Dividend strategies: An underappreciated equity approach hiding in plain sight

Federated Hermes

Portfolio Construction Solutions

2026 annual update

Key takeaways

- **High dividend equity strategies deserve full consideration for a strategic allocation in diversified portfolios.**
- **These are time-tested strategies that can provide a novel addition to the equity strategies commonly incorporated into a diversified portfolio.**
- **A high dividend strategy is not only a fundamentally sound approach employed by generations of investors, but may also provide a diversifying return stream that is distinct from broad equity market indexes.**

High dividends make for low correlations

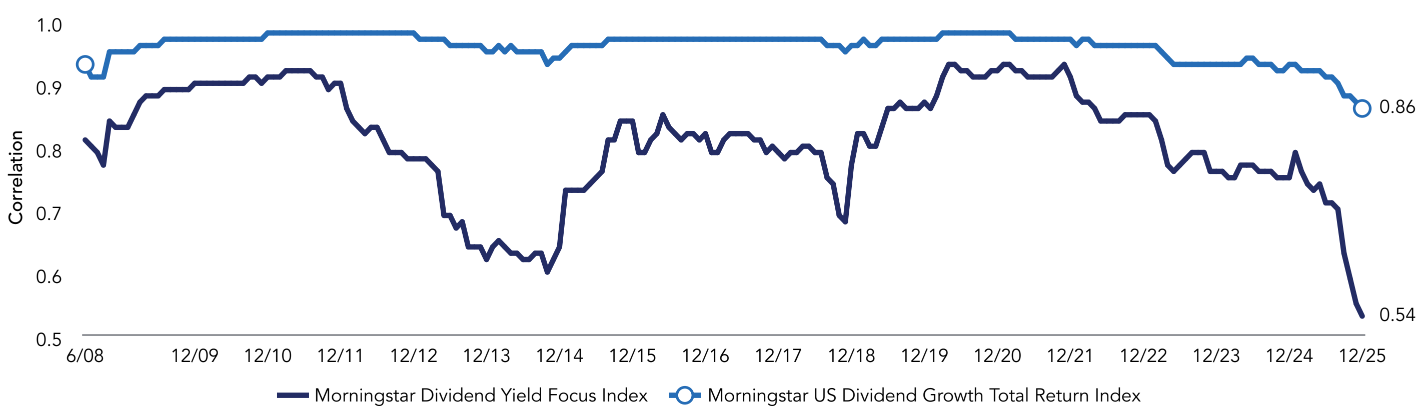
Not all dividend strategies are created equal. For example, the high dividend strategy described below is distinct from a dividend growth strategy. A dividend growth strategy concentrates less on the level of dividend and more on its consistency of payout and growth. We believe that investors may miss out on substantial portfolio diversification benefits by not carefully selecting an appropriate yield or equity income strategy.

Exhibit 1 illustrates the rolling three-year correlation between the Russell 1000® Index and the Morningstar US Dividend Growth Total Return Index,[1] which had a yield of 2.11% (as of 12/31/25), and an average three-year correlation to the Russell 1000® of 0.96 over the period.

Compare it to the Morningstar Dividend Yield Focus Index,[1] which had a yield of 3.37% (as of 12/31/25) and a three-year return correlation to the Russell 1000® Index that averaged 0.81 over the time frame.

Exhibit 1: Dividend strategies' rolling three-year return correlation to the Russell 1000® Index

Morningstar Dividend Yield Focus Index and Morningstar US Dividend Growth Index 6/30/08 - 12/31/25



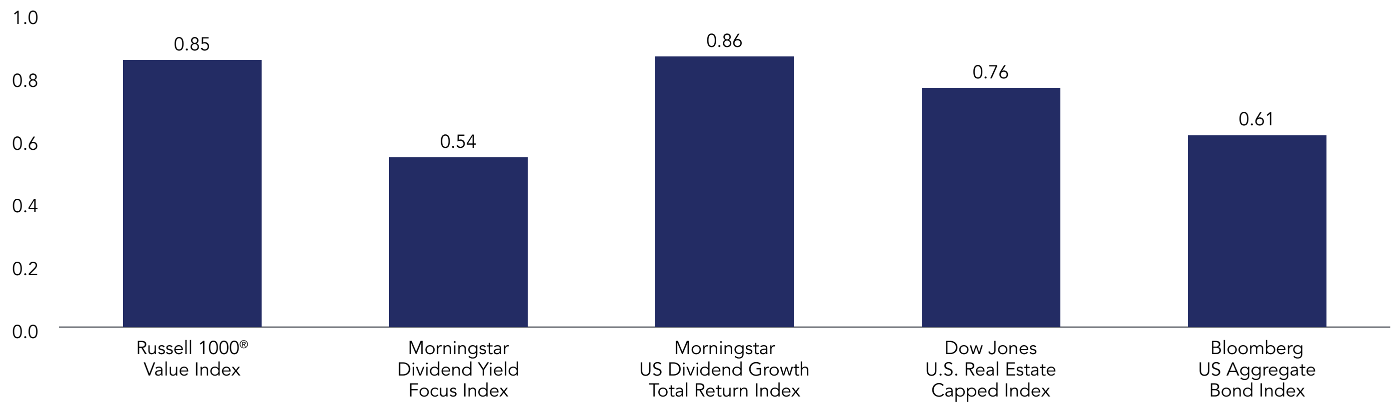
Sources: Morningstar, Inc., Federated Hermes, Inc.; through December 31, 2025.

Past performance is no guarantee of future results.

In a complex world where unexpected events can challenge investor confidence, low correlation assets can be exceptionally valuable. While some investors turn to alternatives for their perceived low correlations to equity markets, a less exotic solution has always been available: high dividend strategies, where the fundamental driver of the low correlations is the high dividend. The return investors receive from the dividend has little to do with equity market fluctuations but is driven by the earnings power of the underlying companies, and a company's commitment to returning part of that earnings to investors in the form of dividends.

The correlation profile of a high dividend strategy has been noticeably lower than some other yield-producing strategies employed in diversified models. The Morningstar Dividend Yield Focus Index has a three-year correlation to the Russell 1000® Index of 0.54 (as of 12/31/25).

Exhibit 2: Trailing three-year correlation to the Russell 1000® Index



Sources: Morningstar, Inc., Federated Hermes, Inc.; through December 31, 2025.

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Blending dividend and value indexes

We have established that a high dividend strategy has attractive diversification qualities. However, low correlation alone may not convince investors to create a strategic position for it in their portfolios. A strategy has to earn its way into an investment portfolio either by improving returns, improving risk, or a combination of the two, by demonstrating better risk-adjusted returns.

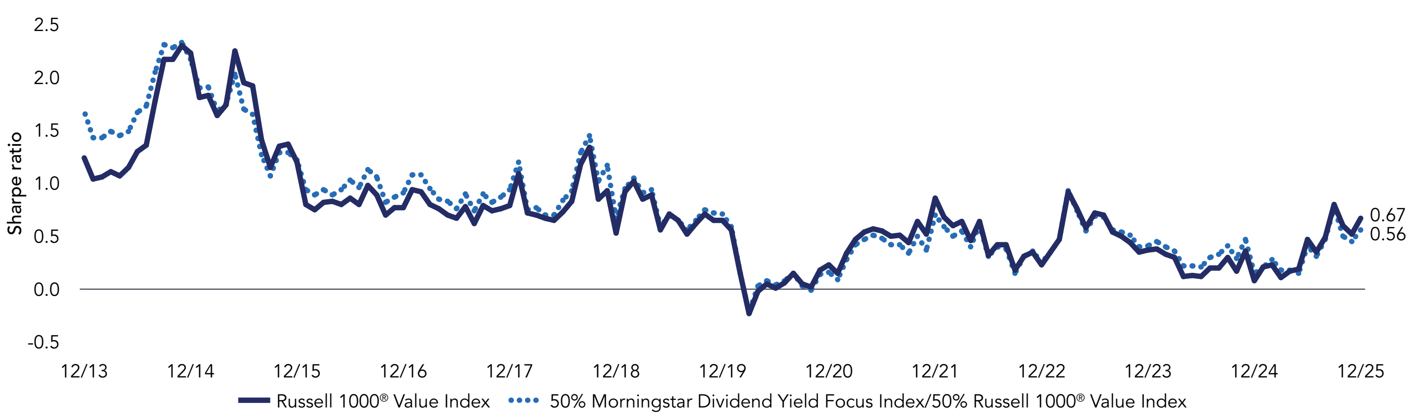
First, we will consider a high dividend strategy as a subset of a value equities allocation and if the combination results in improved risk-adjusted returns. Rolling three-year Sharpe ratios are a valuable tool for this, as any given point represents the three-year experience of a hypothetical investor.

Reviewing 120 months (10 years) of rolling three-year Sharpe ratios and 11 allocation combinations of the Morningstar Dividend Yield Focus Index and Russell 1000® Value Indexes (100/0 to 0/100 in 10% increments) has led us to the following conclusions:

1. A blend of the Morningstar Dividend Yield Focus Index and Russell 1000® Value Index may potentially generate better risk-adjusted returns than either index on a stand-alone basis.
2. The optimal blend is near 50/50, with a range of +/-20%. Over any given period, either index may outperform. Various analyses point toward a blended solution on either side of a 50/50 blend, depending on the time frame.

A 50/50 blend of the Morningstar Dividend Yield Focus Index and Russell 1000® Value Index had better risk-adjusted performance than a stand-alone Russell 1000® Value Index in over 65% of rolling three-year time frames examined, as measured by the Sharpe ratio (see Exhibit 3 below.)

Exhibit 3: Rolling three-year Sharpe ratios



Sources: Morningstar, Inc., Federated Hermes, Inc.; through December 31, 2025.

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Expanding the blend

Do the same benefits of a high dividend strategy we see above apply at the portfolio level as well? Our research indicates that a "neutral" 50/50 value/yield portfolio does improve the return profile of a "60/40" portfolio.

In the time frames below, we see that a high dividend strategy in a 50/50 mix with a large capitalization value approach (represented by the Russell 1000® Value Index) improves risk metrics and absolute and risk-adjusted returns over different time periods. Annualized total returns improved the longest period. Risk metrics were improved over every time period, and risk-adjusted returns were improved in all but the shortest time frame. The unusually strong returns among large and growth companies over the past three years ending 12/31/25 muted some of this strategy's return profile in the trailing three-year period, but standard deviation (risk) is notably lower even if other metrics are less compelling.

In all four measurement periods, risk as measured by standard deviation and maximum drawdown is noticeably improved.

Over longer periods (from the Morningstar Dividend Yield Focus Index performance inception, which captures the period of the Great Financial Crisis), the benefits of this type of strategy are most evident. While over shorter periods a high dividend approach may appear lackluster, we believe it remains a durable long-term investment option for investors.

Exhibit 4: Blended index returns - through 12/31/25

	Annualized total return (%)	Standard deviation	Maximum drawdown (%)	Sharpe ratio	Sortino ratio
Trailing three-year					
30% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	15.17	9.02	-7.10	1.08	1.90
15% Morningstar Dividend Yield Index, 15% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	14.48	8.42	-6.75	1.08	1.87
Trailing five-year					
30% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	7.98	10.90	-20.39	0.46	0.66
15% Morningstar Dividend Yield Index, 15% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	7.93	10.34	-18.89	0.47	0.68
Trailing ten-year					
30% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	9.58	10.21	-20.39	0.73	1.11
15% Morningstar Dividend Yield Index, 15% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	9.39	9.79	-18.89	0.74	1.12
Since Inception (7/1/05)					
30% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	8.05	9.77	-32.71	0.67	0.99
15% Morningstar Dividend Yield Index, 15% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	8.21	9.21	-29.33	0.72	1.08

Sources: Morningstar, Inc., Federated Hermes, Inc.; through December 31, 2025.

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High dividend strategies implementation considerations

The goal of portfolio construction can be described as maximizing return for a given level of risk.

As shown above, high dividend strategies may help reduce risk. In practice, this means two things: that an investor may reduce the risk exposure of the current portfolio by maintaining the current allocations; or that an investor can increase the current equity allocation — and with it, the potential for higher returns — while holding risk at or near the current level. The increase in expected returns can add substantial value over time while maintaining a comparable amount of risk.

Our analysis indicates that a portfolio with a high dividend yield component can be scaled up to approach the risk of the simple 60/40 portfolio with a higher exposure to equities (63/37 allocation). The result is greater annualized returns with comparable levels of risk.

Exhibit 5: Blended index returns with optimized allocation - through 12/31/25

	Annualized total return (%)	Standard deviation	Maximum drawdown (%)	Sharpe ratio	Sortino ratio
Trailing three-year					
30% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	15.17	9.02	-7.10	1.08	1.90
15% Morningstar Dividend Yield Index, 15% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	14.48	8.42	-6.75	1.08	1.87
15.75% Morningstar Dividend Yield Index, 15.75% Russell 1000® Value, 31.5% Russell 1000® Growth, 37% Bloomberg US Aggregate Bond Index	14.98	8.60	-6.86	1.11	1.94
Trailing five-year					
30% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	7.98	10.90	-20.39	0.46	0.66
15% Morningstar Dividend Yield Index, 15% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	7.93	10.34	-18.89	0.47	0.68
15.75% Morningstar Dividend Yield Index, 15.75% Russell 1000® Value, 31.5% Russell 1000® Growth, 37% Bloomberg US Aggregate Bond Index	8.35	10.61	-19.11	0.50	0.72
Trailing ten-year					
30% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	9.58	10.21	-20.39	0.73	1.11
15% Morningstar Dividend Yield Index, 15% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	9.39	9.79	-18.89	0.74	1.12
15.75% Morningstar Dividend Yield Index, 15.75% Russell 1000® Value, 31.5% Russell 1000® Growth, 37% Bloomberg US Aggregate Bond Index	9.75	10.14	-19.11	0.75	1.14
Since Inception (7/1/05)					
30% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	8.05	9.77	-32.71	0.67	0.99
15% Morningstar Dividend Yield Index, 15% Russell 1000® Value Index, 30% Russell 1000® Growth Index, 40% Bloomberg US Aggregate Bond Index	8.21	9.21	-29.33	0.72	1.08
15.75% Morningstar Dividend Yield Index, 15.75% Russell 1000® Value, 31.5% Russell 1000® Growth, 37% Bloomberg US Aggregate Bond Index	8.44	9.58	-30.79	0.72	1.08

Sources: Morningstar, Inc., Federated Hermes, Inc.; through December 31, 2025.

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Selecting a high dividend manager

The efficient markets we face do not hand out free lunches. If a high dividend strategy offers such compelling benefits, why haven't these securities been repriced higher, resulting in a lower yield (and lower total returns) to investors?

A thorough analysis of this issue is outside the scope of this white paper. It should be noted that high dividend securities are often priced to reflect particular risks, and the primary threat to a dividend-focused strategy is dividend cuts. Dividend cuts are problematic for those managing income expectations; and anticipated dividend cuts are often associated with a negative re-pricing of securities, impacting total return on two fronts. A thoughtful approach rooted in fundamentals may successfully navigate the high dividend space.

The Federated Hermes Portfolio Construction Solutions team is available to review your current models and propose approaches that can help improve the risk/return profile of your portfolios.

[1] **Morningstar Dividend Yield Focus Index** holds US companies with a screen for financial health and an ability to sustain above average dividend payouts. The index consists of 74 stocks as of 2/28/26. **Morningstar US Dividend Growth Index** is focused on companies that have raised their dividends consistently, but also maintain a payout ratios below a certain threshold. The highest yielding stocks are eliminated from consideration, to avoid dividend cuts. The index consists of 396 holdings as of 2/28/26.

Note: Both of these strategies employ a rules-based approach to address the nemesis of dividend investing: unsustainable dividends, which can lead to dividend cuts. While rules-based approaches can address basic concerns, they cannot incorporate new information and adapt in the same way a seasoned investment team evaluates market data.

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Views are as of the dates indicated and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Diversification and asset allocation do not assure a profit nor protect against loss.

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. Investing in equities is speculative and involves substantial risk.

Definitions

Drawdown is the measurement of peak-to-trough investment returns during a specific period.

Standard deviation is a statistical measurement of dispersion which depicts how widely the returns varied--or their volatility--over a certain time period. The higher the standard deviation of returns, the greater the volatility.

Sharpe ratio is calculated by dividing a portfolio's annualized return, minus the risk-free rate of return, by its annualized standard deviation. A higher Sharpe ratio, represents better historical risk-adjusted performance.

Sortino ratio is calculated by dividing a portfolio's annualized returns, minus the risk free rate, by its annualized standard deviation of negative returns. A higher Sortino ratio represents better historical risk-adjusted returns.

Bloomberg US Aggregate Bond Index is an unmanaged index composed of securities from the Bloomberg Government/Corporate Bond Index, Mortgage-backed Securities Index and the Asset-backed Securities Index. Total return comprises price appreciation/depreciation and income as a percentage of the original investment. Indices are rebalanced monthly by market capitalization.

Dow Jones U.S. Real Estate Capped Index is designed to track the performance of real estate investment trusts (REITs) and other companies that invest directly or indirectly in real estate.

Russell 1000® Growth Index measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment.

Russell 1000® Index measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000® Index represents approximately 92% of the US market.

Russell 1000® Value measures the performance of the large-cap value segment of the US equity universe. It includes those Russell 1000® Index companies with lower price-to-book ratios and lower expected growth values.

Indexes are unmanaged and investments cannot be made in an index.

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