

Stocks are not always the same price. Therefore we need to add another indicator: the ratio.

Ratio (hedge ratio) is the price of stock1 divided by the price of stock2. This number allows us to know how many more times stock 1 is more expensive than stock 2. We then use this number by multiplying it with stock two. This allows us to have the appropriate "dollar value" hedge position.

$$\text{Pair} = \text{Stock1} - \text{Stock2} * \text{Ratio}$$

**Hedge:** A hedge is an investment used to limit the potential loss of your primary position.

What makes a good pair:

- Price behaviour.
- Fundamental reasons for that behaviour.

We can Track price behaviour in two ways:

- Looking at the charts.
- Looking at correlations.

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