TRADING DOWN GAPS

By Daryl Guppy

This reprinted article uses a Marketcast screen. This is now easily obtained via any of the CFD providers with live feeds. The trading method remains valid and is now easier to implement with new technology. Editor

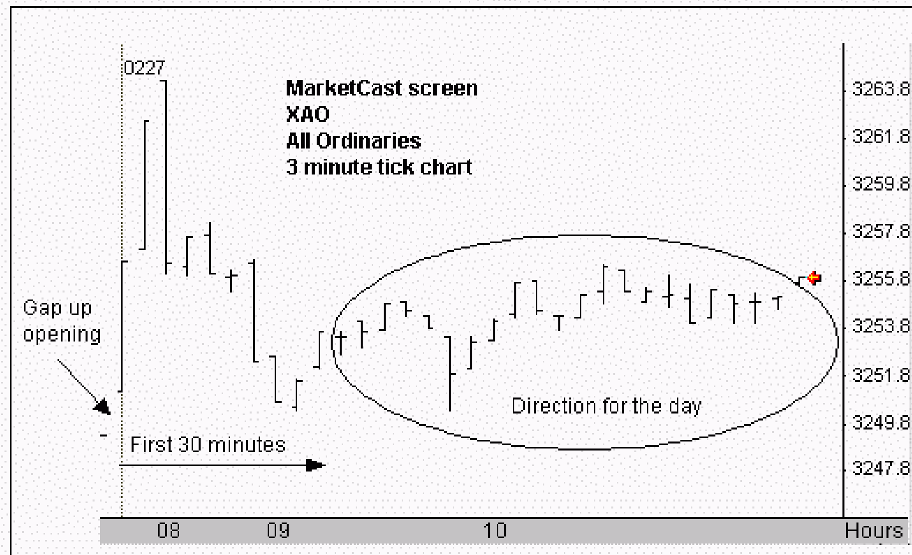
Increased market volatility is leading to an increase in price gapping activity. Trading gaps offers some useful short term strategies.

A gap in prices is when the opening price of today is higher or lower than the closing price of yesterday. As traders we often focus of bullish gaps where the opening price is higher than the previous high. This does provide a number of trading opportunities. We are less inclined to effectively deal with the gap down in price. This is where today's opening price is lower – sometimes significantly lower - than the low of the previous day. It is more than just a sinking feeling. These gaps have the capacity to rip past our stop loss points.

For traders working with end-of-day data these bearish gaps are a fact of life. There is little they can do until the next day's trade. We recognise that these occasional disasters are part of the trading process. They are difficult to forecast in advance, and they are often related to surprise announcements such as earnings downgrades. Rather than attempt to predict these gaps, we need to focus on ways to manage our reactions to them. The end-of-day trader should simply take an exit on the next day at the most favourable prices available. The trader with access to real time screens has a wider range of management responses.

Panic is not one of them. Amateur and inexperienced traders tend to panic. They see the gap, and they sell into it with total desperation in an attempt to get out before price falls even further. "Just get me out," they tell their broker, or they send sell orders to market set cents below the last trade just to make sure than can get an exit. The public, including the institutions, tend to overreact to bad news.

As traders we want to avoid participating in this panic and develop methods to either ignore the gap and stay with a trade that recovers, or to manage a better exit from the gap. In developing these strategies we use the behaviour of the market on the open. It takes around 20 to 30 minutes for the market to establish its direction for the day. Trades taken in the first 30 minutes of market open, or in the first 15 to 20 minutes of trading in a single stock, carry a higher level of risk as the direction of the day has not yet been established.



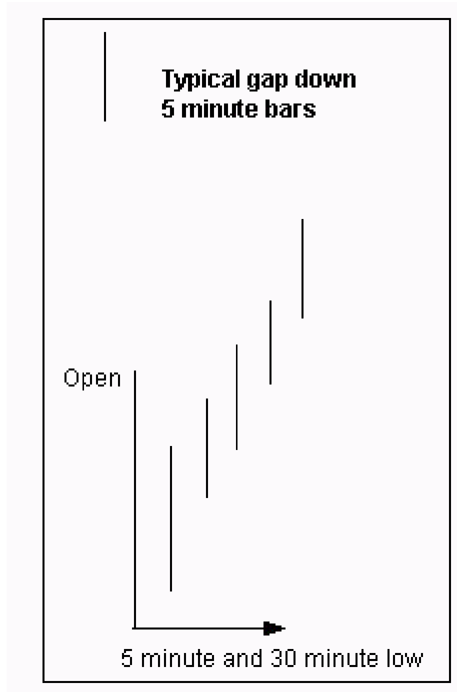
Here is the gap open on the XAO on Tuesday morning. This is a 3 minute tick chart. For the first six minutes the market accelerated upwards on the back of a higher close on the DOW overnight. In the next 21 minutes the market pulled back and began to establish the direction for the remainder of the day. This overreaction on the open is typical and it is in these patterns that traders find ways to deal with gap down days.

US trader Oliver Velez sets out six rules for reacting to these gap days. They are

- Watch and wait
- Mark the 5 minute low
- Sell half the position if prices go below the 5 minute low
- Mark the 30 minute low
- Exit the remainder of the position if the price drops below a 30 minute low
- Use a trailing stop loss for the rest of the day.

RULE 1

The first rule makes sense in any market because it prevents us from joining the market panic. The objective is to do nothing for the first 5 minutes of trading. It's a hard rule to stick with because the market may be plunging dramatically and increasing your losses every second. We should never sell shares when we are panicked, or when a market is panicked. It is not a good state of mind for making good decisions.



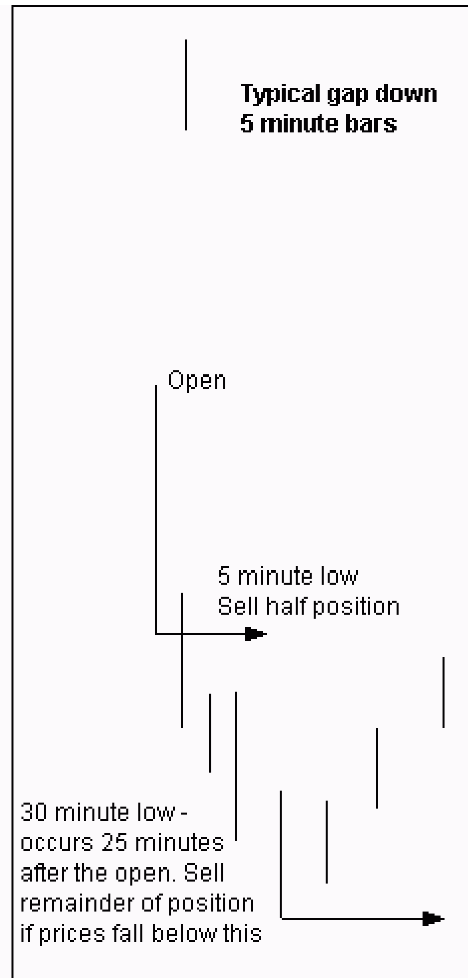
Hindsight will sometimes tell us that we should have sold out in the first 5 minutes. If is difficult to know this for certain in advance. Waiting 5 minutes is not a guarantee of success, but it should help you understand what is happening in the market so you can make a more informed decision.

RULE 2

Rule 2 is to mark the 5 minute low. This is the lowest low for the 5 minute period. This can be noted on either a 5 minute tick chart where each bar represents 5 minutes. We find a 3 minute tick chart most useful in the Australian market. We will modify this rule to take the reading after the first 6 minutes of trading when we apply it to real gap behaviour. In either case, this is the most important price level for the next 25 minutes or so because it sets the short term support level.

RULE 3

Rule 3 tells the trader to sell half his position if prices drop below the first 5 minute (six minute low in our case) in the first 30 minutes of trading. We sell half the position under these conditions as protection against a continuation of the gap down. We accept that it may take 30 minutes for the market to set its direction for the day. However, between the first six minutes and the first 30 minutes the market may carry us a long way down. By taking a small loss on a close below the six minute low we ease the burden of the loss and exercise a bit of damage control.



This sale is a protective action. When we apply these rules to real gap down situations we modify it for Australian conditions.

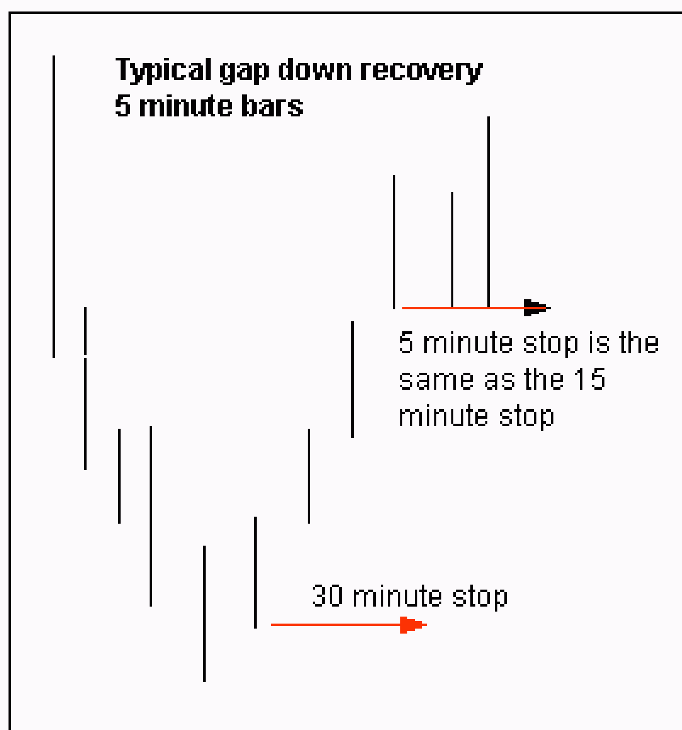
RULE 4

Rule 4 uses the observed behaviour of the market to capture the potential rebound on a time basis. We know the market typically sets the direction for the day after the first 30 minutes or so of trading. This makes the price extremes set during this period a particularly useful reference area. After 30 minutes of trading we mark the lowest point in that period. This is our primary stop loss condition and alert. If prices move lower than this 30 minute level then the entire position is closed. Price action often reaches hysterical levels in the first furious minutes of a panic sale. This 6 minute mark may represent the lowest low in the first 30 minutes of trading. If this is so, then it is this low that is used as the stoploss.

RULE 5

Rule 5 tells the trader to exit the entire position if there is a close below the 30 minute low point. This is the primary stop loss level based on the tendency of the market to react to extremes in the first 30 minutes of trading. If the stock does not trade below the 30 minute low and then moves to a new daily high then we

know the panic selling was an overreaction. Instead of exiting the trade at a panic disadvantage we can stay with the trade as it develops a new and stronger trend. The trend is stronger because the weak hands – the nervous stockholders- have been shaken out in the first minutes of panic.



RULE 6

Rule 6 defines a number of trailing stop strategies used as the price rallies form the 30 minute lows. The suggestion is to use 3 time frames, each a multiple of the first. We would use a 6 minute bar, a 15 minute bar and a 30 minute bar. After each period ends, the trailing stop loss for the period is recalculated. A move below the closest stop loss is an exit signal. This is a complex set of stop loss conditions, and in some circumstances, as a stock trends sideway, the 6 minute stop loss may also equal the 15 minute stop loss.

An alternative is to use a stop loss based on the 30 minute low for the day. This approach may improve the outcomes, but it also takes away the opportunity to reduce the loss. Here the maximum potential loss is the same as the 30 minute gap low of the day.

These are bear gap rules developed by Oliver Velez and they are designed for the US market. In the next article we modify them, for Australian market conditions. With more earnings downgrades on the way, the problem of bearish opening gaps will become more common.