

How To Pairs Trade with Smalls

Frank Kaberna
The Small Exchange

March 4, 2021



Exchange and Industry Sponsored Webinars are presented by unaffiliated third parties. Interactive Brokers LLC is not responsible for the content of these presentations. You should review the contents of each presentation and make your own judgment as to whether the content is appropriate for you. Interactive Brokers LLC does not provide recommendations or advice. This presentation is not an advertisement or solicitation for new customers. It is intended only as an educational presentation.



Disclosures

Options involve risk and are not suitable for all investors. For information on the uses and risks of options, you can obtain a copy of the Options Clearing Corporation risk disclosure document titled [Characteristics and Risks of Standardized Options](#) by calling (312) 542-6901.

Futures are not suitable for all investors. The amount you may lose may be greater than your initial investment. Before trading futures, please read the [CFTC Risk Disclosure](#). For a copy visit [interactivebrokers.com](#).

Security futures involve a high degree of risk and are not suitable for all investors. The amount you may lose may be greater than your initial investment. Before trading security futures, please read the [Security Futures Risk Disclosure Statement](#). For a copy visit [Interactivebrokers.com](#).

There is a substantial risk of loss in foreign exchange trading. The settlement date of foreign exchange trades can vary due to time zone differences and bank holidays. When trading across foreign exchange markets, this may necessitate borrowing funds to settle foreign exchange trades. The interest rate on borrowed funds must be considered when computing the cost of trades across multiple markets.

The Order types available through Interactive Brokers LLC's Trader Workstation are designed to help you limit your loss and/or lock in a profit. Market conditions and other factors may affect execution. In general, orders guarantee a fill or guarantee a price, but not both. In extreme market conditions, an order may either be executed at a different price than anticipated or may not be filled in the marketplace.

There is a substantial risk of loss in trading futures and options. Past performance is not indicative of future results.

Any stock, options or futures symbols displayed are for illustrative purposes only and are not intended to portray recommendations.

IRS Circular 230 Notice: These statements are provided for information purposes only, are not intended to constitute tax advice which may be relied upon to avoid penalties under any federal, state, local or other tax statutes or regulations, and do not resolve any tax issues in your favor.

Interactive Brokers LLC is a member of [NYSE FINRA SIPC](#)

HOW TO PAIRS TRADE

WITH SMALLS



Disclosure Time:

© 2021 Small Exchange, Inc. All rights reserved. Small Exchange, Inc. is a Designated Contract Market registered with the U.S. Commodity Futures Trading Commission. The information presented here is for illustrative purposes only and is not intended to serve as tax or investment advice since the availability and effectiveness of any strategy is dependent upon your individual facts and circumstances. Trading in derivatives and other financial instruments involves risk.

Pairs Trading is a neutral strategy that uses offsetting positions in two highly correlated products.



Source: dxFeed Index Services (<https://indexit.dxfed.com>)

TIME

Pairs Trades can be thought of and visualized as a single, diversified market that's simply the difference in two markets' prices.



Source: dxFeed Index Services (<https://indexit.dxfed.com>)

TIME

Basic Pairs Trading Example		
75SME		STXSME
TSLA FCX CRWD TTD W	vs	Z SNAP TSM SQ MRNA

Pairs Trades can achieve positive returns in bearish or bullish markets since they depend on relationships and not outright direction.

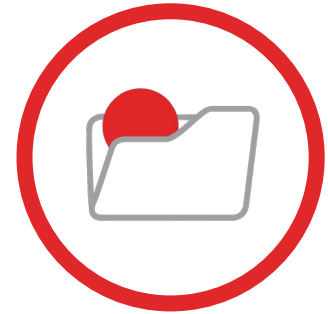
Pairs Trading Benefits



Speculate on relationships, not direction of assets



Offset Risk of single markets and extend time



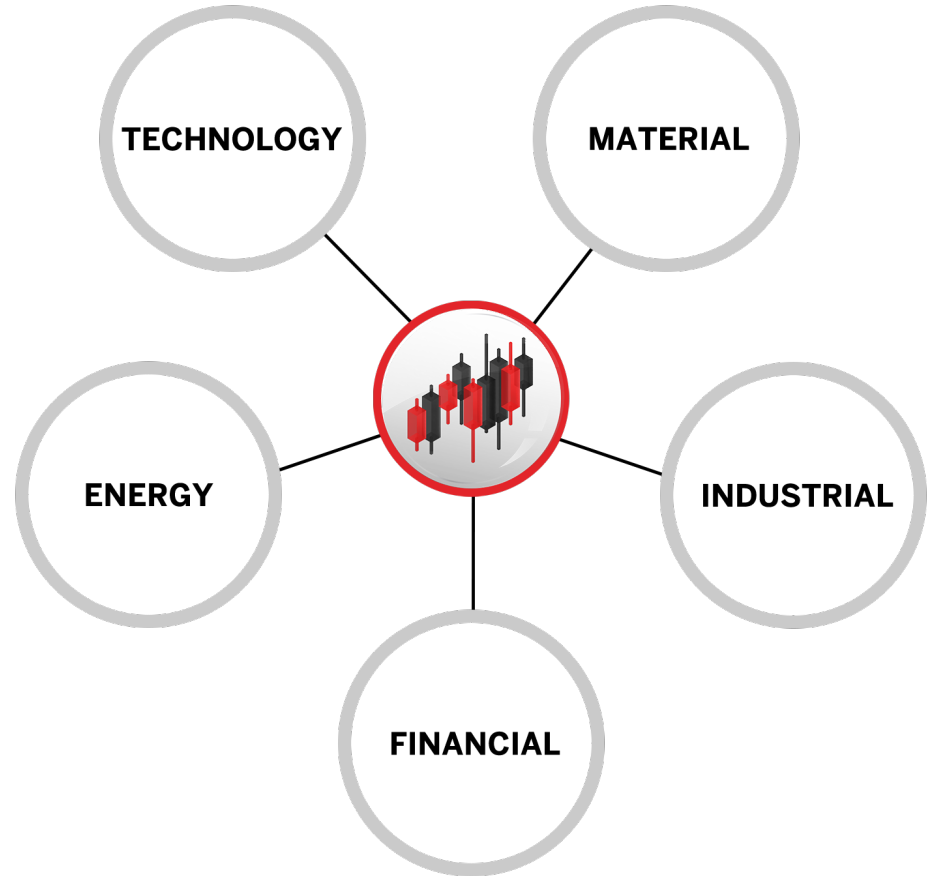
Diversify from directional trades in asset classes



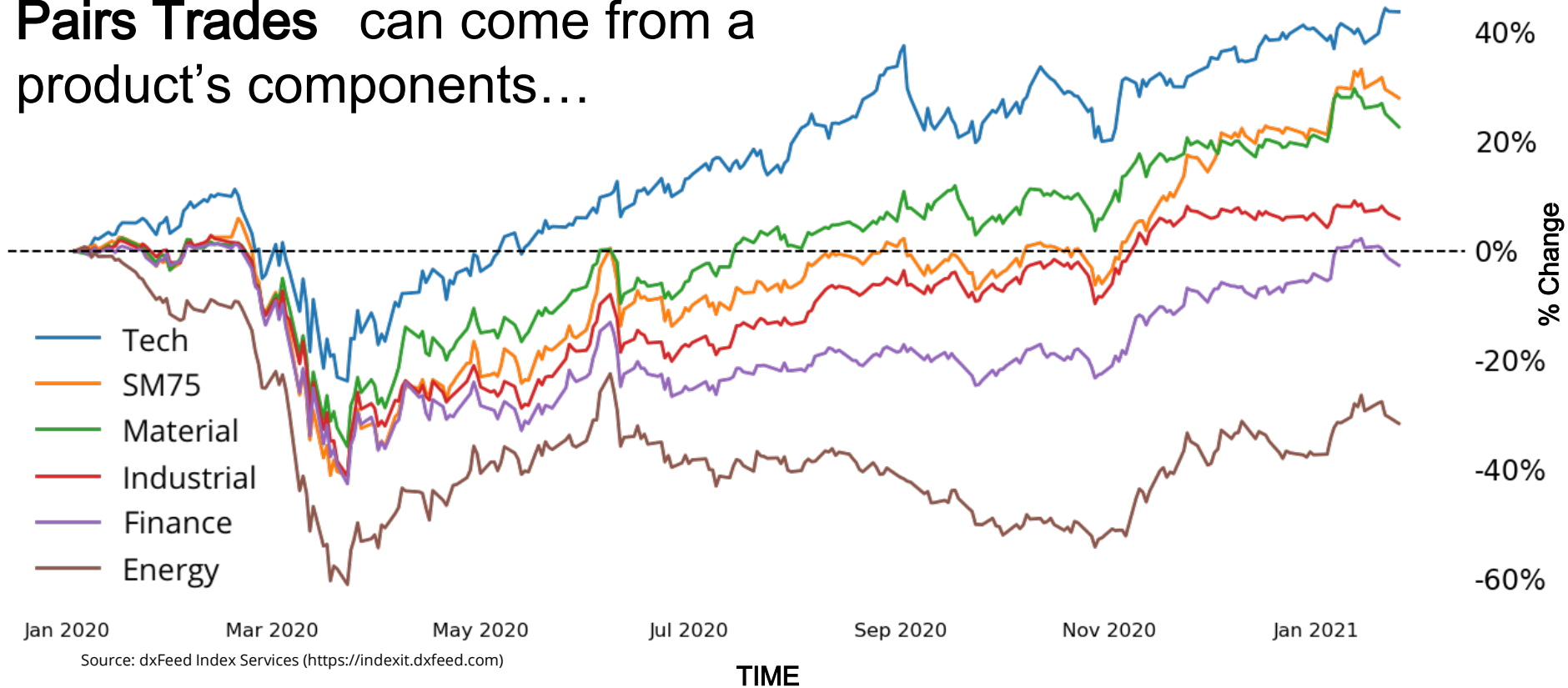
Source: dxFeed Index Services (<https://indexit.dxfed.com>)

TIME

Pairs Opportunity
can be found
between two
markets with strong
correlations. For
example, 75SME is
made up of 5 sectors:



Pairs Trades can come from a product's components...

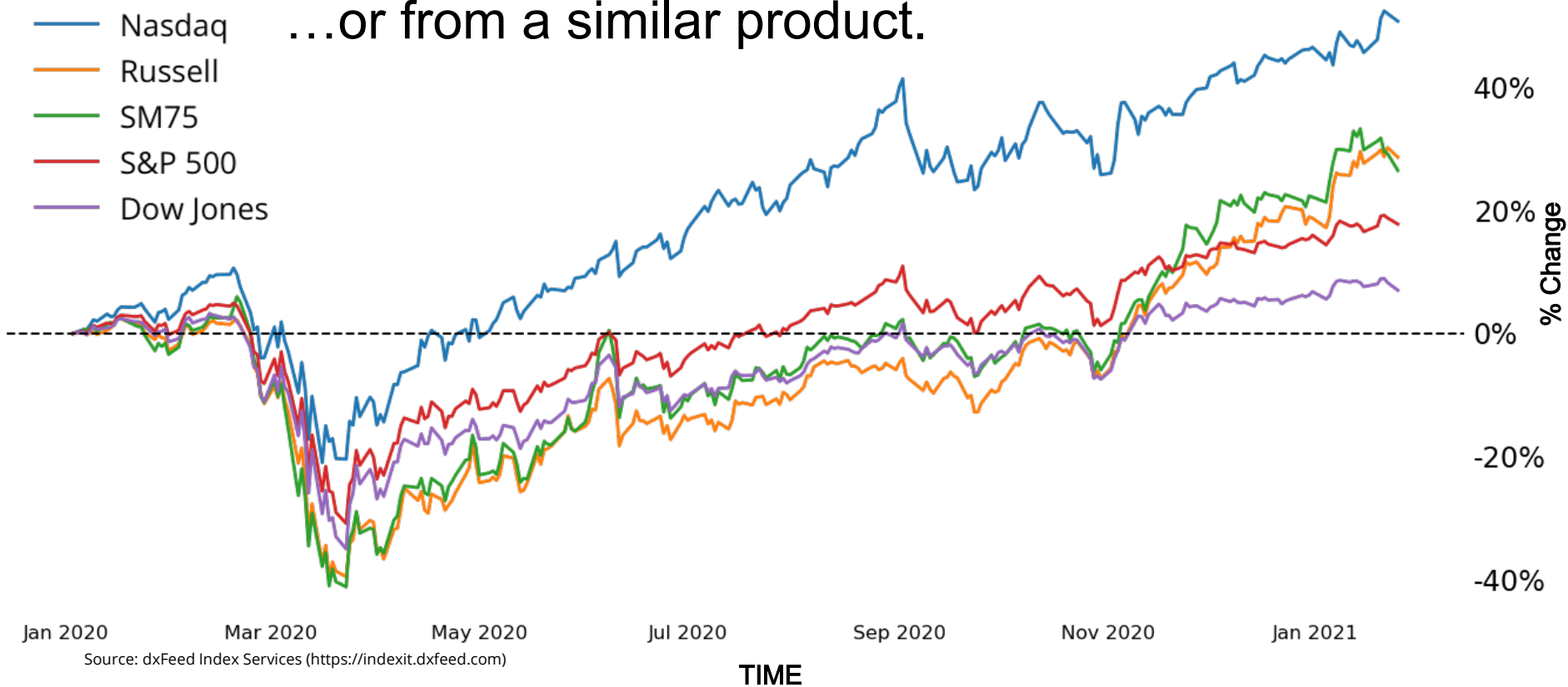


TIME

% Change
40%
20%
0%
-20%
-40%
-60%

- Nasdaq
- Russell
- SM75
- S&P 500
- Dow Jones

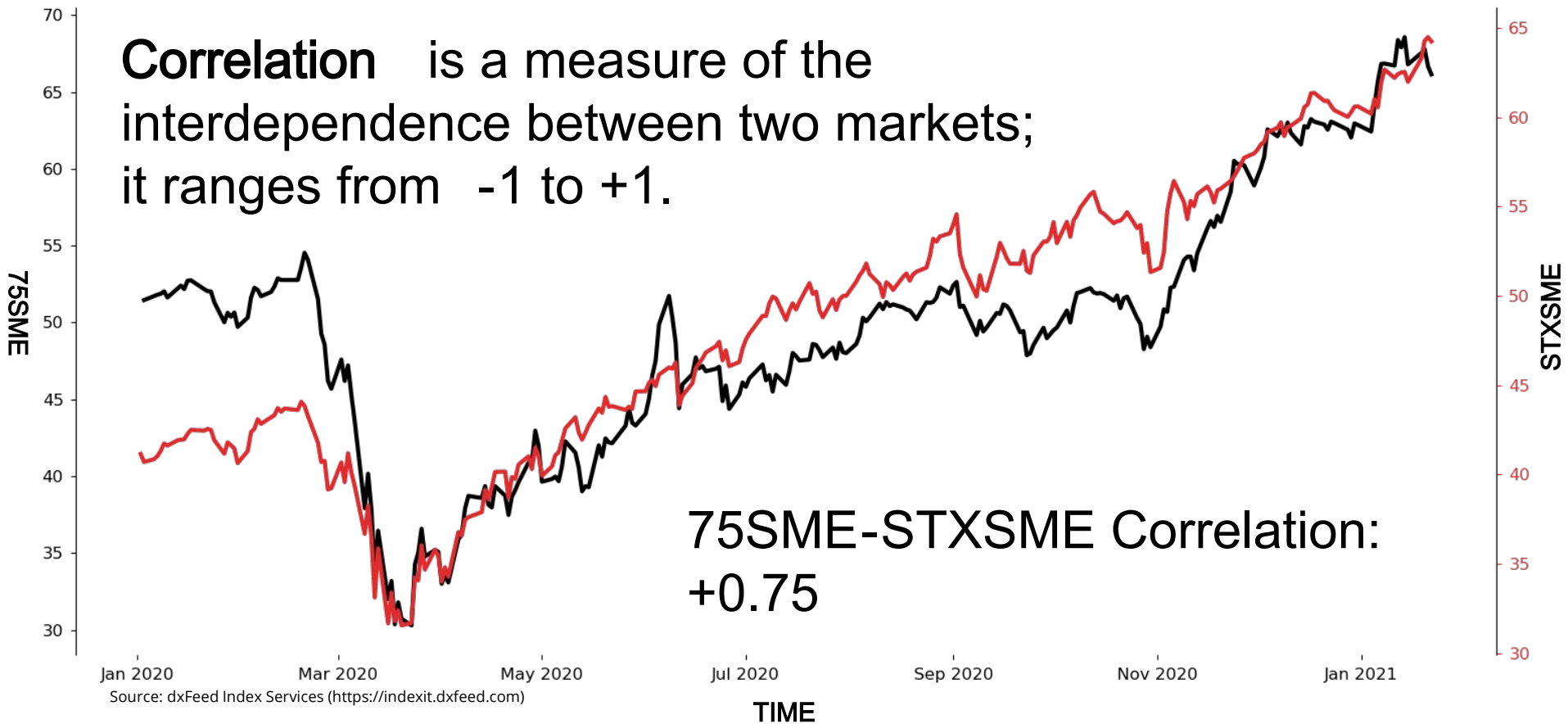
...or from a similar product.



Source: dxFeed Index Services (<https://indexit.dxfed.com>)

TIME

Correlation is a measure of the interdependence between two markets; it ranges from -1 to +1.



**75SME-STXSME Correlation:
+0.75**

Pairs Ratios can be found by simply comparing notional values from two different products...

Simple Pairs Trading Formula		
Front Leg	/	Back Leg
Price X Multiplier		Price X Multiplier

...or by adjusting for volatility as well, which is especially relevant when trading different asset classes.

Advanced Pairs Trading Formula		
Front Leg	/	Back Leg
Price X Multiplier X Volatility		Price X Multiplier X Volatility

Here's An Example:

Simple Pairs Trading Formula		
Front Leg: 75SME	/	Back Leg: STXSME
66.33 X \$100		64.12 X \$100
\$6,633		\$6,412
1 75SME : 1 STXSME		

Source: dxFeed Index Services (<https://indexit.dxfed.com>) as of close on 1/22/21

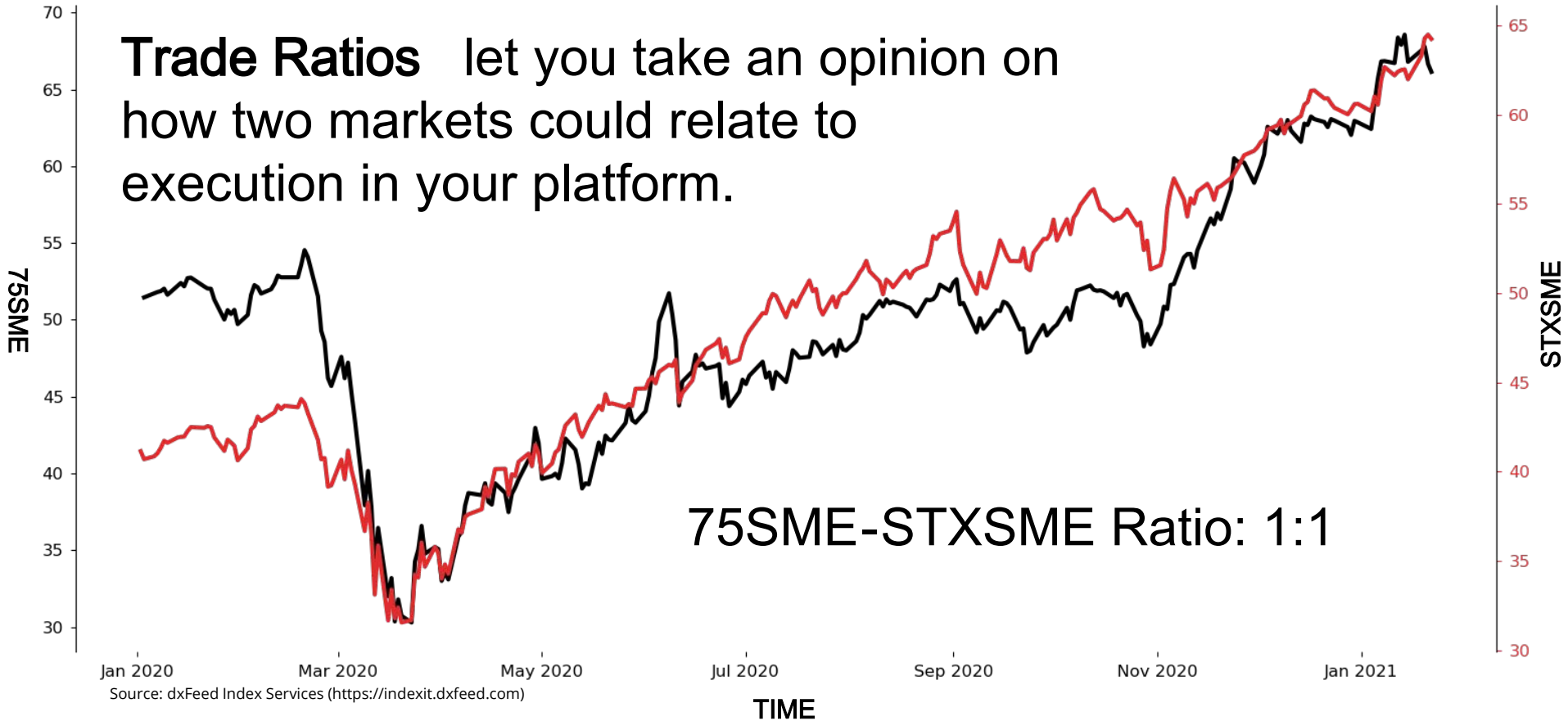
Here's An Example:

Simple Pairs Trading Formula		
Front Leg: 75SME	/	Back Leg: IWM
66.33 X \$100		215.00 X \$1
\$6,633		\$215
1 75SME : 30 IWM		

Here's An Example:

Advanced Pairs Trading Formula		
Front Leg: 75SME	/	Back Leg: CL
66.33 X \$100 X 23%		52.27 X \$1,000 X 43%
\$1,525		\$22,475
15 75SME : 1 CL		

Trade Ratios let you take an opinion on how two markets could relate to execution in your platform.



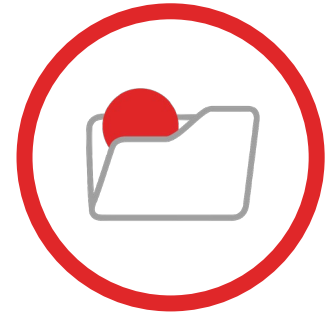
Pairs Trading Benefits



Speculate on relationships, not direction of assets



Offset Risk of single markets and extend time



Diversify from directional trades in asset classes

Price Action can be the catalyst for an opinion on a pairs trade.

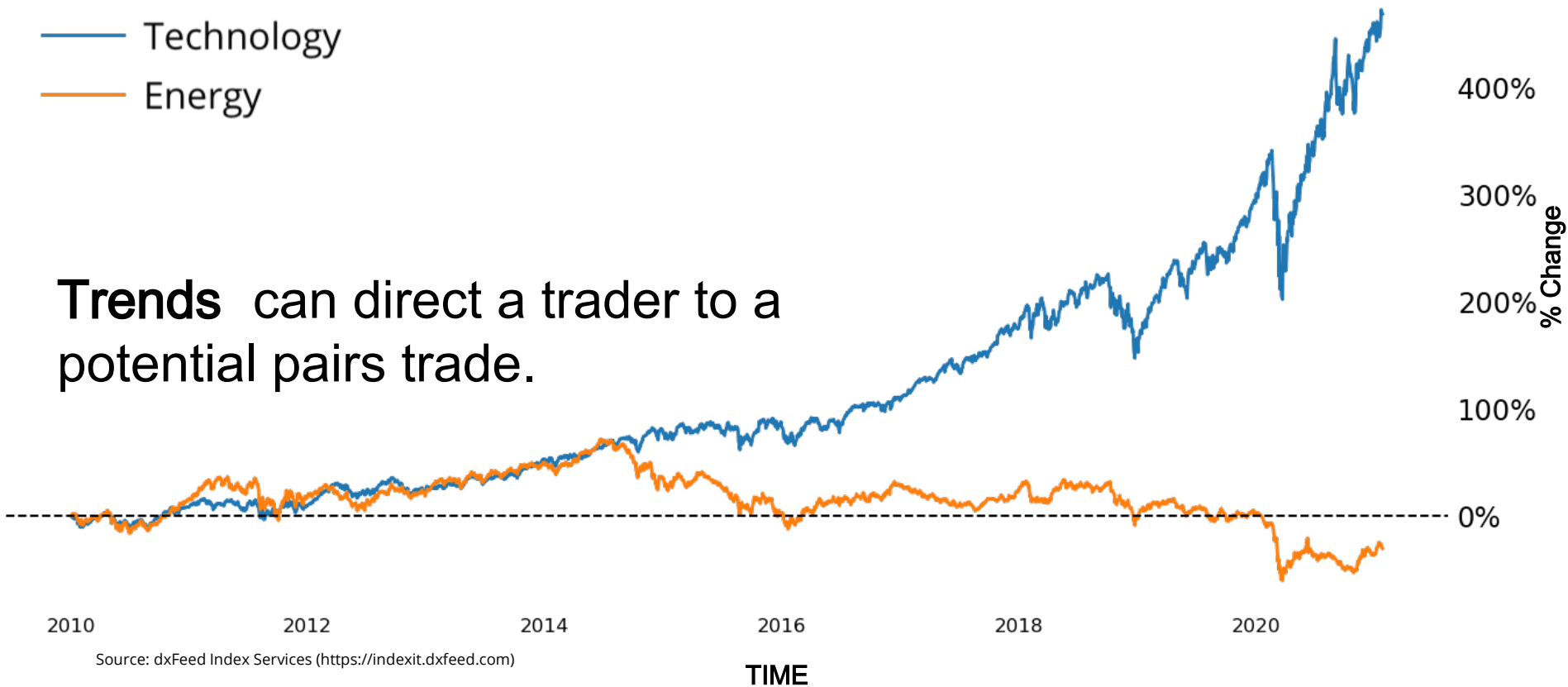


Source: dxFeed Index Services (<https://indexit.dxfed.com>)

TIME

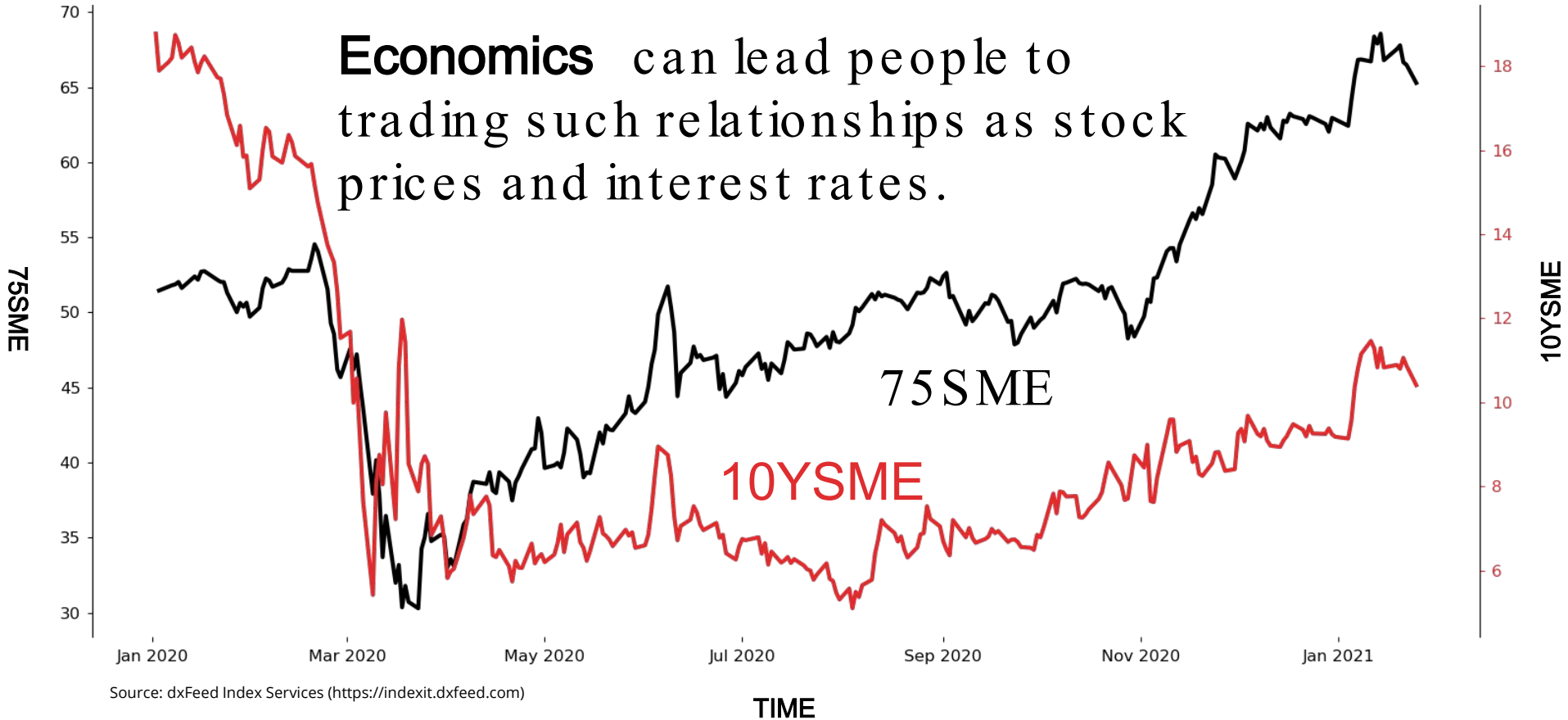
— Technology
— Energy

Trends can direct a trader to a potential pairs trade.



Source: dxFeed Index Services (<https://indexit.dxfed.com>)

TIME



Pairs Trades between highly correlated markets can also offset risk. Take a look at the Y axis ...

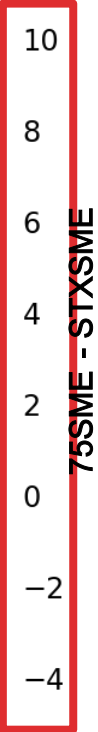


Source: dxFeed Index Services (<https://indexit.dxfed.com>)

TIME

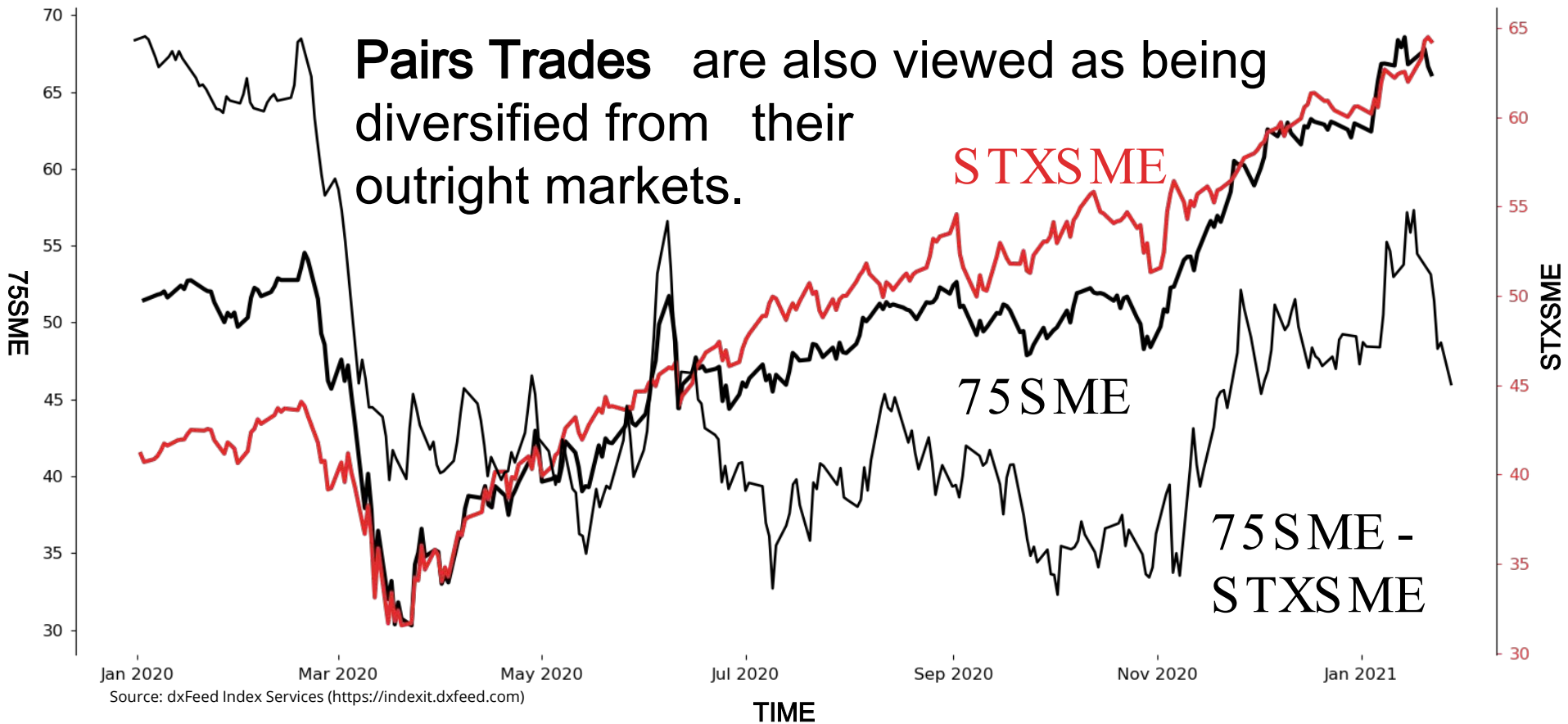
...the difference between the two accounted for half the movement of the markets themselves.

75SME - STXSME



Source: dxFeed Index Services (<https://indexit.dxfed.com>)

TIME



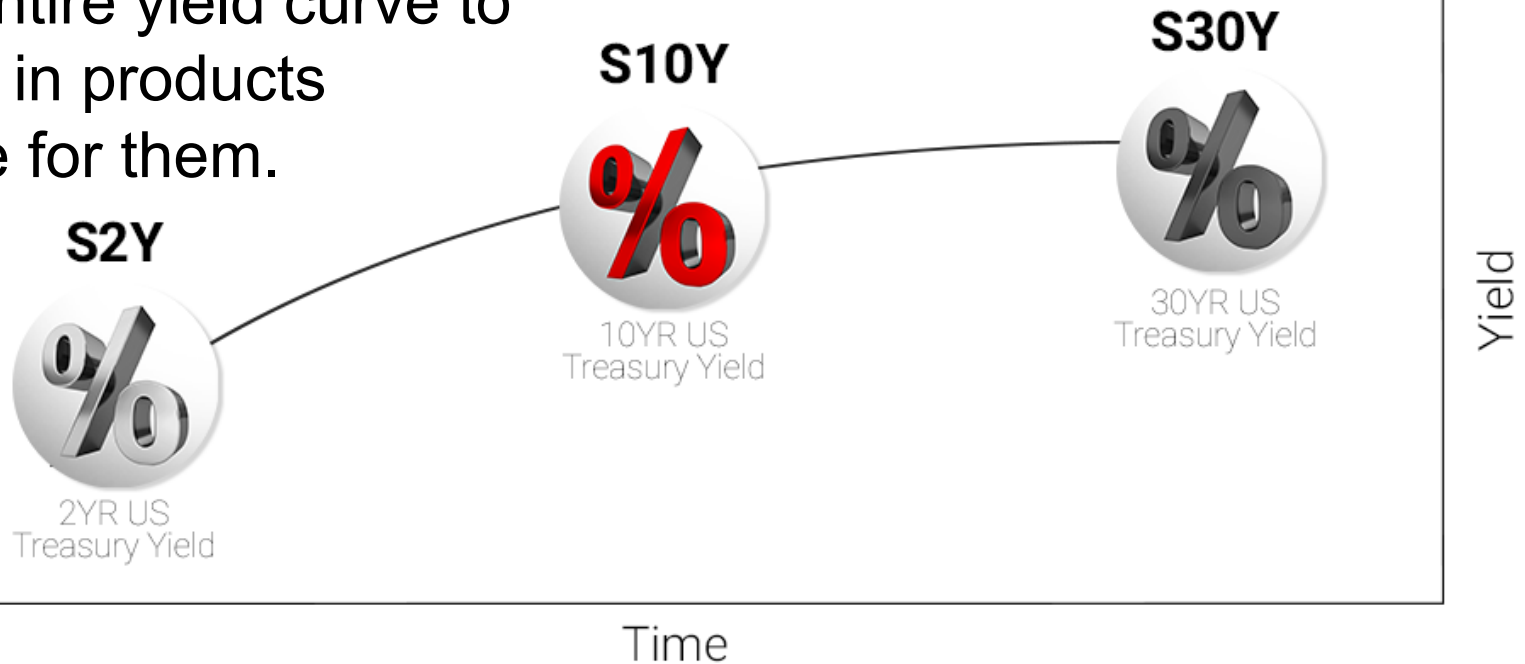
Small 2YR, 10YR, and 30YR Yield Size and Margin*

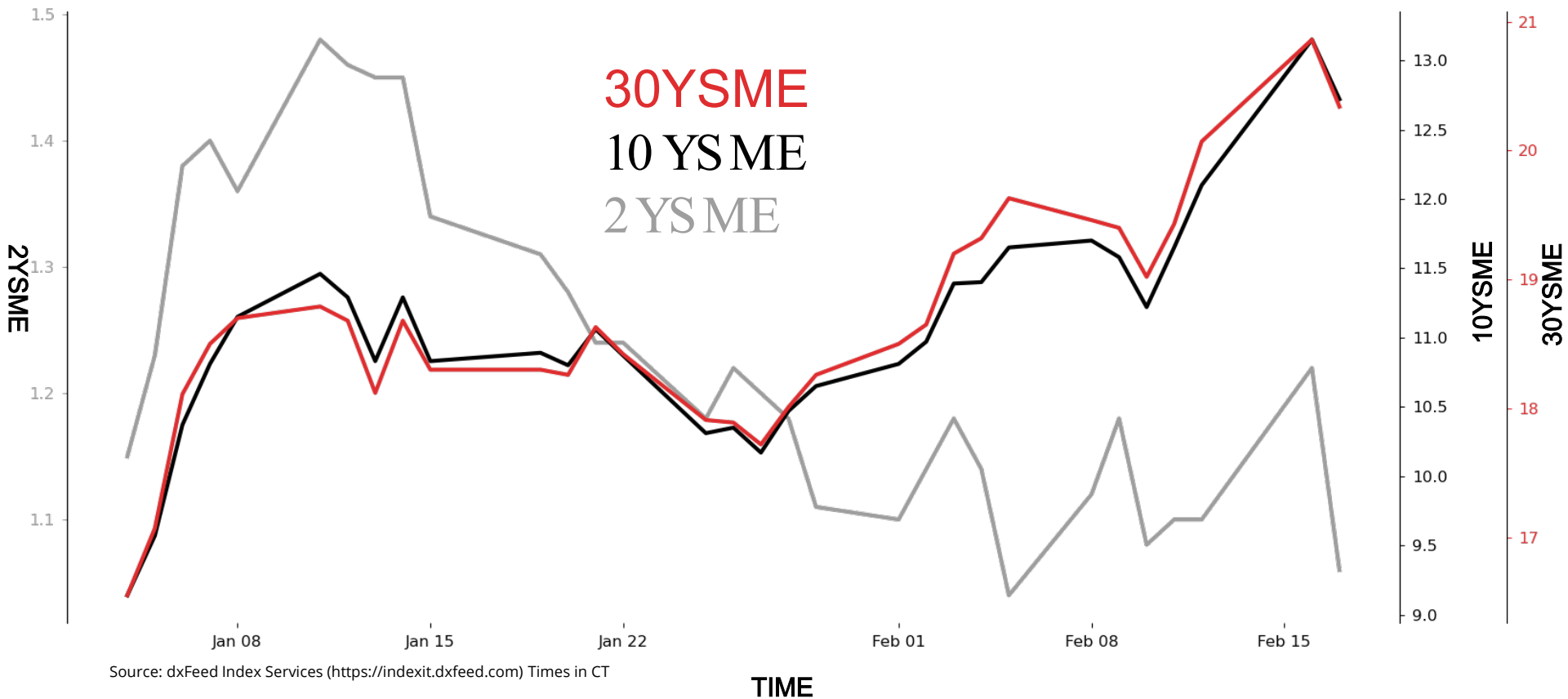
\$100	\$1,300	\$2,000
\$50	\$180	\$300

* Values taken on 2/17/21.

Interest Rates at the Small Exchange come in multiple sizes, so you can test out the new asset with ease.

Everyday Traders now have the entire yield curve to trade in products made for them.





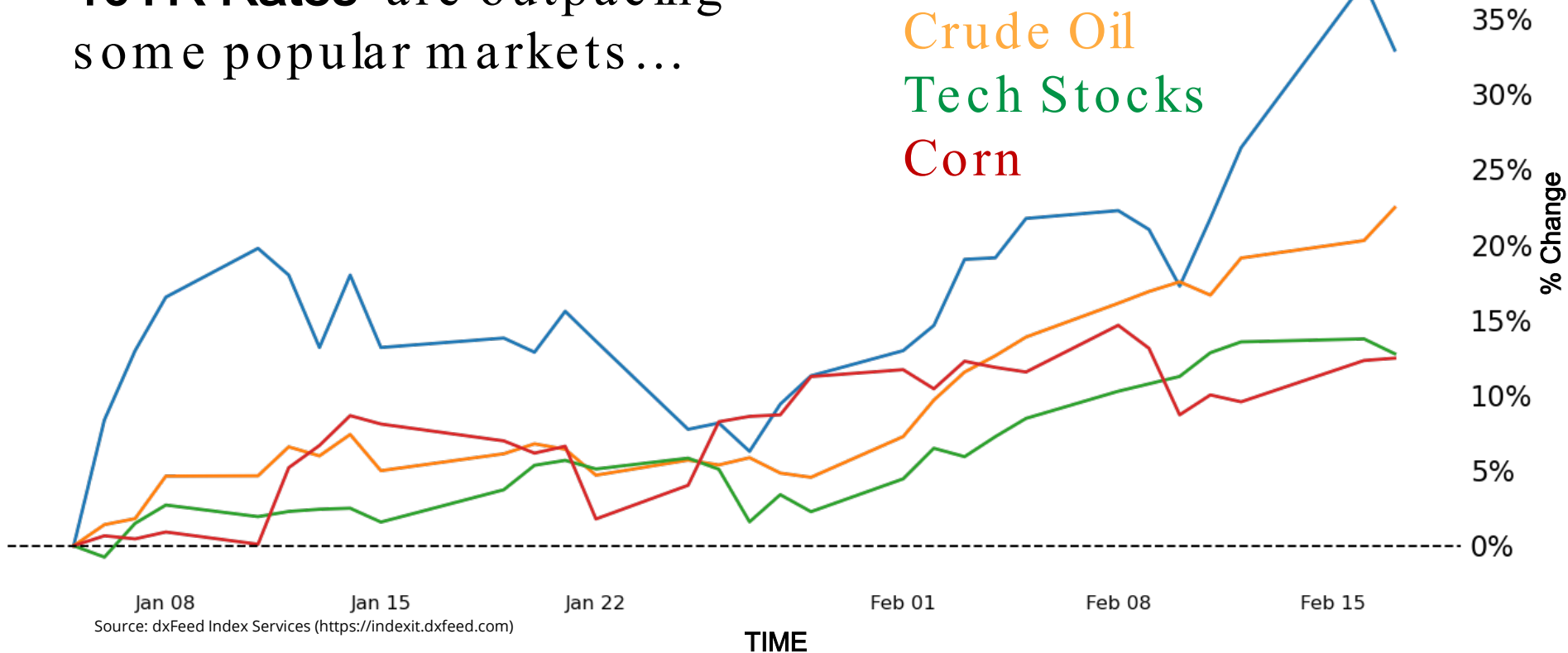
10YR Rates are outpacing
some popular markets...

10YR Yield

Crude Oil

Tech Stocks

Corn



Source: dxFeed Index Services (<https://indexit.dxfed.com>)

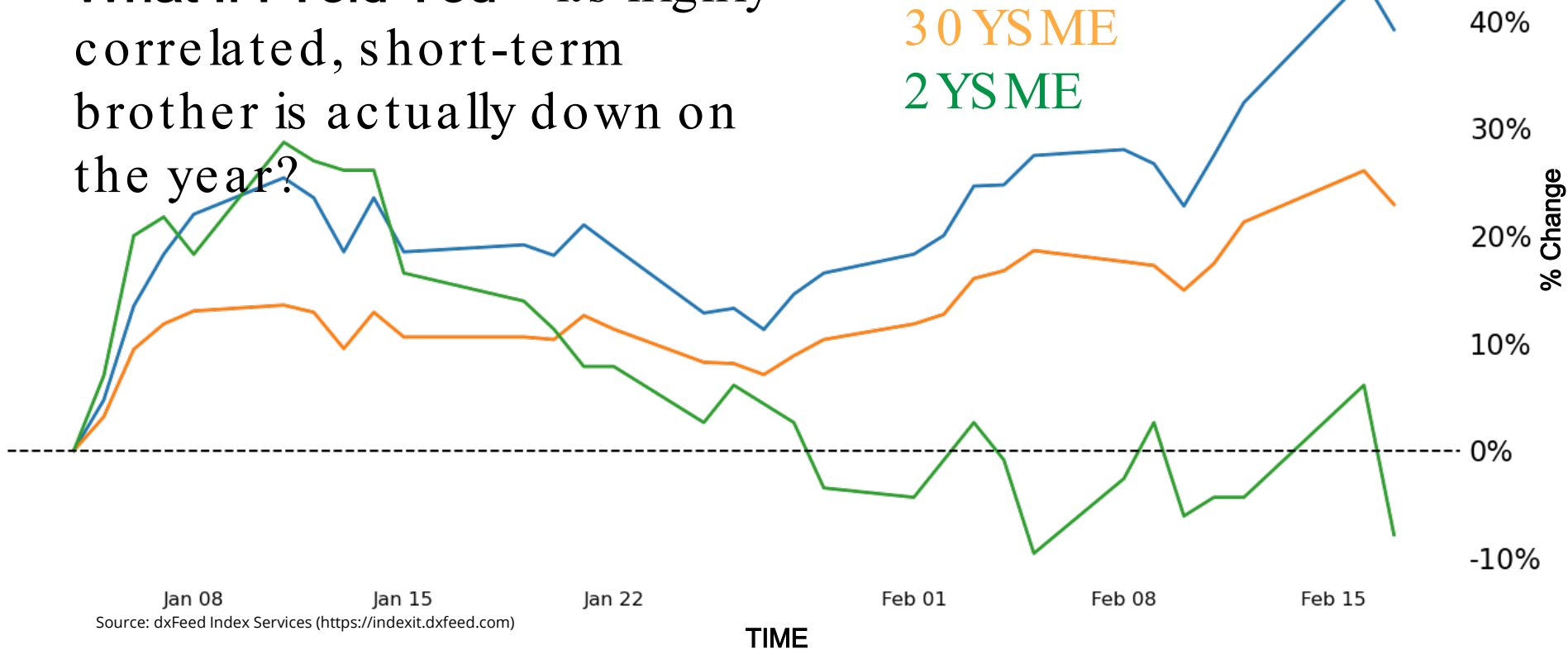
TIME

What If I Told You its highly-correlated, short-term brother is actually down on the year?

10YSME

30 YSME

2 YSME



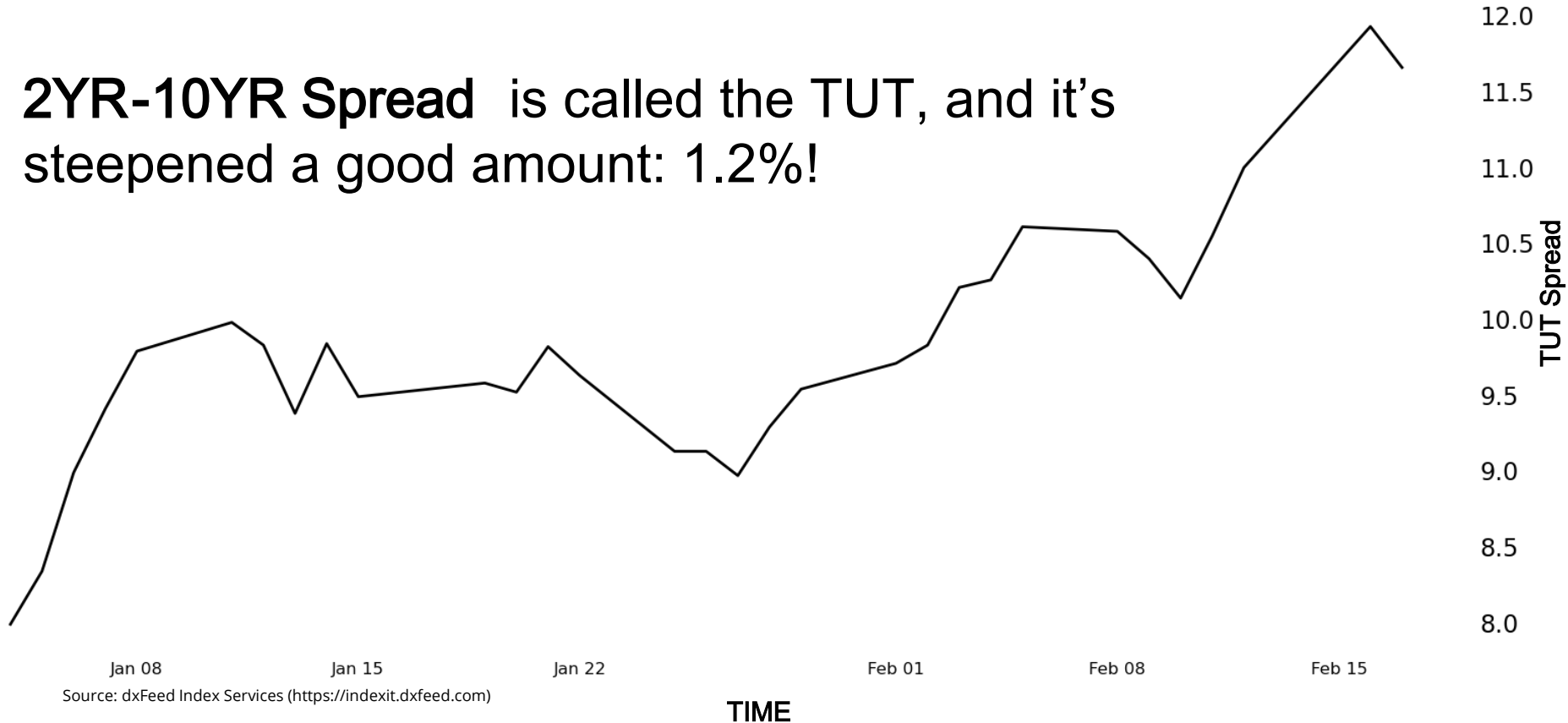
Source: dxFeed Index Services (<https://indexit.dxfed.com>)

TIME

Yield Curve Spreads	
Steepener	Flattener
Diverging Interest Rates	Converging Interest Rates

Welcome to the world of steepeners, flatteners,
and yield curve inversions!

2YR-10YR Spread is called the TUT, and it's steepened a good amount: 1.2%!



Source: dxFeed Index Services (<https://indexit.dxfed.com>)

TIME

TUT Spread

12.0
11.5
11.0
10.5
10.0
9.5
9.0
8.5
8.0

10YR-30YR Spread is called the NOB,
and it's been relatively calm: 0.75%...



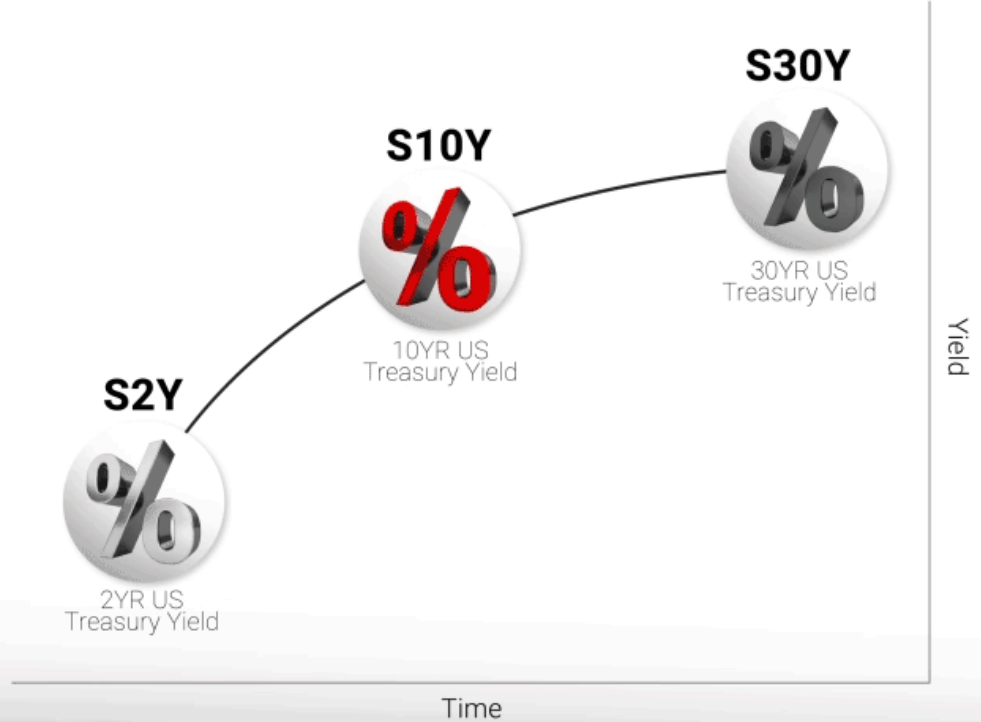
Source: dxFeed Index Services (<https://indexit.dxfed.com>)

TIME

NOB Spread

8.0
7.9
7.8
7.7
7.6
7.5
7.4
7.3

Interest Rates aren't "new" or "in vogue" or "what Elon Musk is tweeting about"...but they sure do move.



Margin for the Smalls*				
75SME	PRESME	FXSME	STXSME	10YSME
\$523	\$462	\$165	\$484	\$180

* Values taken on 1/25/21.

The Smalls let you try out pairs trading strategies without overextending your account or feeling uncomfortable.



Ready to join us?

A one-time payment of \$100 gets you...

- Lifetime subscription
- 50% discounted exchange fees
- Reduced market data fees

visit subscribers.thesmallexchange.com

