

ASIA PACIFIC'S PREEMINENT TRADING MAGAZINE

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ASIA PACIFIC'S PREEMINENT TRADING MAGAZINE

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# Spread And Pairs Trading

**Ron Schelling, private trader, shows how a blend between the technical and the fundamental approach is the best way to successfully execute a pairs trading strategy.**

Historically, spread and pairs traders have been divided into two primary groups:

- 1.) the fundamental approach
- 2.) the technical approach

**W**hile each of these approaches has certain advantages over the other, neither fully captures the breadth of information available in the marketplace.

Spread and Pairs trading is inextricably tied to correlation, but the methodology by which correlated stocks are matched differs greatly from one approach to the other. In both cases the trader is attempting to identify a pair of stocks, futures or Forex that has diverged from its historical average and is likely to revert back to that mean relationship.

This market-neutral approach to trading has been gaining in popularity as retail traders and professional portfolio managers alike seek to capture gains independent of the turbulence usually found in the market.

The fundamental approach, usually favored by large institutions placing sizeable block trades, capitalizes on extensive company research that seeks to determine a proper valuation for a given stock. Once this analysis is complete, the pairs trader creates a trade by buying the most undervalued stock within an industry and shorting the most overvalued. He or

she now waits for the fundamentals to play out and the relative performance to shift.

The technical approach, really a specialized version of statistical arbitrage, relies on technical factors like Bollinger Bands, the Relative Strength Index, or various moving averages to determine an appropriate matching of equities to be traded. These factors are sometimes built into complex 'black box' models that remove the human element from this type of trading program.

### How to find Spreads or Pairs ?

In contrast to many other strategies, pairs trading requires neither high school nor a quantitative analysis degree; traders of all experience levels can execute the strategy successfully. If one considers a pair graphically, the technical and fundamental factors that come into play will become obvious.

Figure 1 shows the charts of Pfizer Inc. (PFE) and the Pharmaceutical HLDRS Trust (PPH) respectively over the same time period.



**Figure 1 - Pfizer Inc. (PFE) and the Pharmaceutical HLDRS Trust (PPH)**

An initial examination of the two charts reveals that there is a great deal of similarity in the price action of the stock and its corresponding ETF (to be considered as a stock for the remainder of this example).

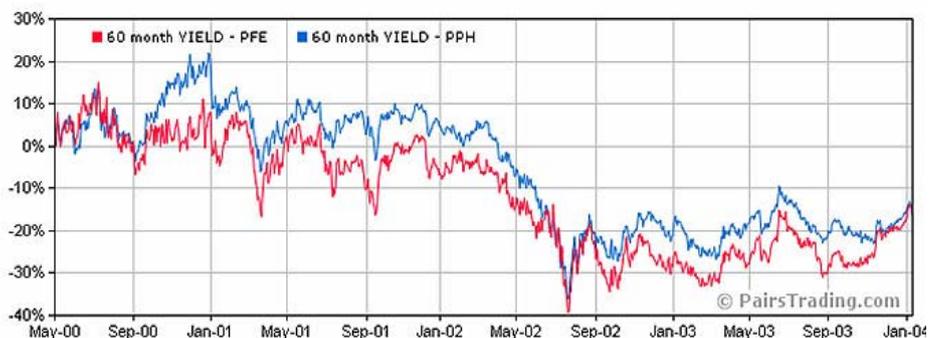
From the graph alone, however, it is impossible to determine how closely related these price movements mirror one another. Without further analysis, a trader might decide that these stocks are likely to have a high statistical correlation to each other, but he has no basis upon which to turn this assumption into a potentially profitable trading opportunity.

A simple correlation analysis will provide support for this assumption, but provides little additional information about the pair.

In Figure 2, the relative performance for the two stocks for the same time period is plotted on the same graph. This information is more useful because it makes clear that the prices of these two stocks go through periods of relative over or under performance. It would be easy to oversimplify the results of this analysis and conclude that when the graphs of the two stocks crossed each other, those points represented appropriate entry or exit spots for the trade.

A problem with this approach is that should the two stocks not follow their historical relationship, the trader has very little guidance information with which to make trading decisions.

Furthermore, the trader has no basis to judge when the pair should be considered successful and when it should be considered unsuccessful and closed.



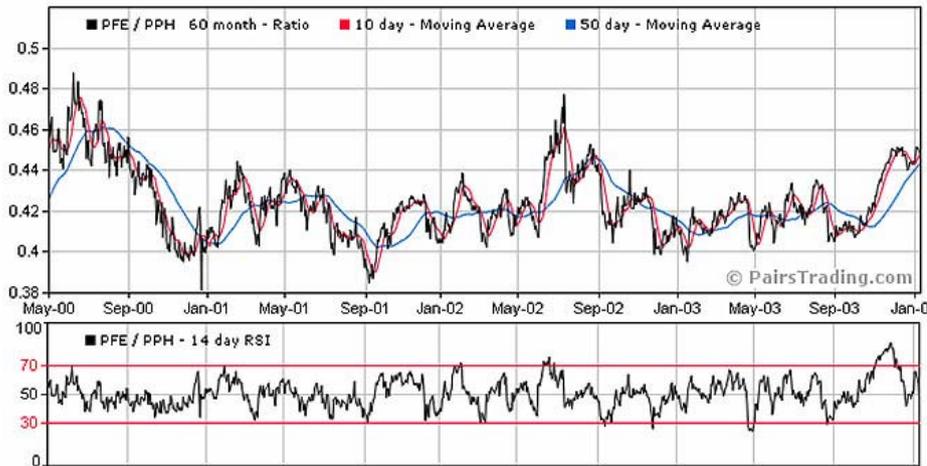
**Figure 2 - Relative Performance**

In order to gain useful information about the likely behavior of the price relationship, the trader must consider the pair from a market-neutral point of view. By graphing the price ratio between the two stocks (PFE / PPH), the manager is considering the price action of the relationship from a dollar-neutral perspective.

Figure 3 represents the chart of the dollar-neutral price action over a specified period of time. Once the relationship is considered from this perspective, one sees quickly that employing this type of market neutrality makes trading this pair a far easier proposition.

The chart in Figure 3 displays a price relationship that moves in a definite range over the period of time being considered. This is useful for the trader because he can now predict not only the likely direction that the pair will move, but also the degree to which the relationship is likely to change.





**Figure 3 - (PFE / PPH)**

Clearly not every pair will produce as obvious a graphical representation as does this one, but from this example some very important observations about both technical and fundamental analysis can be made. Using the chart in Figure 3, a trader can extrapolate many realities of pairs trading.

### A traders approach

By considering the example of PFE / PPH, two very important features of pairs trading become readily apparent: pairs trades should be set up as dollar-neutral and technical analysis should be performed on the pair rather than on the component securities.

Once a trader becomes accustomed to considering a dollar-neutral pair as a single trade the initial oddity of this approach will quickly fade away. The vehicle being traded (represented by the pair in Figure 3 for example) becomes a stable, range-bound instrument and can easily be considered as such.

After the transition is made to considering pairs as singular trading vehicles, the usefulness of applying technical indicators directly to this vehicle is apparent.

A trader can now use established tools that will help him to analyze the future behavior of the pair as if he were considering a single stock. Bollinger Bands, RSI, MACD and the like are now appropriately applied to the pair to help the trader to gauge future fluctuations.

Fundamentals re-enter the picture, however, because the one thing the pairs analyst can mask is the affects of significant fundamental news. If one were considering a single stock, the affects of major news events (both current and potential) are fairly obvious when looking at the chart; a bad earnings report causes a sharp decline that is self-evident. When analyzing a pair, these moves can be masked and therefore must be investigated separately.

The fundamental analysis involved in a pairs trade need not be of the depth or detail that would require either a large staff of analysts or much formal training in the area, but a thorough overlay should be performed to be sure that nothing obvious is overlooked. A pair that appears to be at an ideal entry point may have arrived there because one of the stocks has reported news that has had a significant impact on price.

These pairs are suspect because it is difficult to determine if the price action is a regular divergence from the historical average or if the pair is in the process of entering a new trading range. In either case, understanding the basic fundamentals of each side of the pair is critical to avoiding potentially risky trades in an otherwise stable and low-risk strategy.

The conclusion that can be drawn from these observations is that a blend between the technical and the fundamental approach is the best way to successfully execute a pairs trading strategy. Using this blended approach, traders of all levels of experience and expertise can successfully integrate pairs trading into their arsenal of trading tools. Furthermore, with the proliferation of affordable pairs trading tools available today, anyone can begin trading the strategy.

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