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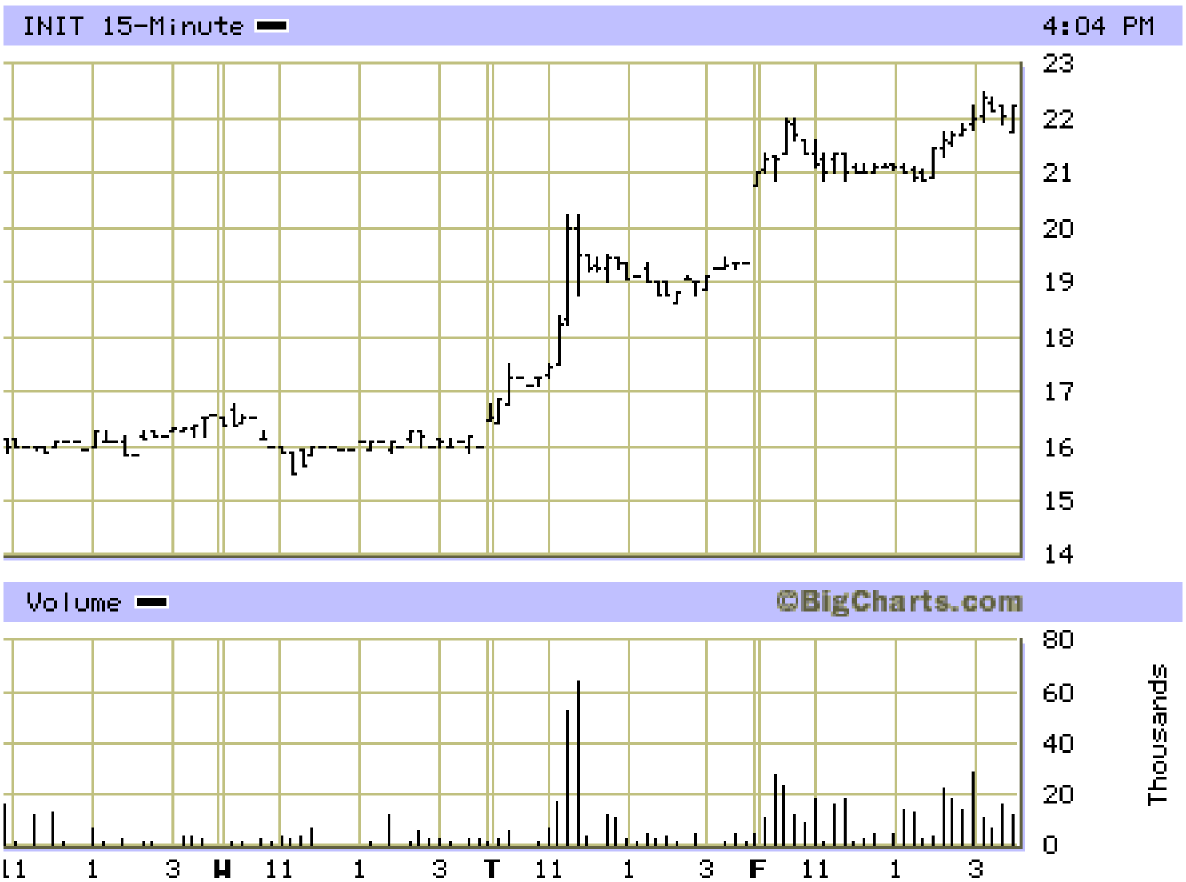
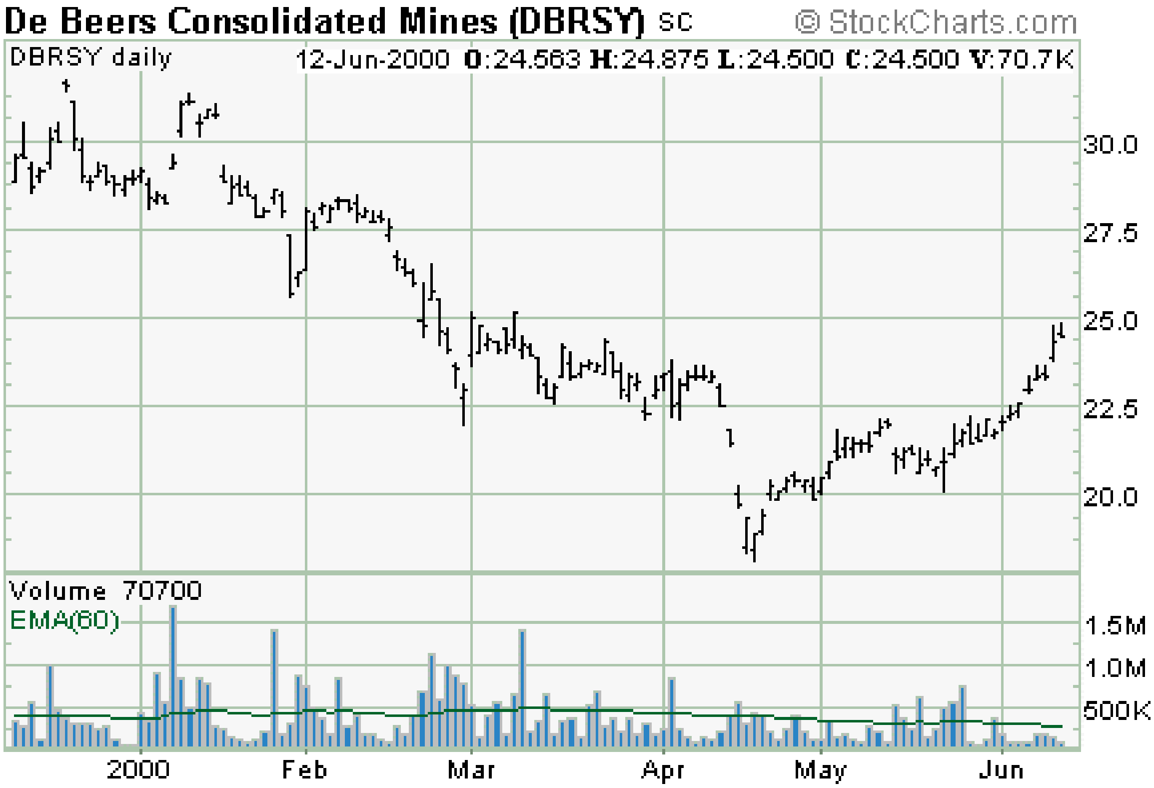
Chart School

Gap Trading Strategies - Part 2

End-of-day Gap Trading

All eight of the Gap Trading Strategies can be applied to end-of-day trading. One can use either intraday charts, such as the example for INIT below, or daily data charts like the DeBeers chart (DBRSY) further down. The trading strategy to be used should be obvious by now.





Using StockCharts.com's Gap Scans, end-of-day traders can review those stocks with the best potential. Increases in volume for stocks gapping up or down is a strong indication of continued movement in the same direction of the gap. A gapping stock that crosses above resistance levels provides reliable entry signals. Similarly, a short position would be signalled by a stock whose gap down fails support levels.

What is the Modified Trading Method?

The Modified Trading Method applies to all eight Full and Partial Gap scenarios above. The only difference is instead of waiting until the price breaks above the high (or below the low for a short); you enter the trade in the middle of the rebound. The other requirement for this method is that the stock should be trading on at least twice the average volume for the last five days. This method is only recommended for those individuals who are proficient with the eight strategies above, and have fast trade execution systems. Since heavy volume trading can experience quick reversals, mental stops are usually used instead of hard stops.

Modified Trading Method: 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 stop equal to the average of the open price and the high price achieved in the first hour of trading. This method recommends that the projected daily volume be double the 5-day average.

Modified Trading Method: 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 long stop equal to the average of the open and low price achieved in the first hour of trading. This method recommends that the projected daily volume be double the 5-day average.

Where do I find gapping stocks?

StockCharts.com publishes lists of stocks that fully gapped up or fully gapped down each day based on end-of-day data. This is an excellent source of ideas for longer term investors.

Intuit Corporation acquired Hutchinson Avenue Software Corporation and redeployed the Mach6 application as their QuickQuotesLive product. The Market Trends feature of this application provides timely lists of stocks on all exchanges with Full and Partial Up and Down Gaps, as well as a PreOpen Gap Up and Gap Down listing.

ClearStation also provides a list of Stocks gapping up and down for all major US markets under their Most Actives & Price Movers listing.

Although these are useful lists of gapping stocks, it is important to look at the longer term charts of the stock to know where the support and resistance may be, and play only those with an average volume above 500,000 shares a day until the gap trading technique is mastered. The most profitable gap plays are normally made on stocks you've followed in the past and are familiar with.

How successful is this?

In simple terms, the Gap Trading Strategies are a rigorously defined trading system that uses specific criteria to enter and exit. Trailing stops are defined to limit loss and protect profits. The simplest method for determining your own ability to successfully trade gaps is to paper trade. Paper trading does not involve any real transaction. Instead, one writes down or logs an entry signal and then does the same for an exit signal. Then subtract commissions and slippage to determine your potential profit or loss.

Gap trading is much simpler than the length of this tutorial may suggest. You will not find either the tops or bottoms of a stock's price range, but you will be able to profit in a structured manner and minimize losses by using stops. It is, after all, more important to be consistently profitable than to continually chase movers or enter after the crowd.

Written by Scott McCormick

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