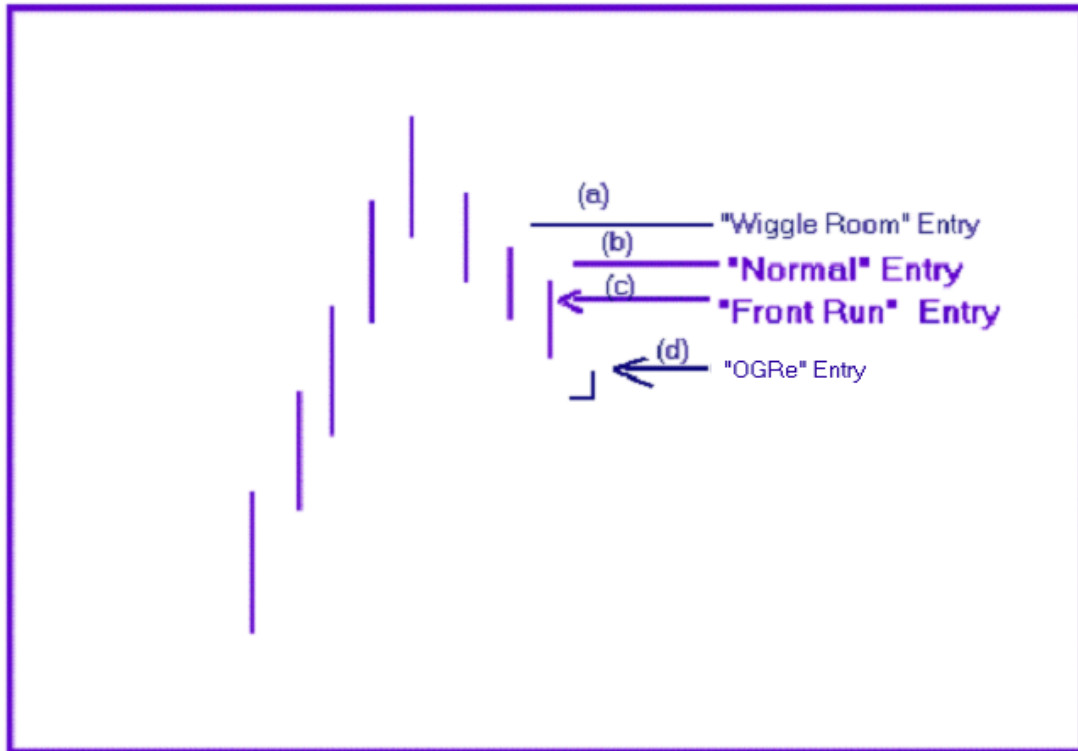


Trading Opening Gap Reversals (OGRes)

Over the past few weeks, I've been discussing the basics of trend trading with pullbacks. Since the market has provided us with a great example this week, I thought it would be a good time to introduce a more advanced concept. We'll get back to the basics soon.

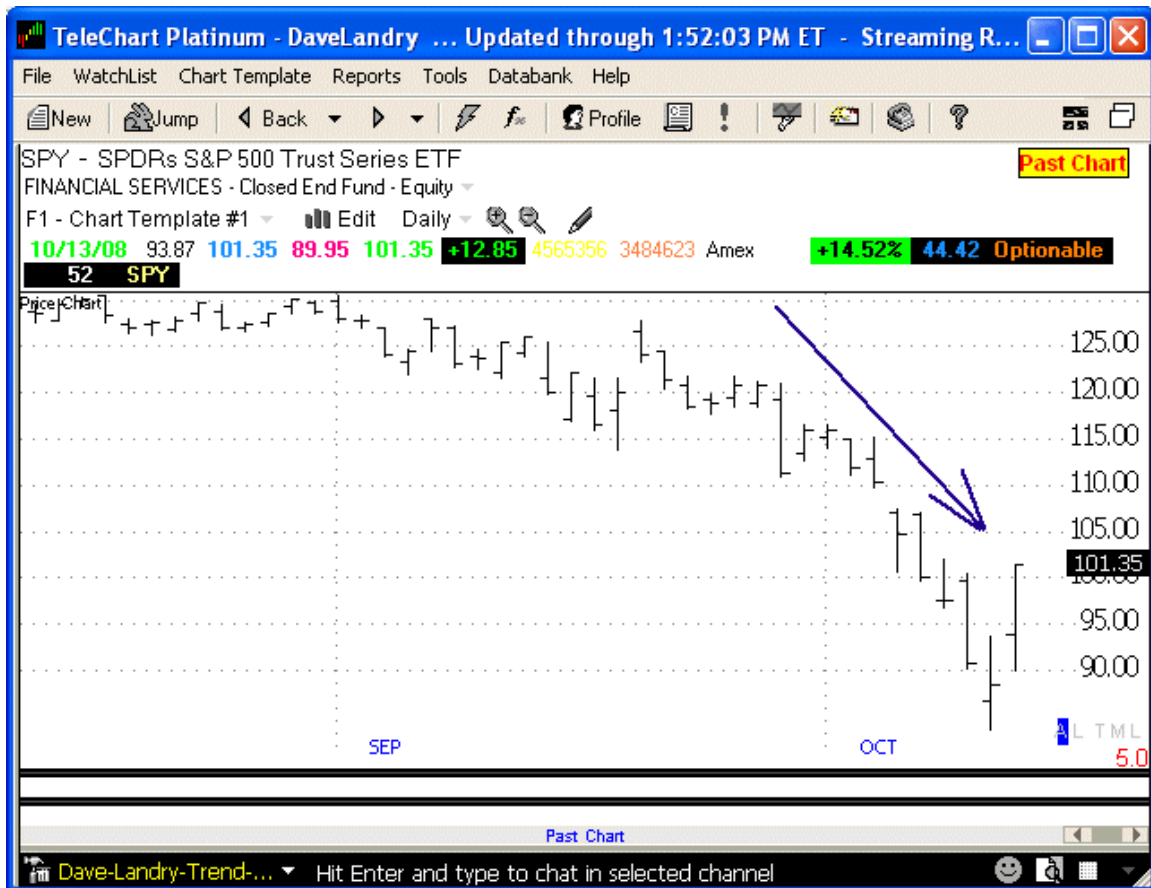
A few weeks ago, I discussed entries. Below is a figure I published that illustrates the various types of entries.



On Tuesday, the market provided us with a wonderful opportunity for an Opening Gap Reversal or "OGRe" (d) entry. Before we look at the actual setup, let's define the concept of trading OGRes in the direction of the trend.

Referring to the figure below, suppose a stock is in a strong trend and then pulls back. If it gaps down on the open (a) and then begins to rally (b), I *may* consider buying the stock and put in a tight stop below the gap (a). If it works, this sets me up for a "head start" on a swing trade which has the potential to turn into a longer-term move. And worst case, I'm out at a small loss.

Although I'm not a big fan of daytrading, as we will see shortly, this daytrading technique has the potential to lead to longer-term gains.



When trading an OGRE (for shorts), you watch to see if market gaps higher and then look to play a reversal off of that opening range. You stop yourself out if the market turns back into the direction of the gap and makes new highs (or lows for longs) for the day. You might want to give it a little room above the high just in case it makes one more attempt to rally before reversing.

Ideally, you want the market to have a significant gap higher--the bigger the gap, the better. This is because more and more people are trapped on the wrong side of the market when it does reverse.

Although the pattern is somewhat discretionary, I published the following comments in my 10/13/08 trading service (email me if you need access to the archives):

Setups/Actionable Items

SPY-sell short

S&P Spydere

Pattern: OGRE (Opening Gap Reversal)

Apply discretion. In attempt to quantify, here's some ideas:

Entry: (See A/V) If the SPY gaps *at least* 1 point higher on the open (102.35), then enter 1 point below the open. For

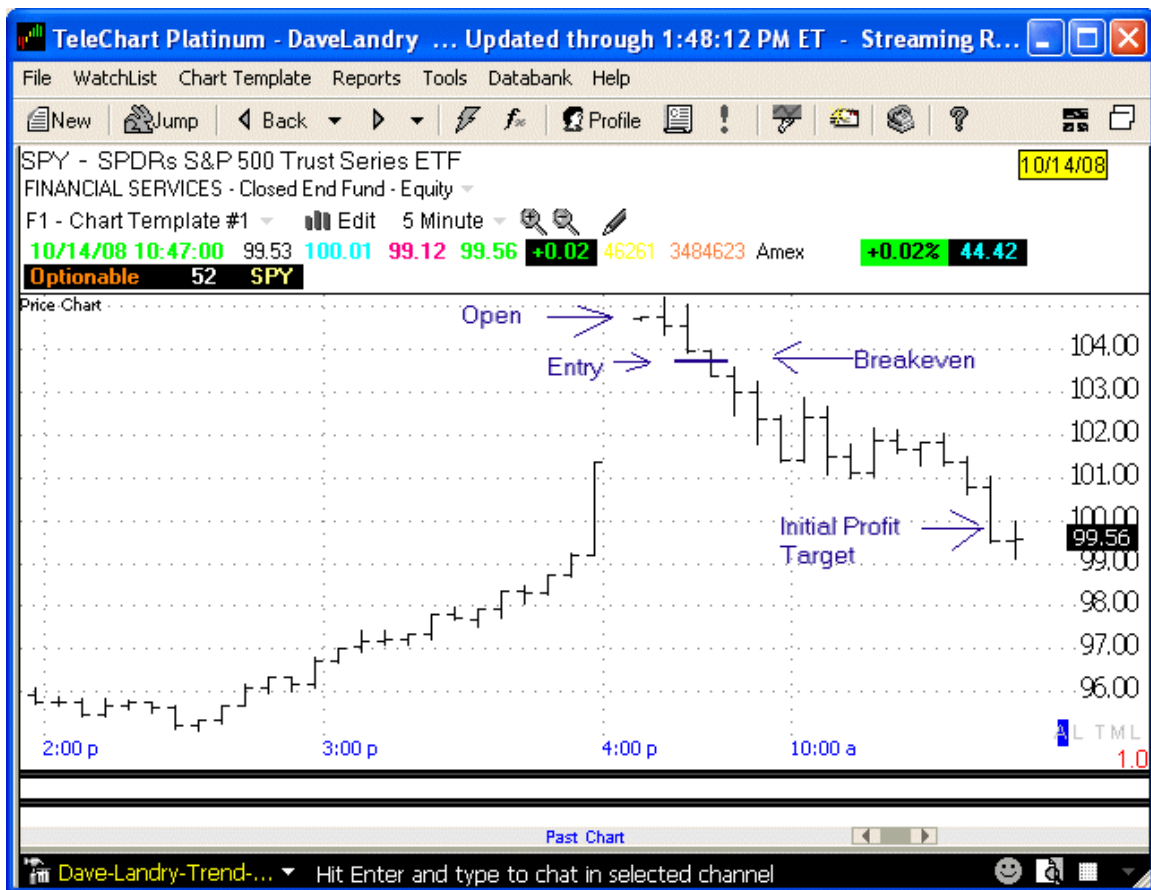
example, if the SPY opens at 102.35, then the entry would be 101.35.

Initial Profit Target: 4 points below entry (97.35 using the above example).

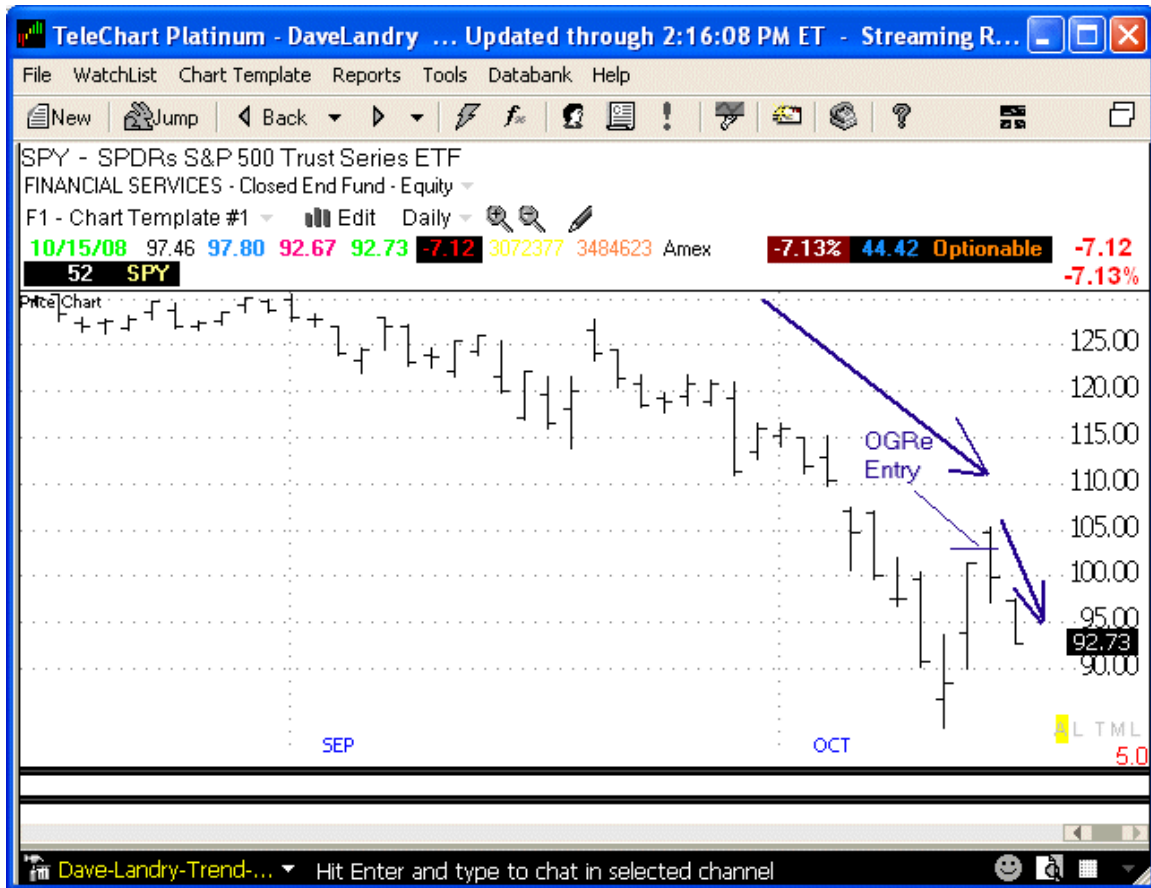
Initial Protective Stop: 2 points above entry (104.35 using the above example).

In coming articles, I'll discuss initial profit targets, basis money management, trailing stops, and other criteria used to determine the above suggestions. For now, let's just look at how things played out based on the above.

We were looking for the SPY to gap open and they did. Notice that they opened at 104.70, 3.35 points above the prior day's high. Following the above plan, this gave us an entry of 103.70 and an initial profit target of 99.70. The setup triggers and the SPY generally moves in the intended direction. Within an hour or so, the initial profit target is hit. At this juncture, partial profits are taken (half)—4 points/4%---and the stop on the remaining shares is moved to breakeven—the same as the entry. This way, barring overnight gaps, the worst you can do on the remaining shares is breakeven.



Just one day later, the market continues to implode---at the time this is being written, the S&P SPY are down over another 7 points.



Of course, they don't always work this well, that's why I recommend using a protective stop. As you can see, in the right conditions, and OGRe entry can give provide a wonderful day trade or as I prefer, a head start on a swing to intermediate-term position.

I'll follow up on the above setup in coming weeks.

Next week, well get back to basics---provided of course, the market doesn't offer us any more wonderful real time examples!

Ciao for now!

Dave