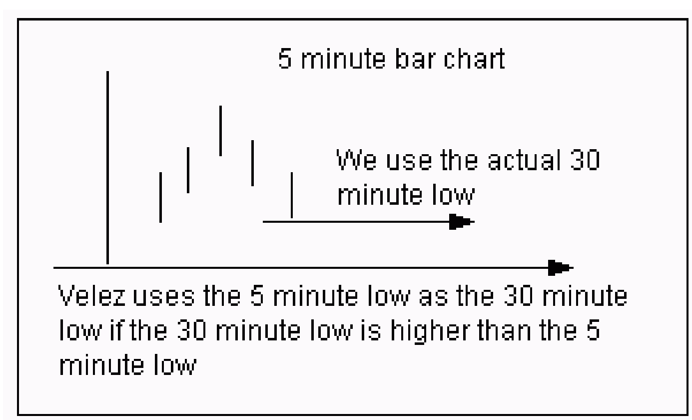
TRADING DOWN GAPS part 2

By Daryl Guppy

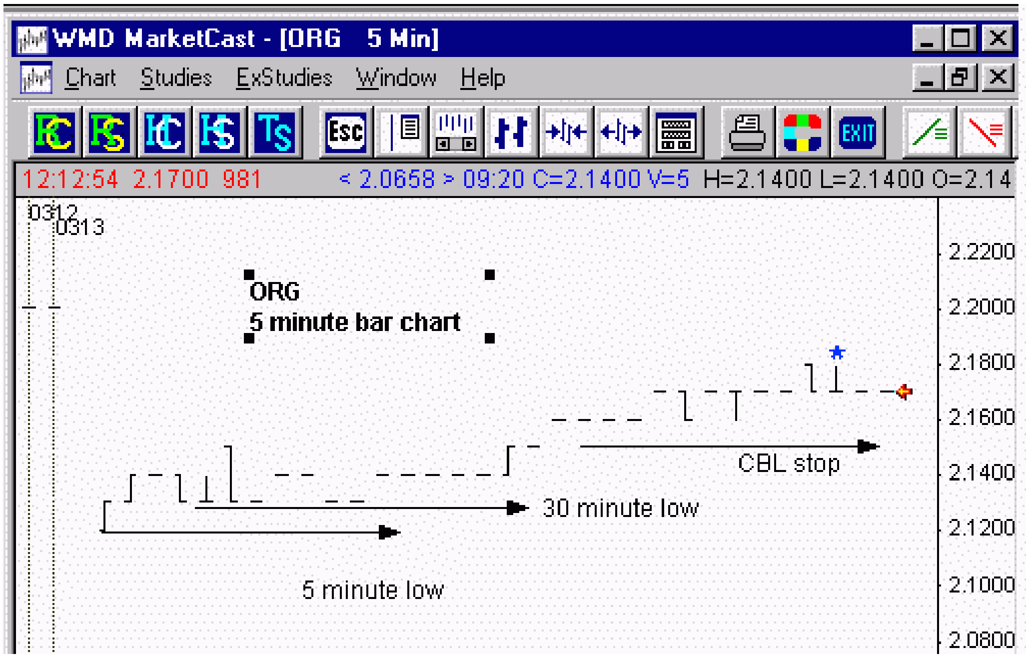
This reprinted article uses a Marketcast screen. This type of screen is now easily obtained via any of the CFD providers with live feeds. The trading method remains valid and is now easier to implement with new technology. Currently we use this method for gap trading with the XJO index. Editor

This week we resume the discussion of monster downward gaps that carry prices below our stop loss points. This was not an unusual experience this week. US Trader, Oliver Velez proposes six rules for surviving these gaps. He uses a three minute chart. We use a five minute chart view. Because we work in a less liquid market, we use the close on the 5 minute tick bar as the signal, rather than just a dip below the level. The modified down gap trading rules are:

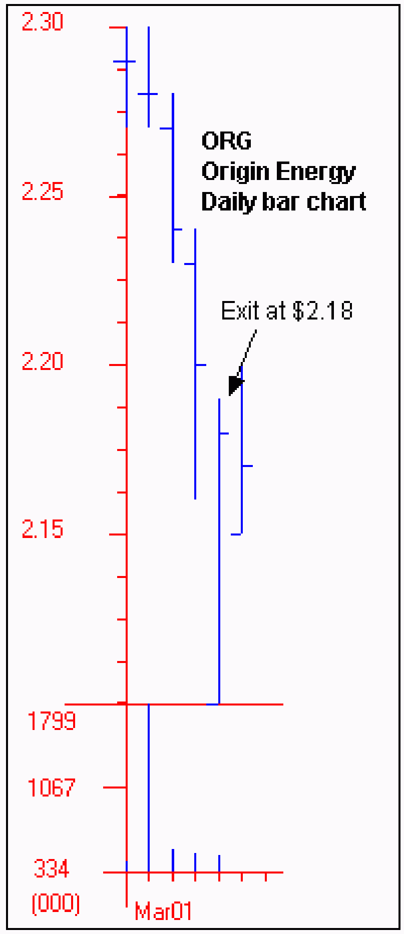
- Watch and wait
- Mark the 5 minute low
- Sell half the position if prices close below the 5 minute low
- Mark the 30 minute low
- Exit the remainder of the position if the price closes below a 30 minute low
- Use a trailing stop loss for the rest of the day if prices remain above the 5 minute and 30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



We do note one important modification of the Velez approach. In plotting the 5 minute and 30 minute low he uses the lowest of the two as the 30 minute low. We have found that it is better to use the actual 30 minute low as the trigger level. We suspect that this is because the Australian market is not as widely liquid as the US market.



Tuesday saw a substantial collapse in the market following falls in the US on Friday and Monday. Our objective in considering the impact of down gap openings is to prevent a panic exit at or near the very low after the open. For the purposes of these examples we will assume that our stop loss has been triggered on Monday and that we are now looking to exit the trade at a favourable price on Tuesday.



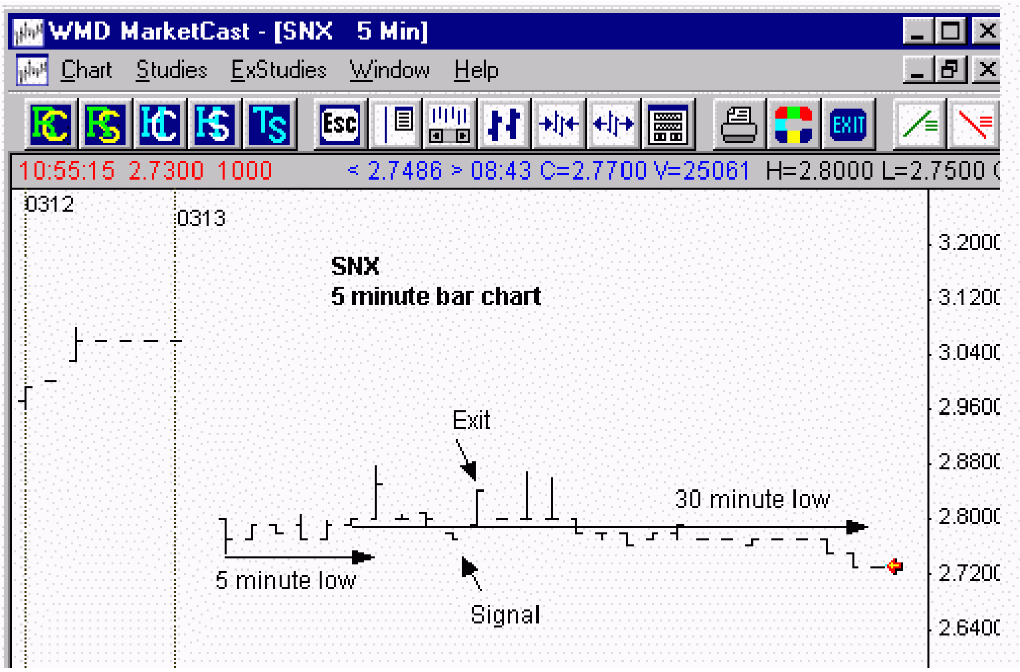
We start with ORG. Here we see the classic chart situation where the Monday fall has triggered a stop loss based on a confirmed collapse from the equilateral triangle pattern. The objective is to manage the monster gap opening in an effective way. The first 5 minute low sets the low for the day, although we do not know this at the time. The 30 minute low is at a higher level and although it spends another 25 minutes before price moves away from this level, the 30 minute low does hold.

This tells us the stock is likely to continue moving upwards for the remainder of the day. We monitor this by using a count back line stop loss calculation based on the most recent 5 minute high. This is shown by the * on the 5 minute tick char t.

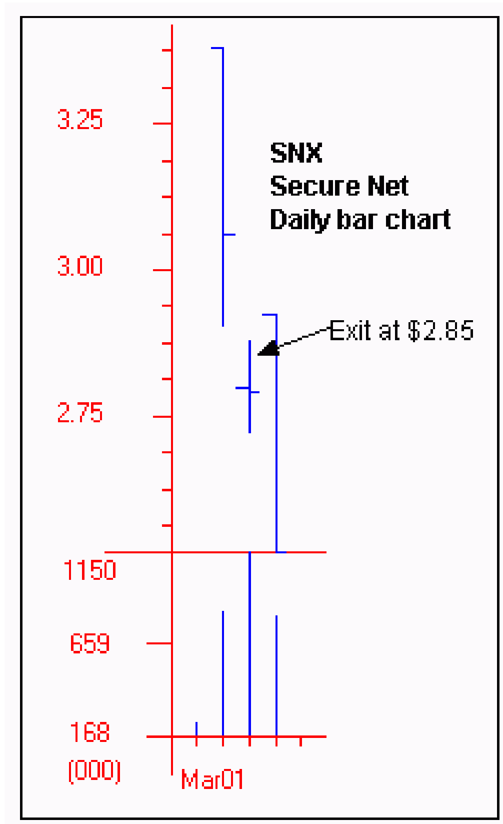
This is an effective way to manage the trade exit. The CBL stop loss keeps us within this bounce and takes us out around $2.18. This is less than the high for the day, but it is much better than taking a panic exit at or near the low for the day. In this situation the trading rules have delivered a better result than an at-market exit on the market open.

The SNX chart also gives us an improved exit. Forget for a moment that any trader should already be out of SNX. Our purpose here is to decide if this gap management method is able to achieve a getter exit on the day. SNX starts the day with a 8% gap down compared to the previous day's close.

Again the first 5 minute low is lower than the 30 minute low. This makes the 30 minute low behave as a stop loss line which will take us out at a higher level, should the SNX price reverse during the day.



The exit signal is delivered as prices dips below the 30 minute low line. This is a 5 minute tick signal and we act on the next 5 minute bar. We use the close of the 5 minute bar to make our decision so our exit takes place on the next 5 minute bar. This takes us out of the trade around $2.85.

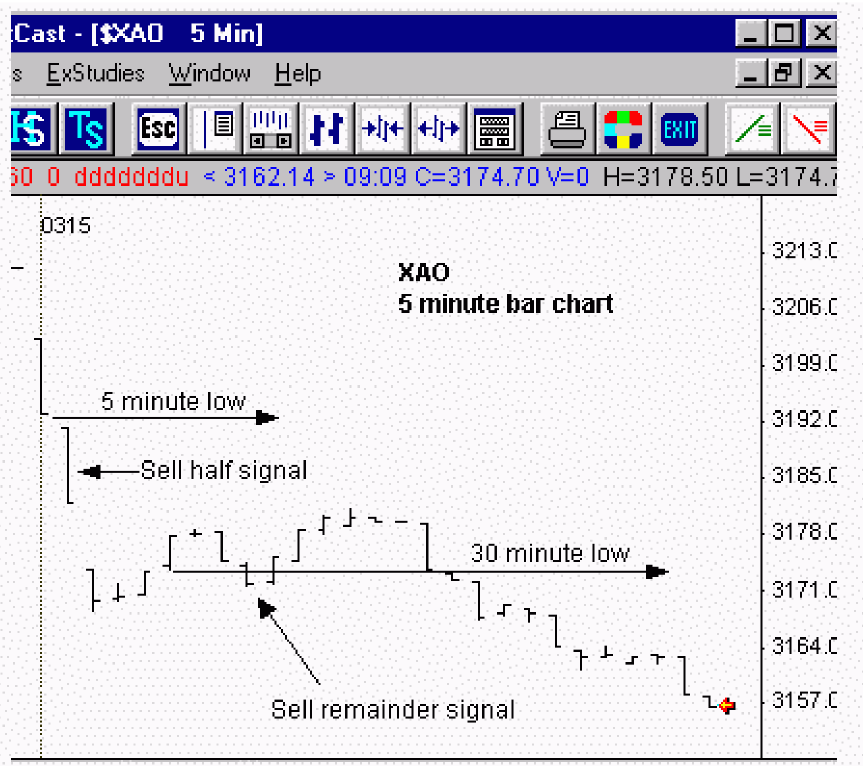


On the full daily bar chart this exit captures a better price than that available on the open. It is also a better price than that available later in the day when SNX moves much lower before staging a slight rally. This method will not get the trader out at the top price for the day, but it does avoid an exit on the very low of the day. Waiting for the first 5 minute low prevents the trader from accidentally adding to the initial overreaction selling pressure.

Neither of these examples will post new profits on the losing trade. They both show how the initial panic loss caused by the gap down can be minimised. On a gap down day we do not have to take the worst price on offer. By waiting we can often obtain an improved exit.

Applying these down gap trading rules provides a better exit when stocks recover. Stocks do not always recover from a downside gap so we need to apply these rules to these situations. The fall in the All Ordinaries on Thursday is a useful test.

The 5 minute low was quickly exceeded. The drop below this 5 minute low is a signal to sell half the open position. This is not going to give a good result with the XAO as our exit will be somewhere in the third 5 minute bar.



The 30 minute actual low is marked. Index values fall below this 15 minute later and we exit before the bloodbath has the opportunity to gain even more momentum. In retrospect we can say that it would have been better to exit the entire trade on the open. However, we cannot know this in advance. By taking a part exit after the 5 minute low is violate, we reduce our losses and still give ourselves the opportunity to participate in any recovery. If the down pressure continues, we sell the remainder of our stock. On some days, such as with the XAO on Thursday, this will result in a slightly larger loss, although the impact of the last sale of half the position is reduced because the size of the position is smaller.

In this example the XAO staged a remarkable recovery in the last hour and a half of trading. Good traders do not build their trading plans around extraordinary events and use them as away of saving a loss or deferring an exit decision.

On most of the examples shown we get a better exit by waiting for the 5 minute low to establish itself before we take action. This will often give a better than expected exit. When this strategy is applied to stock on Thursday, we see the same level of success. These trading rules will not turn a loss into a profit, but they will help traders to avoid hasty exit decisions based on panic. By understanding the behaviour of the crowd on these day, we can give ourselves an advantage.