

O-Matrix Grading System

Written by Dr. Econ

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O-Matrix Grading System is a very simple, yet powerful grading system. I first read about it at Prof. Jeremy Siegel's book, *Stocks for the Long Run*:



"A rule of thumb for stock valuation that is found on Wall Street is to calculate the sum of the growth rate of a stock's earnings plus its dividend yield and divide by its P-E ratio. The higher the ratio the better, and the famed money manager Peter Lynch recommends investors go for stocks with a ratio of two or higher, avoiding stocks with a ratio of one or less."

Peter Lynch is one of my favorite money managers. It is quite amazing that Fidelity's Magellan Fund returned almost 30% every year, between 1977 and 1990. He has some really good skills. I was wondering where to put the dividends in a fair value estimation model. This methodology is an excellent grading system where dividends are perfect substitutes for growth. Thus higher dividends makeup for lower growth expectations. Surely, you want the total to be as higher as possible. You also want to get a good deal at a cheap P/E ratio. Thus the O-Matrix score is calculated as the following:

$$\text{O-Matrix} = 5 \times (\text{Dividend Yield} + \text{Expected Growth}) / \text{PE Ratio}$$

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I multiplied by 5, to get a scale over 10. As an investor, our mission is to find companies with 10+ grades. It is a hard challenge. However, any company with 5+ grade is also acceptable. If you are a dividend oriented investor, living on dividends, a Double Dividend (DD) O-Metrix is more suitable for your needs:

DD O-Metrix = $5 \times (2 \times \text{Dividend Yield} + \text{Expected Growth}) / \text{PE Ratio}$

Again the aim here is to find the companies with highest DD O-Metrix scores.

Dividend yield is the current dividend yield. Simply taking the average of trailing twelve month and forward PE ratios will do the work. For the expected growth parameter, I use the long-term annualized EPS growth estimations.

[I regularly perform back-tests on O-Metrix models. You can find the results here.](#)

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