

Abstract

We investigate the use of investment strategy called pairs trading on small-sized equity markets located in Central Eastern Europe. Pairs trading is self-financing trading strategy that identifies two stocks based on their historical relationship, and makes profit on their short-term relative mispricing, since the strategy relies on their convergence into the long-term equilibrium. The objective of this thesis is to compare two different methods of pairs trading, distance method based on minimizing the sum of squared deviations between normalized historical prices and cointegration method using daily data from June 2008 to March 2017. We examine whether any of those method is profitable on Prague Stock Exchange, Bucharest Stock Exchange and Budapest Stock Exchange and can be used on such markets with high industry diversity. Our findings were not stastically different from zero in all but one case and majority of average returns was negative. In comparison to US and Finnish equity markets the strategy falls behind. Even though we identified some cointegrated pairs, their profitability was more than questionable and further investigation showed that small equity markets such as the ones we have studied are not a good fit for pairs trading strategy.