been levelled considerably because what used to be the domain of central banks and large commercial banks or hedge funds is now available to the retail investor.

So let's take a look at a forex trade, how it is executed, and how money is made or lost.

Reading a currency pair

Firstly, forex currencies are always traded in

pairs. Examples are:

- USD/JPY (US dollar against the Japanese yen)
- EUR/GBP (Euro against the British pound)
- AUD/CHF (Aussie dollar against the Swiss franc)

In any currency pair, the currency on the left is termed the 'base currency' and the currency on the right is termed the 'counter currency'.

The unit of the base currency is always 1, and it is expressed as a figure of the counter currency.

Here are a few examples:

- EUR/USD = 1.4150 (1 euro is equivalent to 1.4150 US dollars)
- GBP/USD = 1.6135 (1 GBP is equivalent to 1.6135 US dollars)
- USD/CAD = 1.5055 (1 US dollar is equivalent to 1.5055 Canadian dollars)
- USD/JPY = 90.50 (1 US dollar is equivalent to 90.50 Japanese yen)

Take note that whenever the Japanese yen is quoted as a counter currency, the price is always quoted to two decimal places, as

opposed to four decimal places for most other currencies.

So, when you see a quote showing 'USD/JPY = 90.50', you can infer three things:

1. US dollar is the base currency.
2. Japanese yen is the counter currency.
3. 1 USD is equivalent to 90.50 Japanese yen at that time.

Long and short

A trader executes a 'long' when he feels that prices will rise. This is a 'buy' trade. A trader executes a 'short' when he feels prices will fall. This is a 'sell' trade.

Executing a trade

Look at the USD/JPY chart in figure 1.

In the first instance, our trader executes a long at 91.55 (let's omit the last digit since it is always zero) because he feels the price will rise. This is his entry price. He exits the trade at 93.02. This is known as his profit target.

In the second instance, our trader executes a short at 92.60 because he feels the price will fall. 92.60 is known as his entry price. He exits the trade with a profit at 90.78. This is his profit target.

Note that when you execute a long trade, the profit target is numerically higher than the entry price (93.02 > 91.55). When you execute a short trade, the profit target is numerically lower than the entry price (90.78 < 92.60).

Understanding pips

Let's start with the definition of a 'pip'. A pip is basically the smallest movement on the chart. For instance, if the quote of GBP/USD moves

from 1.6250 to 1.6251, we say the movement is one pip. If the quote of USD/JPY moves from 90.50 to 90.40, we say the movement is 10 pips.

Take note that whenever the Japanese yen appears as the counter currency, the second decimal is referred to as a pip. Most other non-JPY currencies like EUR/USD, GBP/USD, USD/CAD and AUD/USD are quoted to four decimal places, thus, the fourth digit is one pip.



Let's look at a few examples to help us understand the value of a pip. Let's assume that the current prices for a few major currency pairs are now:

- 1) EUR/USD = 1.4245 (1 pip = 0.0001 EUR)
- 2) USD/JPY = 90.55 (1 pip = 0.01 USD)
- 3) USD/CAD = 1.0538 (1 pip = 0.0001 USD)

In Forex, the value of 1 standard lot is 100,000 units of the base currency.

In our 1st example of EUR/USD, EURO is the base currency. The pip value is calculated as such:

$$\begin{aligned} \text{Pip value} &= \{0.0001/1.4245\} \times 100,000 \\ &= \mathbf{7.02 \text{ EUR}} \\ \text{OR} \\ &= 7.02 \times 1.4245 \\ &= 10 \text{ USD} \end{aligned}$$

In the second example of USD/JPY, USD is the base currency. The pip value is calculated as such:

$$\begin{aligned} \text{Pip value} &= \{0.01/90.55\} \times 100,000 \\ &= \mathbf{11.04 \text{ USD}} \end{aligned}$$

In the third example of USD/CAD, USD is the base currency. The pip value is calculated as such:

$$\begin{aligned} \text{Pip value} &= \{0.0001/1.0538\} \times 100,000 \\ &= \mathbf{9.49 \text{ CAD}} \\ \text{OR} \\ &= 9.49 \times 1.0538 \\ &= \mathbf{10 \text{ USD}} \end{aligned}$$

In short, whenever the US dollar appears as the counter-currency, the pip value is always 10 USD.

Whenever the US dollar appears as the base currency, the value of 1 pip can be derived from the above calculations. The good news is that most Forex brokers will calculate this for you in the platform they provide.

Calculating profit and loss

Let's again look at the same chart we discussed earlier, now in figure 2.

In the first trade, our trader made 147 pips by going long. This is calculated by subtracting 91.55 from 93.02. Recalling that 1 pip is roughly \$US10, our trader made a cool \$US1,470 in that one trade! If our trader had started with an account of \$US10,000, he would have made a return of 14.70 per cent in one trade.



In the second trade, our trader made 182 pips by going short. This is calculated by subtracting 90.78 from 92.60. In this trade, our trader made \$US1,820. Again, if our trader had started with an account of \$US10,000, he would have made a return of 18.20 per cent in one trade.

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Stop loss

We're almost there. So far, we have discussed only entry price and profit target. A complete trade must have three positions, and the third is a position called a stop loss.

A stop loss is defined as the maximum amount a trader can afford to lose if the trade doesn't go his way. A stop loss is essential in every trade to help a trader limit his losses.



Let's take a look at the graph again, this time in figure 3.

The red line in the middle of the chart helps us see that the trade on the left-hand side is a long trade and the trade on the right-hand side is a short trade.

Notice that now we have also put in the stop loss. To illustrate this example with a stop loss, we shall use the most basic risk/reward ratio of 1:1. For the long trade, our stop loss is placed at 90.08 (exactly 147 pips below the entry price). For the short trade, our stop loss is placed at 94.42 (exactly 182 pips above the entry price).

Putting it all together

A trade exits in one of two ways: either the profit target or the stop loss is hit.

Wait a minute! Does that mean that had our trader lost the trade, he would have been staring at a loss of 14.7 per cent and 18.2 per cent respectively on a single trade?

Not exactly. In forex, it is imperative to understand risk per trade.

Great traders do not risk more than one to five per cent of their capital on any trade.

The formula for calculating risk per trade is:

$$\text{Risk per trade} = \frac{\text{lot size} \times \text{stop loss} \times \text{pip value}}{\text{capital}}$$

To put us in the domain of the great traders, we need to emulate their approach to forex trading. Their approach is to determine risk first. As an example, let's assume that our trader starts trading with a capital of \$US10,000. He then decides that his risk per trade is three per cent, and his stop loss is 100 pips. The calculation goes like this:

$$\text{Risk per trade} = \frac{\text{lot size} \times \text{stop loss} \times \text{pip value}}{\text{capital}}$$

$$0.03 = \frac{\text{lot size} \times 100 \times 10}{10,000}$$

$$\text{Lot size} = 0.3 \text{ lots}$$

This tells us that our trader can only execute this trade with 0.3 lots if his capital is \$US10,000 and his stop loss is 100 pips.

If either value is different, simply plug in the figures in the formula again.

In summary, always start with risk first. Decide how much you are willing to risk on each trade (this figure must be between one to five per cent of your capital – nothing greater) to determine your lot size.

Never 'take a swing' by starting with lot size first.

Many amateur traders have a 'more the merrier' mentality and take huge positions in their lot size without understanding the consequences. This attitude borders on gambling. It should be avoided at all costs. VTE

Mario has been trading forex for five years. He is the co-founder and CEO of FX1 Academy, the largest Forex Academy in Asia. He is a popular seminar speaker, writer and forex coach. As he is a regular guest on CNBC, his views are widely sought in the industry. See www.fx1academy.com and www.mariosingh.com.

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