The basics of long-dated calls

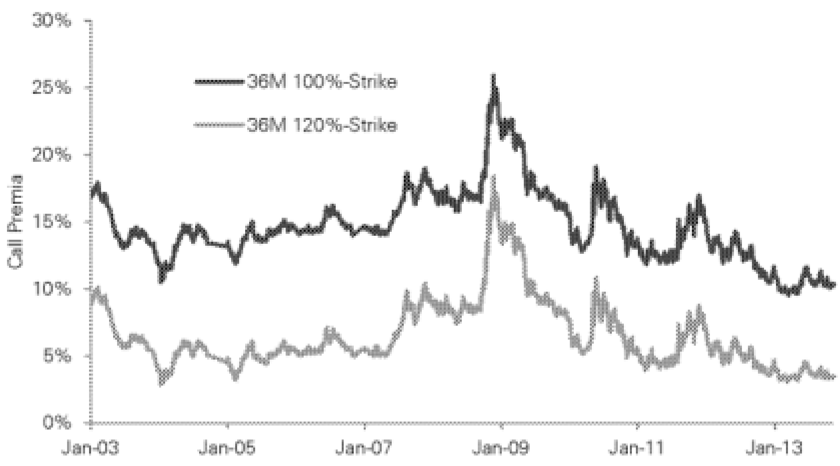
Better risk-adjusted returns at an attractive price

Buying long-dated call options offers benefits to investors seeking equity exposure. They allow for continued upside participation and at the same time provide a floor should the broad market decline rapidly. In this note, we show that longer-dated SPX call strategies have historically provided better risk-adjusted returns compared with buying and holding the broad index.

There are several key features of call options that should appeal to a wide range of equity investors:

- Current pricing: Long-dated calls on the SPX index are priced attractively with levels for both ATM and OTM calls near decade-long lows (see Figure 1)
- Embedded risk management characteristics: Call 'delta' (sensitivity of the call's price to spot moves) increases in a rally and decreases in a sell-off. Thus investors get longer as the market moves higher and less long as the market sells off. This convexity property of long options is especially attractive in a market pullback and is a reason why long-dated calls result in higher risk-adjusted returns in our backtests vs long equity only

Figure 1: Current long-dated call option premium near decade-long lows



Source: Deutsche Bank.

The note is divided into three parts:

- Why current pricing on long-dated calls is attractive relative to history
- How different long-dated call structures have performed historically, including partly cheapening long-dated calls by selling higher strike calls with the same maturity and by selling 1M calls
- What is the relative magnitude of the different risks inherent in long call positions