Notes on Spread Trading

What is Spread Trading?

- Spread trading is a trading strategy that involves taking a long and short position in two related securities. The goal is to profit from the change in the difference between the two securities, which is known as the spread. Spread trading is considered to be a less risky trading strategy than taking a position in a single security because the investor is hedging their bets that the spread between the two securities will change in their favor.
- A synthetic pair between related instruments
- Often involves like instruments that carry some relationship to each other

How can I trade spreads?

Pricing a Spread

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The price of a spread instruments involves three components: the price of the first instrument, the price of the second instrument, and the spread ratio. The spread ratio is the number of units of the second instrument that are needed to equal one unit of the first instrument. For example, if the spread ratio is 2, then the price of the spread instrument is the price of the first instrument minus two times the price of the second instrument. If the spread ratio is 0.5, then the price of the spread instrument is the price of the first instrument minus half the price of the second instrument.