Forex dos and don’ts

Trading and investing in the volatile currency market calls for understanding and care. MINDY TAN reports

The global foreign exchange market is huge. In April 2016, the market’s average daily turnover was estimated at US$1.98 trillion, a growth of some 20 per cent over April 2007, according to the Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2010 conducted by the Bank for International Settlements (BIS).

While it is true that the foreign exchange market is one of the most exciting markets around, is it the right platform for young investors? Low Buen Sin, director of NTU-SGX Centre for Financial Education, says: “Newcomers in forex, stock and other asset markets should first try to become investors instead of traders. Trading should be done only after you have accumulated an adequate sum of investment and can afford to put some spare cash to take trading risk.

While used interchangeably by laymen, a clear line should be drawn between “trading” and “investing.”

In trading, the appreciation of capital is the objective; if dividends are paid out, this is an added advantage. Traders look to profit on short-term price fluctuations, which means the amount of time an active trader holds on to an asset is very short.

In contrast, investing looks more towards income over time. Income producers – for example, dividend or bond interest payments – are thus the prime motivation.

Professor Low adds: “Foreign currencies can be a rewarding asset class to invest in. The investment can be done by directly investing in foreign currency deposits or bonds, or FX funds. It can also be invested indirectly through equities and other foreign currency-denominated assets. A more sophisticated investor can consider capital-protected structured products.”

What is forex?

When talking about forex, the image conjured up in the mind of most people is the risky and exciting world of forex trading.

The foreign exchange market is the figurative place where currencies are traded. The need for exchange currencies is the primary reason why the forex market is the largest, most liquid financial market in the world.

There is no central marketplace for foreign exchange: rather, currency trading is conducted electronically between traders around the world.

The main thing young investors should be aware of is the fact that forex trading has much higher leverage than the stock market. When someone decides to invest in forex, they can expect higher profits – and, conversely, higher losses.

Currency trading is generally short-term in nature. A day trader who buys euros versus the dollar is not trying to predict what is going to happen to the euro in the next 10 years; he is concerned with the price fluctuations after he enters a position.

His goal is for the euro to appreciate in value as soon as possible after his purchase. In order to increase his chances of trading successfully, a currency trader will study the past price history of the currency pair he is trading and compare it to the current prices to determine what the price is probably going to do next.

Many people use forex as a means of diversification. According to Jeremy Goh, associate professor of finance at SMU’s Lee Kong Chian School of Business: “The key to having a diversified portfolio is to not hold just a single class of assets. Hence, having forex in one’s portfolio can be a good source of diversification. The basic idea is that forex returns are not perfectly correlated with the market, just like bonds, real estate and commodities. So as long as you have an asset class that is not perfectly correlated to the market, having them in a portfolio will help with diversification of unsystematic (or idiosyncratic) risks.”

The trading pairs

Major currency trading consists of seven international currency pairs which are divided into the majors, and the commodity pairs.

The majors are the most liquid and thus the most widely traded currency pairs. They include euro/US dollar, US dollar/yen, British pound/US dollar, and US dollar/Swiss franc.

The commodity pairs consist of major currencies trading associated with commodities. US dollar/canada/US dollar is associated with oil commodities, whereas Australian dollar/US dollar and New Zealand dollar/US dollar are closely associated with gold commodities. Forex traders often trade these commodity pairs to gain exposure to commodity volatility.

Each pair responds to different events and requires a unique approach and strategy.

“The specific currency pairs that you choose would depend on several factors,” says Ser-Keng Ang, senior lecturer of finance at SMU’s Lee Kong Chian School of Business.

“One such factor is liquidity or volume. Generally, the G-7 currencies have good liquidity or volume. It is also dependent on your appreciation and understanding of the economies of the two countries – for example, to understand how the Australian dollar performs, you would need to understand that its value is driven by commodities (hence it is known as a commodity currency), and who it sells these commodities to (for example, China, to fuel its growth). This explains why the Australian dollar has appreciated significantly, in tandem with China’s fast pace of growth.”

A final caveat emptor

Though currencies don’t tend to move as sharply as equities on a percentage basis (where a company’s stock can lose a large portion of its value in a matter of minutes after a bad announcement), it is the leverage in the market that creates the volatility. It is therefore important to take into account the risks involved in the forex market before diving in.

NTU’s Prof Low says: “Before entering the FX market, you must know the forex market well and you must have time. Trading is not something you spend 5-10 minutes on. You must pay attention to market movements because you are essentially taking advantage of short-term changes. You must also understand how to control downside risk and the maximum loss you are willing to incur.”

SMU’s Mr Ang adds: “I would recommend that young investors undergo requisite training to understand the market and to monitor the market carefully before putting a significant proportion of their monies into FX trading. Set some trading rules to ensure trading discipline is maintained – for example, set a time horizon, level of return and/or cut-loss levels. This will provide a non-emotional way of trading. Prudence also dictates that one should diversify one’s portfolio.”

(Next week, we will show you how you can get exposure to currencies and forex, without getting involved in forex trading.)