JANUARY 2005

Leveraged Value™

By Scott Owens

Position sizing is one of the most important and overlooked skills in trading. In the FX market, high leverage creates even more pressure to make correct sizing decisions. For many traders, the criteria employed to make these choices is unknown or rarely used. The sophisticated investor applies consistent rules to these critical trading choices using a risk-based system like Leveraged Value™ from FX Engines.

ANALYSIS
- What are the critical elements of position sizing?
- What is Leveraged Value™?
- Comparing Disparate Systems

ACTION
- Build engines that take advantage of Leveraged Value
- Harness Leveraged Value with FX Engines Managed Engines

RELATED MATERIAL
Test-drive FX Engines for free online at www.fxengines.com to see the power of system building, system testing, and system automation.

ABOUT THIS REPORT
The Forex Report is a periodic publication that investigates advanced strategies for superior trading performance in the foreign exchange markets. These reports utilize advanced statistical and econometric modeling techniques to create new insight into the trading strategy of the average trader. This Data Brief, Leveraged Value, is intended for all audiences, including those new to the forex market.

To learn more about The Forex Report or to register for delivery of all future reports by email, including Case Studies & Data Briefs, please visit www.fxengines.com.

FX Engines, Inc.

The world leader in forex trading. For more information visit:

www.fxengines.com

FX ENGINES

ANALYSIS

What would you rather trade – an engine which yields 5,000 pips over two years or one that yields 1,500 pips over two years? The answer might surprise you. Position sizing systems can be extremely complicated, but like most things simplicity and ease of implementation can carry you a long way towards the realization of your goals. The FX Engines basic position sizing system is based on two factors: Trader Profile and Leveraged Value.

TRADER PROFILE

What kind of trader are you? Do you want to make the most possible, with little attention paid to risk, or do you want to carefully calculate each transaction and all its variables?

Traders come in many different flavors, with each trader's profile determined by his or her particular set of circumstances:

Out of these variables can come many different and nuanced profiles, but for the sake of position sizing we shall name three: conservative, moderate, and aggressive. In the simplest terms, these three profiles address the trader's overall perspective and set an appropriate level of risk.

LEVERAGED VALUE

To help determine position size in forex, we came up with a concept called Leveraged Value. Leveraged Value dictates that trader profile and system performance are the only two important factors in determining position size. From these two variables comes the Leverage Factor, which is simply the number of standard contracts per $100,000 to trade given a particular system[1].

This simple concept is backed by common sense: an aggressive trader paired with a high success rate engine should trade more contracts than either a conservative trader or a lower success rate engine. Success rate is determined by the sum of historical testing, live testing, and live trading. Once your success rate is determined (see "Test Environments" below) you can then use our approach to Leveraged Value or create your own.

Forex dealers allow leverage as high as 200:1 in some cases. We cannot advise leverage this extreme for *investing* purposes. In formulating Leveraged Value, we started with the Moderate trader profile using maximum leverage of 10:1, which translates to 10 standard contracts traded for every $100,000 in capital. This ratio is halved for the Conservative trader and doubled for the Aggressive trader. We do not recommend leverage above 20:1 for most traders.

To illustrate Leveraged Value in action, let us return to our original question: would you trade the 5,000 pip engine or the 1,500 pip engine? The problem with this comparison is it does not include any information about trader profile or success rate – our two critical elements for position sizing. If we assume a Moderate trader profile and a success rate of 58% for the 5,000 pip engine and 93% for the 1,500 pip engine, we now have all of the information we need to make a decision.

According to the charts below, the Leverage Factor for a Moderate Trader with a 58% success rate engine is 2, vs. a Leverage Factor of 9 for the 93%

---

[1] Mini traders can use contracts per $10,000 in capital as the standard reference.

success rate. The Leverage Factor simply says how many contracts to trade. For the 5,000 pip engine 2 contracts would be traded per $100,000 in capital, and 9 contracts would be traded per $100,000 in capital for the 1,500 pip engine. The result:

Net Pips	Success Rate	Leverage Factor	Leveraged Value
5,000	58%	2	10,000 pips
1,500	93%	9	13,500 pips

Clearly the 1,500 pip engine is superior, but why? In any forex trade, but especially in leveraged forex trades, drawdowns are critical events. Worse, when consecutive losses occur with ill-applied leverage, account liquidation is not far behind. We believe this is the single greatest mistake made by most traders. It follows that higher success rate systems provide extra insulation against these losses, and only these engines are suitable for moderate to high leverage.

Below are three additional charts which take a sample engine that yields 2,000 pips and shows its Leveraged Value for each of the trader profile and success rate combinations:

Leveraged Value: Conservative Risk Management

Success Rate	Leverage Factor	Leveraged Value
95.0% - 100%	5	10,000 pips
90.0% - 94.9%	4	8,000 pips
85.0% - 89.9%	3	6,000 pips
80.0% - 84.9%	2	4,000 pips
75.0% - 79.9%	1	2,000 pips
70.0% - 74.9%	.8	1,600 pips
65.0% - 69.9%	.6	1,200 pips
60.0% - 64.9%	.4	800 pips
55.0% - 59.9%	.2	400 pips
30.0% - 54.9%	.1	200 pips

Leveraged Value: Moderate Risk Management

Success Rate	Leverage Factor	Leveraged Value
95.0% - 100%	10	20,000 pips
90.0% - 94.9%	9	18,000 pips
85.0% - 89.9%	8	16,000 pips
80.0% - 84.9%	7	14,000 pips
75.0% - 79.9%	6	12,000 pips
70.0% - 74.9%	5	10,000 pips
65.0% - 69.9%	4	8,000 pips
60.0% - 64.9%	3	6,000 pips
55.0% - 59.9%	2	4,000 pips
30.0% - 54.9%	1	2,000 pips

Leveraged Value: Aggressive Risk Management

Success Rate	Leverage Factor	Leveraged Value
95.0% - 100%	20	40,000 pips
90.0% - 94.9%	18	36,000 pips
85.0% - 89.9%	16	32,000 pips
80.0% - 84.9%	14	28,000 pips
75.0% - 79.9%	12	24,000 pips
70.0% - 74.9%	10	20,000 pips
65.0% - 69.9%	8	16,000 pips
60.0% - 64.9%	6	12,000 pips
55.0% - 59.9%	4	8,000 pips
30.0% - 54.9%	2	4,000 pips

APPLES TO APPLES COMPARISONS

One of the chief benefits of Leveraged Value as a metric is its ability to show disparate engines in an apples-to-apples comparison. Stating that a system earned 8,000 pips or had a 88% success rate is not enough – some

commonality is needed for comparison. Leveraged Value allows traders to build and perfect systems against a benchmark, then take them into real trading with confidence.

TEST & LIVE TRADING ENVIRONMENTS

It should be noted that your success rate must be valid before venturing into real trading. FX Engines' test platform is identical to its real trading platform, so all historical and live test metrics are valid, since the engines will perform nearly identically in live trading[2].

Not all platforms can say this, and some in particular are very poor test platforms. If you suspect this you may want to live trade with one mini contract until you have sufficient confidence in your success rate to go live with leverage.

CREATE YOUR OWN LEVERAGED VALUE SYSTEM

The system of Leveraged Value discussed in this report is intended to be a simple, fast approach to position sizing. Some traders may disagree with the leverage factors employed here, and may want to create a more conservative or aggressive version.

Risk averse investors may want to give special attention to maximum drawdown, making the Leveraged Value more risk adjusted. We suggest a modified Leveraged Value formula of Net Pips – Max Drawdown x Leverage Factor. This formula penalizes maximum drawdown more heavily than the standard formula referred to throughout this report. In any case, we recommend that all traders understand the loss potential of every trade (historical maximum drawdown x contracts) before trading.

As always, it is important to re-state that this report IS NOT directing traders to a particular course of action. We merely hope to provide a framework for tackling a major element of trading. We hope that each trader will employ a personalized risk assessment and positioning sizing system, and Leveraged Value is one simple framework among many that can be selected.

---

[2] Remember, market volatility and/or the effect of interest as a carrying cost may cause live trades to differ from test trades.

ACTION

Build engines for high success rate first, then for high net pips.

USE HISTORICAL & LIVE TESTS TO DETERMINE LEVERAGE

The key to winning in Forex is making carefully measured risks and applying the correct money management method to maximize the return from those risks. Position size is the foundation of money management and in forex, leverage is a key factor.

Use advanced trading and testing platforms like FX Engines to build and test your systems. Once you have an engine that performs well historically move it into live testing so you can observe the engine's performance in real time market conditions. Finally, activate the engine for live trading, apply the correct amount of leverage, and allow the system to work per your design.

Engines that do not qualify for high leverage are not necessarily bad. Some engines, like the 5,000 pip engine mentioned in this brief, are excellent, and can be superior to the high percentage engine. The challenge is to extract all of the value from these kinds of systems, and FX Engines will release new tools to make this possible soon.

FX ENGINES ANNOUNCES MANAGED ENGINES™

For those of you without a system or an idea where to begin, FX Engines will soon be releasing Managed Engines™. Managed Engines are our own systems, and all of them will feature Leveraged Values near or exceeding 15,000 pips for two years – some with far more than that.

Managed Engines will be made available with a maximum number of contracts available per engine. We'll offer these engines on a first come, first served basis, but we expect each engine's available contracts to be subscribed quickly by our users. If you want an edge, get started with FX Engines now and fund your live account. Any FX Engines trader who funds a live account by March 1, 2005 will join the FX Engines Founder's Club and have special early access to these Managed Engines. Visit www.fxengines.com for more info.

MORE INFORMATION

For more information about The Forex Report, visit www.fxengines.com or email info@fxengines.com. The Forex Report is available for distribution on third party websites as a co-branded offering. Contact us for more information.

THE FOREX REPORT

Analyzing statistical, econometric, and behavioral trends in the foreign exchange markets for insight into the optimal use of the FX Engines trading platform.

The information contained in this report is represented without warranty or any statement of its veracity. The contents of this report are intended to stimulate thinking on issues related to trading forex. This report does not suggest any particular action that could be utilized in live trading for profit or loss.

I can put it no better than Hoffer, who deferred to Montaigne:

"All I say is by way of discourse, and nothing by way of advice. I should not speak so boldly if it were my due to be believed."