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The high sensitivity of pairs trading returns

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Abstract

Pairs trading is a simple and popular relative value trading strategy. This article deals with the most common implementation of the method based on a distance criterion. It demonstrates the high sensitivity of the return to changes in the length of the formation period and shows that a reasonable modification of this parameter may lead to generate positive excess returns which are robust to data snooping. This empirical result underlines the difficulty in understanding pairs trading returns, dynamics and sources of profitability through time.

Keywords:

pairs trading | pairs selection | sensitivity

JEL Classification:

G11 | G14

Notes

[1] A popular alternative is a 1-day delay.

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