Is Currency Trading Worth the Risk?

The Foreign-Exchange Market Is Luring Record Numbers of Retail Investors—but the Potential Pitfalls Are Huge

By STEPHEN L. BERNARD

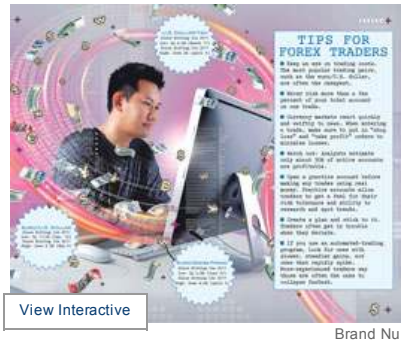
Michael Bolduc has seen his account wiped out three times since he started trading currencies. Yet he still keeps returning to the high-risk, high-reward foreign-exchange market for more.

Many people call it gambling—and he agrees.

Mr. Bolduc, a 52-year-old bill collector in Denver who began currency trading in 2003 after trading stocks for years, cites the ease of opening an account and getting a free charting program up and running quickly. He is one of a rapidly growing number of retail forex traders around the world.

"There seems to be so much money that can be made," he says.

Tips for Forex Traders



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Forex is the biggest financial market in the world, with some $4 trillion traded each day. While it is dominated by big banks, corporations and private investment funds, the retail segment is the fastest-growing, according to Bank for International Settlements. Daily retail volume in 2010 was $313 billion, up from $300 million in 2000, according to Boston-based research firm Aite Group LLC—which estimates volume will rise by at least 14% in 2011 alone.

Many forces are driving the boom, from stock-market volatility to a rise in online programs that have made forex easier than ever to trade. Giants like Citigroup Inc. have launched online currency-trading platforms geared toward smaller account sizes. Yet upstart online platforms like Oanda Corp. and Forex Capital Markets' FXCM are capturing much of the retail sector with smaller balance requirements, tighter trading spreads and low fees. A customer can open an account at Oanda with just a $1 balance, for example, while Citi FX Pro requires a minimum balance of $10,000.

All this comes at a time of rising volatility in currency markets caused by looming debt problems in the U.S. and Europe and signs of slowing U.S. growth. That volatility has been especially magnified in currency trading. In recent months the dollar fell to a record low against Japan's yen, dropping by more than 4% on the day it sank to that record low. Within 24 hours of hitting the low, the dollar was back up 7.5% against the yen from its record bottom.

Forex's frenetic pace can be brutal to rookies and sophisticates alike. Managing proper trade sizes and rapid price movements—all while using "leverage," or borrowed money, to amp up bets—can be devilishly difficult; one bad trade can blow up an entire account.

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The bottom line: Proceed with caution.

"I think individuals should allocate zero dollars to currency trading," says Joshua Brown, vice president of investments at Fusion Analytics Investment Partners LLC, an asset-management firm in New York. "To go to an online brokerage and think you're doing anything more than gambling is foolish."

Some advisers say there is a place for trading currencies—albeit as part of a broader investment strategy.

"If you are an investor looking for diversification, FX offers a real opportunity," says David Rodriguez, currency strategist at dailyFX.com, the research arm of FXCM. For example, traders looking to reduce the interest-rate risk of their overseas bond investments can buy the currency of that same country, since a currency often strengthens when rates rise, he says.

For those who want to try their luck, here are some tips:

The Biggest Brokers

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The Basics

Currencies trade in pairs, with investors buying one currency and selling another at the same time. The U.S. dollar/yen and euro/U.S. dollar are two of the most popular trading pairs; other popular ones include the British pound, Swiss franc and the Canadian and Australian dollars.

In a U.S. dollar/yen trade, for example, the amount of yen you can buy for one dollar is currently ¥80.65. If you bet on the dollar, the higher the number rises, the more you would make, and vice versa.

Mostly, the vice-versa scenario plays out: Only about 30% of all retail forex trades are profitable, according to Aite Group, largely because of traders' lack of education and experience in dealing with a market dominated by institutions. Commission costs, which run about $10 to $20 for a standard contract, also can add up quickly.

Traders often make bad trades far more damaging by using leverage, which can be as high as 50-to-1. Sure, profitable trades can be big: A fully leveraged $1,000 bet the euro would fall in relation to the U.S. dollar on July 1, for example, could have netted as much as $500 by Thursday afternoon. But even a small move the other way could wipe out your entire stake.

Forex used to be even riskier: Late last year, the National Futures Association, an independent self-regulator of futures trading in the U.S., cut the maximum ratio level for common currency pairs, such as the euro/U.S. dollar or U.S. dollar/yen, to 50-to-1 from 100-to-1. More-obscure pairs, which don't trade in such high volumes and thus are prone to bigger swings, are now restricted to a 25-to-1 leverage ratio, such as the U.S. dollar/Czech koruna and U.S. dollar/Mexican peso.

The lower leverage ratios mean a retail customer who put $1,000 into an account before the ratio was changed, and earned $100 in a month of trading euro/U.S. dollar or U.S. dollar/yen pairs, would now need to start with $2,000 in the account to earn that same $100. The new rules also reduce potential losses by an equal amount.

Until the retail forex market's explosive expansion, regulators generally assumed the sophisticated institutional investors who dominated the currency market could look after themselves without extra regulatory checks and balances.

Now, regulators like the NFA and Commodity Futures Trading Commission are trying to figure out how to protect ordinary folks from being crushed in a market whose genesis was as a hedging tool for big companies and investors, not as a betting vehicle for day traders.

Regulators often focus more on simple warnings than actually educating customers on how to set up trades and manage the pitfalls of trading, analysts say. As a result, many traders enter the market, quickly lose their initial investment—and never trade again. Professionals call them the "one and dones."

How to Trade Safely

• **Limit your forex trading.** In general, experts recommend that small investors devote no more than a few percentage points of their overall portfolio to forex trading in order to limit any possible damage.

• **Size your bet right.** Among the risks that traders should be aware of before they make their first transaction: "overtrading." That happens when customers trade a position that is too large compared with the size of their account. Brian Dolan, chief currency strategist at GAIN Capital

Holdings Inc.'s Forex.com trading platform and co-author of the book "Currency Trading for Dummies," recommends never putting more than 5% to 10% of an account balance into one trade. Overtrading often comes from a lack of a plan, Mr. Dolan says. Traders need to develop a strategy based on fundamental and technical analysis before initiating a trade.

Novice traders often get caught up in quick price movements and the potential for huge gains. That can lead them to lose focus on their strategy and ultimately end up with big losses. Yet the allure and adrenaline of a high-risk environment draw some back repeatedly. Others' lack of tolerance for steep losses means they lose their initial investment and never return.

Timing—and luck—play a big role in many forex trades. Mr. Bolduc, the Denver day trader, says his worst-ever trade, which involved multiple currencies, including the dollar, euro and Swiss franc, lost $8,000 over a long period of time. Conversely, he says he once made $2,500 "in a very short period of time" trading the euro-dollar pair by error—he mistakenly left open a trade order during the release of an economic report, leading to a rapid payoff.

• **Set limits.** One way to limit the damage is to set up a "stop-loss" order, which automatically exits a position when a certain price is hit, limiting losses.

Following Mr. Dolan's advice, for example, a trader with a $5,000 account wouldn't want to risk losing more than $500 on any particular trade and should set up a stop-loss order accordingly.

A trader might determine that the euro is about to go up against the U.S. dollar, and that a nice entry point is $1.4500. If that investor buys euros and sells dollars, he might place a stop-loss order at $1.4460, limiting his losses. If the trade is a standard-size one—often measured as 100,000 units—a drop from $1.4500 to $1.4460 would be equivalent to a loss of $400.

Traders also can use "take-profit" levels, or orders set up to automatically cash out at a preset profit, Mr. Dolan says. Take-profit levels keep traders from losing profits when currencies abruptly change direction, which often happens when economic reports or announcements are released. In the earlier scenario of the euro and the dollar, the trader could set up a take-profit order at $1.4600, which would lock in a profit of $1,000.

• **Beware of trading programs.** Most small investors also should avoid automated-trading programs that promise huge returns in a short time period. These programs—also known as "expert advisers," or EAs—execute trades in milliseconds and may raise even greater risks for unsophisticated investors. New EAs pop up online all the time and have names like IrisFx, Kangaroo EA and Forex Combo System. Their prevalence has grown rapidly in the past few years, analysts say. The Bank for International Settlements cited the rise of automated-trading systems as one of the key drivers of the market's growth in recent years.

The systems, which are similar to the ones used by hedge funds, can automatically execute trades when specific parameters such as price levels are hit. Those trades often occur at much faster speeds than a human could input and click through a trade online. That faster execution can enable better pricing and the ability to take advantage of smaller moves in markets.

But for all but the most experienced traders, the systems can have hidden dangers. As market dynamics change or news alters trends, the programs often "collapse at some point," says Walter Peters, an American living in Sydney. Mr. Peters started out as a retail trader and went on to develop his own automated programs, and now manages other people's forex accounts.

The programs that advertise huge returns in short periods are likely to crash and burn the fastest, he says. Computer programs that show smaller but steadier gains over long periods are the best bets.

• **Research.** Retail brokerages often provide vast amounts of data and historical trading information that can help inform trades and be used to spot trends. Some platforms, like Forex.com, also provide news feeds that give customers information that could be affecting the foreign-exchange market.

Nearly any major economic report or major news event can affect a currency, so news websites also can be tapped as resources for determining which way currencies might move.

• **Diversify.** There are other ways to minimize those potential losing periods that can frustrate and eventually drive retail customers away. Traders should diversify trading across multiple currencies or simultaneously use strategies that work in different market conditions, analysts say.

Mr. Peters says he puts only 10% of his money into automated trading programs, leaving the rest for manual trades. Winsor Hoang, who lives in Vancouver, British Columbia, and sells access to his trading strategies, has three automated-trading systems running at all times. The programs perform best in different market conditions, so when one might be losing, the others might be winning, he says.

Write to Stephen L. Bernard at stephen.bernard@dowjones.com

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