10 essentials of forex trading pdf

Throughout history, the sale and purchase of goods and services created a need for currency exchange standards. By the 20th century, the value of gold was the most important factor that traders relied on to assess the value of one country's currency versus another's. American Express notes that in 1944, international financiers who recognized the importance of foreign exchange markets met and drafted the Bretton Woods agreement. This agreement helped to standardize international currency trading exchange rates or valuations. Significantly, this new forex standard removed the value of gold as the basis for trading all currencies except the U.S. dollar. All other currencies traded on the foreign exchange at fixed rates against the U.S. dollar. Although this method of currency valuation no longer used gold as its standard, the value of the U.S. dollar remained tied to the value of gold. Therefore, the value of gold indirectly affected the value of all other currencies in the forex exchange system. By 1971, major world currencies abandoned fixed rates for foreign currency exchange, says Nasdaq. Widespread technological developments contributed to a shift toward online trading platforms and online brokers. International banks, investors and brokers all gained access to daily currency trading data with fewer delays. During the first 10 years of the 21st century, forex trading options increased participation in forex markets. Deregulation of certain types of financial transactions also made forex trading simpler for smaller, non-institutional investors. Over time, the standardized terms for foreign currency exchange morphed into the shortened term of forex, meaning currency exchanging in both consumer and speculative or investment markets. These two types of forex trading differ in several ways. However, the common element between them is the potential for fluctuations that increase or decrease the value of currencies you trade for another. For the consumer market, foreign currency exchanges normally take place at a bank or airport kiosk during international trips. When you travel internationally, you need to be able to pay for hotels and certain small purchases with local currency in most countries. Currency exchange rates fluctuate, and it's almost impossible to know the value of your own currency until you try to exchange it overseas. If you don't exchange currency in advance, you'll buy the currency of the country you're visiting at the rate set by forex activity that day. If you use your credit or debit card in a foreign country, your home bank also uses the forex rate to calculate the rate that you're paying in your own currency. Read More: Foreign Exchange Restrictions Currency trading for profit is somewhat like buying and selling stocks. Although this market is public, unlike with some stock trades, you must use a forex broker to take part in this investment. Licensed brokers offer accounts that allow you to invest in almost any currency, and you can have more than one forex account. With multiple electronic trading options, forex trading for beginners is only a mouse click or palm swipe away. Read More: The Foreign Exchange Trading Process Currency trading doesn't come with any FDIC insurance like your checking or savings account. War, natural disasters and even shady brokerage firms could cause the profit you expect from your forex investment to turn into losses or debts. Forex regulations do little to protect you against unanticipated currency fluctuations. Trades take place 24 hours a day in markets worldwide. This makes monitoring risks essential to successfully investing in this market. Read More: Pros & Cons of Foreign Exchange Markets The FOREX or foreign exchange market is the largest and most liquid market in the world. Prices are constantly changing as traders buy and sell currencies. There is a lot of data available to help traders, but the sheer amount of information might be overwhelming to those who are just entering the market. Using Excel, new traders can group and graph only the essential data and bypass some of the noise. Pick the currency pair or pairs that you intend to trade. In FOREX, currencies are traded in pairs. The first currency is called the base currency and the second currency is called the quote currency. For example, a EUR/USD currency pair tracks the value of a euro quoted in U.S. dollars. Obtain relevant information about the currency pair or pairs you identified in Step 1. The most important information is the price, but you can use other information as well. Other factors to consider include trading volume, open interest and a moving average of the price. Open a new Excel spreadsheet and input the information you obtained in Step 2. Input the data in either rows or columns, and use one row or column per data type. For example, if you input the data in columns, use one for price, another for volume and so on. Use the graph feature in Excel to create graphs of your data. There are several ways to do this step. Highlight one column at a time to create separate graphs for each data set, or highlight all the data to create a graph featuring all of the data sets. Use the graphs to aid you in making trading decisions. Once you have a graph of prices, look for patterns such as double tops or bottoms that indicate possible market reversals. If you graph trading volume, look at rising and falling volume in contrast to the price information, to determine the strength of price moves. Options trading may seem overwhelming at first, but it's easy to understand if you know a few key points. Investor portfolios are usually constructed with several asset classes. These may be stocks, bonds, ETFs, and even mutual funds. Options are another asset class, and when used correctly, they offer many advantages that trading stocks and ETFs alone cannot. An option is a contract giving the buyer the right, but not the obligation, to buy (in the case of a call) or sell (in the case of a put) the underlying asset at a specific price on or before a certain date. People use options for income, to speculate, and to hedge risk. Options are known as derivatives because they derive their value from an underlying asset. A stock option contract typically represents 100 shares of the underlying stock, but options may be written on any sort of underlying asset from bonds to currencies to commodities. Options are contracts that give the bearer the right, but not the obligation, to either buy or sell an amount of some underlying asset at a pre-determined price at or before the contract expires. Options can be purchased like most other asset classes with brokerage investment accounts. Options are powerful because they can enhance an individual's portfolio. They do this through added income, protection, and even leverage. Depending on the situation, there is usually an option scenario appropriate for an investor's goal. A popular example would be using options as an effective hedge against a declining stock market to limit downside losses. Options can also be used to generate recurring income. Additionally, they are often used for speculative purposes such as wagering on the direction of a stock. Alison Czinkota {Copyright} Investopedia, 2019. There is no free lunch with stocks and bonds. Options are no different. Options trading involves certain risks that the investor must be aware of before making a trade. This is why, when trading options with a broker, you usually see a disclaimer similar to the following. Options involve risks and are not suitable for everyone. Options trading can be speculative in nature and carry substantial risk of loss. Options belong to the larger group of securities known as derivatives. A derivative's price is dependent on or derived from the price of something else. Options are derivatives of financial securities—their value depends on the price of some other asset. Examples of derivatives include calls, puts, futures, forwards, swaps, and mortgage-backed securities, among others. Options are a type of derivative security. An option is a derivative because its price is intrinsically linked to the price of something else. If you buy an options contract, it grants you the right, but not the obligation to buy or sell an underlying asset at a set price on or before a certain date. A call option gives the holder the right to buy a stock and a put option gives the holder the right to sell a stock. Think of a call option as a down-payment for a future purchase. A potential homeowner sees a new development going up. That person may want the right to purchase a home in the future, but will only want to exercise that right once certain developments around the area are built. The potential home buyer would benefit from the option of buying or not. Imagine they can buy a call option from the developer to buy the home at say $400,000 at any point in the next three years. Well, they can—you know it as a non-refundable deposit. Naturally, the developer wouldn't grant such an option for free. The potential home buyer needs to contribute a down-payment to lock in that right. With respect to an option, this cost is known as the premium. It is the price of the option contract. In our home example, the deposit might be $20,000 that the buyer pays the developer. Let's say two years have passed, and now the developments are built and zoning has been approved. The home buyer exercises the option and buys the home for $400,000 because that is the contract purchased. The market value of that home may have doubled to $800,000. But because the down payment locked in a pre-determined price, the buyer pays $400,000. Now, in an alternate scenario, say the zoning approval doesn't come through until year four. This is one year past the expiration of this option. Now the home buyer must pay the market price because the contract has expired. In either case, the developer keeps the original $20,000 collected. Now, think of a put option as an insurance policy. If you own your home, you are likely familiar with purchasing homeowner's insurance. A homeowner buys a homeowner's policy to protect their home from damage. They pay an amount called the premium, for some amount of time, let's say a year. The policy has a face value and gives the insurance holder protection in the event the home is damaged. What if, instead of a home, your asset was a stock or index investment? Similarly, if an investor wants insurance on their S&P 500 index portfolio, they can purchase put options. An investor may fear that a bear market is near and may be unwilling to lose more than 10% of their long position in the S&P 500 index. If the S&P 500 is currently trading at $2500, they can purchase a put option giving the right to sell the index at $2250, for example, at any point in the next two years. If in six months the market crashes by 20% (500 points on the index), they have made 250 points by being able to sell the index at $2,250 when it is trading at $2,000—a combined loss of just 10%. In fact, even if the market drops to zero, the loss would only be 10% if this put option is held. Again, purchasing the option will carry a cost (the premium), and if the market doesn't drop during that period, the maximum loss on the option is just the premium spent. There are four things you can do with options: Buy calls Sell calls Buy puts Sell puts Buying stock gives you a long position. Buying a call option gives you a potential long position in the underlying stock. Short-selling a stock gives you a short position. Selling a naked or uncovered call gives you a potential short position in the underlying stock. Buying a put option gives you a potential short position in the underlying stock. Selling a naked or unmarried put gives you a potential long position in the underlying stock. Keeping these four scenarios straight is crucial. People who buy options are called holders and those who sell options are called writers of options. Here is the important distinction between holders and writers: Call holders and put holders (buyers) are not obligated to buy or sell. They have the choice to exercise their rights. This limits the risk of buyers of options to only the premium spent. Call writers and put writers (sellers), however, are obligated to buy or sell if the option expires in-the-money (more on that below). This means that a seller may be required to make good on a promise to buy or sell. It also implies that option sellers have exposure to more, and in some cases, unlimited, risks. This means writers can lose much more than the price of the options premium. Speculation is a wager on future price direction. A speculator might think the price of a stock will go up, perhaps based on fundamental analysis or technical analysis. A speculator might buy the stock or buy a call option on the stock. Speculating with a call option—instead of buying the stock outright—is attractive to some traders since options provide leverage. An out-of-the-money call option may only cost a few dollars or even cents compared to the full price of a $100 stock. Options were really invented for hedging purposes. Hedging with options is meant to reduce risk at a reasonable cost. Here, we can think of using options like an insurance policy. Just as you insure your house or car, options can be used to insure your investments against a downturn. Imagine that you want to buy technology stocks. But you also want to limit losses. By using put options, you could limit your downside risk and enjoy all the upside in a cost-effective way. For short sellers, call options can be used to limit losses if the underlying price moves against their trade—especially during a short squeeze. In terms of valuing option contracts, it is essentially all about determining the probabilities of future price events. The more likely something is to occur, the more expensive an option would be that profits from that event. For instance, a call value goes up as the stock (underlying) goes up. This is the key to understanding the relative value of options. The less time there is until expiry, the less value an option will have. This is because the chances of a price move in the underlying stock diminish as we draw closer to expiry. This is why an option is a wasting asset. If you buy a one-month option that is out of the money, and the stock doesn't move, the option becomes less valuable with each passing day. Since time is a component to the price of an option, a one-month option is going to be less valuable than a three-month option. This is because with more time available, the probability of a price move in your favor increases, and vice versa. Accordingly, the same option strike that expires in a year will cost more than the same strike for one month. This wasting feature of options is a result of time decay. The same option will be worth less tomorrow than it is today if the price of the stock doesn't move. Volatility also increases the price of an option. This is because uncertainty pushes the odds of an outcome higher. If the volatility of the underlying asset increases, larger price swings increase the possibilities of substantial moves both up and down. Greater price swings will increase the chances of an event occurring. Therefore, the greater the volatility, the greater the price of the option. Options trading and volatility are intrinsically linked to each other in this way. On most U.S. exchanges, a stock option contract is the option to buy or sell 100 shares; that's why you must multiply the contract premium by 100 to get the total amount you'll have to spend to buy the call. What happened to our option investment May 1 May 21 Expiry Date Stock Price $67 $78 $62 Option Price $3.15 $8.25 worthless Contract Value $315 $825 $0 Paper Gain/Loss $0 $510 -$315 The majority of the time, holders choose to take their profits by trading out (closing out) their position. This means that option holders sell their options in the market, and writers buy their positions back to close. Only about 10% of options are exercised, 60% are traded (closed) out, and 30% expire worthlessly. Fluctuations in option prices can be explained by intrinsic value and extrinsic value, which is also known as time value. An option's premium is the combination of its intrinsic value and time value. Intrinsic value is the in-the-money amount of an options contract, which, for a call option, is the amount above the strike price that the stock is trading. Time value represents the added value an investor has to pay for an option above the intrinsic value. This is the extrinsic value or time value. So, the price of the option in our example can be thought of as the following: Premium = Intrinsic Value + Time Value $8.25 $8.00 $0.25 In real life, options almost always trade at some level above their intrinsic value, because the probability of an event occurring is never absolutely zero, even if it is highly unlikely. American options can be exercised at any time between the date of purchase and the expiration date. European options are different from American options in that they can only be exercised at the end of their lives on their expiration date. The distinction between American and European options has nothing to do with geography, only with early exercise. Many options on stock indexes are of the European type. Because the right to exercise early has some value, an American option typically carries a higher premium than an otherwise identical European option. This is because the early exercise feature is desirable and commands a premium. There are also exotic options, which are exotic because there might be a variation on the payoff profiles from the plain vanilla options. Or they can become totally different products all together with "optionality" embedded in them. For example, binary options have a simple payoff structure that is determined if the payoff event happens regardless of the degree. Other types of exotic options include knock-out, knock-in, barrier options, lookback options, Asian options, and Bermudan options. Again, exotic options are typically for professional derivatives traders. Options can also be categorized by their duration. Short-term options are those that expire generally within a year. Long-term options with expirations greater than a year are classified as long-term equity anticipation securities or LEAPs. LEAPS are identical to regular options, they just have longer durations. Options can also be distinguished by when their expiration date falls. Sets of options now expire weekly on each Friday, at the end of the month, or even on a daily basis. Index and ETF options also sometimes offer quarterly expiries. More and more traders are finding option data through online sources. While each source has its own format for presenting the data, the key components generally include the following variables: Volume (VLM) simply tells you how many contracts of a particular option were traded during the latest session. The "bid" price is the latest price level at which a market participant wishes to buy a particular option. The "ask" price is the latest price offered by a market participant to sell a particular option. Implied Bid Volatility (IMPL BID VOL) can be thought of as the future uncertainty of price direction and speed. This value is calculated by an option-pricing model such as the Black-Scholes model and represents the level of expected future volatility based on the current price of the option. Open Interest (OPTN OP) number indicates the total number of contracts of a particular option that have been opened. Open interest decreases as open trades are closed. Delta can be thought of as a probability. For instance, a 30-delta option has roughly a 30% chance of expiring in-the-money. Delta also measures the option's sensitivity to immediate price changes in the underlying. The price of a 30-delta option will change by 30 cents if the underlying security changes its price by one dollar. Gamma (GMM) is the speed the option is moving in or out-of-the-money. Gamma can also be thought of as the movement of the delta. Vega is a Greek value that indicates the amount by which the price of the option would be expected to change based on a one-point change in implied volatility. Theta is the Greek value that indicates how much value an option will lose with the passage of one day's time. The "strike price" is the price at which the buyer of the option can buy or sell the underlying security if they choose to exercise the option. Buying at the bid and selling at the ask is how market makers make their living. The simplest options position is a long call (or put) by itself. This position profits if the price of the underlying rises (falls), and your downside is limited to loss of the option premium spent. If you simultaneously buy a call and put option with the same strike and expiration, you've created a straddle. This position pays off if the underlying price rises or falls dramatically; however, if the price remains relatively stable, you lose premium on both the call and the put. You would enter this strategy if you expect a large move in the stock but are not sure which direction. Basically, you need the stock to have a move outside of a range. A similar strategy betting on an outsized move in the securities when you expect high volatility (uncertainty) is to buy a call and buy a put with different strikes and the same expiration—known as a strangle. A strangle requires larger price moves in either direction to profit but is also less expensive than a straddle. On the other hand, being short either a straddle or a strangle (selling both options) would profit from a market that doesn't move much. Below is an explanation of straddles from my Options for Beginners course: And here's a description of strangles: Spreads use two or more options positions of the same class. They combine having a market opinion (speculation) with limiting losses (hedging). Spreads often limit potential upside as well. Yet these strategies can still be desirable since they usually cost less when compared to a single options leg. Vertical spreads involve selling one option to buy another. Generally, the second option is the same type and same expiration, but a different strike. A bull call spread, or bull call vertical spread, is created by buying a call and simultaneously selling another call with a higher strike price and the same expiration. The spread is profitable if the underlying asset increases in price, but the upside is limited due to the short call strike. The benefit, however, is that selling the higher strike call reduces the cost of buying the lower one. Similarly, a bear put spread, or bear put vertical spread, involves buying a put and selling a second put with a lower strike and the same expiration. If you buy and sell options with different expirations, it is known as a calendar spread or time spread. Combinations are trades constructed with both a call and a put. There is a special type of combination known as a "synthetic." The point of a synthetic is to create an options position that behaves like an underlying asset, but without actually controlling the asset. Why not just buy the stock? Maybe some legal or regulatory reason restricts you from owning it. But you may be allowed to create a synthetic position using options. A butterfly consists of options at three strikes, equally spaced apart, where all options are of the same type (either all calls or all puts) and have the same expiration. In a long butterfly, the middle strike option is sold and the outside strikes are bought in a ratio of 1:2:1 (buy one, sell two, buy one). If this ratio does not hold, it is not a butterfly. The outside strikes are commonly referred to as the wings of the butterfly, and the inside strike as the body. The value of a butterfly can never fall below zero. Closely related to the butterfly is the condor - the difference is that the middle options are not at the same strike price. Because options prices can be modeled mathematically with a model such as the Black-Scholes, many of the risks associated with options can also be modeled and understood. This particular feature of options actually makes them arguably less risky than other asset classes, or at least allows the risks associated with options to be understood and evaluated. Individual risks have been assigned Greek letter names, and are sometimes referred to simply as "the Greeks." Below is a very basic way to begin thinking about the concepts of Greeks. Options do not have to be difficult to understand once you grasp the basic concepts. Options can provide opportunities when used correctly and can be harmful when used incorrectly. (For related reading, see "Best Online Stock Brokers for Options Trading")