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Pairs trading and selection methods: is cointegration superior?

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Abstract

Pairs trading is a popular dollar-neutral trading strategy. This article, using the components of the S&P 500 index, explores the performance of a pairs trading system based on various pairs selection methods. Whereas large empirical applications in the literature focus on the distance method, this article also deals with well-known statistical and econometric techniques such as stationarity and cointegration which make the trading system much more demanding from a computational point of view. Trades are initiated when stocks deviate from their equilibrium. Our results confirm, after controlling for risk and transaction costs, that the distance method generates insignificant excess returns. While a pairs selection following the stationarity criterion leads to a weak performance, this article reveals that cointegration provides a high, stable and robust return.

Keywords:

pairs trading | trading rules | distance | cointegration | stationarity

JEL Classification:

G11

Notes

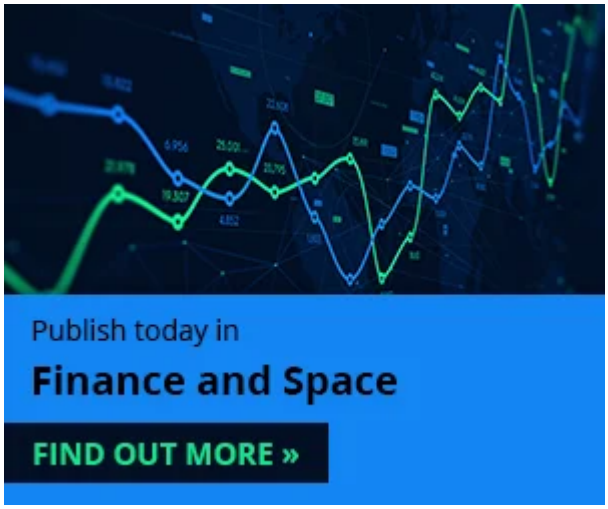
[1] The sample really considers 500 stocks only at the end of the trading period due to initial public offerings/newcomers in the index: Google in 2004 for example.

[2] As an example, see Table 3, transaction costs for the 1-year formation period, distance method, 2 SDs are 0.38%. .

[3] The part of the initial deviation greater than the opening threshold plus the part exceeding the crossing with the equilibrium after convergence.

[4] Data and details on construction of these factors series can be found from Ken French's website: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

[5] The fourth one, 2-year formation period, 2 SD, is significant at 10% level.



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