Gap Trading Strategies

Table of Contents

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.

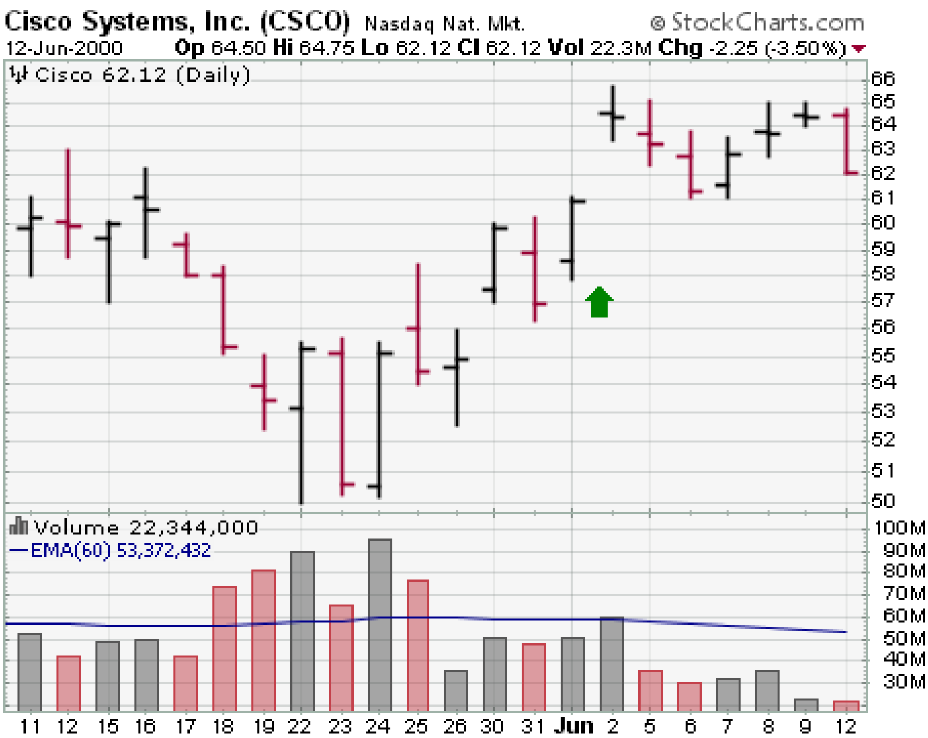
What is a Gap?

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 (CSCO), 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.



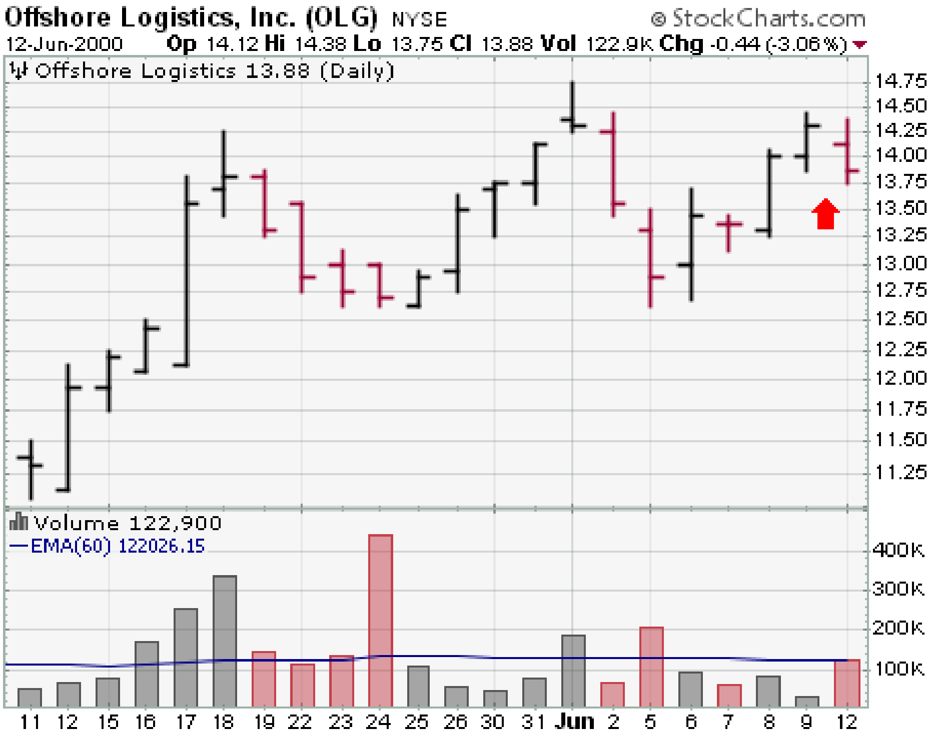
A **Full Gap Down** occurs when the opening price is less than yesterday's low. The chart for Amazon (AMZN) below shows both a full gap up on August 18 (green arrow) and a full gap down the next day (red arrow).

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 (ELNK) 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 (OLG), below, shows where the stock opened below the previous close, but not below the previous low.



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 Gaps

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.)

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.

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.

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.

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.

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.

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.

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 10:30 AM 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.

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).

End-of-day Gap Trading

All eight of the Gap Trading Strategies can also be applied to end-of-day trading. 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 signaled 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?

Members of StockCharts' Extra service can run scans against daily data that is updated on an intraday basis. This is perfect for finding gapping stocks. Simply run the pre-defined gap scans using the Intraday data setting around 10:00 AM Eastern. StockCharts.com also 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.

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.