

Dr Chandra Gulati,
Senior Lecturer, CSSM
University of Wollongong

Title: Pairs Trading

Abstract: Pairs trading is one of the arbitrage strategies employed by some traders in some stock markets. It is a strategy involving two stocks X and Y, buying the undervalued stock X and selling the overvalued stock Y when the two stocks are temporarily out of equilibrium. After the stock prices return to equilibrium, position is reversed, i.e., previously bought share X is sold and previously sold share Y is bought. Using cointegration technique, it can be determined when the two stocks X and Y are out of equilibrium. In this talk, pairs for which cointegration error follows an AR(1) process, evaluation of average trade duration, average number of trades and profit over a specified trading period are considered. Also, determination of pre-set boundaries to open and close a trade is considered. Results are applied to some trading pairs in the Australian Stock Market.