

Layman's Guide to Pair trading



www.pairtradefinder.com

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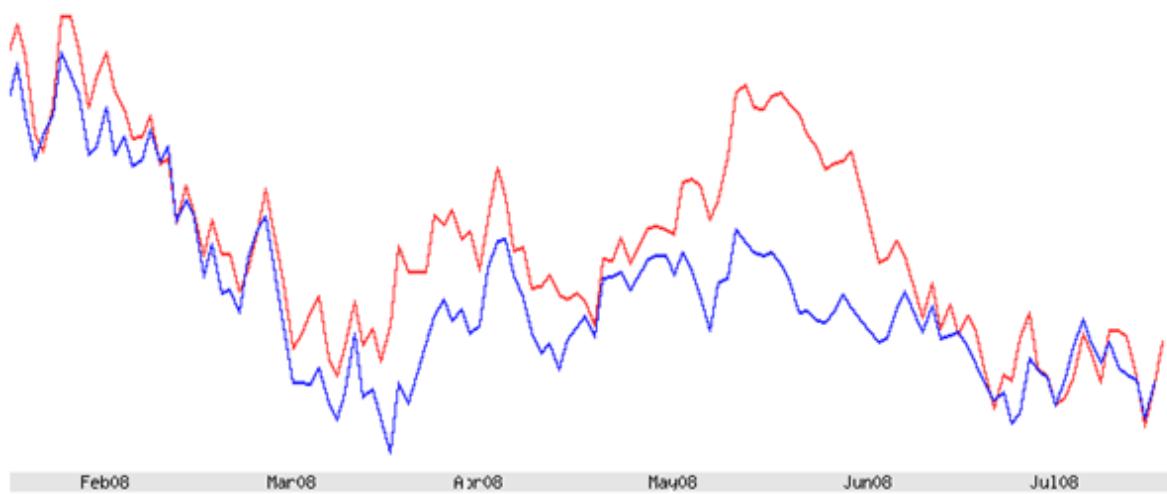
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1.0 Introduction to Pair Trading

Pair Trading, also referred to as Statistical Arbitrage, Relative Value Arbitrage, and Long & Short Equity has been used successfully among market professionals for 59+ years now. It is widely used among hedge funds, institutions and other market participants. The main attraction of pair trading is its controlled risk, low correlation to the market averages and ability to generate significant & consistent returns.

Have you ever bought a stock and it's gone down straight away? Chances are the whole market has gone down as well. That's because all stocks have a correlation to the general market to a certain degree. Wouldn't it be great if you could profit from stocks regardless of what direction the market goes, up, down, sideways, high volatility, low volatility, choppiness, spikes etc.....

A pair trader will monitor two similar stocks and aim to buy the oversold issue and simultaneously sell the overbought issue, exiting once the relationship returns to its norm. The professional pair trader will match stocks based on their statistical correlation, market capitalisation, valuation, price similarity and underlying business similarity among other characteristics.



2.0 History and Growth of Pair Trading

Melbourne born, Alfred Winslow Jones is credited with creating the first hedge fund in 1949. This fund also happened to be the first known user of Pair trading. AW Jones used leverage to go both long & short stocks in equal amounts to significantly reduce market & sector risk also delivering consistent profits. This style proved highly successful and Jones significantly outperformed the market averages and other mutual funds.

The style became widely used among hedge funds & investment banks in the late 1980's. Gerald Bamberger from Morgan Stanley popularised the concept & implemented the application through quantitative modelling & rules-based computer execution.

Many large Hedge Funds from around the world continue to use Pair Trading as a means to deliver low risk, high reward returns to their investors and partners. Recent studies have shown this style to deliver superior returns with lower risk than any other style of trading, especially in volatile, bear markets.

This strategy once reserved to this rich & privileged, has in recent years become available to the everyday online trader through significant developments in technology & markets. Online traders can today too, enjoy the significant benefits that come from Pair Trading.



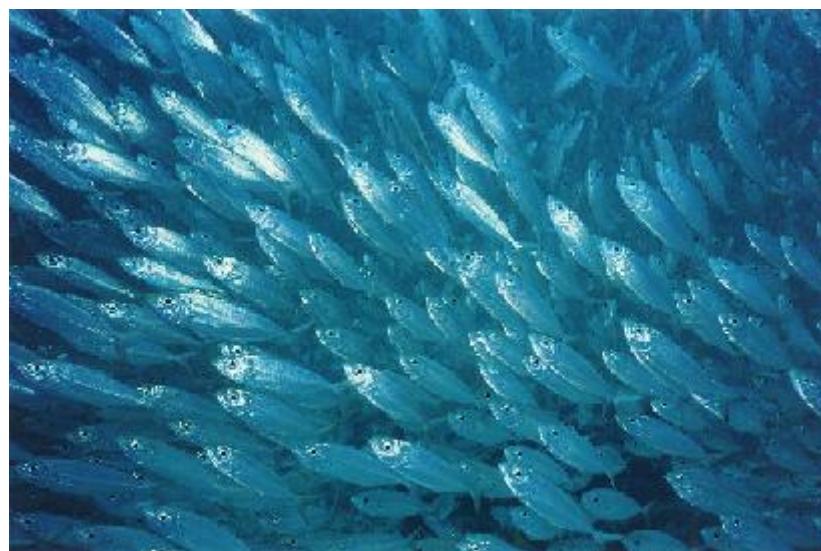
Alfred Winslow Jones

3.0 The Basics of Pair Trading

Contrary to popular belief, a form of logic does run through the world's stock markets. Most of the time, stocks are priced efficiently, that is all information is discounted in a logical, relative manner. However, every now and then the market does something stupid and creates inefficiency. Stocks don't buy and sell themselves, those orders are entered by people, people are driven by emotions, emotions cause irrational decisions and this emotional decision making characteristic is multiplied many times when it comes to a crowd of people.

Stocks trade like several schools of fish, all schools roughly going in the same direction. Imagine each school of fish represents a certain sector within the stock market, for example let's take the bank shares, all things being equal (news not affecting particular stocks), bank shares trade in a similar manner as the macro-economic factors affecting those companies are almost exactly the same.

If, out of no good reason, two of those shares diverge away from each other, there is an inefficiency created & an opportunity to profit. The main benefit of pair trading is that your exposure to market & sector risk is significantly reduced by holding both long & short positions in equal amounts. The relationship between two correlated stocks is much more predictable & reliable than the outright prediction of the direction of a particular stock.



4.0 The Application of Pair Trading

Professional pair traders know the key to successful trading is having the right platform for analysing potential trades. Many novice traders will attempt to use free websites, excel spreadsheets & other scapegoat methods in attempting to pair trade whilst a serious trader isn't afraid to pay for an analytical program that will put him in the winning trades and ahead of the game; this is what separates the boys from the men in the highly competitive trading world.

When choosing a pair trading program look for one that can scan for correlated pairs, generate buy and sell signals, show graphical visualisations of the relationship between stocks and of course the program should have an integrated portfolio management system.

Large investment banks, institutions & hedge funds spend millions of dollars each year on developing pair trading programs and the application of them, they know it's crucial to not only have the right information, but be able to view & analyse it in a timely manner. With the significant advances and development in technologies in recent years this has become possible for the average online trader to view & analyse the same information.



5.0 12 Different Hints, Tips & Tricks to enhance your Pair Trading

This section which is written by former investment bank, long time pair trader Jared Mann is only available to those who have downloaded a free trial to Pairtrade Finder. You simply enter a valid email address during the setup process and this highly valuable section will be emailed to you immediately.

Please visit;

www.pairtradefinder.com

And download your free trial and receive this 5 page section for free now.

6.0 The Future of Pair Trading

Pair trading is a relatively young style of trading only becoming popular among institutions in the late 80's and available to online traders at the turn of this century. With foreign governments opening up and cross-border hurdles breaking down, the future ground for pair trading looks very fertile and we can scan 1000's of correlated stocks from around the globe that trade in high volumes. Given the rapid developments in markets, technologies and globalisation, pair trading has quite a way to go yet.

You, the online trader have one massive advantage over the big institutions, investment banks and hedge funds; your size. Because you're smaller, you are more nimble and can achieve a higher growth rate more easily. You don't have to buy & sell millions of shares, eroding your entry & exit prices, limiting yourself to only the highest traded stocks and have to spend millions on executing trades.

Take advantage of your only strength as an online trader, your size.



7.0 Useful Links

Australian Stocks:

www.asx.com.au/asx/statistics/announcementSearch.do (great for company news)
www.news.com.au/business/markets/ (great for analysing fundamentals)

USA Stocks:

www.yahoo.com/finance (great for company news)
<http://moneycentral.msn.com/investor/research/welcome.asp> (great for analysing fundamentals)



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info@pairtradefinder.com