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Forex Trading

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CURRENCY INSIGHT LIMITED FOREX MANAGED ACCOUNTS CLIENT INFORMATION

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Introduction to Currency Exchange and the FX Market

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What is Currency Exchange?

Currency exchange is the trading of one currency against another. Professionals refer to this as foreign exchange, but may also use the acronyms Forex or FX.

The Need for Currency Exchange

Currency exchange is necessary in numerous circumstances.

Consumers typically come into contact with currency exchange when they travel. They go to a bank or currency exchange bureau to convert one currency (typically, their "home currency") into another (i.e. the currency of the country they intend to travel to) so they can pay for goods and services in the foreign country. Consumers may also purchase goods in a foreign country or via the Internet with their credit card, in which case they will find that the amount they paid in the foreign currency will have been converted to their home currency on their credit card statement. Although each such currency exchange is a relatively small transaction, the aggregate of all such transactions is significant.

Businesses typically have to convert currencies when they conduct business outside their home country. For example, if they export goods to another country and receive payment in the currency of that foreign country, then the payment must often be converted back to the home currency. Similarly, if they have to import goods or services, then businesses will often have to pay in a foreign currency, requiring them to first convert their home currency into the foreign currency. Large companies convert huge amounts of currency each year; for example, a company such as General Electric (GE) converts tens of billions of dollars each year. The timing of when they convert can have a large affect on their balance sheet and "bottom line."

Investors and speculators require currency exchange whenever they trade in any foreign investment, be that equities, bonds, bank deposits, or real estate. For example, when a New Zealand investor buys shares in Sun Microsystems on the NASDAQ, he will have to pay for the shares in U.S. Dollars and likely have to convert New Zealand Dollars to U.S. Dollars. Similarly, a Japanese real estate investor who sells a New York property may well want to convert the proceeds of the sale in U.S. Dollars to Japanese Yen.

Investors and speculators also trade currencies directly in order to benefit from movements in the currency exchange markets. For example, if an investor believes that the Japanese economy is strengthening and as a result expects the Japanese Yen to appreciate in value (i.e. go up relative to other currencies), then he may want to buy Japanese Yen and take what is referred to as a long position. Similarly, if an investor believes that the Euro will go down over time, then he may want to sell Euro to take a short position. Interestingly, investors and speculators can profit equally from currencies becoming stronger (by taking a long position) or from currencies becoming weaker (by taking a short position). Speculators are often day traders, trying to take advantage of market movements in very short time periods; buying a currency and then selling it again may happen within hours or even minutes. They are attracted to currency trading for numerous reasons, including (i) the size and daily volatility of the market, which gives them unparalleled excitement, (ii) the almost perfect liquidity of the currency exchange market, (iii) the fact that the currency exchange market is "open" 24 hours a day and (vi) the fact that currencies can be traded with no brokerage charges.

Commercial and Investment Banks trade currencies as a service for their commercial banking, deposit and lending customers. These institutions also generally participate in the currency market for hedging and proprietary trading purposes.

Governments and Central banks trade currencies to improve trading conditions or to intervene in an attempt to adjust economic or financial imbalances. Although they do not trade for speculative reasons --- they are a non-profit organization --- they often tend to be profitable, since they generally trade on a long-term basis.

Currency Exchange Rates and Spreads

Currency exchange rates are determined by the currency exchange market. (The currency exchange market is described further below.) A currency exchange rate is always quoted for a currency pair using ISO code abbreviations. For example, EUR/USD refers to the two currencies Euro (the European currency) and U.S. Dollar. The first is referred to as the **base currency**, while the second as the **quote currency**. The EUR/USD exchange rate specifies how many US Dollars you have to pay to buy one Euro, or conversely how many US Dollars you obtain when you sell one Euro. More generally, if buying, an exchange rate specifies how much you have to pay in the quote currency to obtain one unit of the base currency, and if selling, the exchange rate specifies how much you get in the quote currency when selling one unit of the base currency.

A currency exchange rate is typically given as a pair consisting of a **bid** price and an **ask** price. The ask price applies when buying a currency pair and represents what has to be paid in the quote currency to obtain one unit of the base currency. The bid price applies when selling and represents what will be obtained in the quote currency when selling one unit of the base currency. The bid price is always lower than the ask price.

In the currency market, the following abbreviation for the currency exchange rate pair is used:

1.0720/30

The first component (before the slash) refers to the bid price (what you obtain in USD when you sell EUR), and in this case includes four digits after the decimal point. The second component (after the slash) is used to obtain the ask price (what you have to pay in USD if you buy EUR). The ask price is obtained by increasing the first component until the last two decimal places are equal to the digits in the second component. In this example, the ask price is 1.0730. As another example, 1.0690/00 refers to a bid price of 1.0690 and an ask price of 1.0700. (Note that for some exchange rates it is customary to quote rates in units of 100, as is the case with USD/JPY.)

The difference between the bid and the ask price is referred to as the **spread**. When trading large amounts of \$1M or higher, the spread obtained in a quote is typically **10 basis points** or **PIPs**, with each basis point referring to 0.0010 (or 0.10 when, say, the Yen is involved). In the example above, the spread is 0.0010 or 10 PIPs. When trading smaller amounts, the spread may be larger; for example, when trading less than \$100,000, spreads of 50-200 PIPs are common. Credit card companies typically apply a spread of 200-300 PIPs. Banks and exchange bureaus typically use a spread in the range of 200-1000 PIPs (in addition to charging a commission). For investors and speculators, a lower spread translates into easier profit taking due to movements in exchange rates.

The Currency Exchange Market

The currency exchange market is an inter-bank or **inter-dealer market** that was established in 1971 when floating exchange rates began to materialize. In addition, it is an Over-The-Counter market, meaning that transactions are conducted between any two counter parties that agree to trade via the telephone or electronic network. Trading is thus not centralized, as is the case with many stock markets (i.e. NYSE, LSE, CME) or as the case for currency futures and currency options, which trade on special exchanges. Dealers often "advertise" exchange rates using a distribution network, such as the one provided by Reuters or Bridge. Dealers then use the information obtained there (or directly) to "agree" to a rate and a trade.

The major **dealing centres** today are: London, with about 30% of the market, New York, with 20%, Tokyo, with 12%, Zurich, Frankfurt, Hong Kong and Singapore, with about 7% each, followed by Paris and Sydney with 3% each.

In terms of trading volume, the currency exchange market is the **world's largest market**, with daily trading volumes in excess of \$1.5 trillion US dollars. This is orders of magnitude larger than the bond or stock market. For example, the New York Stock Exchange has a daily trading volume of approximately \$60 billion. Thus, the currency exchange market is by far the most liquid market in the world today. Because of the volume in trading, it is impossible for individuals or companies to affect the exchange rates. In fact, even central banks and governments find it increasingly difficult to affect the exchange rates of the most liquid currencies, such as the US dollar, Japanese Yen, Euro, Swiss Frank, Canadian Dollar or Australian Dollar.

The currency exchange market is a **true 24-hour market**, 5 days a week. There are dealers in every major time zone. Trading begins Monday morning in Wellington (which corresponds to 9pm GMT, Sunday) and then daily moves around the globe through the various trading centres until closing Friday evening at 9:30pm GMT in New York.

Today, over 85% of all currency exchange transactions involve a few major currencies: the US Dollar (USD), Japanese Yen (JPY), Euro (EUR), Swiss Frank (CHF), British Pound (GBP), Canadian Dollar (CAD), Australian Dollar (AUD) and the New Zealand Dollar (NZD). In the currency exchange market, most of the currencies are traded only against the US Dollar. The term **cross rate** refers to an exchange rate between two non-dollar currencies. Trading between two non-dollar currencies usually occurs by first trading one against the US Dollar and then trading the US Dollar against the second non-dollar currency. Because of this, the spread in the exchange rate between two non-dollar currencies is often higher. (There are a few non-dollar currencies that are traded directly, such as GBP/EUR or EUR/CHF.) The following directly traded currency pairs make up the vast majority of the trading volume and are thus considered to be the most important ones: EUR/USD, USD/JPY, EUR/JPY, USD/CAD, EUR/GBP, GBP/USD, USD/CHF, AUD/USD, and NZD/USD.

How currency trading is done traditionally

Currency trading is always done with currency pairs, such as EUR/USD, and so it is useful to consider the currency pair as an instrument, which can be bought or sold.

- Buying the currency pair implies buying the first, base currency and selling (short) an equivalent amount of the second, quote currency (to pay for the base currency). (It is not necessary for the trader to own the quote currency prior to selling, as it is sold short.) A speculator buys a currency pair, if she believes the base currency will go up relative to the quote currency, or equivalently that the corresponding exchange rate will go up.
- Selling the currency pair implies selling the first, base currency (short), and buying the second, quote currency. A speculator sells a currency pair, if she believes the base currency will go down relative to the quote currency, or equivalently, that the quote currency will go up relative to the base currency.

After buying a currency pair, the trader will have an open position in the currency pair. Right after such a transaction, the value of the position will be close to zero, because the value of the base currency is more or less equal to the value of the equivalent amount of the quote currency. In fact, the value will be slightly negative, because of the spread involved.

In today's currency market, a trade goes through a three-step process:

1. The trader communicates the currency pair and the amount he/she would like to trade with another dealer.
2. the dealer responds with a bid and an ask price
3. the trader responds to the bid and ask price with one of:
 - a. buy (by saying "Mine" or "I buy" or "I take")
 - b. sell (by saying "yours" or "I give you" or "I sell")
 - c. Refuse.

The transaction occurs if the final response is either a buy or a sell. The dealer is required to quote a "good" market price, since he does not know whether the trader will buy or sell.

The currency exchange market described above is referred to as the **spot market** and the transaction described is referred to as a **spot deal**. A spot deal consists of a bilateral contract between a party delivering a specified amount of a given currency against receiving a specified amount of another currency from a second counter party, based on an agreed exchange rate, within two business days of the deal date, which is referred to as the **settlement** date. (The settlement date for USD/CAD is one business day after the deal date.) Speculators rarely deliver, however. Instead, they use what is referred to as a **rollover swap**. The rollover swap is designed to allow the changing of an old deal date to the current date by simultaneously closing an open position for today's date and opening the same position for the next day at a price reflecting the interest rate differential between the two currencies.

When a trader buys or sells a currency pair, the value of the currency pair, as an instrument, initially is close to zero. This is because (in the case of a buy) the quote currency is sold to buy an equivalent amount of the base currency. As the market rates fluctuate, however, the value of the currency pair position held will also fluctuate. Thus, if the rate for the currency pair goes down, the speculators long position will lose in value and become negative. To ensure that the speculator can carry the risk for the case where the position results in a loss, banks or dealers typically require sufficient collateral to cover those losses. This collateral is typically referred to as **margin**.

To limit down-side risk, traders often specify a **Stop-Loss** rate for each open trade. The Stop-Loss specifies that the trade should be closed automatically when the currency exchange rate for the currency pair in question reaches a certain threshold. For long positions, the Stop-Loss rate is always lower than the current exchange rate; for short positions, it is always higher. Traders, at times, also specify a **Take-Profit** rate for their trades in order to lock in a profit when the exchange rate reaches a certain threshold. For long positions, the Take-Profit rate must be above the current rate, while for short positions, it must be below the current rate.

A trader may also leave an order with a bank, broker or dealer. These so called **leave orders** are orders that a trade should be executed (in the future) when certain market conditions occur. There are three types of leave orders:

1. **entry orders**: specifies that a currency pair should be traded when it reaches a certain exchange rate. Entry orders are used when the trade would not offset a current position.
2. **take-profit orders**: are used to clear a position by buying (or selling) the currency pair of the position when the exchange rate reaches a specified level.
3. **stop-loss orders**: are used to clear a position by buying (or selling) the currency pair of the position when the exchange rate reaches a specified level.

Currency Trading Basics

Exchange Rates and Spreads:

All currencies are assigned an International Standards Organization (ISO) code abbreviation. In currency trading, these codes are often used to express which specific currencies make up a currency pair. For example, USD/JPY refers to two currencies: the US Dollar and the Japanese Yen.

An exchange rate is simply the ratio of one currency valued against another. The first currency is referred to as the **base currency** and the second as the counter or **quote currency**. If buying, an exchange rate specifies how much you have to pay in the counter or quote currency to obtain one unit of the base currency. If selling, the exchange rate specifies how much you get in the counter or quote currency when selling one unit of the base currency.

USD/JPY
base currency/quote currency

A currency exchange rate is typically given as a bid price and an ask price. The **bid price** is always lower than the ask price. The bid price represents what will be obtained in the quote currency when selling one unit of the base currency. The **ask price** represents what has to be paid in the quote currency to obtain one unit of the base currency. The following USD/JPY price quote is an example of bid/ask notation:

USD/JPY: 124.48/58

The first component (before the slash) refers to the bid price (what you obtain in JPY when you sell USD). In this example, the bid price is 124.48. The second component (after the slash) is used to obtain the ask price (what you have to pay in JPY if you buy USD). In this example, the ask price is 124.58.

The difference between the bid and the ask price is referred to as the **spread**. In the example above, the spread is .10 or 10 pips. Unlike the USD/JPY, most currency pair quotes are carried out to the 4th decimal place (i.e. EUR/USD may be quoted at 1.0617/27), in which case 5 pips represents a difference of .0010. Although a pip may seem small, a movement of one pip in either direction can translate into thousands of dollars in gains or losses in the inter-bank market.

When trading amounts of \$1M or higher, the spread obtained in a quote is typically 10 pips. When trading smaller amounts, the spread is typically larger. For example, when trading less than \$100,000, spreads of 50-200 pips are common. Credit card companies typically apply a spread of 200-300 pips. Banks and exchange bureaus typically use a spread in the range of 200-1000 pips (in addition to charging a commission). For investors and speculators, a lower or tighter spread translates into easier profit taking due to movements in exchange rates.

Buying and Selling

All trades result in the buying of one currency and the selling of another, simultaneously.

Buying ("going long") the currency pair implies buying the first, base currency and selling an equivalent amount of the second, quote currency (to pay for the base currency). It is not necessary to own the quote currency prior to selling, as it is sold short. A trader buys a currency pair if he/she believes the base currency will go up relative to the quote currency, or equivalently that the corresponding exchange rate will go up.

Selling ("going short") the currency pair implies selling the first, base currency, and buying the second, quote currency. A trader sells a currency pair if he/she believes the base currency will go down relative to the quote currency, or equivalently, that the quote currency will go up relative to the base currency.

An open trade or position is one in which a trader has either bought or sold one currency pair and has not sold or bought back an adequate amount of that currency pair to effectively **close the trade**. When a trader has an open trade or position, he/she stands to profit or lose from fluctuations in the price of that currency pair.

Benefits of Currency Trading vs. Equity Trading

Historically, smaller-scale, individual investors have had limited access to the FX market. Major Banks, multinational corporations and other participants, trading in large transaction sizes and volumes, have dominated this market for decades. Technology, however, has lowered the barriers of entry and opened up this attractive marketplace to a new breed of FX investors and speculators. Increasingly, FX trading is winning favour as an alternative investment opportunity. The following are some of the benefits of trading currencies vs. trading equities:

Continuous, 24-hour trading

The currency exchange market is a true 24-hour market. Equity trading is restricted to the operating hours of the various equity exchanges. While after-hours trading has become available through Electronic Communication Networks (ECNs), there are no guarantees that the market will be liquid at all times, or that trades will be executed at "market prices".

High liquidity and greater efficiency

Trading volume in the currency markets can be 70-100 times larger than the New York Stock Exchange. Twenty-four hour, five day per week accessibility greatly increases the probability of finding dealers willing to buy or sell currencies at fair market price. Equities are more vulnerable to liquidity risks due to limited trading volumes and market accessibility. In the less liquid equity markets, large price movements may occur when individual transactions take place.

Intra-day volatility

Large volume and liquidity combined with fewer instruments generates greater intra-day volatility in the currency markets than exists in the equity markets. This volatility can be profitably exploited by day-traders.

Low spreads

Currency trading offers spreads that are much lower than what can be obtained when buying or selling equities (especially in after-hour markets). Although the tight currency spreads of 5 to 10 pips historically have only been available for transaction sizes of \$1M or higher, a shift towards offering these tighter spreads for smaller transaction sizes is occurring. FX Dealer offers these types of tight spreads in amounts of \$100K or more.

Leverage

Typically, margin ratios associated with trading currencies are higher than those associated with trading equities. This is primarily attributed to the higher levels of liquidity within the currency markets. Margin trading allows FX market participants to trade much larger amounts than they have deposited. For example, with a margin ratio of 20:1 and a deposit of \$10,000, an investor/speculator can trade amounts up to \$200,000. Trading in larger volumes, in turn, allows these investors/speculators to take better advantage of small price movements.

Profit potential regardless of market direction

By definition, an investor with an open position is long one currency and short another. If a trader believes a currency is about to depreciate, he/she sells that currency short and goes long another currency. In the currency markets, selling or shorting is a necessary component of completing a trade. Profit potential exists in the FX market regardless of whether a trader is buying or selling and regardless of whether the market is moving up or down. In equity markets, short-selling is less common and more difficult to transact due to certain market rules and regulations. This makes it more difficult to profit when the stock market and/or the share price for a particular stock begins to head south.

No commissions or transaction costs

A currency transaction typically incurs no commission or transaction fee.

Trading Styles

Currency traders make decisions by analyzing technical factors and economic fundamentals. Traders must decide which style and/or combination of analysis works best for them.

Technical Traders

Technical traders make their decisions using two primary tools: 1) Charting tools (trend lines, support and resistance levels, etc,) and 2) Quantitative Trading Models (mathematical analyses to identify trading opportunities). Whether using proprietary charts and/or models or those developed by third-party providers, the goal of a technical analyst is to study historical data or past behaviour of the market in order to predict future market movement.

Fundamental Traders

Fundamental traders analyze key economic data, including news and government reports, to evaluate trading opportunities. From the fundamentalist perspective, currency exchange rates are affected primarily by economic and political conditions, and occasionally by central banks intervening in the currency markets in an attempt to influence the value of their currencies. Some of the key figures tracked by fundamentalists include interest rates, inflation, trade balance, GDP (Gross Domestic Product), CPI (Consumer Price Index), PPI (Producer Price Index), capacity utilization, factory orders, durable goods orders, inventories, and employment statistics. Fundamentalists are also constantly evaluating the potential impact of military conflicts, natural disasters, and changes in political leadership.

Market Sentiment

Another factor that often influences trading decisions is market sentiment. Traders often read news, analyst reports, and Web site bulletin boards to get a sense of the general market sentiment and then trade either with or against that sentiment.

Margin-Based Trading

When a trader buys (goes long) or sells (goes short) a currency pair, the value of the currency pair, as an instrument, initially is close to zero. This is because (in the case of a buy) the quote currency is sold to buy an equivalent amount of the base currency. As the market rates fluctuate, however, the value of the currency pair position held will also fluctuate. Thus, if the rate for the currency pair goes down, the trader's long position will lose value and become negative. To ensure that the trader can carry the risk in the case a position results in a loss, banks typically require sufficient collateral to cover those losses. This collateral is typically referred to as **margin**.

By leveraging one's account to trade in larger transaction sizes, traders can better take advantage of small movements in the market to build up profits quickly. Conversely, leveraging one's account to trade in larger transaction sizes can just as easily work against a trader and magnify losses.

To limit downside risk, traders often specify a **stop-loss rate** for each open trade. The stop-loss specifies that the trade should be closed automatically when the exchange rate for the currency pair in question reaches a certain threshold. The trader may change his/her stop-loss order at any time to take current market prices into account. For long positions, the stop-loss rate is always lower than the current exchange rate; for short positions, it is always higher. Traders, at times, also specify a **take-profit rate** for their trades in order to lock in a profit when the exchange rate reaches a certain threshold. For long positions, the take-profit rate must be above the current rate, while for short positions, it must be below the current rate.

The Advantages of CIL Managed FX Margin Accounts

Global Diversification

Diversification creates safety, because the investment allocation is spread across a number of assets and will not be overly sensitive to the volatility of one particular investment option. The performance of equity and fixed income investments in one country is often highly correlated to the performance of equity and fixed income investments in other countries. As a result, global portfolios comprised solely of equity and fixed income investments lack full diversification, even if they are geographically dispersed. Investing in currencies gives investors access to markets independent of equity and fixed income investments, providing more complete diversification and a reduction in portfolio risk.

Non - Cyclical Investment

The ability to profit in rising or declining markets, unlike equity and fixed income managers, a currency dealer employs both long and short positions in its currency portfolio to profit under any market condition. As a result, regardless of the overall direction of the currency market, managers can achieve positive results. The returns of currency funds have no correlation to the economic performance of any particular economy.

Liquidity and Lower Transaction Costs

Size can hinder performance in the equities and futures market where liquidity is limited. The currency market is the choice market for large hedge funds because it is a \$1.5 trillion daily market and can absorb trading sizes that dwarf the capacity of any other market. The combination of unlimited liquidity and low transaction cost enhances the performance of a customer's account and increases investor returns.

Specialization and Expertise

Money managers specialize in utilizing the capital markets to their advantage. They dedicate themselves full time to the task of increasing their customer's net worth. Managers also have access to a wide range of market information and more importantly, have the ability to interpret it. In today's investment climate, the profitable trader is the educated trader so it should come as no surprise that professional money managers tend to outperform individual speculators.

Peace of Mind

Investing in currencies incorporates disciplined risk control procedures in order to limit risk and achieve the smoothest possible growth in an investor's account. Although returns are not guaranteed, money managers follow disciplined money management techniques and systematic trading approaches. With a managed account, investors can distance themselves from the stress of trading yet benefit by the opportunity for profit.

Risks of Managed Accounts

Lack of autonomy, once funds are in the hands of a money manager, the manager has the authority to employ the strategy he/she believes will maximize the customer's net worth. Since each position has its own time frame and risk variance, an investor whose strategy contrasts with the manager's trading style may be caught in a bind. The customer's investment objectives need to be in tune with the manager's approach to trading in order to maximize the benefits of a managed FX account.

Cost

CIL money managers provide the service of their trading skills, and must be compensated accordingly. We at CIL charge a performance fee of 20% based on positive gains to our customer's account. This fee is deducted from the customer's account on a quarterly basis. There is a fee of \$250 required to open an account, which covers the cost of back office administration and set up.

RISK DISCLOSURE STATEMENT

Foreign exchange transactions carry a high degree of risk and any transaction involving currencies is exposed to, among other things, changes in a country's political condition, economic climate and acts of nature – all of which may substantially affect the price or availability of a given currency.

Speculative trading in the foreign exchange market is a challenging prospect where above average returns are accessible to those with the experience and knowledge to assume above average risk. You must therefore carefully consider your investment objectives, level of experience and appetite for such risk prior to entering this market. Most importantly, do not invest money that you are not in a position to lose.

Currency trading is a very high risk activity which involves the exercise of judgment by CIL as to the future direction of prices of specific currencies. Whilst CIL will exercise all reasonable care in forming its judgments, it cannot guarantee that losses will not be made from time to time and it will have no liability for any losses incurred in connection with any decision taken by CIL to enter into a Contract or to close out an Open Position on behalf of the Client.

In addition, trading on a margin basis means that any market movement will have a proportionate effect on your deposited funds. This can work for you as well as against you. The possibility exists that you could sustain a total loss of initial margin funds and any profits derived there from.

The CIL trading system is designed to automatically liquidate all open positions if your margin deposit is in jeopardy so that you cannot lose more than the funds that you have on deposit on your account.

There are also risks associated with utilising an internet-based trade execution software application including, but not limited to, the failure of hardware and software, power outages and telephone line disruptions.

Margin accounts with CIL are not insured under any government insurance program, or by any other entity. In the event CIL or its Counterparties should become insolvent or file for protection under the bankruptcy laws, it is possible that you would lose the entire amount in your margin account