

OVERNIGHT GAP STRATEGY

By Daryl Guppy

Gap openings occur when prices open higher than the previous day. This creates a 'gap' in the price activity. This is an area of white space between the bars of the price chart. Analysts speak of common gaps, runaway gaps, exhaustion gaps and breakaway gaps. These are all very easy to see retrospectively on an historical chart. They are much more difficult to identify as they happen.

A more effective way of trading this behavior is to clearly understand how a gap is defined and what it tells us about the actions of the crowd. A gap appears when there has been a change of opinion. The value people thought was appropriate yesterday is no longer considered appropriate today. For some reason, usually related to a news event, the crowd has changed its opinion overnight.

This is a two day trading strategy. It is triggered by an open that is significantly higher than the previous days high. The overnight gap strategy accepts that we will miss out of the best price of the day. Our intention is to buy on day 1 and sell at a good price on day 2. At the end of day 1 many traders do a routine search of the market looking for stocks that have posted large percentage gains and with good volume.

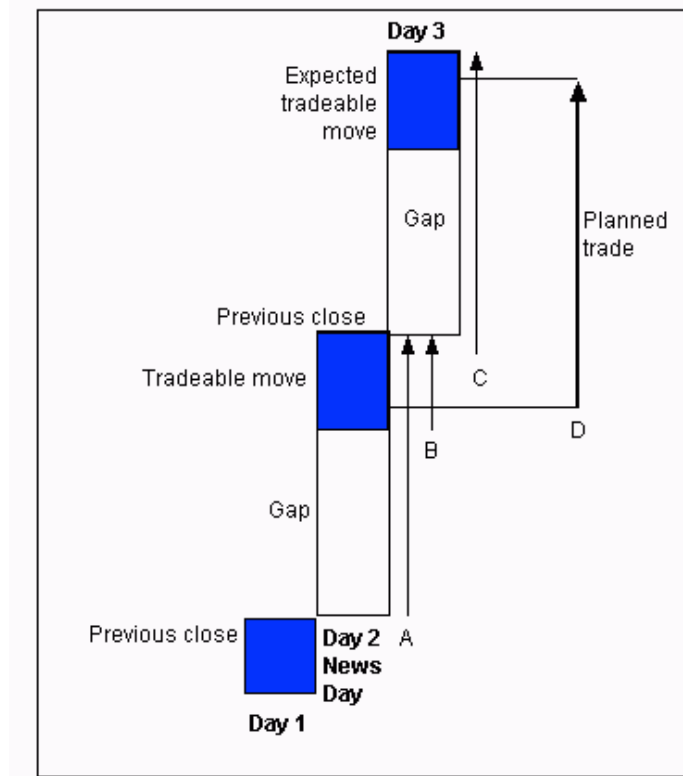
These people act on day 2 with the hope of joining a trend breakout, a rally, or perhaps a rebound trade. This crowd will buy the stock we purchased on day 1. Our strategy is based on the continuation of crowd excitement as the size of the initial price move is discovered by traders using end of day data.

In some stocks this is a regular occurrence, and reflects no more than the general ebb and flow of trading activity. These are the common gaps. When we look at a gap on today's price action and then compare it with the longer term chart we are likely to see many of these common gaps. If the stock has a history of common gaps, then it is not suitable for a gap trading strategy.

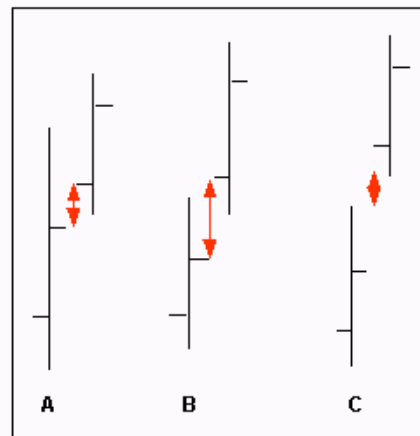
We want stocks that show significant gaps and which are actively traded. Additionally, when the gap appears, we want to see plenty of trading action. Some stocks show a lot of gap activity, but this is simply a move from one price level to the next. This may be a jump from \$0.40 to \$0.42 which shows up on the chart as a flat spot. This spot activity shows there is no trading range for the day. The open, high, low and close are exactly the same. Stocks with a history of this type of activity do not provide trading opportunities. With only a small number of trades all taking place at the one price level, there is limited opportunity to apply effective trading strategies.

We are looking for gaps driven by crowd enthusiasms, and which have attracted many trades. Without trading liquidity, we cannot implement our trading strategy.

The strategy recognizes that we will not capture the benefits of a fast gap move on the first day that it appears. The gap trade A, from the high of the previous day to the high of the gap trade, is available only to those who already hold the stock. It is not available to traders who chase the gap during the day. This opportunity is shown as line B. It is difficult to actually capture the full profit potential on the day of the gap. Typically there are few trades at the opening price, so the level of profit is substantially reduced.



The strategy of running with the gap relies on a continuation of gap activity, or momentum on the day following the initial gap. In theory this gives traders an opportunity to execute the trade shown as line C. In practice this is often difficult as this two day continuation pattern can peak on just a few trades and then start a rapid pullback. The strategy we use aims to capture a midpoint entry on the day of the gap, and a midpoint exit on the day after the gap. This is shown as line D. This is an overnight trading strategy. It works most effectively when leverage is available. Returns from the sample gap trade last week were 20% overnight. These types of return are also generated from similar trades in ordinary stock which have the benefit of price leverage.

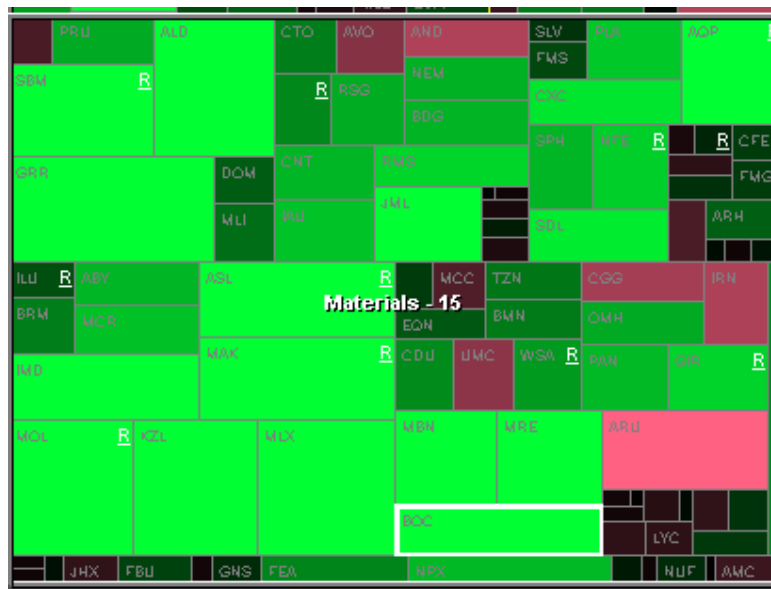


The key to success in this strategy lies in the correct identification of the gap. Each of the bar chart configurations shown are classed as gap trading activity, as shown by the red arrows. Example A shows today's open higher than yesterday's close. This is typically the gap relationship identified by many charting program searches and by some live market scan searches. It does not set up a tradable gap. This is the relationship used by the standard Metastock Gap Up exploration.

Example B is also a common search criteria which shows today's open above yesterday's high. This is a better relationship, but it is not the type of gap we are looking for.

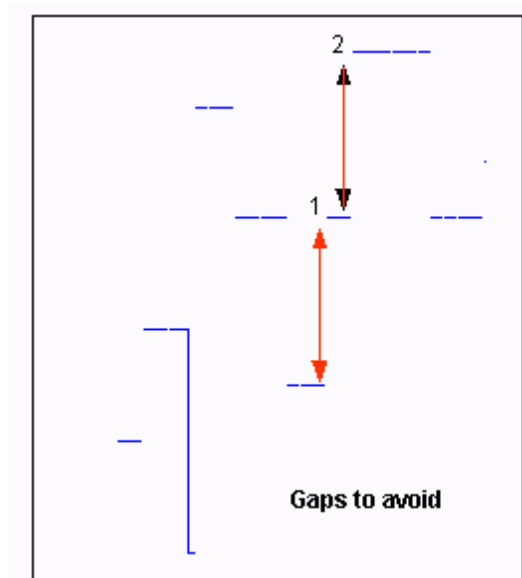
We are interested in the gap shown in example C. This is where the low of today is higher than the high of yesterday. This is where crowd enthusiasm has gone into overdrive. This is a true gap situation, and it pays to set up a data base search exploration based on these criteria. In using live screening to identify these early gaps it is also important to ensure that the gap conditions remain valid during the day. I screen for these gaps after the first 30 minutes of trading.

In the past we used a live screen which gave a tabular output. This service is no longer easily available so we use the WebIress market heat screen as a starting point for potential gaps. This is a slower process. We look for the green hotspots, then check on the daily chart to identify any gapping activity. Alternatively we use the JustData snapshot service. We take a snapshot of market data after the first 30 minutes of trading and then run the Metastock gap exploration scan.



This search throws up many potential opportunities, but only a few of them are true gaps. Each of these must be checked against the chart of yesterday's price high. Traders also check the current low. If this is below the high of the previous day, then no gap trade exists.

Using these conditions we also set up a Metastock search formula which can be used in back testing this trading approach. The search filter looks for two additional features.



The first is a percentage gain. We look for price moves on the gap day where the price range between the low and the high for the gap day is greater than 7%. The objective is to weed out stocks that gap up, but which fail to keep on moving up during the day.

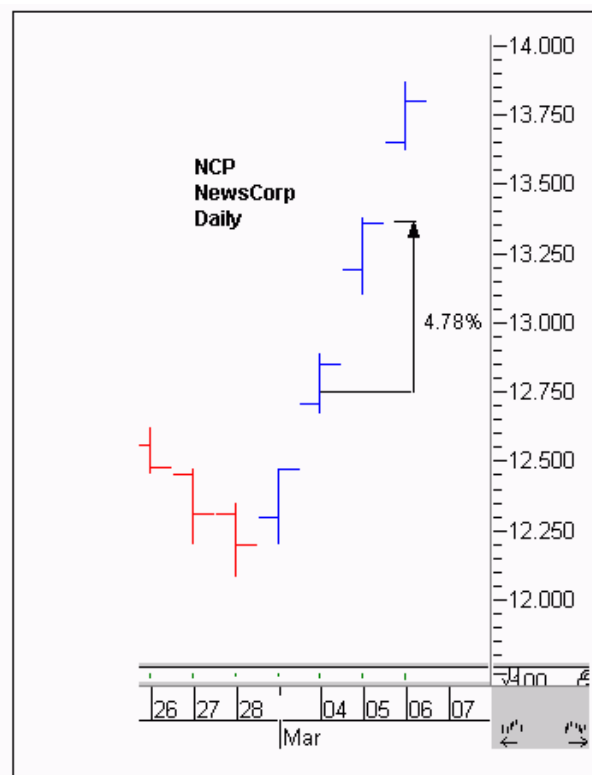
This is the type of gap activity we want to avoid. Prices gap upwards, as shown by the red arrows, but at each price level there is virtually no trading. It is very difficult to buy stock at point 1 and then sell it at point 2. In some stocks we may be just 1 of only 2 or 3 traders. There is not enough breadth of activity on the day of the gap to make an entry achievable. By using a filter of 7% we ensure that an interested crowd has gathered.

Additionally, we include a volume filter. In the formula below we want to see 10,000 shares trading during the day. These filters can be adjusted to suit individual trading circumstances. We use 7% because this identified gap moves that have the advantage of price leverage. We show this strategy applied to NCP below, but NCP does not turn up on the search scan because the intraday price moves are below 7%. This is expected with a stock trading at this price level. The SSI example has a wider price range, and this is generated by price leverage. It is this price leverage that allows us to lock in a better return from the strategy.

The volume filter is designed to make sure we can trade at the size we want. Some traders modify this to provide a dollar figure based on the close for the day. Additional filters can be added to identify stocks that offer price leverage. These typically trade below \$1.00. The full formula is at the bottom of these notes.

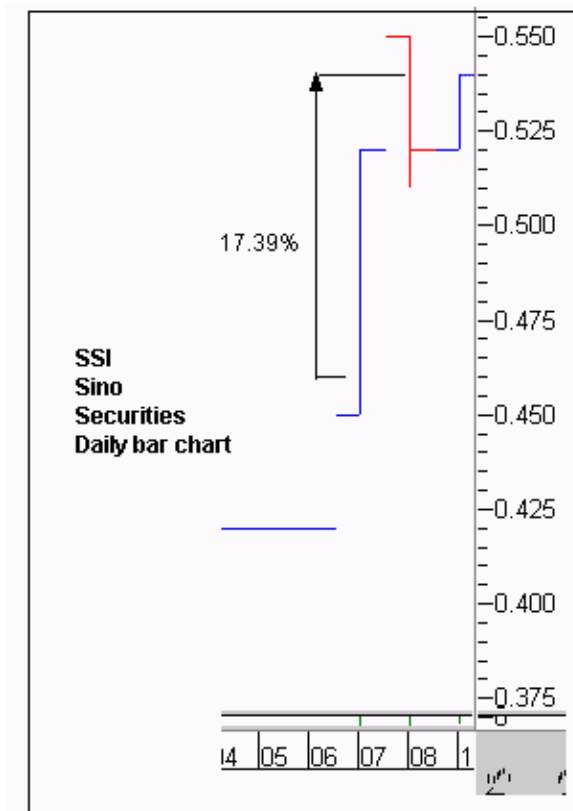
Running with the gaps is not a strategy that throws up many stock candidates. Of the 8 to 10 identified on any given day, only 3 or 4 might meet the

conditions. The others show spotty price activity. Despite this, the strategy offers the opportunity for rapid trading profits overnight based on a continuation of crowd enthusiasms. Success depends on striking the balance between price leverage, price range and volume. Without these three factors the strategy is difficult to implement, and difficult to close successfully if the overnight momentum fails.



The NCP chart shows why price leverage is important. The rapid series of price gaps meets all the conditions necessary for this strategy – apart from price leverage. Applying the strategy gets the trader in at around \$12.75. Exiting near the high of the next day gets the trader out at \$13.36. This is a 4.78% return. Even if the trader moves a very large position, the return on capital is still quite low. This type of opportunity is best traded using the leverage offered by a warrant. If no warrant is available, then the opportunity is usually abandoned. Trading a continuation of crowd momentum overnight carries a risk that the momentum will not continue. When the returns are marginal, just a few percentage points, the trade does not represent the best use of trading capital. NCP does not show up on our exploration search because the intraday price move does not exceed 7%.

With NCP prices continue to gap upwards and an extended trade with an exit around \$13.80 returns 8.24%. However, we cannot rely on gap momentum continuing. The probability of this is much lower than the probability of momentum continuation after the initial gap day.



The SSI chart example meets all the conditions of price and volume. When entering these trades the trader must make a judgment about the potential for the intraday price to exceed 7% as this figure is not determined until the day's trading

is completed. This is an intraday trading technique so the trader must monitor live trading screens. His judgment of price volatility is based on the level of price leverage available. There is a higher probability of a stock trading at \$0.50 adding 7% for the day than with a stock trading at \$13.00.

The trade is managed with a tight stop loss. Better trades do not retreat below the open. The momentum of trading remains upwards as shown with SSI. The trader is able to enter this trade at \$0.46. Some of these trades will gap open the next day, as with NCP, and offer very good overnight returns. Others, like the SSI example, gap open, but the momentum fails.

This momentum failure is monitored by the trader using live screens. When there is a good balance of buying and selling in the order line a small price retreat is an acceptable part of normal trading activity. Some traders will work the open, offering slightly lower prices to get out of the trade. If this lower selling is chased by a good crowd of buyers it shows continued support.

The danger signal is when buyers start to dry up. Here the open is not supported by new buyers. Sellers start to crowd the market, so our strategy calls for an exit at market. In this example the exit is at \$0.54. This delivers a 17.39% overnight profit.

This is a day trading technique. It requires full time access to live trading screens. Trade entry is initiated after the initial spike of buying activity has subsided or consolidated after the first 30 minutes of trade. After this time the trader can form a better idea of the probability of the momentum continuing. The key factor is the continued presence of good buying support.

These trades are closed sometime during the second day. If the gap up continues the trade is monitored to ensure continued buying support. Unless this is maintained, the trade is closed. The trade is closed later in the day at the first signs of a withdrawal of buyer support. This can also be controlled using a tight trailing stop loss set 1 to 2 ticks below the last traded price.

Trades that fail to gap up the next day are closed quickly to lock in profits. With careful management, and the use of price leverage, this is a successful overnight trading strategy.

GAP TRADING EXPLORATION SEARCH

Exploration notes

Stocks which have gapped upwards, with low higher than previous high by at least 5%

Col A: $\frac{((LOW-(Ref(HIGH,-1)))/(Ref(HIGH,-1))) * 100}{1}$
Col B: $\frac{(((Ref(OPEN,-1)-(Ref(CLOSE,-1)))/(Ref(OPEN,-1))) * 100)}{1}$
Filter colA > **7** AND colB > **5** AND VOLUME > **10000** AND Fml("deaddays")

Note. The highlighted figures in bold can be changed to suit individual requirements. They currently filter for stocks with a gap for more than 7% and a range in the previous day of more than 5% and with volume greater than 10,000.

The image shows a software window titled "Indicator Editor". It has a tab labeled "Formula". Below the tab, there is a "Name:" field containing the text "deaddays" and a checked checkbox labeled "Display In QuickList". Below that, there is a "Formula:" field containing the text "DayOfMonth()=3 AND Month()=2 AND Year() = 2011".

The Deaddays formula must be entered in the Indicator builder. Dates are adjusted to match the most recent last date of your data. This indicator is referenced in the gap up search formula.