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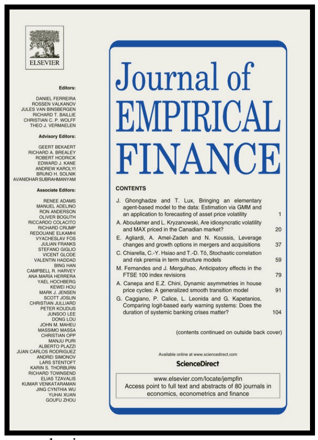

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How Some Bankers Made a Million by Trading Just Two Securities?☆

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Abstract
In this paper, we study a pair trading strategy that utilizes short-term return reversals in the stock market. Using U.S. data, we show that returns to our pair trading strategy exceed reasonable estimates for transaction costs. The strategy also generates positive alpha when controlling for the standard risk factors. Second, using transaction level data from Finland, focusing on a popular pair, we provide evidence that these kinds of pair trading returns are compensation from providing liquidity. On the days when the expected returns to our pair trading strategy are the highest, the trading volume is abnormally high and, judging from active brokers' net trades, nearly 45% of all brokers (or their customers) engage in pair trading in accordance with our trading strategy. These brokers are mainly counterparties to few brokers that trade large quantities of stocks inconsistent with our strategy.

JEL classification
G10, G12, G23

Keywords: pair trading, short-term return reversals, liquidity provision

1. Introduction

It is well established that at short horizons equity returns revert providing high returns to short-term contrarian trading strategies, see e.g., Jegadeesh (1990), Lehman (1990), and Khandani and Lo (2007, 2011). These returns can be viewed as returns from providing liquidity, see e.g., Nagel (2012) and Hendershott and Menkveld (2014). Building on this literature, Jylhä *et al*. (2014) examine the profitability of a contrarian trading strategy where long-short portfolios of stocks are formed based on the stocks' 5-

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