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Pairs trading: does volatility timing matter?

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Abstract

Pairs trading is a dollar-neutral trading strategy. Using the components of two major stock indices, the S&P 500 and the Nikkei 225, this article deals with the performance of a pairs trading system based on various pairs selection methods (distance, stationarity, cointegration, etc.). The article also discusses the performance of a classical framework in Japan during the 1990s and the 2000s, and the performance of the VIX index during the 2008 financial crisis. It is shown that the performance of the pairs trading system has no significant difference from the classical framework.

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Notes

¹ The Nikkei 225 Index contains about twofold fewer stocks than the S&P 500, which makes the detection of a large number (at least 20 per month/sequence) of cointegrated pairs, at a 5% rate, quite difficult. For cointegration only, the pre-selection is based on a 20% filter so that the population after this preliminary step remains large enough.

² The Japanese factors reported in this library are in dollars and not in yen.
http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html.

³ These time series end in March 2013. Regressions are thus computed between July 2003 and March 2013 (117 points versus 120 points with U.S. data),
http://homepage.sns.it/marmi/Data_Library.html.

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