“Hedge Hog” Trade Rules

Using Inverse correlation to decrease market exposure

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If you are reading this please note that the system is still in testing and requires a clear money management strategy applied to it…

Getting Started

This system is based on the inverse correlation of the EURUSD and USDCHF. Typically if you hedge, you will buy a currency after you have sold it, or vice versa. Since these two currency pairs are the two most inversely correlated pairs, to hedge you would buy or sell both the EURUSD and the EURCHF.

The entry for a trade is based on the divergence (or move away from) the EURCHF from the close of the previous day. To determine what to use for the daily close, you should use GMT as the time. When the EURCHF moves away from (or diverges) from the previous day's close, it means the EUR and CHF are also getting out of correlation, and will typically want to move back towards the correlation.

Below are the rules for entry/exit on the Hedge Hog system:

1. If the EURCHF moves -.25% from the previous day's close, then you will buy both the EURUSD and USDCHF. If the EURCHF moves +.25% from the previous day's close, then you will sell both the EURUSD and USDCHF. To determine the percentage, use the calculation below:

   Previous Close x .0025 = deviation from close to enter a trade. For example, if the previous close was at 1.4800, then 1.4800 x .0025 = .0037. This means that the entry point for a sell on the EURUSD and USDCHF would be 37 pips above 1.4800, which is 1.4837. The entry point for a buy on the EURUSD and USDCHF would be 37 pips below 1.4800, which is 1.4763.

2. Since the EURUSD and USDCHF typically do not pay out proportionately as the USD is in a different position on the two pairs. To be closer to a perfect hedge, you will need to adjust the number of lots you trade on the USDCHF compared to the EURUSD. Whatever the current price is for the EURUSD, you should trade that many more lots on the USDCHF.

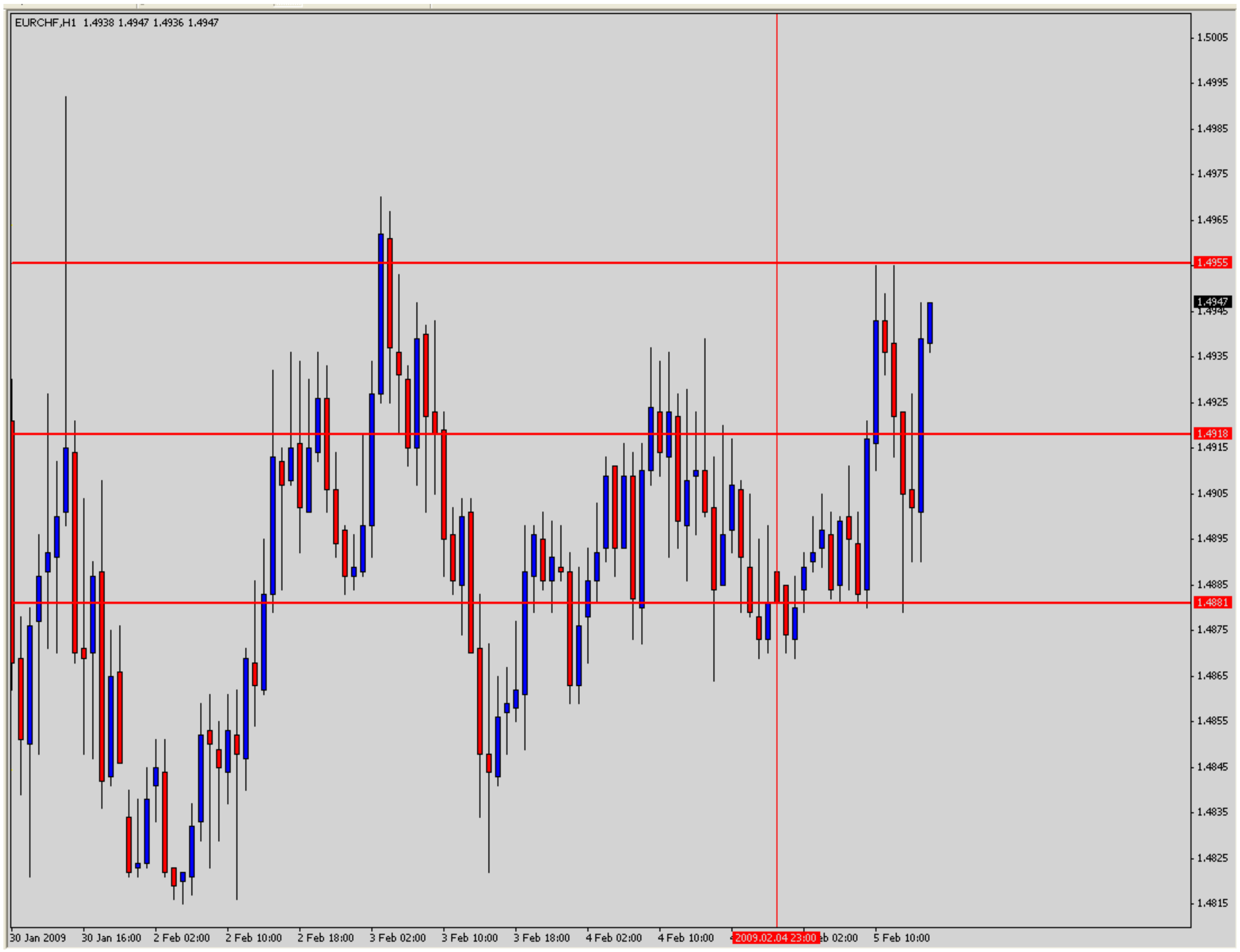
   For example, if the current price on the EURUSD is around 1.3000, you should trade 1.3 lots on the USDCHF for each 1 lot traded on the EURUSD. Depending on your broker and how they can break down the lots, you may need to round up or down to the nearest tenth of a lot. This may not make it a perfect hedge, but it should be close enough.

3. If the EURCHF keeps moving further away from the previous day's close, there are additional levels that you can enter on. You can re-enter the trades at each .25% level, up to 1.0%. (.50%, .75%, 1.0%) So in the example above, if the EURCHF keeps moving an additional 37 pips away from the daily close, you could enter another position on the EURUSD and USDCHF. Most of the time it will not go much past the .50% level, except in the even of an extreme trending day.

4. The exit on the trade occurs when the EURCHF returns back to the price of the previous day's close. In the example in #1 above, it would be when the EURCHF returned to 1.4800. This is the basic exit spot for this trade.

5. There are some additional things that you can do to mitigate risk on this trade, as you typically will not put stops on this trade. If the EURCHF continues away from the daily close and you re-enter at the .50% level or higher, you can keep an eye on the trades and close the original entries when they are breakeven with each other. You can then wait for the EURCHF to return to the daily close to close the rest of the trades.

It is important to use proper money management when using this technique. Although the trades should be hedged well, if there is a strong trend in the EURCHF there could be some drawdown. This doesn't happen often, but it can happen and you should be prepared if it does.



In the example above, the previous day's close was 1.4881 (noted by the vertical line), so to find the .25% point we use the equation 1.4881 x .0025 = .003720, so that rounds off to 37 pips. Therefore the +.25% level is 1.4918 and the .50% level is 1.4955. As you can see from this example, the EURCHF went almost exactly to the .50% level before falling right back to the previous close level of 1.4881. This would have afforded two entries, at the .25% and .50% levels, then an exit on all the trades as it hit 1.4881. The EURCHF then went back to the .25% level for another entry and is now close to the .50% level for another potential entry. On the two trades entered so far, there was the potential to net approximately 70 pips.

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