Bollinger Bands Can Give You a Huge Trading Edge

One of the critical pieces of forex education for any Forex trader is to understand the concept of standard deviation of price and how to use volatility to their advantage.

If you understand the concept you can easily apply it with Bollinger bands which are an essential tool for all forex traders.

Let¡¯s look at why Bollinger Bands are so useful and profitable, when incorporated in your Forex Strategy.

If you don¡¯t know what standard deviation is simply check our article on the concept ¨C right, let¡¯s take a look at Bollinger bands.

Bollinger Bands Defined

Bollinger bands are simply volatility bands drawn either side of a moving average.

You calculate Bollinger bands using the standard deviation of price over the same period as moving averages the mean price, then the volatility bands are plotted above and below the moving average.

Moving averages are used to identify the underlying trend of currencies and Bollinger bands take this one step further by:

Combining the moving average of the currency with the volatility of the individual market (or the standard deviation) ¨C this then creates a trading envelope ¨C with a middle mean price (moving average and 2 x bands (expanding or contracting) either side that reflect volatility or standard deviation.

As prices move away from the longer-term average, the standard deviation rises - and thus the bands will fluctuate in varying amounts, away from the average.

Why they work

In any market, the value of a currency traded tends to rise slowly over the longer term.

Prices can and do spike quickly in the short term, but will normally return to the longer term moving average - which represents fair value.

The standard deviation of the outer bands (how far they are from the mean) shows how far prices are from longer-term value.

Most price spikes are caused by trader psychology with greed and fear to the fore and this can be graphically seen with Bollinger bands.

So how should you use Bollinger bands?

There are 3 main ways to use them.

1. Spotting price spikes

When the bands are a long way from the mean you can use Bollinger bands as profit taking signal on existing trades or use them to spot contrary trades.

2. Enter exisiting trends

If you have a good trend in the forex markets then you can use dips to the middle band to buy at fair value.

3. Entering new trends

When prices are trading in tight range and start to breakout with a change in volatility a great new trend could be emerging.

Bollinger bands can certainly give you a new dimension to your forex trading strategy and any currency trading system can benefit from the extra insight that they can give you.

A word of warning

Like all technical indicators you should not use Bollinger bands in isolation to enter trades, however combined with timing indicators such as, the stochastic or RSI, then you have a powerful combination for greater FX profits.

With regard to forex education, knowing what standard deviation is and how to apply the concept through Bollinger Bands, will give you a huge trading edge, so make sure you use them.

About the Author

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