TOPSTEP FX™

10 COMMANDMENTS OF FOREX TRADING

Welcome to Topstep's 10 Commandments of Forex Trading. This ebook is meant to give you a general overview of the skills you will need to succeed in the currency markets. We have conveniently broken down the basics of forex trading into 10 rules that we feel every trader should follow—or at bare minimum understand. Since we have a slight flair for the dramatic, we decided to call these the 10 Commandments of Forex Trading.

We hope that you find value in these rules, but remember, this is only the beginning. Forex trading is one of the hardest games on Earth and becoming a master requires practice, patience, and a deep dedication to improvement. Only a small fraction of those who trade will find success, but for those who do, the rewards are great.

Please be sure to visit the Topstep blog and YouTube page to find additional resources beyond this booklet. We wish you the best on your journey toward consistent profitability, and we can't wait to see what you can accomplish!

TOPSTEPFX™

ALWAYS BE AWARE OF FUNDAMENTALS

1

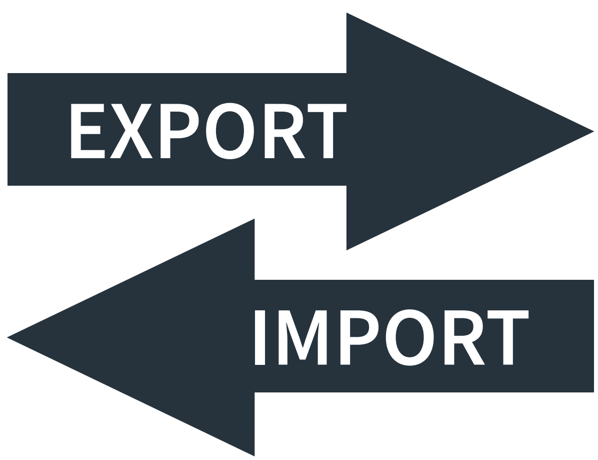
First, let's define what fundamental analysis is. This is the method of evaluating the intrinsic or fair value of a product (in this case a currency market) based on the position of that nation's economy.

Retail traders are often drawn to the technical side of the market, and for a good reason. There are many educational resources readily available to assist in one's learning curve of the technical analysis of trading. Whereas fundamental analysis often requires a different level of attention.

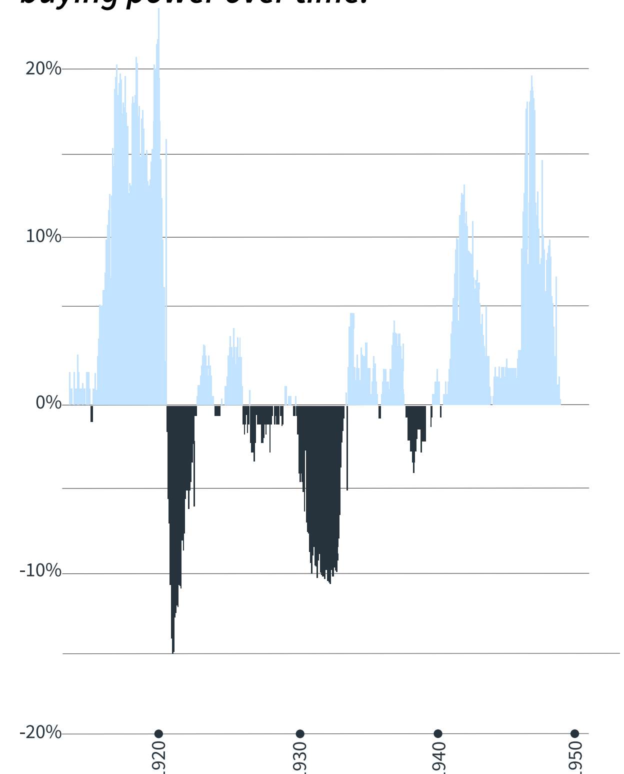
2018 GDP (US$billions) of 5 largest economies according to the World Bank.

1	U.S	20,494
2	China	13,608
3	Japan	4,970
4	Germany	3,996
5	U.K	2,825

Balance of trade is fundamental to the value of a nation's currency.



The Inflation rate measures changes in buying power over time.



Fundamental analysis also has a reputation for being disconnected from the underlying price, and this observation may be correct. However, technical patterns are by no means flawless methods either. Whereas technical moves often give a micro indication, the fundamental view gives a much larger picture of the background music (so to speak). If you look at significant trading desks around the world, you'll find that fundamental analysis plays a vital role in the day to day decision making of professional traders.

If you trade for any length of time, you will notice busy economic calendars throughout the world. Various indicators of financial health are reported on a near-daily basis; some of these are significant indicators, others are minor. You have likely noticed that some volatility often accompanies these notable economic releases. However, you may not have ever taken time to interpret the meaning of these indicators.

> **"Institutions have the brightest economic minds in the world, let them do homework for you."**

Fundamental tactics require further observation than drawing lines on a chart, and this is where doing your homework becomes important. You don't have to become an economist to think and trade like one.

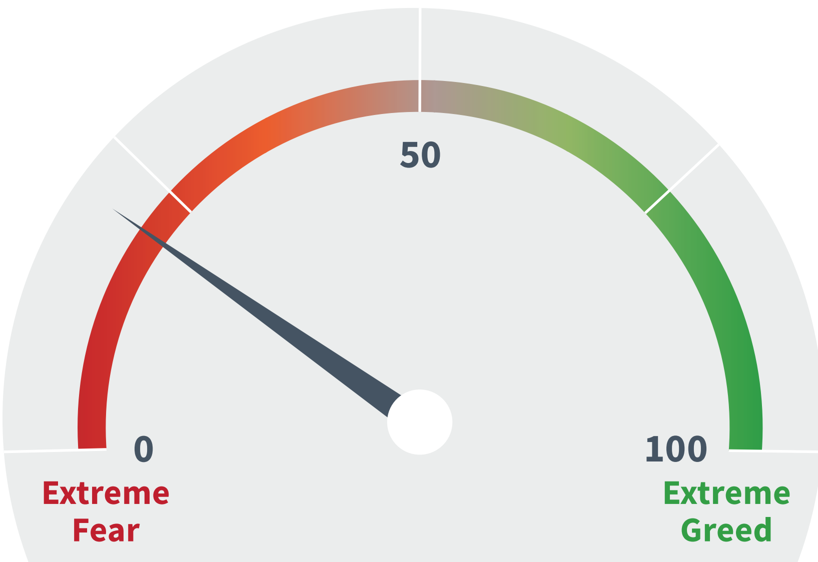
When you choose a global economic calendar, look for one that will mark which events are of extreme importance, such as GDP, employment numbers, and central bank meetings. Also, locate resources that feature analysis from a real economist—both before the economic release and following the indication. Be sure to read more than one opinion on the matter. Sometimes traders have a mistrust of institutional economists who are experts in theory but have never traded. I'm only suggesting you follow their fundamental assessment and make your own trading choice. Institutions have the brightest economic minds in the world, let them do homework for you.

Lastly, how does one implement this information? When it comes to significant indicators, there is often a consensus of economic interpretation. After all, fundamental analysis can be subjective but less so than technical patterns.

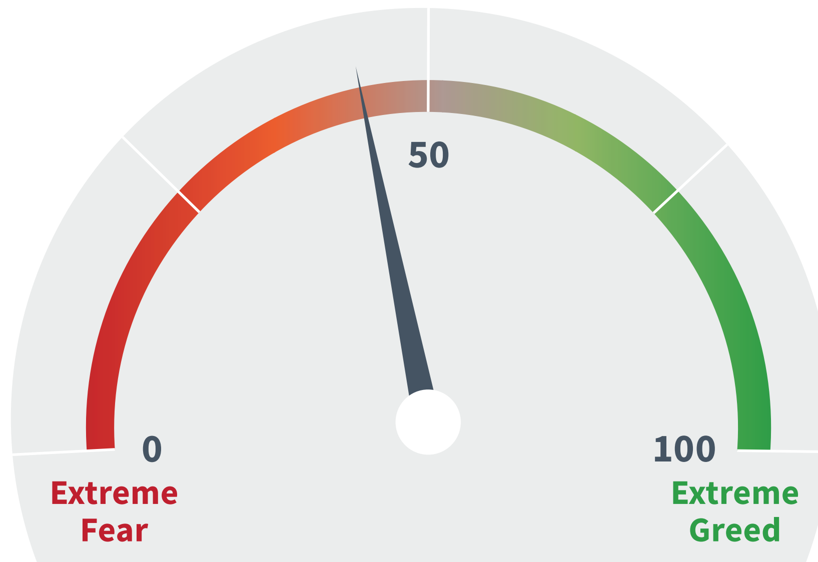
Some analysts may be “light bears,” while others “strong bears” and many in between. Widely speaking, when interest rates are fluctuating, or employment is shifting, there is a general understanding of what is occurring.

Fundamentals can work for you in this manner. When you are trading with the fundamental grain, you might be confident of holding a trade longer looking for more measurable realized gains. However, should you position against the economic trend, then you should at least be aware of this. In response, you may consider trading with less size since there is reason to believe you might be on the wrong side of the market.

CNN’s Fear and Greed index comprises 7 factors to gauge market sentiment.



Extreme Bear Consensus



Light Bear Consensus

ALWAYS BE AWARE OF THE TECHNICALS

2

Technical trading is centered on the chart and revolves around using price history and patterns to anticipate future movements. By no means is this methodology flawless; however, it is the quickest to learn, and there are many available resources to assist in your learning curve.

As with any practice, the longer one watches charts; the more conscious they will be of the flows and setups created. Technical analysis has very scientific and mathematical formulations that make the methods consistently applied to any market. However, there is an underemphasized art that comes with trading charts.

Technical analysis is often evolving, and new ways are found to implement various indications onto the chart. However, as a science, the concepts have been used for quite some time.

One famous trader was known to chart hundreds of markets each night in the days before easily accessible charting. Back then, the wealthy would often pay college students to create a line graph chart for visibility. There was an art to reading charts that were manufactured by this less technological culture.

Daily EUR/USD chart with multiple Moving Averages and Volatility indicators.

Technology has come a long way, as we now have access to market data throughout the world in real-time. Additionally, we have available to us charting programs that feature extensive libraries of indicators. If those indicators are not enough, we can learn how to construct our own indicators and algorithms. As technology has grown, so has our ability to move quickly, and to take away some of the mental strain by having to think and calculate less, and the emotional stress by having a programmed plan.

THE DEBATE OVER FUNDAMENTALS vs. TECHNICALS IS A *FALSE DICHOTOMY.*

The debate over fundamentals vs. technicals is a false dichotomy. It is not an either-or proposition but a both/and scenario. When you combine the fundamental basis mentioned in rule #1 with formulated plans based on technical analysis, you have leveled the playing field considerably for yourself.

Some traders may thrive with and genuinely enjoy utilizing the complex technical systems. However, one can still be profitable with far more basic systems by mastering principles such as risk management and trading psychology. The concept of keeping it simple can benefit many technical traders. With all of the advertising of dream return systems that make us lust for money, often, the answer lies within one's self. What works for a trader with one style and personality may be different than what works for you.

3

THE TREND IS YOUR FRIEND (UNTIL IT CHANGES)

There is a well-repeated adage among the investing and trading communities that "the trend is your friend;" however, rarely is this expression qualified. Trading attracts various personalities who find unique styles that match their persona. This is no more evident than in a trending market.

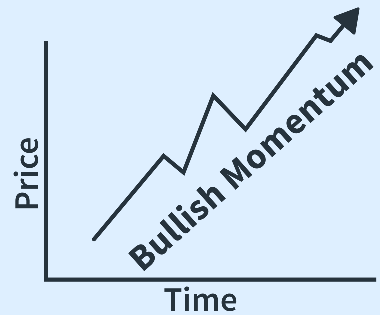
On one side, there are momentum traders trying to catch and ride the trend; on the opposite end of the spectrum are the contrarians, looking to find reversal signals.

Each approach is valid. Trend traders sometimes find they must hold positions longer to earn a desirable profit. Meanwhile, traders looking for trend reversals often experience lower win-loss ratios. Still, they may often be able to use a higher reward-to-risk ratio.

Whether you are trading with or against the trend, being aware of the direction is vital. In this way, you can appropriately judge your size and risk-to-reward ratio.

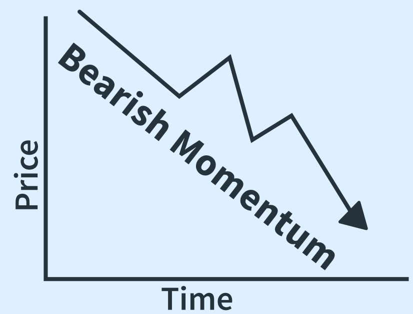
> **"On one side, there are momentum traders trying to catch and ride the trend; on the opposite end of the spectrum are the contrarians, looking to find reversal signals."**

Traders who prefer the path of less resistance may opt for a trend-following strategy. Rather than going against the grain, you are fighting with momentum. There is something psychologically challenging for traders about buying near the top of a breakout. If this is you, then you may consider trading short-term trend breaks, such as a small pullback in an uptrend.



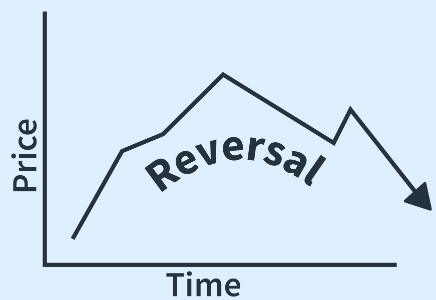
Uptrend

A market trending higher, or an uptrend, is identified by a series of consecutive higher highs and higher lows.



Downtrend

Inversely, a market trending lower, or a downtrend, is identified by a series of consecutive lower highs and lower lows.



Trend Reversal

A trend reversal occurs when sentiment shifts and an uptrend turns into a downtrend, or vice versa.

Most charts show that nothing goes straight up or down—there is usually a series of zig-zags along the way. If you can find a healthy market, trending higher, in a moment of short-term weakness, you may implement a useful trend continuation strategy.

The trend is your friend. It's challenging to turn an 18-wheeler around, even more so to re-route an aircraft carrier. However, it's telling that most retail sentiment indicators show non-institutional traders trying to go against the trending momentum. At the same time, it is widely known that most retail traders lose money.

> **ON ONE SIDE, THERE ARE MOMENTUM TRADERS TRYING TO *CATCH AND RIDE* THE TREND; ON THE OPPOSITE END OF THE SPECTRUM ARE THE CONTRARIANS, LOOKING TO FIND *REVERSAL SIGNALS.***

Another trading pitfall is falling in love with positions. Trading is not a marriage; there is no commitment to any side of the market. What often happens to traders who trade consistently from one side of a trending market is that they only view that side. Hence when the trend changes, they refuse to change and, in turn, become counter-trend traders.

A wise, old trader once likened trading to being a mercenary soldier. This means you must be willing to go with the side that's winning and paying the most. At the same time, you cannot hesitate to switch sides when the tide of battle turns.

4

KNOW WHAT TIME IT IS

Time value is important on so many levels when trading financial markets. When analyzing an instrument, know which times affect your said market.

For instance, we might start with the macro and work our way down. There are certain portions of the calendar year that are relevant to your market. It may be because of how the price history performs in a particular season. Additionally, there also may be some fundamental reason why the market should behave differently at different times of the year. This is something that swing traders, in particular, should pay attention to.

Secondly, there are periods within each quarter of the year, and each month of the year. Institutions will tend to flow money into markets at the beginning of both the quarter and each month, which could create higher momentum. It is helpful to mark the open of each month on your chart. Likewise, big money often adjusts and rebalances positions at the end of the quarter or month. This will often lead to some profit-taking or filtering out holdings that are not performing well. This again may create momentum, or more often, counter-trend opportunities.

Each market has a way it behaves during the week as well, and often this shifts according to sentiment. This will be unique to the instrument you trade. Still, you can look for patterns, it may be that when a market is trending higher, it tends to be bullish on Mondays. Then perhaps this market trades weaker in the middle of the week (Turnaround Tuesday and Wednesday) only to resume a rally late in the week. Even intraday, your market will develop different patterns.

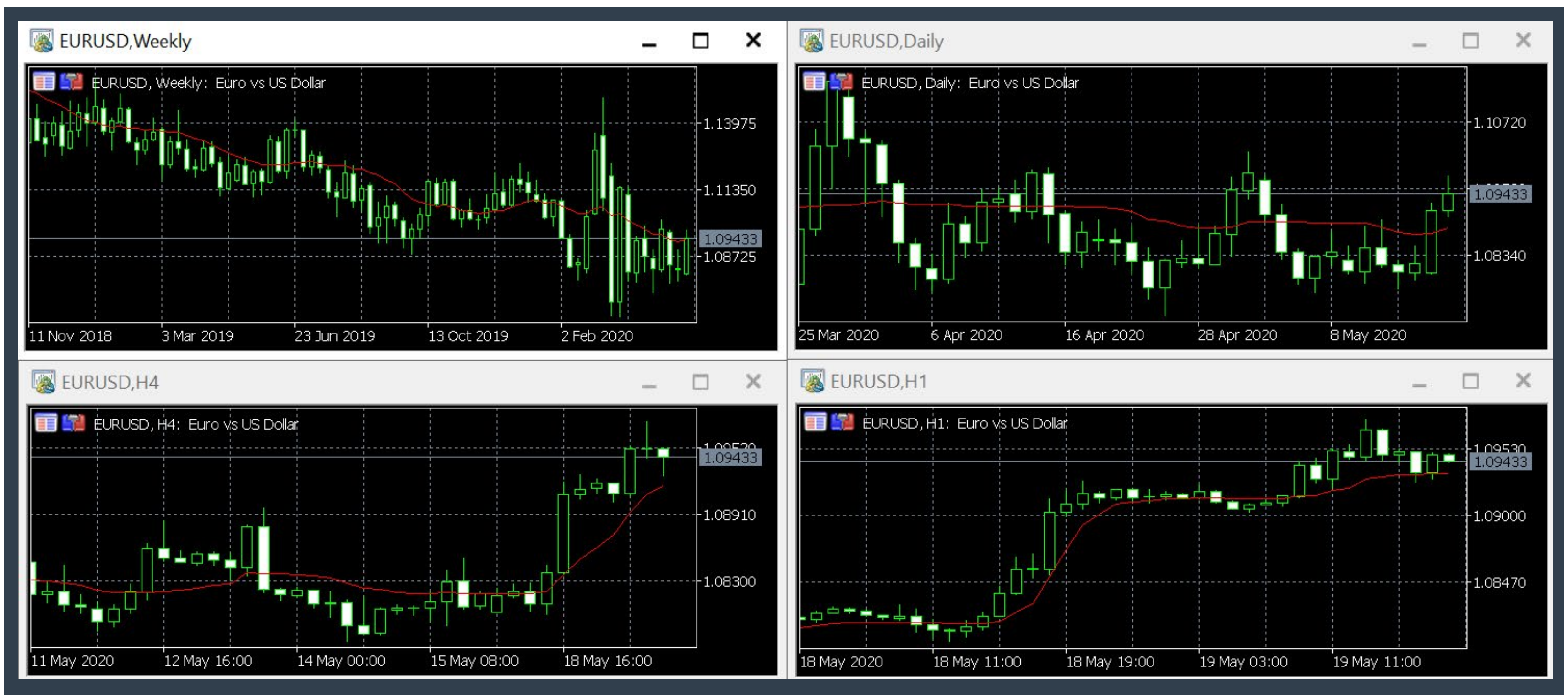
Be aware of seasonal trends and economic announcements.

For Forex traders, an instrument may behave differently from the Asian session to the European hours and then to the New York timeframe. Additionally, given what is on the economic calendar for the day, a market may experience unusual volatility when indicators are released.

Some markets tend to rise in the Asian and Euro sessions and then sell off when New York opens. Furthermore, if you are trading a currency market that is highly correlated to U.S. equities, then you may see volatility when the U.S. stock markets open. Or for example, if you are trading the Canadian dollar, then you are aware that it is closely related to crude oil. In this case, you may see a surplus of volatility on figures in the U.S. correlated to oil.

An additional way a trader should be aware of time is by looking at their market on multiple time frames. If you don't trade time-based charts, then you still may want to look at various bar frames. Depending on your style, it may be helpful to use three or even more different periods on the charts.

For example, if you swing trade, you may want to look at a monthly, weekly, and daily chart to detect your overall bias. Then you may wish to have an hourly chart to time your specific entry. Likewise, if you are a micro day trader, you may want to see a broader market view before making a decision. In this case, you might have a one, five, and a fifteen-minute chart to see a more comprehensive view of your market before making a trade.



EUR/USD Chart: Weekly, Daily, 4-Hour, 1-Hour

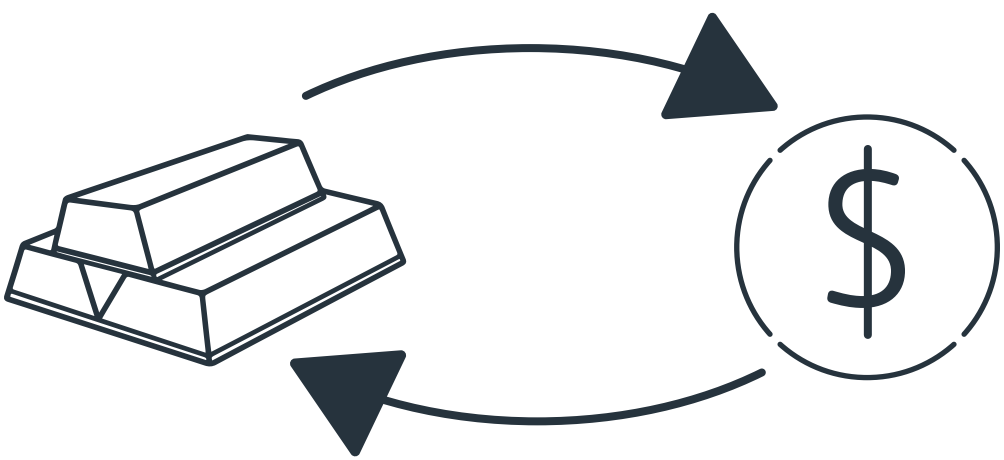
PAIR A STRONG MARKET WITH A WEAK MARKET

5

This is a rule that may seem to have a very particular appeal to currency trading; however, every kind of trading is a pairs trade. If one is trading an individual stock, that stock is paired against the underlying currency. If one buys a commodity future such as gold on the CME, then they are trading gold against the U.S. Dollar.

When it comes to Forex, traders are much more consciously aware that they are pairing one market directly to another. However, sometimes traders fail to appreciate the flexibility that currency trading offers in terms of picking an ideal pair.

You have probably observed many instances of a specific currency trading higher against one market but then lower against another currency. This can be frustrating if traders have shorted a market, and theirs is going sideways or even against them. Meanwhile, against every other pair, their chosen currency may be weaker.



All currencies have fundamental correlations.

For example, let's assume you believe that the fundamental picture for the U.S. Dollar is bearish. Then when looking at the charts, there seems to be confirmed resistance at the dollar's current price, or perhaps even some downward momentum already developing. In this case, you may want to short the dollar. You may be used to trading the dollar versus the Japanese Yen (USD/JPY); in this case, you would short the product to profit from a bearish dollar. However, what if the Yen was also seeing some weakness as conditions in Japan were creating a bearish yen. In this case, your trade may go sideways or could possibly even go against you.

Now, let's say the Canadian Dollar has fundamental and even technical reasons why it is bullish. Then this is the market you may consider buying against the dollar by shorting the USD/CAD.

In Forex trading, it is essential to remember that you can be correct about the general direction of a currency. Still, if you don't pair it shrewdly, then this may be the difference between large gains and modest gains, or even a loss.

> **IT IS ESSENTIAL TO REMEMBER THAT YOU CAN BE CORRECT ABOUT THE GENERAL DIRECTION OF *A CURRENCY.***

RISK-TO-REWARD - THINK LIKE A MATHEMATICIAN

6

When I talk to new traders, I find that very few ever consider reward-to-risk (R2R) when establishing their trading plan. With others, I find that they have either consciously or unconsciously allowed for their R2R to be less than 1:1. Furthermore, most new traders I've interviewed find the suggestion of a 2:1 or even 3:1 R2R to be unfathomable.

First, let's look at some of the mathematics behind the developing thesis. If you are going to use an R2R ratio of 1:2, risk two to make one that is (and yes, I have seen traders attempt such a strategy). Then you would need a 70% win rate just to keep your head above water and break even after commissions, data, and platform fees. Think about it in simple terminology—if you lose $2 on three trades, that equals $6. If you earn $1 on the other seven trades, then you've barely come out ahead.

From my experience in both professional and retail work, a 70% win rate is extremely rare over the long haul. Additionally, with this type of R2R, you would need to be trading huge size or extremely frequently to earn an income.

But then, in this system, let's say you have five losing trades in a row, which most definitely will happen at some point. In this case, let's say you lost $2 per trade and are now down $10. To earn this $10 back over the next twenty trades using the same size would require 85% accuracy. A 15% better rate than the 70% win rate, and this would be just to get back to even and cover costs.

"I find that very few ever consider reward-to-risk (R2R) when establishing their trading plan"

Now, alternatively, let's say you use an R2R of 3:1, earning three for every one risked. In this case, you could be profitable with a 40% win rate. Consider six losing trades risking $1 amounts to $6; meanwhile, four results earning $3 amounts to $12. What this scenario suggests is that with this R2R, one could have roughly half the win rate and still make twice as much as they lost!

Now, let's see what happens when this strategy loses five trades in a row, which amounts to $5. The twenty results that follow would require a 35% win rate to return to profitability, which is even less than the 40% assumed win rate of this strategy.

I have observed that many retail and especially new traders, see a 3:1 R2R ratio as being astronomical. However, this type of approach with a sub 50% win rate is common among professional and institutional traders. In fact, if you think this is extreme, I know one profitable trader who utilized a 9:1 R2R ratio and is profitable about 20% of the time. Furthermore, I once spoke to a fund manager—who you may have seen on TV at some point—and he told me that his most successful year was when he had the lowest win rate on his trades. He somehow lost on more than 90% of his positions, but had a very successful year. How did he do this? See rule #7 coming up.

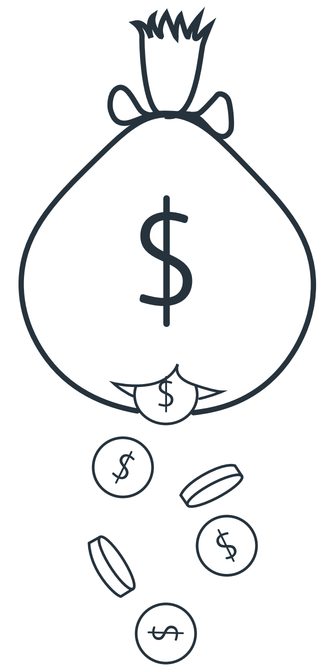
Reward	Risk	Breakeven Win Rate %
1	50	98%
1	10	91%
1	5	83%
1	3	75%
1	2	67%
1	1	50%
2	1	33%
3	1	25%
5	1	17%
10	1	9%
50	1	2%

Your R2R ratio should directly reflect your strategy's Win/Loss ratio.

ALLOCATE LIKE A RISK MANAGER

7

One of the biggest mistakes that new traders make is allocating too much of their accounts to one or two positions. In gambling, this might be called "going all in," however, in trading, this is synonymous with failure. An oversized holding may enjoy the fruit of profitability when the trade goes your way. However, when things don't go your way, and especially when on a losing streak, going all-in will leave your account in ruins.



Given the leverage one enjoys in Forex trading, it is imperative that you trade responsibly. With 50:1 leverage, one can control $100,000 worth of currency for $2,000. If a trader piles on extreme risk and goes 100% into a trade with a stop loss of 10%, then five losers in a row will account for a 50% loss in the account. Furthermore, it will then require a 100% gain in the account just to bring the total balance back to even. You can avoid these mistakes with proper risk management.

You will find within a survey of relevant literature the suggestion to never risk more than 1-2% of your account value on a single trade. This may seem modest, but it's a rule of preservation that helps assure longevity in trading. Any trading system needs to account for the worst-case scenario. I've been using the example of five losers in a row; however, for a worst-case scenario, a trader should plan for an eventual ten losers in a row. Let's say you are risking 5% per trade; in this case, your account would be down 50% and need a 100% gain to reach the breakeven mark. Once again, this is not acceptable.

The benefit of allocating 2% of the account value for risk on each trade means that even with a rare ten trade losing streak, your account would only be down 20%. This would then require about a 25% gain to get back to break even. This is much more manageable.

Likewise, many traders, when taking profit, tend to go "all-out," removing all their gains at once. This can be appetizing because you lock in your profit; however, this may also limit your profit potential. How many times have you exited a trade early and regretted as the market continued to move higher? Sometimes you may try to jump back in, but due to the ebbs and flows of price, you may get stopped out.

Scaling out is the process of taking profit in pieces as the market moves in your favor. You might want to remove ¼, ⅓, or ⅕ of your position depending on your parameters, and then scale out of additional portions as the market continues to move in your direction. By leaving a runner, the trader can squeeze as much profit potential out of the trend.

Another way a trader who is using a smaller size may benefit is the incorporation of the excess capital not employed. You may wish to add to a trade. There are lower-risk ways and more dangerous ways of doing this. The safest of the ways is to add to a winning position. A trader may lose on quite a majority of trades, like the friend I mentioned in the previous section who lost on more than 90% of positions in a given year. However, the ability to build a longer-term winning trade is what compensates for a sizable losing percentage.

When a trade is working for you, adding small increments gives you more profit exposure. This can be a double-edged sword because your average price for the position becomes less favorable. However, if a trade has moved enough in your favor, then you can add to that trade, and set a stop-loss at your breakeven point. Then you have more opportunity to scale out as you continue to ride the trend.

Instead of using all of your predetermined sizes, you split that apportionment in half.

Additionally, doubling down or adding to a losing trade can be detrimental, and is a recipe for disaster. However, when done with proper risk, it can be a helpful strategy. Let's say, instead of going into a trade using all of your predetermined sizes, you split that apportionment in half. This leaves you the ability to add to the position when it goes against you and do so with the possibility of not taking on additional risk. This means you will enter the at a better price when the market goes against you. Still, your underlying fundamental and/or technical thesis remains intact.

IMPORTANT NOTE: Adding to losers should only be done when small size is implemented, and the strategy is intentional and pre-planned. Furthermore, this strategy should never be employed out of emotion or impulse. If you cannot add to losers responsibly and stick to an appropriate risk plan, then eliminate this scenario from your strategy options.

BE EXOTIC

8

Not all Forex markets are created equal. The differences in liquidity are generally based on the popularity of the currency. Where there is more liquidity, the spread differential between the bid and offer will narrow. Inversely, the less liquid a currency pair is, the wider the gap in the spread and the more volatile the market will be. This is why you might notice that your broker will have a higher leverage ratio for more liquid markets

Typically, the USD, CAD, EUR, GBP, CHF, JPY are all very liquid (with the AUD and NZD following in right behind). However, then other markets come into play; usually, these are currencies based on much smaller economies. In these markets, the trend will often be "firmer." Some examples include the MXN, TRY, NOK, SEK, RUB, and others.

Liquid Currencies

- $ The U.S. Dollar
- € The Euro
- C$ The Canadian Dollar
- ¥ The Japanese Yen
- £ The Great British Pound
- ₣ The Swiss Franc

Iliquid Currencies

- ₺ The Turkish Lira
- R$ The Brazilian Real
- ₱ The Mexican Peso
- ₽ The Russian Rouble
- ₹ The Indian Rupee
- HK$ The Hong Kong Dollar

As mentioned, you must be aware that these markets can be illiquid, volatile, and hard to enter/exit. These markets are nearly impossible to day trade but can be attractive to swing trading with proper risk measures. One of the benefits of these markets that modestly offsets some of the risks is that they have much lower pip value. These markets should only be considered for small positions by experienced traders who are trading account sizes above the minimum.

9

BECOME SENTIMENTAL

Sentiment indicators can be helpful, but they can also be a double-edged sword. Successful traders tend to exhibit contrarian characteristics as they become more and more independent. Following popular opinion can often lead you in the wrong direction, and while sentiment indicators may be helpful for swing traders, they provide little to no value for day traders.

> **SUCCESSFUL TRADERS TEND TO EXHIBIT CONTRARIAN CHARACTERISTICS AS THEY BECOME MORE AND MORE INDEPENDENT.**

Some Forex brokers will compile data from all of their clients and configure it into an indicator that expresses where traders are positioned in the most popular markets. One thing you will often see from this analysis is that the crowd is usually wrong—and retail traders often stack themselves against the trend. Retail sentiment can often be helpful in terms of analyzing what NOT to do in a market circumstance. Retail money is not big enough to change market sentiment. When it piles up too heavily in one direction, it more often than not becomes fuel for stop hunts.

A popular sentiment indicator published weekly by the CFTC is the Commitment of Traders Report (COT). The COT collects and reports the positions of large retail and institutional futures traders in the U.S. markets. For Forex traders, currency futures products based on U.S. Dollar (USD) pairs are useful indicators to see where substantial money is positioning in terms of the USD.

There are many ways to interpret these COT reports. One way would be to look at small speculators and hedgers as being on the wrong side of market momentum. As mentioned above, retail money often attempts to fade the trend, while hedgers are utilizing the futures markets for different reasons than those of small speculators.

> **"Large speculators usually give a good indication of momentum and direction for swing trades"**

Large speculators usually give a good indication of momentum and direction for swing trades. However, you might notice that there comes a point where it appears that too many speculators have loaded up on one side of the market. This leads to concerns that there won't be enough new money entering the market to keep the trend intact. Or that, with so much money aligned in one direction, these positions become vulnerable to being stopped out. Either of these scenarios could lead to a loss of momentum, and possibly a reversal of trend.

While sentiment indicators and COT charts should be utilized, these alone are unlikely to yield a reliable trading system. Instead, they serve as a secondary tool for you to best analyze currency markets.

10 PROCESS, PLAN & PREPARE FOR THE LONG-TERM

"I find that very few ever consider reward-to-risk (R2R) when establishing their trading plan"

All too often, traders trap themselves in a short-term view of the market and end up living from trade to trade. Those who wish to go to the next level and professionalize their trading will take a longer term approach to the market. This doesn't necessarily have to translate into putting on long-term positions, but rather having a long-term game plan. Learning the lessons of longevity and successful habits will keep a trader viable in all market conditions.

Every trader should continually analyze themselves with the same scrutiny as the markets they watch. They must study their mental and emotional responses to their trading habits, as well as to the equity fluctuations in their trading accounts. Building self-awareness in this way is key to developing your potential. Understanding trader psychology can mean the difference between being a successful trader and an unsuccessful trader.

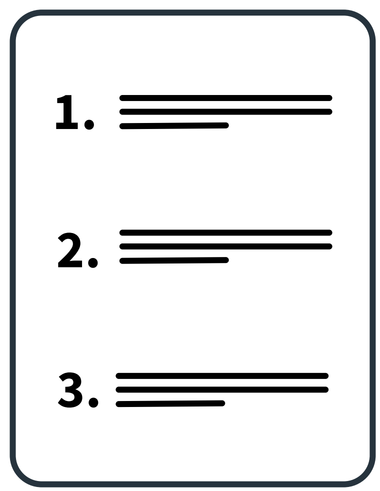
It's also a good idea for every trader to create a list of rules as they begin to understand their habits better. It's also important to critique and analyze your trades; you can learn just as much from your winning trades as you can from your losing trades. By chronicling your results you can develop an idea of what circumstances yield the best outcomes. Include factors such as what products you're trading, and what timeframes you do better or worse in.

Keep your list of rules in a place that's visible while you're trading. This will go a long way to helping retain the information to the point where it's embedded within you and can be recalled instantly. Backtest, simulate and prepare for the long-term. When you backtest a trade setup, look for holes in your strategy to learn what can and will go wrong. Be conscious of losing streaks, but never judge your trading based on your worst, or especially your best days.

Processing and preparation are critical. This is the difference between winning and losing over the long-term. Planning ahead will help you to better control emotions and impulses to keep you calm and collected when facing difficulty.
Sun Tzu says that if you know your enemy and yourself, you need not fear the outcome of a hundred battles.

Traders Should...

Analyze Themselves



Create a List of Rules

Understand Trader Psychology