

Pairs Trading: Performance of a Relative-Value Arbitrage Rule

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Abstract

We test a Wall Street investment strategy, “pairs trading,” with daily data over 1962–2002. Stocks are matched into pairs with minimum distance between normalized historical prices. A simple trading rule yields average annualized excess returns of up to 11% for self-financing portfolios of pairs. The profits typically exceed conservative transaction-cost estimates. Bootstrap results suggest that the “pairs” effect differs from previously documented reversal profits. Robustness of the excess returns indicates that pairs trading profits from temporary mispricing of close substitutes. We link the profitability to the presence of a common factor in the returns, different from conventional risk measures.

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