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Chart School

Gap Trading Strategies - Part 1

Gap trading is a simple and disciplined approach to buying and shorting stocks. Essentially one finds stocks that have a price gap from the previous close and watches the first hour of trading to identify the trading range. Rising above that range signals a buy, and falling below it signals a short.

What is a Gap?

A gap is a change in price levels between the close and open of two consecutive days. Although most technical analysis manuals define the four types of gap patterns as Common, Breakaway, Continuation and Exhaustion, those labels are applied after the chart pattern is established. That is, the difference between any one type of gap from another is only distinguishable after the stock continues up or down in some fashion. Although those classifications are useful for a longer-term understanding of how a particular stock or sector reacts, they offer little guidance for trading.

For trading purposes, we define four basic types of gaps as follows:

A Full Gap Up occurs when the opening price is greater than yesterday's high price.

In the chart below for Cisco, the open price for June 2, indicated by the small tick mark to the left of the second bar in June (green arrow), is higher than the previous day's close, shown by the right-side tick mark on the June 1 bar.

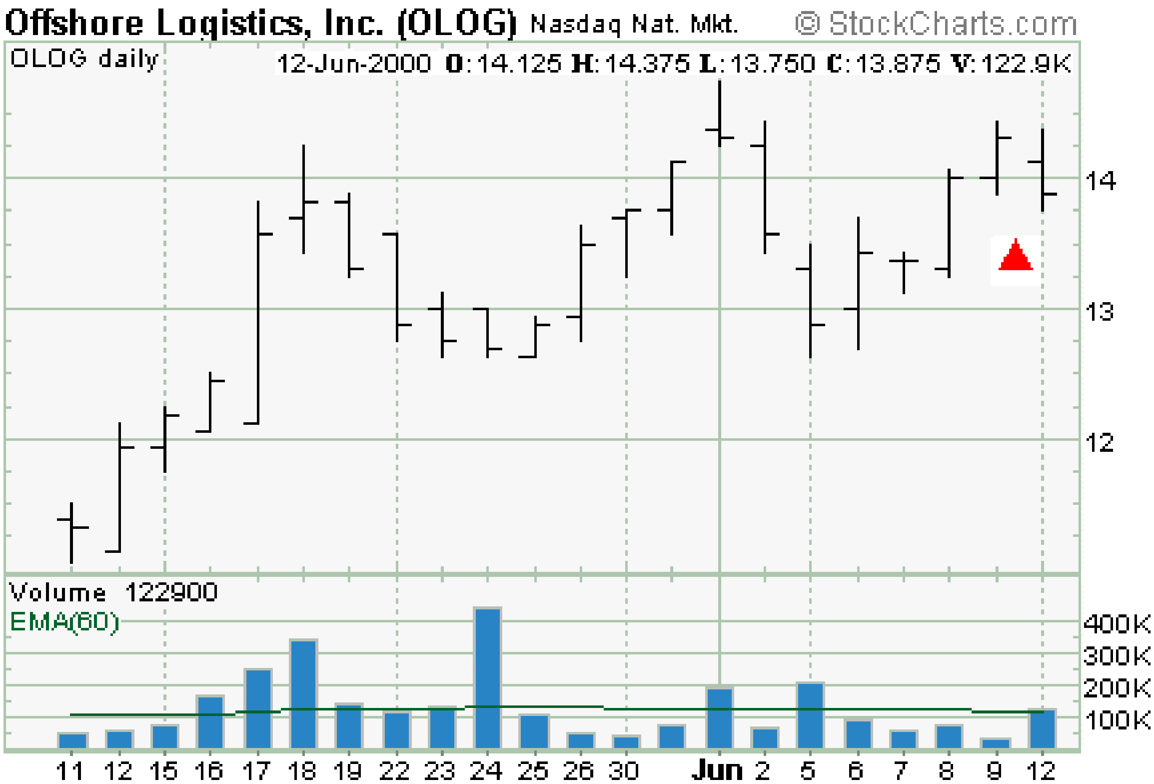
A Full Gap Down occurs when the opening price is less than yesterday's low.
The chart for Lycos, below, shows both a full gap up on May 16 (green arrow) and a full gap down the next day (red arrow).

A Partial Gap Up occurs when today's opening price is higher than yesterday's close, but not higher than yesterday's high.

The next chart for Earthlink depicts the partial gap up on June 1 (red arrow), and the full gap up on June 2 (green arrow).

A Partial Gap Down occurs when the opening price is below yesterday's close, but not below yesterday's low.

The red arrow on the chart for Offshore Logistics, below, shows where the stock opened below the previous close, but not below the previous low.



For the bulk of this tutorial, intraday charts of 2, 5 or 10 days will be used to demonstrate entry and exit signals for long and short positions. Notice that the intraday chart (below) is graphed slightly differently, showing a composite of the trades occurring every 15 minutes. Although a trade-by-trade intraday charting tool would show the exact bid and ask spread, this tutorial will refer to the left-side horizontal line of each bar as the open, and the right side horizontal bar as the close of each trade.

The beige vertical double lines represent day-to-day breaks, and the single beige vertical lines represent one or two hour divisions. Reference the time scale at the bottom of each chart.

Why Use Trading Rules?

In order to successfully trade gapping stocks, one should use a disciplined set of entry and exit rules to signal trades and minimize risk. Additionally, gap trading strategies can be applied to weekly, end-of-day, or intraday gaps. It is important for longer-term investors to understand the mechanics of gaps, as the 'short' signals can be used as the exit signal to sell holdings.

The Gap Trading Strategies

Each of the four gap types has a long and short trading signal, defining the eight gap trading strategies. The basic tenet of gap trading is to allow one hour after the market opens for the stock price to establish its range. A Modified Trading Method, to be discussed later, can be used with any of the eight primary strategies to trigger trades before the first hour, although it involves more risk. Once a position is entered, you calculate and set an 8% trailing stop to exit a long position, and a 4% trailing stop to exit a short position. A trailing stop is simply an exit threshold that follows the rising price or falling price in the case of short positions.

Long Example: You buy a stock at $100. You set the exit at no more than 8% below that, or $92. If the price rises to $120, you raise the stop to $110.375, which is approximately 8% below $120. The stop keeps rising as long as the stock price rises. In this manner, you follow the rise in stock price with either a real or mental stop that is executed when the price trend finally reverses.

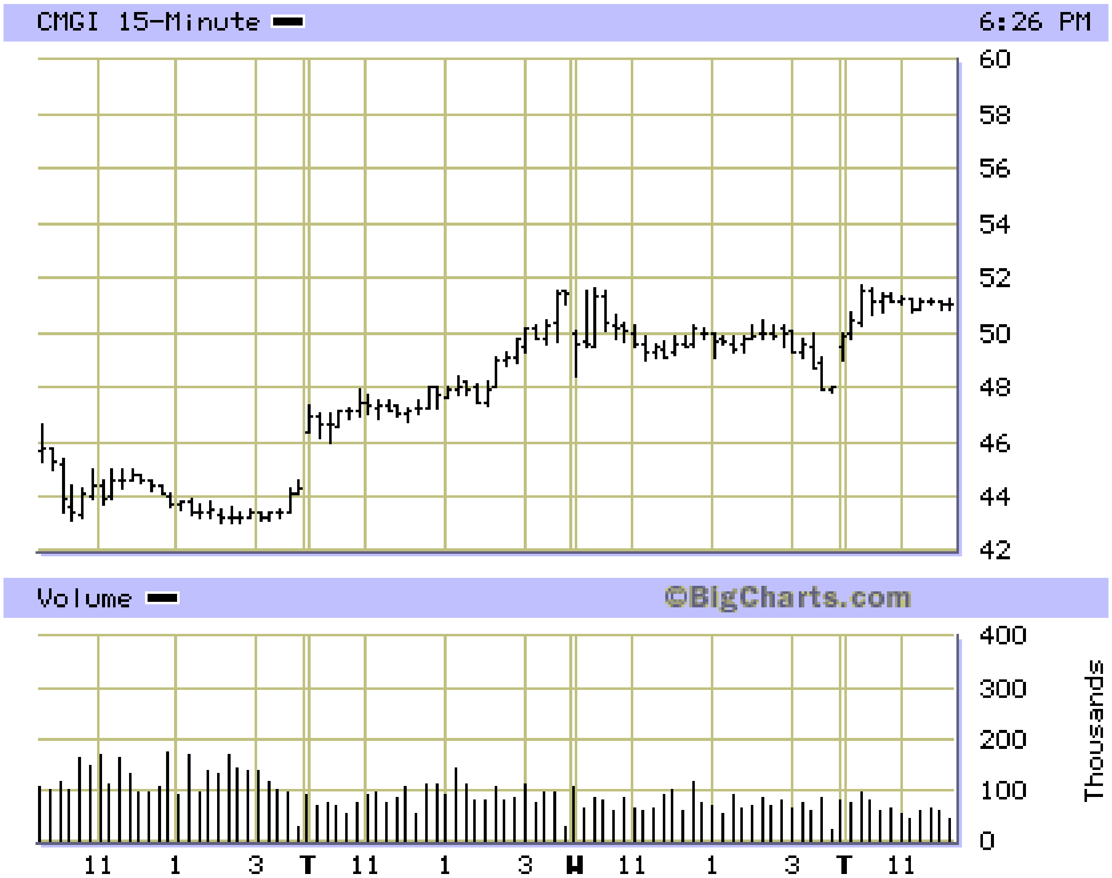
Short Example: You short a stock at $100. You set the Buy-to-Cover at $104 so that a trend reversal of 4% would force you to exit the position. If the price drops to $90, you recalculate the stop at 4% above that number, or $93 to Buy-to-Cover.

The eight primary strategies are as follows:

Full Gap Up: Long

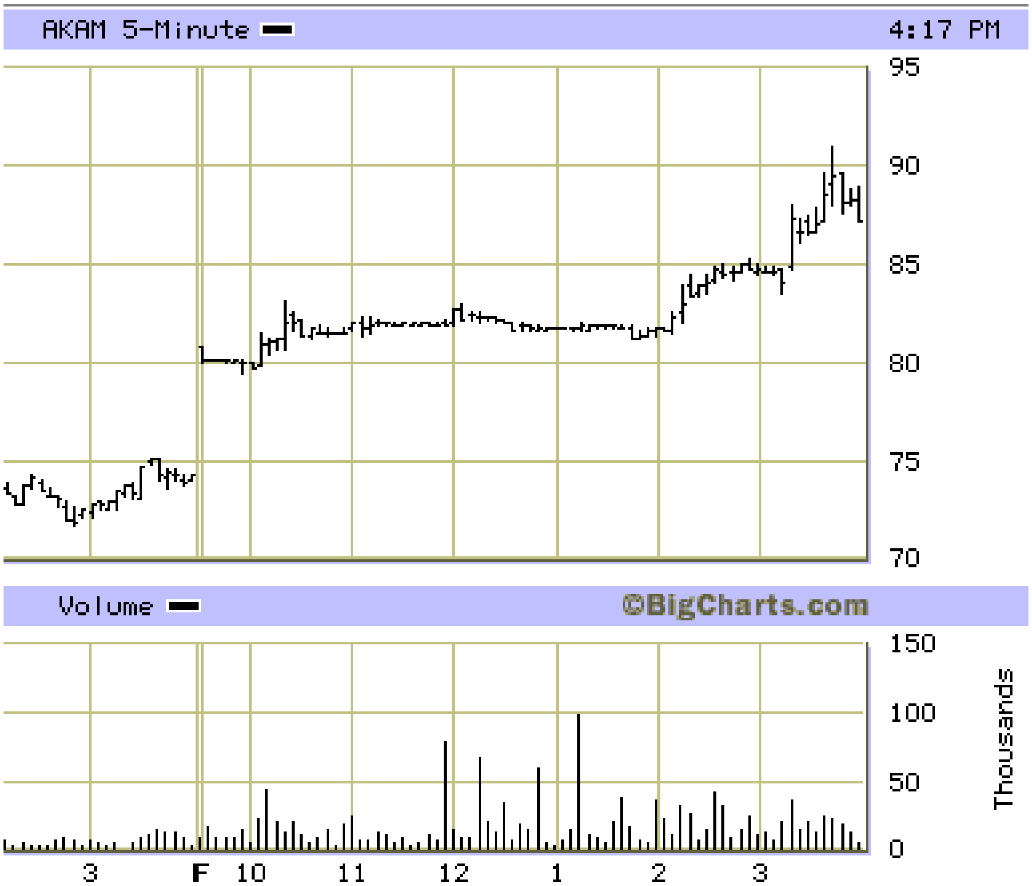
If a stock's opening price is greater than yesterday's high, revisit the 1-minute chart after 10:30 am and set a long (buy) stop two ticks above the high achieved in the first hour of trading. (Note: A 'tick' is defined as the bid/ask spread, usually 1/8 to 1/4 point, depending on the stock.)

In the case of CMGI below, the stock gapped open on a Tuesday morning and opened at $46.25. The high reached in the first hour of trading on the day of the gap was $47.50. A buy stop at $47.75, or two 1/8 ticks above the high, would have been triggered shortly before 11:00 am that day. CMGI closed at $51.75 that day, for a $4.00 (8.4%) gain.



An 8% protective sell stop is roughly $44 on the day you entered, and over the next five days rises to $53.875 (which is 8% below the final close of $58.50). At this point, even if the sell stop is triggered, you are up over $6, or 12.5%. At this level of price growth, however, one would normally reduce the sell stop to 5% or less to protect profit.

The chart below for AKAM shows that the high of $83.5 was reached by 10:30 am, and a buy signal was generated when that price was broken around 2:15 PM. An entry of $84 would have profited $3 by the close, and the trailing stop would be set at $80 (8% less than the $87 close).

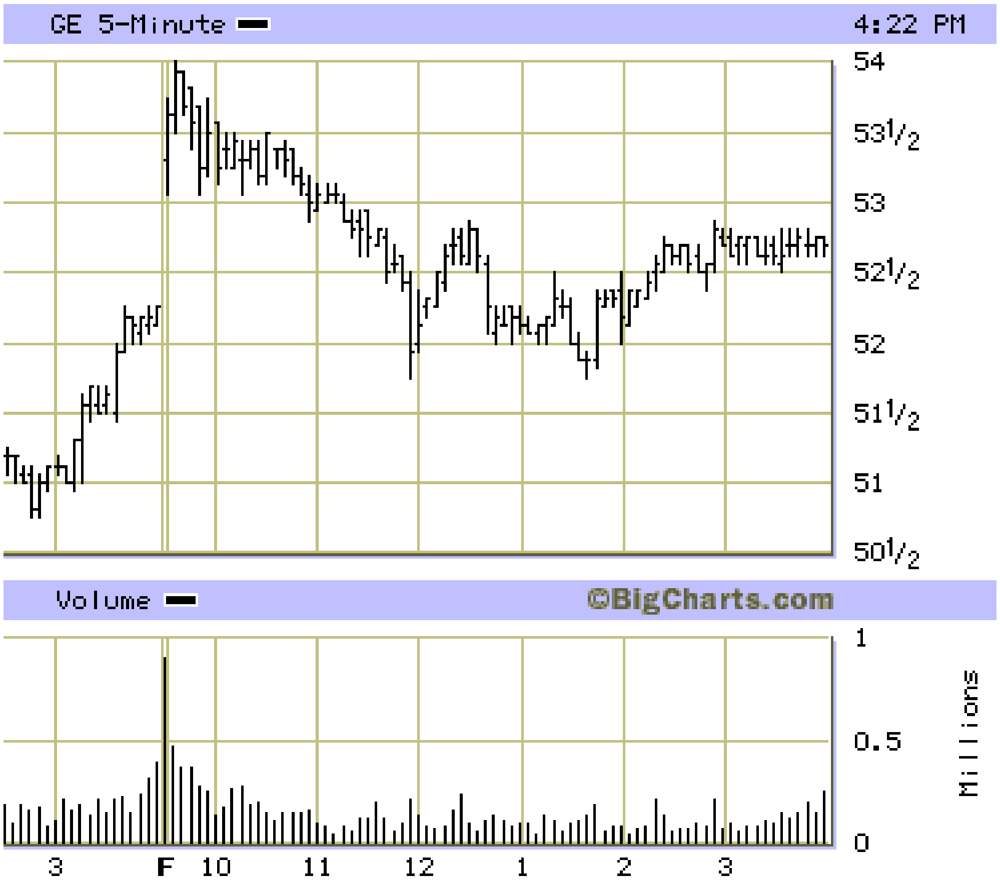


Full Gap Up: Short

If the stock gaps up, but there is insufficient buying pressure to sustain the rise, the stock price will level or drop below the opening gap price. Traders can set similar entry signals for short positions as follows:

If a stock's opening price is greater than yesterday's high, revisit the 1-minute chart after 10:30 am and set a short stop equal to two ticks below the low achieved in the first hour of trading.

In the case of General Electric, it gapped open, and established a low of $53.25 in the first hour of trading. This support level was broken before 11:00 am and would have signaled a short entry at $53. A trailing stop of 4% would set a Buy to Cover limit of $55.125.



Full Gap Down: Long

Poor earnings, bad news, organizational changes and market influences can cause a stock's price to drop uncharacteristically. A full gap down occurs when the price is below not only the previous day's close, but the low of the day before as well. A stock whose price opens in a full gap down, then begins to climb immediately, is known as a "Dead Cat Bounce."

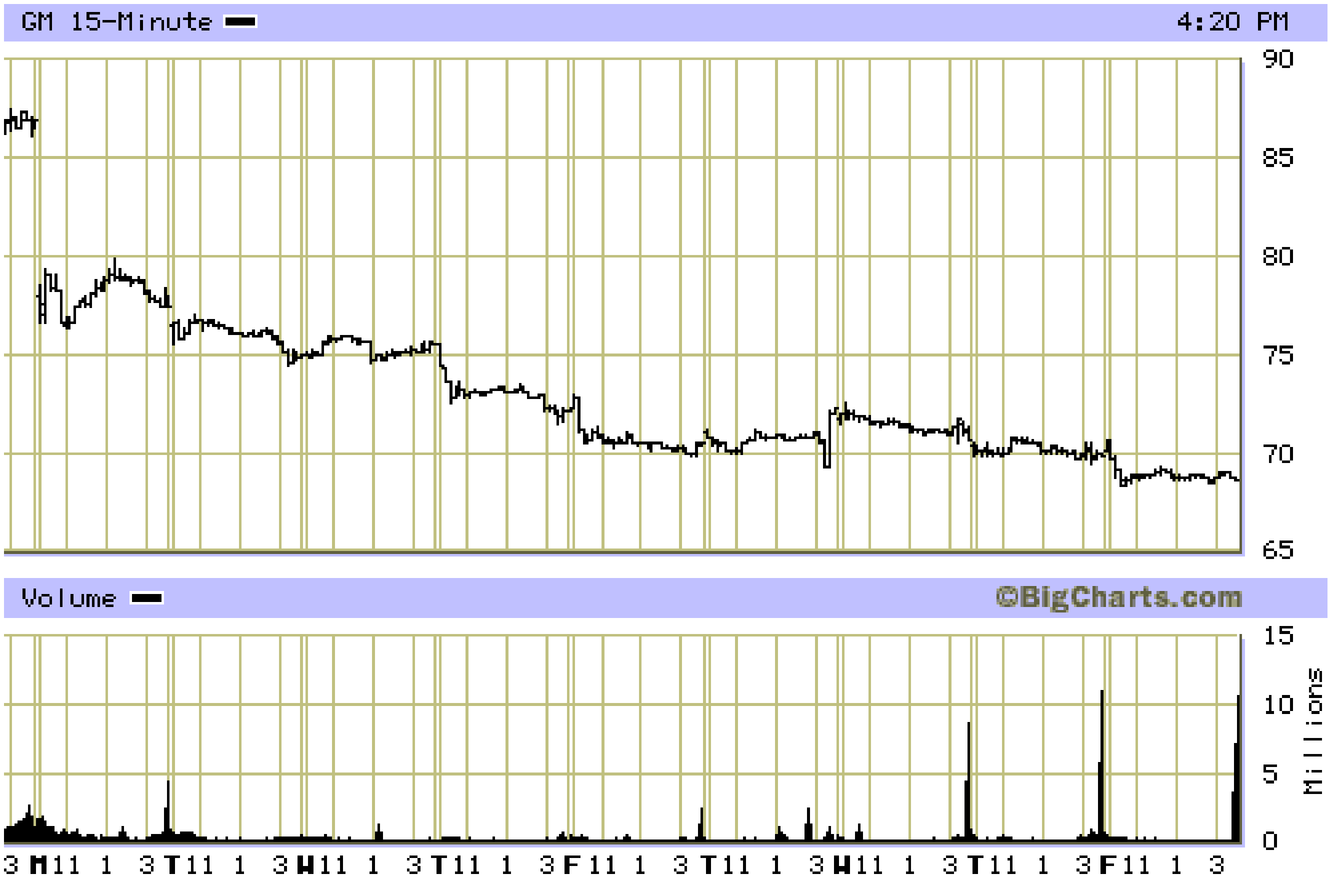
If a stock's opening price is less than yesterday's low, set a long stop equal to two ticks more than yesterday's low.

The Time Warner Telecom chart shows a full gap down 6 days ago at $42, below the previous day's low at $42.50. An entry signal for a long position was signaled with a gap at open to $48, well above the $43 buy stop. This chart illustrates why an immediate entry may be taken at open as long as it has been preceded by an another gap signal. An 8% trailing stop after entry would never have forced an exit, and this trade would be up over 40% in one week.

Full Gap Down: Short

If a stock's opening price is less than yesterday's low, revisit the 1-minute chart after 10:30 am and set a short stop equal to two ticks below the low achieved in the first hour of trading.

The signal to short General Motors occurs the day after the major gap down at $76. Although a 4% trailing stop would be calculated at $79, the large volume spikes at close and open during the last two days of the chart would reasonably suggest accumulation and that it was time to buy to cover.



Partial Gaps

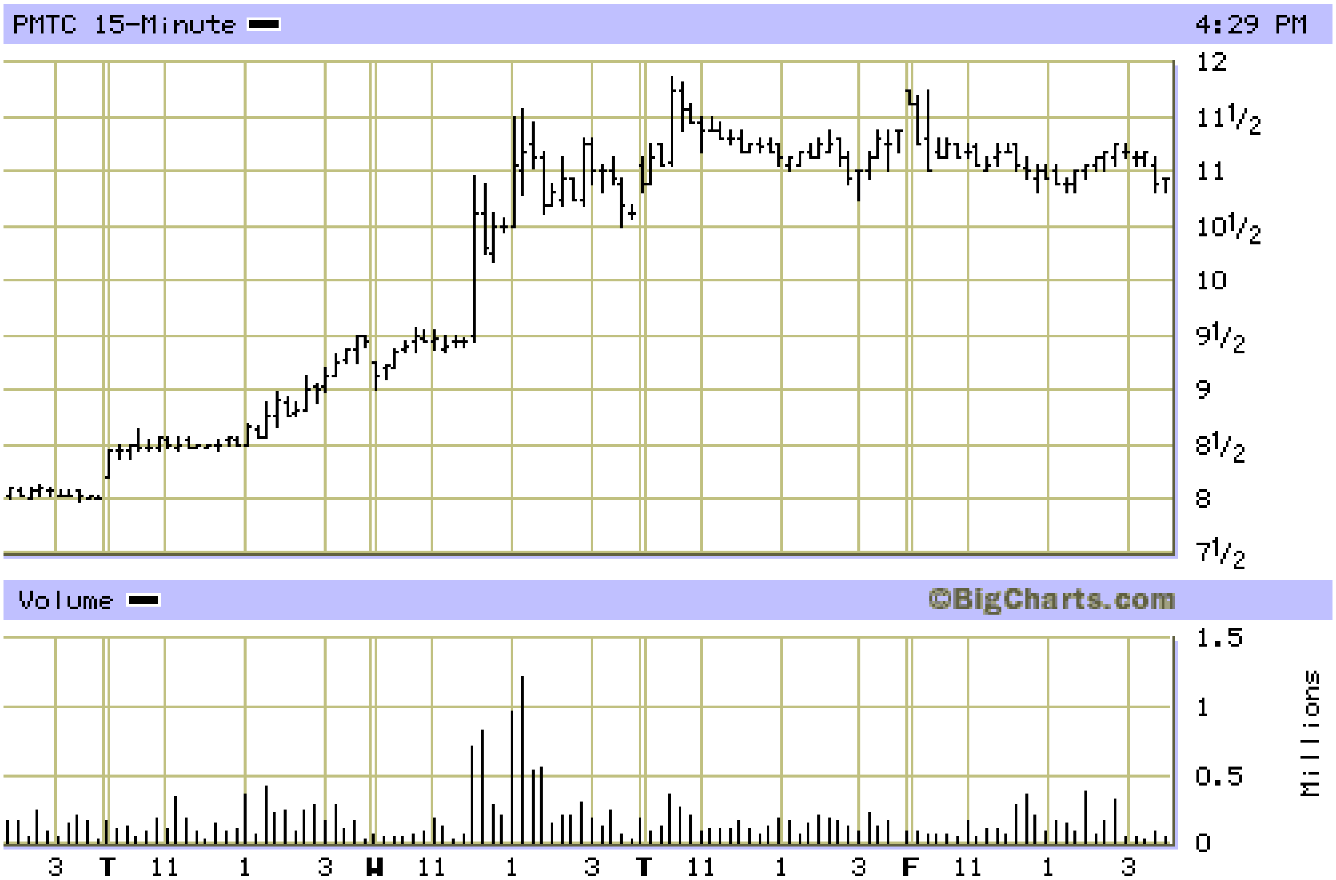
The difference between a Full and Partial Gap is risk and potential gain. In general, a stock gapping completely above the previous day's high has a significant change in the market's desire to own or sell it. Demand is large enough to force the market maker or floor specialist to make a major price change to accommodate the unfilled orders. Full gapping stocks generally trend farther in one direction than stocks which only partially gap. However, a smaller demand may just require the trading floor to only move price above or below the previous close in order to trigger buying or selling to fill on-hand orders. There is a generally a greater opportunity for gain over several days in full gapping stocks.

If there is not enough interest in selling or buying a stock after the initial orders are filled, the stock will return to its trading range quickly. Entering a trade for a partially gapping stock generally calls for either greater attention or closer trailing stops of 5-6%.

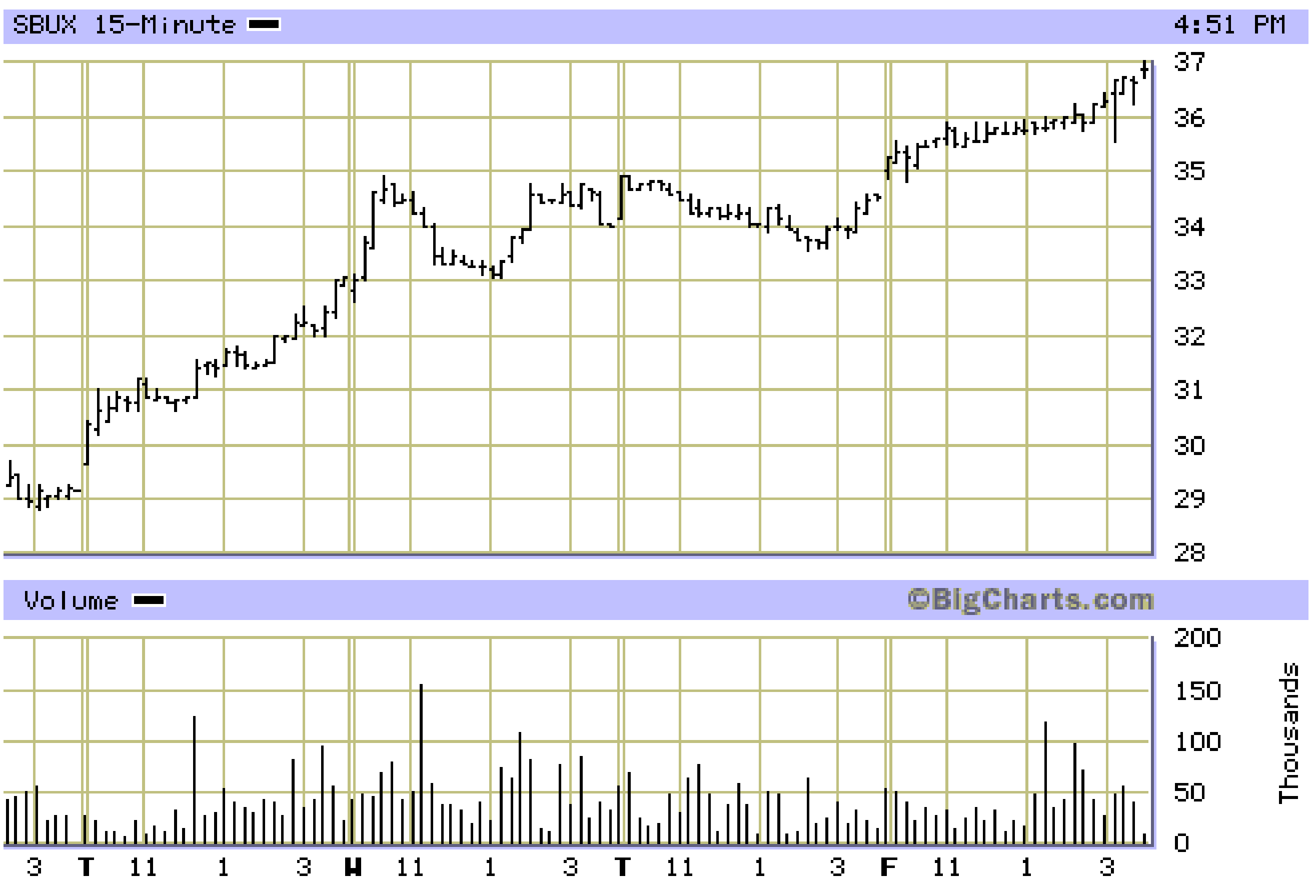
Partial Gap Up: Long

If a stock's opening price is greater than yesterday's close, but not greater than yesterday's high, the condition is considered a Partial Gap Up. The process for a long entry is the same for Full Gaps in that one revisits the 1-minute chart after 10:30 am and set a long (buy) stop two ticks above the high achieved in the first hour of trading.

Parametric Technologies chart gapped above the previous close and broke through the first hour's high around noon. The following three days provided a substantial return.



Starbucks similarly provided a partial gap up and broke through by noon on the day of the gap. It also climbed significantly for the following three days.



Partial Gap Up: Short

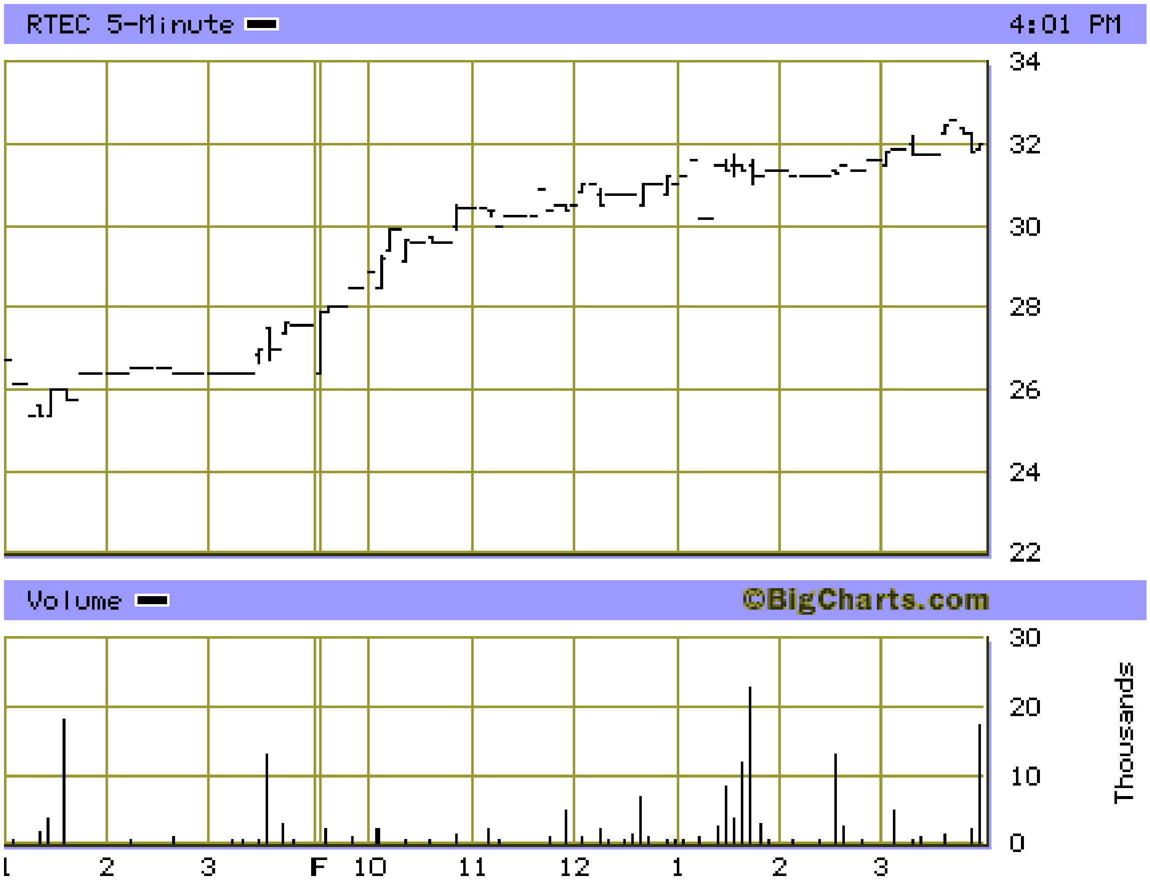
The short trade process for a partial gap up is the same for Full Gaps in that one revisits the 1-minute chart after 10:30 am and sets a short stop two ticks below the low achieved in the first hour of trading.

Perot System's open on the second of the two-day chart below is above the close but not above the high of the previous day. The low by 10:30 am was 15.625, broken at 11:30 am and triggering a short.

Partial Gap Down: Long

If a stock's opening price is less than yesterday's close, revisit the 1 minute chart after 10:30 am and set a buy stop two ticks above the high achieved in the first hour of trading.

Rudolph Technologies closed at $27.50 and opened at $26.5 the following day. The high by 10:30 am was $30, and that was penetrated just before 11:00 am. A limit buy entry was signaled at $30.25 and the stock closed at $32.



Partial Gap Down: Short

The short trade process for a partial gap down is the same for Full Gap Down in that one revisits the 1-minute chart after 10:30AM and sets a short stop two ticks below the low achieved in the first hour of trading.

If a stock's opening price is less than yesterday's close, set a short stop equal to two ticks less than the low achieved in the first hour of trading today.

Digital Insight closed at $47 and opened as a partial gap down at $46 the following morning. The low by 10:30 am was $45 providing a $44.50 short signal. DGIN sank from that entry and closed $1 lower.

If the volume requirement is not met, the safest way to play a partial gap is to wait until the price breaks the previous high (on a long trade) or low (on a short trade).

Written by Scott McCormick

Part 1 | Part 2

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