Strategy 2: Pair Trading

Pair trading strategy was developed in the 1980's by Morgan Stanley and since then, it's one of the most popular hedge fund 'strategy until today.

It's a market neutral trading strategy which means that we can profit from any market conditions: uptrend, downtrend, or sideways movement.

Synonyms of pair trading: statistical arbitrage, long/short strategy, convergence trading strategy, Equity-market-neutral.

In pair trading we are looking for 2 stocks that are very correlated (that move together). We track the price movement of these stocks since we know they should be moving in line with one another. A way of tracking their price movement is by comparing the spread (the difference between the price of one stock to the price of the other stock) and if that spread narrows or widens we know that the stocks are converging or diverging. If the pairs (the stocks) diverge from one another, we know that there is a high likelihood that they converge in the near future. This creates a trading opportunity that we can capitalize on. We can buy the stock that is undervalued and short the one that is overvalued. In this situation we have just entered a pair.

We call a pair the combination of the long and short position. This portfolio of 2 positions is our pair. We can then talk about the pair as if we were talking about one product. We can say buy the pair at 5 and sell it at 6. we can say we are long the pair or short the pair.

PAIR = Stock1 - Stock2

Long the Pair -> Long stock 1 and short stock 2
Short the Pair -> Short stock 1 and long stock 2

Because we are long and short we are in a market neutral strategy. This means that no matter what the market is doing we don't care as it shouldn't affect our returns.

How we expect the pair/stocks to behave under different scenarios:

<u>When Long Pair</u>

Market crash: Stock1 ->
               Stock2 ->
               Total   ->

Market rally: Stock1 ->
              Stock2 ->
              Total   ->

Market is sideways: Stock1 ->
                   Stock2 ->
                   Total   ->

<u>When Short Pair</u>
Market crash: Stock1 ->
               Stock2 ->
               Total   ->

Market rally: Stock1 ->
              Stock2 ->
              Total   ->

Market is sideways: Stock1 ->
                   Stock2 ->
                   Total   ->

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