Title: Pairs Trading at the Prague Stock Exchange
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Abstract: Since its birth in the 1980s, pairs trading has become a widely used strategy for making profits among hedge funds and institutional investors. This technique identifies pairs of securities whose historical prices show long-run relationship, and takes advantage of their short-term relative mispricing. Profit is generated due to correcting behavior of security prices as they converge towards equilibrium value of their spread. The aim of this thesis is to compare two traditional approaches to pairs trading: cointegration and sum of squared deviations between normalized historical returns, known as distance criterion, within the Prague Stock Exchange equity market. We further investigate whether the two methods, so commonly employed in the US equity market, can be applied with similar success in the PSE. Our results reveal that the strategy using distance criterion outperforms the method of cointegration in nearly every aspect considered. Nevertheless, its returns are not statistically different from zero, and in other measures the return distribution lags behind the one found in the US equity market.We conclude that with the form of trading we present here the PSE is not a suitable stock market for pairs trading technique.