Beyond dividends: Augmenting an equity income strategy

Federated Hermes

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Key takeaways

- **Investors often face a trade-off between receiving current income and pursuing long-term capital appreciation.**
- **While some income-oriented approaches may provide relative stability during market volatility, they may not consistently deliver sufficient capital appreciation to meet investor objectives.**
- **A strategy that combines an equity income approach with selling call options may address an investor's need for income and appreciation.**

The relatively consistent income streams provided by income-oriented approaches can serve as both a financial and psychological underpinning in the face of market volatility.

The search for growth with income

Investing is frequently a choice between accepting current income or postponing it in favor of longer-term growth. Yet, many investors require both, and the resulting challenge is determining an optimal exposure to each approach that suits their or their clients' particular needs. A portfolio consisting entirely of 100% income-generating bonds will have a different outcome than one with 100% exposure to small-cap growth stocks.

The relatively consistent income streams provided by income-oriented approaches can serve as both a financial and psychological underpinning in the face of market volatility. However, even for those who prefer current income over future capital appreciation, the income received from traditional investment approaches may fall short of their objectives.

The equity income approach

There are various income-producing strategies, including dividend-paying stocks, bonds, real estate investment trusts and preferred stocks, among others.

A dividend-paying equity investment strategy may address the challenge of balancing income and capital appreciation. Many companies — labeled as 'dividend aristocrats' — have paid increasing dividends regularly for decades or longer. Some investors fully embrace a cash payment that, once received, can't be nullified by future stock performance. Regular dividends can be a sign of a successful business, which can be accompanied by capital appreciation, increasing dividend payments or both. Additionally, while not typically experiencing the massive growth on par with many technology stocks of recent years, dividend stocks — in addition to regular dividend payments — can still capture market upside and participate in a growing economy.

Options for income

Investors who appreciate the cash generation from a dividend-oriented portfolio may still prefer current income that exceeds what an S&P 500® portfolio (or even a portfolio of higher-paying dividend equities) may yield. It is worth noting that as of November 30, 2025, the yield on the S&P 500® was approximately 1.15%, falling short of many investors' income targets.

One strategy long-employed (and recently popularized) by investors is combining a traditional equity portfolio with a call option writing overlay, providing a potential additional source of income generation.

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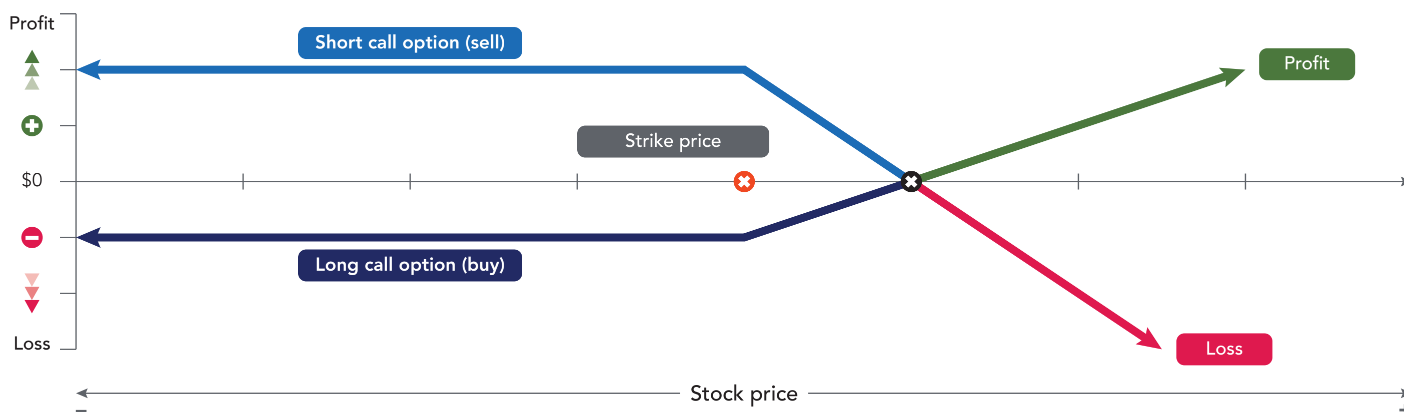
A basic approach is to write options on individual stocks, entitling the option purchaser to buy a stock at a preset price. The call option writer collects money by selling the option (the premium) and sets the strike price at a level that they believe minimizes the likelihood of the option being exercised. In which case, the option expires unexercised, and the option writer keeps the premium.

That call option premium can be passed along to an investor as an additional cash distribution in addition to any dividend payments. Selling call options, however, carries the risk that as the stock rises, it may be exercised, placing a cap on upside price potential if the option seller owns the underlying stock. If the option seller does not own the stock, they may be exposed to unlimited losses from having to purchase the stock, but at much higher price than the strike price, and transferring the stock to the option holder.

Exhibit 1: Call option examples



Source: Federated Hermes. The table above is provided for illustrative purposes only and does not represent a specific strategy, nor does it address every potential outcome.

Mitigating the risk of call writing

One approach to mitigating the risk of writing call options is to implement a 'call spread' strategy. Call spreads combine writing (selling) a call option at a certain strike price, with buying a call option with the same expiration date at an even higher strike price (hence, the 'spread'). The premium paid for the long call is typically less than the premium received for selling the call. This 'long' option can help mitigate risk should the underlying stock price rise quickly and substantially above the strike price of the written option. Without the second option position, the call writer would have to deliver the stock or potentially incur unlimited losses.

Exhibit 2: Portfolio manager call spread strategy matrix

	Action	Preferred result	Potential risk	Potential reward
Sell a call option/ Short call	Sell an out-of-the-money call option and receive the premium.	The asset price rises gradually, never reaching the strike price. The option buyer lets the option expire.	The asset price rises sharply above the strike price and the option gets exercised, exposing the option seller to an unlimited loss if the seller does not own the asset (uncovered).	The option seller receives and retains the premium if the option expires without being exercised.
Buy a call option/ Long call	As a hedge, the seller may simultaneously buy a call option on the same asset, further out of the money, using the proceeds (the premium) from the option sale.	Largely neutral. This position serves as a hedge for the call that was sold to cap a potential loss before or at expiration. The option price may increase if the underlying asset's value appreciates.	The option buyer is out the premium regardless. If the underlying asset falls, the option can be sold and a new option bought with any proceeds; or it can simply be allowed to expire.	This is a hedge to mitigate losses. Should the asset price rise above the strike price, the option holder can buy the asset at the lower strike price and sell it at the higher market price, netting a profit.
Net result	A call option sale is hedged against a sharply rising market by the purchased option.	The option writer retains the premium from selling the call, minus the premium paid to buy the call option (plus any proceeds from closing out the long call position).	The call spread strategy seeks to limit losses versus potential unlimited losses from call writing.	Proceeds from the short call minus premium paid for the long can provide a potential boost to income if both options remain unexercised.

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How an options portfolio strategy might work

Options can be employed on their own or combined with a 'traditional' portfolio as part of an overall portfolio management strategy. A portfolio manager/asset owner can write their own options or purchase options written by others. Options can be used speculatively to leverage a bullish outlook or as a defensive measure by receiving income from writing calls, which can provide a cushion to the downside; or by buying put options, which can provide the holder of the option with some downside defense if the asset falls below the strike price.

In addition to writing options on individual securities, options can be written on baskets of stocks (indexes) such as the S&P 500®. For example, investors can buy or sell options on an index ETF or index futures.

Combining options on a broad index ETF with an underlying portfolio composed of actively managed, dividend-paying stocks would also have the potential to provide some internal diversification within the portfolio. Dividend-paying stocks have historically demonstrated lower betas and a differentiated return stream than broader market returns.

Similarly, the portfolio of underlying equities may serve as a counterbalance in a sharply rising market environment where options have hit their strike price and the option writer is facing potential losses. In this case, the underlying equity portion of the portfolio, in theory, would have also participated in the rally.

Active options management

An actively managed options approach involves setting option positions to seek to optimize income and return. This can be achieved by dynamically adjusting the strike prices, the width of the call spreads and closing out or rolling over options positions based on market conditions.

Market volatility — commonly measured by the Cboe Volatility Index or VIX — is a key determinant of options prices. Options prices tend to increase in a high-VIX environment and decrease in a low-VIX environment. In a high-VIX environment, an options writer may choose to write an option further out-of-the-money because the premium someone is willing to pay will likely be higher, in the expectation that market volatility as a factor will drive a price higher (or lower in the case of put options).

The converse also comes into play. In a low-VIX environment, options may have to be written with a strike price that is closer to the market price to increase the value of the call to help generate sufficient income.

Conclusion

Seeking to increase income as part of a portfolio strategy can take many forms, which may involve some trade-offs. We believe in the capital appreciation potential that equity markets provide, but investor time horizons and unique needs should ultimately determine the proper portfolio structure. With the S&P 500® yielding at the lower end of its historical range, an equity tilt toward dividend-paying stocks may help investors toward their income goals. Additionally, an approach that combines dividend payments with options writing, when appropriately managed, may address the need for both income and appreciation.

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For informational purposes only and not a recommendation.

Past performance is no guarantee of future results.

Options terminology

Call option is a contract that gives the holder the right to buy the underlying stock/index at a specified price for a certain fixed period of time.

Call spreads involve selling a call option at a certain strike price and buying a call option at an even higher strike price, creating the 'spread'. Utilizing a call spread strategy effectively caps the amount that could be lost on this position to whatever the 'spread' is between the two strike prices.

Strike price (exercise price) is the stated price per unit of which the underlying stock/index may be purchased (in the case of a call) or sold (in the case of a put) by the option holder upon exercise of the option contract.

Expiration date is the last day on which an option may be exercised.

Out-of-the-money call option is if the strike price is greater than the market price of the underlying stock/index. A put option is out-of-the-money if the strike price is less than the market price of the underlying index.

Premium is the price of an option contract, determined by the competitive marketplace, which the buyer of an option pays to the option writer for the rights granted by the option contract.

Put option is a contract that gives the option holder the right to sell the underlying index at a specified price for a certain fixed period of time.

A word about risk

Equity securities may decline in value because of an increase in interest rates or changes in the stock market.

The use of derivative instruments involves risks different from, or possibly greater than, the risks associated with investing directly in securities and other traditional instruments.

Writing option contracts can result in losses that exceed the seller's initial premium collected and may lead to additional turnover and higher tax liability.

While stocks have higher return potential, they may be more volatile than bonds.

Investments are subject to risk and may lose value.

There are no guarantees that dividend-paying stocks will continue to pay dividends. In addition, dividend-paying stocks may not experience the same capital appreciation potential as non-dividend-paying stocks.

Diversification does not assure a profit nor protect against loss.

There is no assurance that this type of strategy will achieve either current income or capital appreciation objectives.

Definitions

Beta analyzes the market risk of a fund by showing how responsive the fund is to the market. The beta of the market is 1.00. Accordingly, an investment with a 1.10 beta is expected to perform 10% better than the market in up markets and 10% worse in down markets. Typically, higher betas represent riskier investments.

Futures are contracts that obligate holders to buy or sell an asset at a specific price on a predetermined date; unlike options, where only one party has an obligation.

S&P 500® is an unmanaged capitalization-weighted index of 500 stocks designated to measure the performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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