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Price Gap Day Trading System

Do It The Easy Way! Trade Price Gaps Using Signals From AIQ's Alerts Software

By David Vomund

In his book, *Day Trader*, Jake Bernstein says that his favorite day trading systems use price gaps. Trading price gaps is easy using AIQ's Alerts module. Using Alerts, you don't have to constantly monitor charts watching for entry points. The software will alert you anytime a stock passes your criteria.

Before describing one of Mr. Bernstein's systems, let's review what a price gap is. An upward gap occurs any time a stock opens higher than the previous day's high price. A downward gap occurs when a stock opens lower than the previous day's low price.

Here's an example: suppose yesterday's price range on an equity was $25.60 as the high and $25.10 as the low. An upward gap occurs when the next day's open is greater than $25.60 and a downward gap occurs when the next day's open is less than $25.10.

Most large price gaps occur because of news that was released sometime between the previous day's close and the current day's opening price.

DAVID VOMUND

Mr. Bernstein views a downward gap as a possible buying opportunity. That's because most of the shareholders who were close to selling do so once a stock gaps down.

The first criterion for a buy signal is that the stock must gap down. If the lower opening price gap occurs, then enter the day trade once the security rises above the previous day's low. In other words, a long position is established once a gap is filled.

"What is a price gap? An upward gap occurs any time a stock opens higher than the previous day's high price. A downward gap occurs when a stock opens lower than the previous day's low price."

The sell strategy uses either a trailing stop or you sell if the stock falls below its daily low. If the trade works out, sell right before the close.

According to Mr. Bernstein, once a stock gaps lower traders interpret it as a bearish sign. This brings more selling as stops are hit. If selling pressure begins to decrease and buyers emerge, the stock begins to rally. Traders enter the security once it moves higher. Frequently, the surprise recovery tends to accentuate upside movement.

The AIQ software can alert you anytime a stock gives a buy or short-sell signal using this technique. This allows you to run the screening on a large database of stocks. To do this, select the *Alerts* icon in the Quick Launch Menu.

The Alerts application provides users with the capability of adding lists of stocks and thus avoiding the task of manually entering each individual ticker symbol. From the menu bar of Alerts, select *Tickers* and *Add Tickers From List*. Select the desired list and click *OK*. We ran the system on a database of the S&P 500 and Nasdaq 100 stocks. If you have

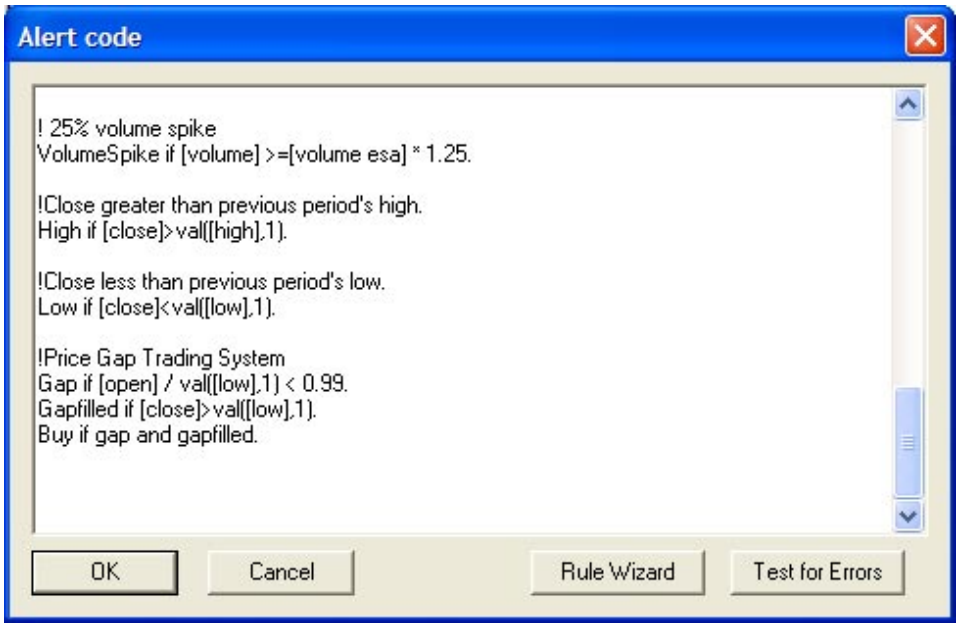

Figure 1. Alert code window used to enter/edit coded statements that define an alert. The last four lines shown define the Price Gap buy rule. The first rule, Gap, finds stocks that have gapped lower by at least 1%. The second rule states that the price has then moved above prior day's low.

"The first criterion for a buy signal is that the stock must gap down. If the lower opening price gap occurs, then enter the day trade once the security rises above the previous day's low…The sell strategy uses either a trailing stop or you sell if the stock falls below its daily low. If the trade works out, sell right before the close."

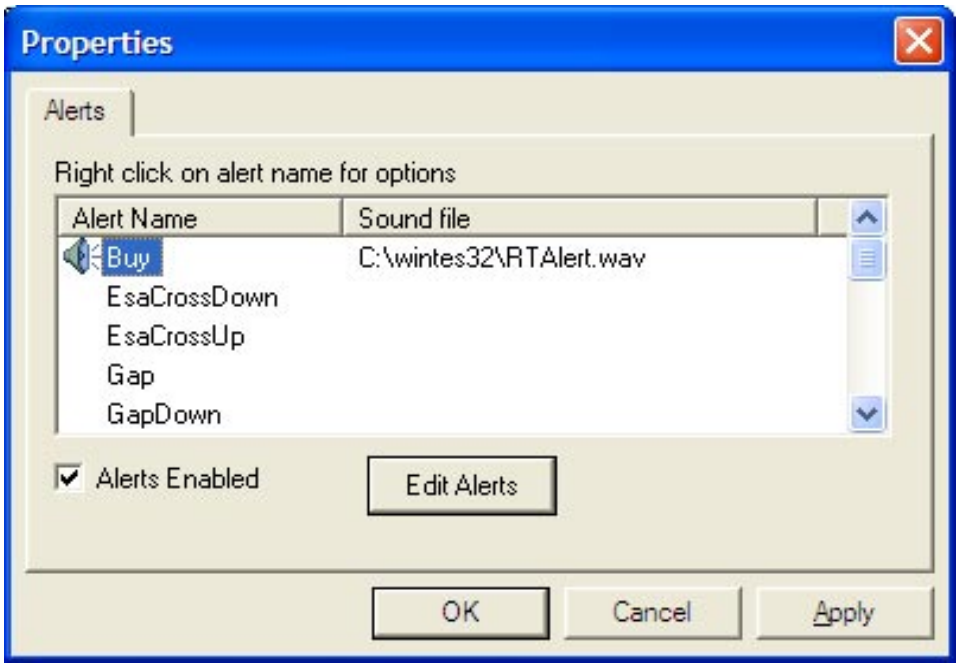

Figure 2. Once an alert has been created, the Alert Properties window is used to activate or deactivate the alert. To acivate, right-click on Alert Name and click *Alert Enabled*.

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a dial-up connection, limit the stocks you track in Alerts to less than one hundred.

Next, we have to create the EDS code for this trading system. Here is the code for the buy signals:

Gap if [open] / val([low],1) < 0.99.

Gapfilled if [close]>val([low],1).

Buy if gap and gapfilled.

The first rule called Gap states that the stock must have gapped down by at least 1%. That eliminates stocks with price gaps of only 1/8 point. The second line called Gapfilled states that the stock must have rallied above its previous day's low. The final rule called Buy states that both the Gap and Gapfilled rules are true.

You will want to type this code into the Alerts program. On the Alerts menu bar, click *File* and *Alert Properties*. In the Properties box, click *Edit Alerts*. Scroll to the bottom of the Alerts code and enter the three trading rules (**Figure 1**).

Once entered, click *OK*. In the Properties screen we want to activate this new alert. Right-click on the Buy rule name and select *Alert Enabled*. A speaker symbol should appear next to the Buy rule. We can also have the computer make a sound anytime an alert is triggered. Right-click on the Buy rule and select *Add Sound*. Click RTAlert and *OK*. Your screen should resemble **Figure 2**.

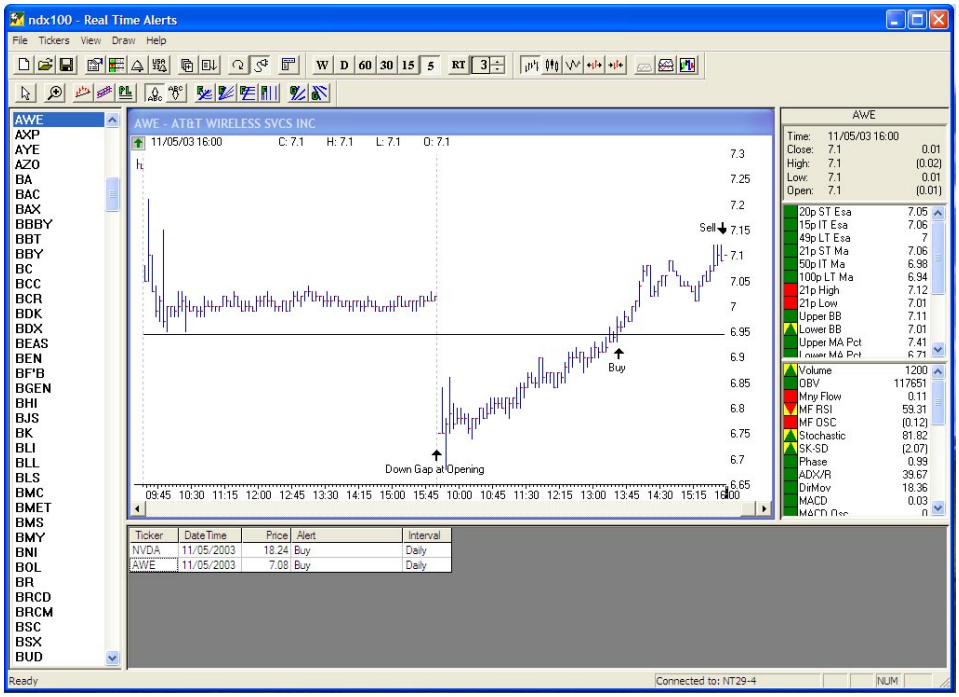

Figure 3. RT Alerts window displaying 5-min chart of AWE one of two price gap alerts triggered on 11/05/03. AWE gapped down on open and then rallied above prior day's low (horizontal trendline) triggering Buy signal (arrow).

When an alert is triggered, an alert will appear at the bottom of the Alerts page. In **Figure 3** we see two stocks met our Buy criteria on November 5. Nvidia Corp (NVDA) and AT&T Wireless (AWE) both gapped lower at the opening but recovered and rallied above their previous day's low price. By the end of the day, both were profitable positions.

Figure 3 plots AWE so we can see how the trade developed. In the middle of the chart we see that AWE gapped lower when it opened on November 5. If AWE fails to rally above its previous day's low then the Buy criteria is not satisfied and there is no trade.

AWE did find buyers, however, and it rose above the previous day's low price. To see this, we've drawn a horizontal trendline from the previous day's low. That trendline was penetrated at about 13:30 and the alert was triggered. The position was profitable so it was sold shortly before the market's close.

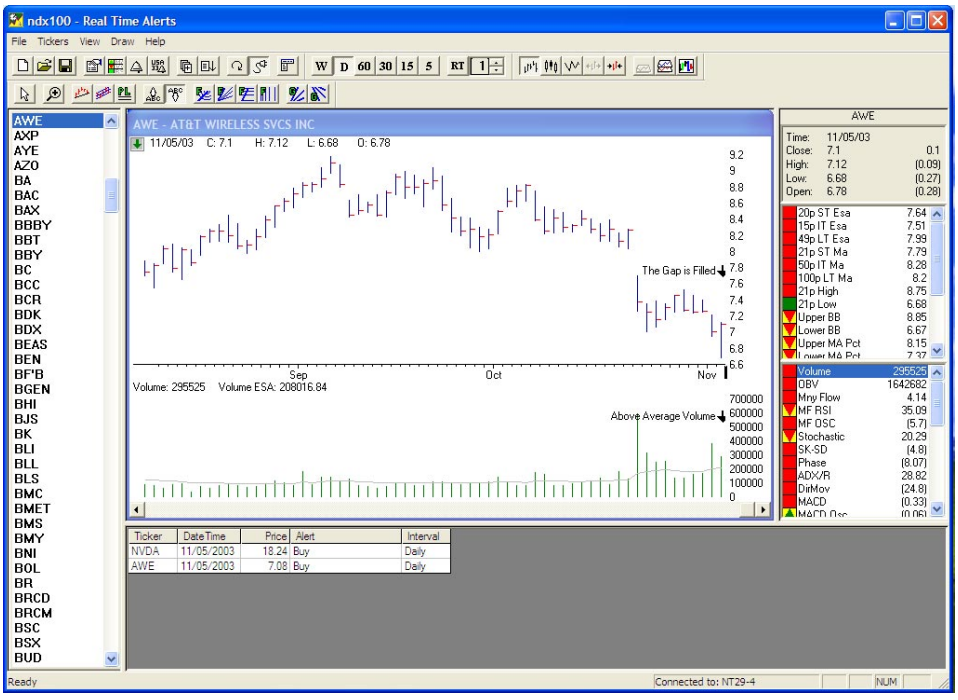

Figure 4. RT Alerts window displaying daily chart of AWE. Price bar for 11/05/03 does not show that AWE gapped down on open since stock later rallied and closed above prior day's low.

Figure 4 shows the same trade using an end-of-day chart. The entire trade occurs on the last price bar. Since the bars show only the high, low, and close for the day, the price gap on 11/05/03 is not seen on the daily chart. However, it is apparent that a big sell-off took place during the trading day then rallied above the prior day's low and closed near its high.

When the Buy rule criteria is met, volume is usually above average because of the extreme price action.

When running alerts on this model, it is important to have an end-of-day chart plotted. If you are plotting a 5-minute chart, then alerts are run on five-minute bars. After an alert is triggered, always chart the security to see if it fits your criteria. When an alert is triggered, right-click on its ticker symbol and select *Chart Security*.

"In this article, we focused on long trades but the system is designed for short positions as well. For a short trade, the stock must gap higher but then fall below the previous day's high price."

In this article, we focused on long trades but the system is designed for short positions as well. For a short trade, the stock must gap higher but then fall below the previous day's high price. Here is the EDS code:

Gap2 if [open] / val([high],1) > 1.01.

Gapfilled2 if [close] < val([high],1).

Short if gapup and gapfilled2.

Although we said that if a position is profitable it should be closed at the end of the day, obviously profits can be taken midday as well. For profitable positions, you can raise the stop level to a level above your purchase price in order to secure a profitable trade after commissions. If that stop is not triggered, sell at the close.

David Vomund publishes VIS Alert, a weekly investment newsletter. For sample issues, visit ***www.visalert.com.*** *For information on Vomund's managed account program, visit www.lvim.com or call 775-832-8555.*

Market Review

The market experienced a mild correction in November. From the November high to the low, the S&P 500 corrected 2% and the Nasdaq corrected 4.8%. There was enough technical damage to bring in more sellers but that didn't happen. People want to be in this market.

The figure shows the market breakdown and its quick recovery. A trendline drawn from the Nasdaq Composite's March low was touched on four occasions (see arrows). The Nasdaq remained above this support trendline for eight months until mid-November, when the trendline was finally broken.

A break like this usually denotes the beginning of a consolidation or a correction. In this case, the Nasdaq quickly recovered and moved toward its highs by month's end. It appears the trendline break was a fake out.

At month's end, the S&P 500 was at its early November highs and the Nasdaq was just off its highs. The area of leadership was in small-cap stocks. The Russell 2000 index, a measure of small-cap stocks, hit a new yearly high at the end of November.

Behind the continued strength in the market is a strong economy. Tax cuts are helping people save, invest, and spend. That's one reason third quarter GDP growth was 8.2%, the strongest in 20 years. The employment picture is improving as well.

The best performing group in November was Environmental Services, gaining 16%. Allied Waste and Waste Management did well. Metals-Mining, Retail-Consumer & Electronics, and Office-Electronics all gained more than 13%. A group that you would expect to do well in a rising market is Biotechnology, but this group was one of the month's worst performers. It lost 6%.

S&P 500 Changes

Changes to the S&P 500 Index and Industry Groups:

Biogen (BGEN) is now Biogen Idec (BIIB). BIIB is in the Biotechnology (BIOTECHN) group.

Sector Fund Trading Strategy

Our 'Relative Strength Report Strategy' Is Tested on Fidelity's Sector Funds The Results? Very Good!

By David Vomund

In the October *Opening Bell,* we applied and tested an effective trading system on Exchange Traded Funds that are designed to track market indexes. This trading system uses AIQ's Relative Strength report. It worked well.

In last month's issue we applied the same strategy to the Select Sector SPDRs but had disappointing results. We attributed the problem to the trading vehicles rather than the trading strategy. Now we'll see if that is true. This month we'll apply the trading strategy to the Fidelity sector funds.

Fidelity offers the most popular sector trading vehicles. Fidelity's 40 sector fund choices comprise the broadest selection compared to competitors. Plus, Fidelity has eliminated the 3% sales load once charged for these funds.

"The year 2002 was the harshest in the bear market but this strategy outperformed the S&P 500 by holding Gold in one of its two positions. Gold was held from January to July. This sector held its value during a time when the S&P 500 lost 25%."

Fidelity does charge a penalty if you hold a fund for less than 30 days, however. Information on Fidelity sector funds can be found at www.fidelity.com.

The Strategy

As noted above, our trading strategy utilizes AIQ's Relative Strength report. The Short-Term Relative Strength-Strong report was run every other Friday on the Fidelity sector funds. This report looks at the last 120 trading days (approximately six months) and breaks them into quarters. A percentage return figure is calculated for each quarter. These returns are then averaged, with twice the weight placed on the most recent quarter's worth of data.

At the start of the test, the two highest ranked Fidelity sector funds were purchased with equal dollar amounts to establish a fully invested portfolio. Two weeks later, the same Relative Strength report was run again. If the current holdings were rated in the top half of the report, then there were no trades. If a holding had fallen in the Relative Strength report to where it was no longer in the top half of the report (i.e. one of the top 20), then it was sold and the highest rated sector fund was purchased.

The portfolio was always fully invested in two sector funds. The strategy is designed to rotate to the sectors of the market that have the best performance.

The buy and sell prices used were the closing prices at the end of the week (i.e. the day the reports were run). Although this is possible, most people would buy and sell the fund on Monday morning. Also, the portfolio was rebalanced at the end of each year to create equal positions in the two holdings.

"From January 1998 to November 17, 2003 the portfolio gained 278%. That gain came at a time when the S&P 500 lost 15% of its value."

Results

The testing results are very good. From January 1998 to November 17, 2003 the portfolio gained 278%. That gain came at a time when the S&P 500 lost 15% of its value. With that kind of return this is obviously an aggressive system.

Only two funds are held at one time and there were times when both funds were technology oriented. The portfolio is anything but diversified.

Table 1 shows the yearly returns compared to the S&P 500. Our strategy outperformed each year, including the time during the brutal bear market. The 41% return in 2000

is especially impressive. It shows that the strategy benefited from the technology run at the start of 2000 but by design it rotated out of technology before the year was finished.

The individual trades are found in **Table 2**. Notice that in the second half of 1998 the sector system rotated to an all-technology portfolio consisting of Computers and Electronics. These two holdings were held throughout 1999 and gained 170% and 216% respectively. That was at the height of the bubble and this action may never be repeated in our lifetimes!

As the bubble burst and technology stocks fell apart, the system rotated out of Computers on May 19, 2000 and rotated out of Electronics on July 28, 2000. Energy Services and Insurance were purchased. Despite the bear market, Energy Services, Insurance, and several other trades were profitable.

The year 2002 was the harshest in the bear market but this strategy outperformed the S&P 500 by

Table 1. Yearly Returns (%)

Year	Sector Trading	S&P 500 Index
1998	30.25	28.58
1999	93.77	21.04
2000	41.22	-14.14
2001	-7.65	-13.04
2002	-14.10	-23.37
2003 *	36.32	21.21

* through 10/31/03

"The portfolio went from 100,000 to 278,051 during the 12/31/97 to 11/17/03 testing period. That's a 278% return (25.36% annually)…The annual return is very attractive but this is a volatile portfolio. From its highest point to its lowest point, the portfolio lost 44%."

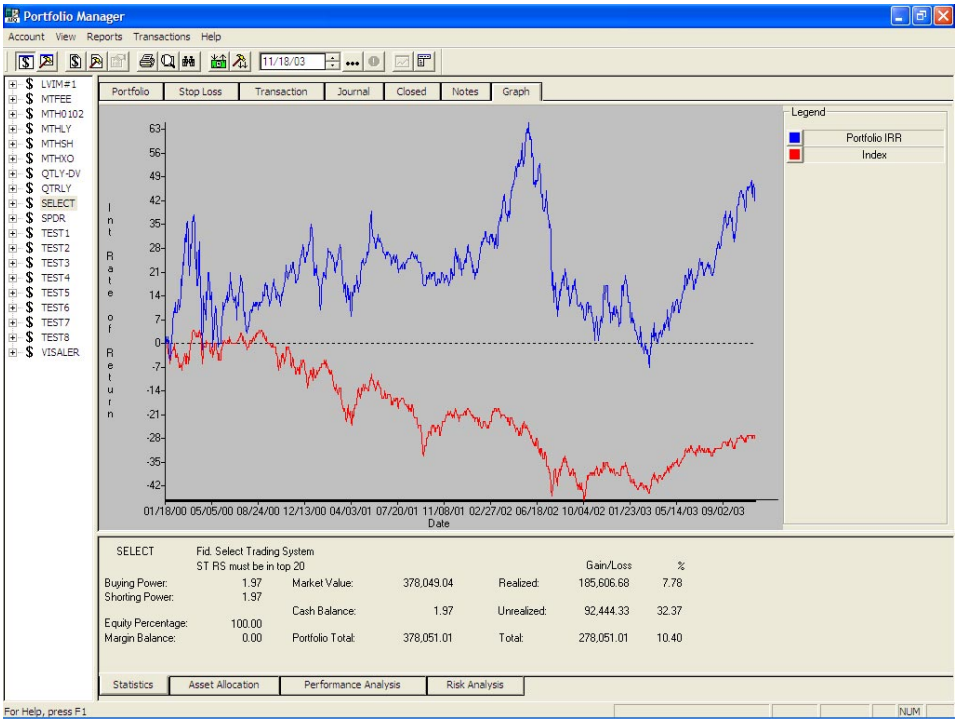

Figure 1. Portfolio Manager window with Graph comparing IRR performance of Select Portfolio (upper/blue line) vs. S&P 500 (lower/red line) over four year period.

holding Gold in one of its two positions. Gold was held from January to July. This sector held its value during a time when the S&P 500 lost 25%.

The market improved in 2003 and our strategy benefited by rotating to aggressive sectors once again. Developing Communications was purchased in April and as of this writing it has an amazing 50% gain.

Figure 1 shows the Internal Rate of Returns for the portfolio and the S&P 500. Notice that the portfolio doesn't necessarily move with the market. It is not a diversified portfolio. The sector portfolio hit a new high in May 2002, well into the bear market. That's when the bear market hit this portfolio.

The spike in the middle of the graph was a result of a dramatic rise

and fall in the Gold and Energy Services holdings.

Figure 2 (page 8) shows the account's Statistics page for our testing time period. The portfolio went from 100,000 to 278,051 during the 12/31/97 to 11/17/03 testing period. That's a 278% return (25.36% annually). Gains during the 1998 & 1999 bull market played a big role.

The annual return is very attractive but this is a volatile portfolio. From its highest point to its lowest point, the portfolio lost 44%. There were 27 trades, with 17 winners and 10 losers. The largest losing trade was 22%.

To backtest this portfolio, I ran the Relative Strength reports and manually entered the trades in the Portfolio Manager. This is a useful exercise for people who are going to apply real money to a trading system. You see its behavior more clearly with this manual process.

"Our trading system worked well for the Fidelity sector funds. It should also work well for other sector fund vehicles, such as the Rydex family of funds."

In doing so, I found a problem with backtesting mutual funds. The system uses unadjusted mutual fund prices but doesn't take into account dividend and capital gain distributions. Presently, these have to be entered manually. A fix for this will be available in the TradingExpert program in the first quarter of 2004. The Internal Rate of Return calculation on the Summary Statistics page will also be fixed at that time.

Continued on page 8.

Table 2. Individual Trades

Ticker	Sector Fund	Buy Date	Buy Price	Sell Date	Sell Price	% Change
FSLBX	Brokerage & Inv. Mgmt.	01/02/98	27.200	8/28/98	26.30	-3.31
FSTCX	Telecommunications	01/02/98	34.41	10/09/98	32.28	-6.19
FDCPX	Computers	08/28/98	28.19	05/19/00	76.33	170.77
FSAGX	Gold	10/09/98	13.11	11/06/98	13.06	-0.38
FSELX	Electronics	11/06/98	27.32	07/28/00	86.50	216.62
FSESX	Energy Services	05/19/00	36.09	10/20/00	36.87	2.16
FSPCX	Insurance	07/28/00	38.43	01/12/01	42.93	11.71
FSHCX	Medical Delivery	10/20/00	23.43	04/20/01	23.57	0.60
FSESX	Energy Services	01/12/01	36.64	05/04/01	38.42	4.86
FSAGX	Gold	04/20/01	11.72	11/16/01	13.23	12.88
FSDPX	Industrial Materials	05/04/01	23.79	10/19/01	20.65	-13.20
FSMEX	Medical Equipment	10/19/01	15.59	03/08/02	15.86	1.73
FSELX	Electroncs	11/16/01	48.80	01/25/02	49.67	1.78
FSAGX	Gold	01/25/02	15.33	07/26/02	15.78	2.94
FSESX	Energy Services	03/08/02	32.22	09/20/02	25.11	-22.07
FSHCX	Medical Delivery	07/26/02	28.38	11/01/02	27.51	-3.07
FSAGX	Gold	09/20/02	21.77	11/01/02	19.21	-11.76
FBMPX	Multimedia	11/01/02	33.25	05/02/03	36.04	8.39
FSTCX	Telecommunications	11/01/02	24.64	04/17/03	24.53	-0.45
FSDCX	Developing Communications	04/17/03	10.94	N/A	16.41	50.00
FSRFX	Transportation	05/02/03	27.53	N/A	33.34	21.10

In Summary: How to make the trading system less aggressive

Our trading system worked well for the Fidelity sector funds. It should also work well for other sector fund vehicles, such as the Rydex family of funds. It is an aggressive system, however, that can rise in a falling market or fall in a rising market.

There are ways to make it less speculative. One way would be to hold more than two funds in a fully invested portfolio. Another would be to only allow one technology related fund to be held at a time.

Finally, one could incorporate market timing. Volatility can be reduced by periodically raising cash levels. As with any strategy, past performance does not guarantee future returns and losses can occur.

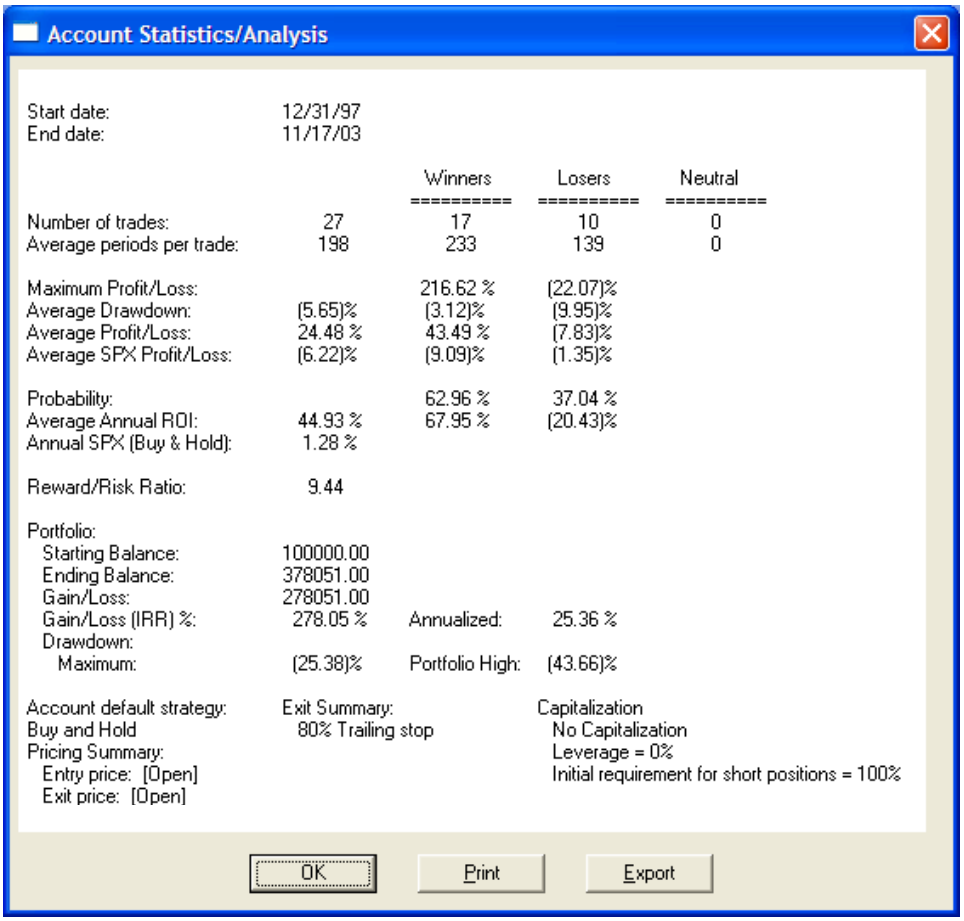

Figure 2 . Portfolio Manager Account Statistics page with summary of information computed from backtest of Select Portfolio. During 6 year test period, portfolio gained 278% for an annualized return of just over 25%.

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STOCK DATA MAINTENANCE

Stock Splits and other changes:

Stock	Ticker	Split	Approx. Date
BCF Financial Corp.	BFCF	5:4	12/02/03
Harman Int'l	HAR	2:1	12/05/03
CKF Bancorp	CAFB	2:1	12/12/03
Select Medical	SEM	2:1	12/23/03

Trading Suspended:

Alberto-Culter (ACVA)
Dwyer Group (DWYR)
Foster Wheeler (FWC)
Handspring Inc. (HAND)
Keane Inc. (KEA)

Name/Ticker Symbol Changes:

Cathay Bancorp (CATY) to Cathay General Bancorp (CAYT)
IDEC Pharm. (IDPH) to Biogen Idec Inc. (BIIB)
Innodata Corp (INOD) to Innodata Isogen (INOD)
Palm Inc. (PALM) to PalmOne Inc. (PLMO)