

## AlphaScreens: the quest for quality

15 November 2021

### Balance quality shares' cyclical and valuation risk

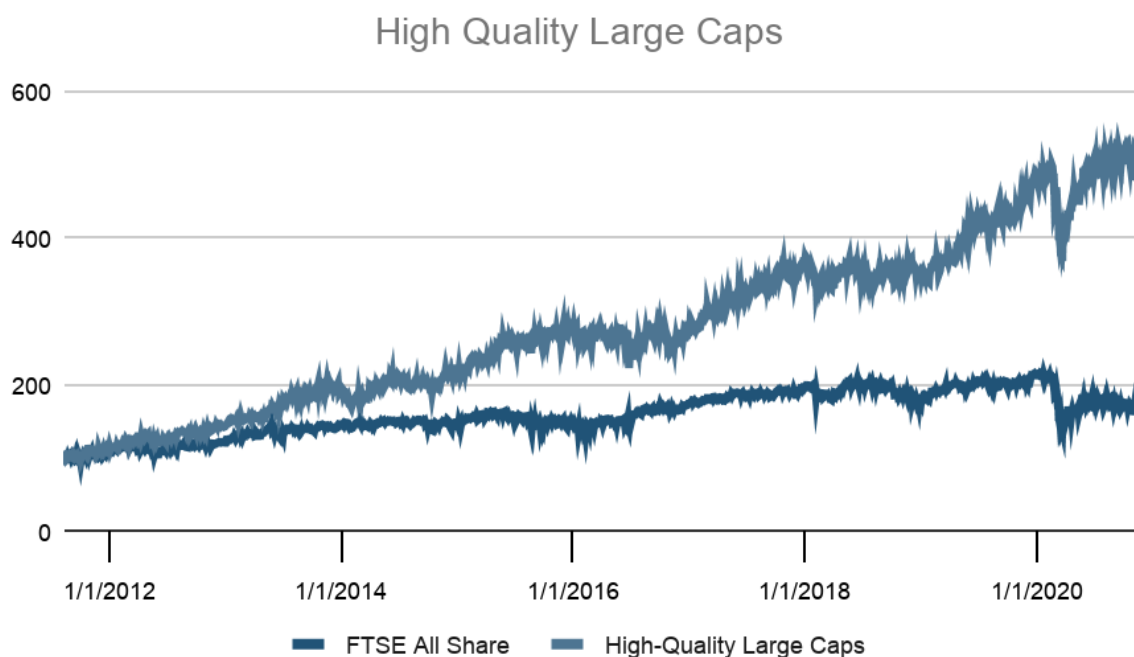
*The holy grail for buy-and-hold investors is to find a business that is capable of generating a high return on capital and sustaining it while reinvesting profits. This screen looks for shares that display these quality characteristics and can potentially deliver significant compounded returns over time*

#### Comment by Alpha editor:

- Investing in the shares of quality companies with strong balance sheets and robust profitability is a well attested-to method of building returns. Yet there are pitfalls, notably that these companies become so popular that the shares get very expensive, and this valuation risk means they are vulnerable to price falls on macro economic news or even the slightest disappointment in performance. So, along with quality, there needs to be some focus on value - even if some of the best companies remain worth paying up for.
- Diversifying portfolio strategy so that not all shares held are priced expensively relative to expectations of future profits is sensible. However, it is also worth keeping in mind that companies in different sectors of the economy should not be valued the same way.
- IT company Kainos (KNOS) is valued on 53 times earnings estimates for the next twelve months according to our FactSet data, so the fact that it fails our price-to-earnings growth test should be a flag to pause and consider if it is now too expensive. Data business Experian (EXPN) has a NTM PE of 36, but it doesn't fail a single test. The other FTSE All Share companies scoring 9/9 are Hikma Pharmaceuticals (HIK) and mobile and IT network specialist Spirent Communications (SPT). These perfect score companies shouldn't be avoided because they have long forward PE multiples, rather the quality signs are reassuring so long as the growth prospects are good.
- Balancing valuation risk with some cyclical risk, investors might look to other sectors. For example, several mining companies do well on our quality screen but have potential to be volatile on external shocks that affect commodity prices. It's also worth noting that although they look cheaper than other flagged quality companies on Fwd PE, measures like share price to free cash flow or share price to net asset value are better metrics for the sector.

## The dream company

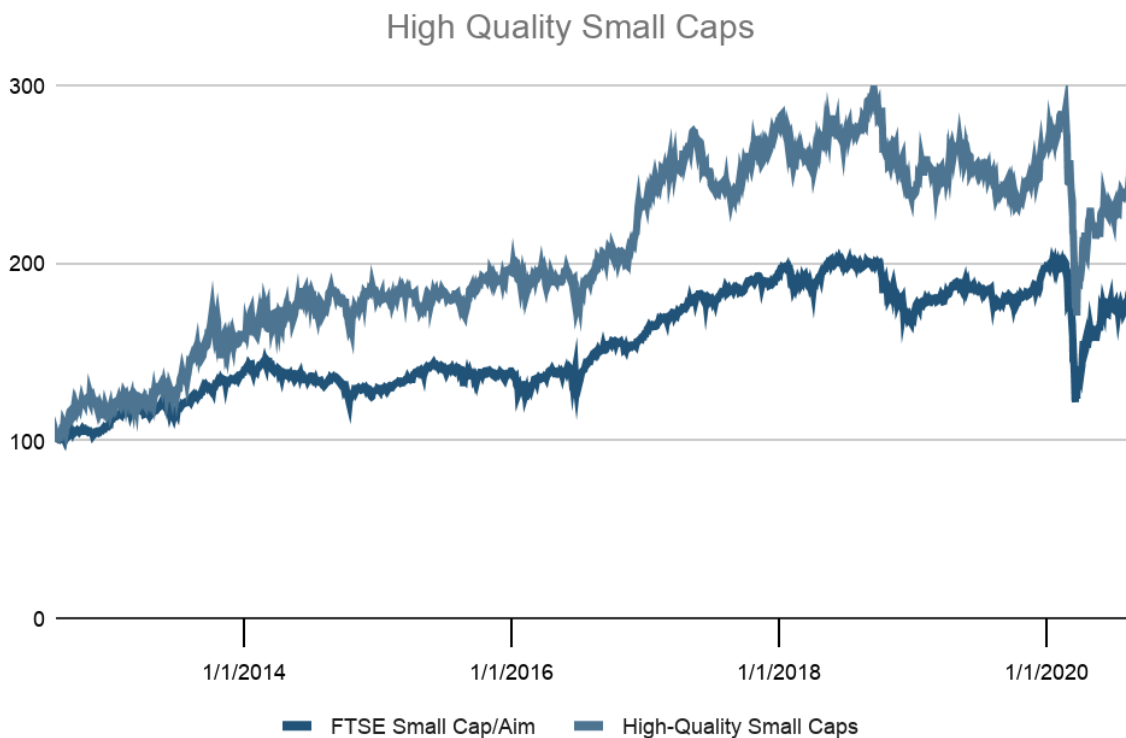
The holy grail for buy-and-hold investors is to find a business that is capable of generating high returns on its capital and is able to reinvest all its profits for decades to come, while maintaining those returns. The compounding effect of such an investment is what every long-term investor's dreams should be made of. A company making a consistent 15 per cent post-tax return on its equity and reinvesting all its profits would experience a near-30-fold (28.6 to be precise) growth in its equity base over 25 years, and after 50 years it would be a mind-boggling 1,084 times bigger than when it started. For a patient investor convinced that they have found such a situation, valuation should not act as a major impediment to a purchase.



Source: Refinitiv, Investors' Chronicle

Unfortunately, this kind of dream company is extremely rare and stock screens are too crude to provide the depth of analysis needed to provide confidence that a business may be the real deal. In particular, it is inevitable that some of the shares highlighted by our Alpha Quality screen will be cyclical companies that are enjoying a good run rather than companies that are well placed to sustain high returns through many business cycles to come. What our screen does do, however, is attempt to find pointers for companies that may have the potential to go some way to filling the dream brief. What's more, buying shares in companies that look attractive based on quality metrics can often prove a

profitable strategy, even if many of the shares picked fall short of the buy-and-hold ideal.



Source: Refinitiv, Investors' Chronicle

## Alpha Quality screening criteria

Our Alpha Quality screen uses two key measures of quality: operating margins and return on equity. We are mindful that debt can flatter a company's return on equity, so we aim to reduce this risk from the screening results by introducing interest cover tests, to eliminate companies that are aggressively gearing up their balance sheet. The screen uses two key measures of quality, which are operating margins and return on equity (RoE).

The advantage of using RoE to measure the quality of a company is that it focuses on the returns that are ultimately of most significance to shareholders: after-tax earnings. However, RoE can be boosted by a company if it increases the amount of debt it carries. That means a high and rising RoE can sometimes simply reflect a reduction in the quality of the company's balance sheet and little improvement, or even a deterioration, in the quality of its operations. The screen attempts to counter this with its interest cover test, which should help it avoid companies with very aggressively 'geared' balance sheets. Focusing on

operating margins also provides an assessment of quality at the operating level – i.e. before the impact of debt.

- An operating margin higher than the median average (mid-ranking) stock in each of the past three years (i.e. quality that shows some signs of persistence).
- A return on equity (RoE) higher than the median average (mid-ranking) stock in each of the past three years (i.e. again, quality that shows some signs of persistence).
- RoE higher than it was two years ago (i.e. quality is improving as well as persistent).
- Operating margin higher than it was two years ago (i.e. quality is improving as well as persistent).
- A dividend-and-debt adjusted price/earnings growth (PEG) ratio below the top fifth of stocks screened (ie stocks must not be too egregiously expensive for the growth on offer).
- A price/earnings (PE) ratio above the bottom 10 per cent of stocks screened and below the top 10 per cent (i.e. not a suspiciously cheap or dangerously expensive valuation).
- Interest cover of more than five (i.e. high RoE is not overly dependent on the use of debt).
- Forecast earnings growth for each of the next two financial years.
- Positive forecast free cash flow.

The Alpha Quality screen is conducted separately on constituents of the FTSE All-Share, FTSE All-Small and FTSE Aim All-Share indices, with the results from each screen reported in separate tables.

Not many stocks pass such a stringent list of criteria. The ones that pass all the tests are listed at the top of the table, followed by those failing one test, then those failing two tests as detailed in the 'Tests passed' column. All stocks must pass the test for three-year, higher-than-average RoE and margin to feature in the table. While the primary ranking of the stocks is based on the number of tests they pass, inside each of these groupings stocks are ordered according to their attractiveness based on operating margin and three-month share price momentum.

## Stock screen and methodology by Algy Hall

## Large-cap quality selection (passing at least 7 of 9 tests)

Name	TIDM	Mkt cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/debt(-) in £	Tests passed (out of 9)	Test failed
Experian	EXPN	£32,160m	3,485p	36	1.0%	24.6%	12.6%	11.4%	-1,606m	9	na
Spirent Comm.	SPT	£1,753m	287p	23	1.6%	15.5%	6.5%	-2.1%	63m	9	na
Hikma Pharma.	HIK	£5,458m	2,358p	15	1.6%	17.3%	14.6%	-7.3%	-495m	9	na
Kainos	KNOS	£2,536m	2,052p	53	1.0%	1.5%	6.5%	14.3%	8m	8	/PEG/
Dunelm	DNLM	£2,777m	1,366p	19	7.3%	12.4%	5.5%	2.6%	-107m	8	/RoE grth/
IMI	IMI	£4,684m	1,792p	18	1.3%	13.5%	11.3%	0.5%	-376m	8	/RoE grth/
Avast	AVST	£5,785m	559p	19	2.0%	9.9%	6.7%	-5.4%	-327m	8	/RoE grth/
BHP	BHP	£41,414m	1,961p	8	11.2%	4.8%	-24.3%	-14.3%	-835m	8	/Fwd EPS grth/
Games Workshop	GAW	£3,172m	9,660p	25	2.3%	3.2%	5.7%	-17.7%	41m	8	/PEG/
Oxford Instruments	OXIG	£1,303m	2,260p	26	0.8%	8.5%	2.1%	-10.1%	-46m	8	/PEG/
Ferrexpo	FXPO	£1,786m	303p	4	23.6%	97.6%	-51.1%	-27.3%	-19m	8	/Fwd EPS grth/
Auto Trader	AUTO	£6,834m	718p	27	1.1%	86.6%	11.6%	12.2%	21m	7	/RoE grth/Marg grth/
Croda Int'l	CRDA	£13,801m	9,892p	39	1.0%	35.8%	7.9%	11.1%	-239m	7	/RoE grth/Marg grth/
Spirax-Sarco	SPX	£12,573m	17,045p	49	0.7%	29.4%	5.0%	8.8%	18m	7	/RoE grth/PE/
PayPoint	PAY	£470m	684p	13	4.7%	140.6%	5.3%	8.4%	-182m	7	/RoE grth/Marg grth/
Electrocomponents	ECM	£5,868m	1,246p	26	1.8%	44.0%	12.8%	22.9%	-433m	7	/RoE grth/Marg grth/
Diageo	DGE	£89,197m	3,826p	28	1.9%	13.3%	11.2%	5.9%	-4,272m	7	/PEG/Marg grth/
Halma	HLMA	£11,959m	3,150p	48	0.6%	6.0%	10.6%	7.6%	-114m	7	/PEG/RoE grth/
Rightmove	RMV	£6,165m	725p	30	1.0%	79.6%	8.5%	3.2%	74m	7	/RoE grth/Marg grth/
ITV	ITV	£5,036m	125p	8	2.6%	37.7%	0.3%	5.1%	-736m	7	/RoE grth/Marg grth/
Polymetal Int'l	POLY	£7,066m	1,492p	8	6.5%	-1.1%	13.2%	0.7%	-180m	7	/PEG/Fwd EPS grth/
Next	NXT	£10,835m	8,150p	15	0.0%	128.4%	9.5%	1.3%	-578m	7	/RoE grth/Marg grth/
Intertek	ITRK	£8,267m	5,122p	24	2.1%	10.7%	13.2%	-2.6%	-547m	7	/RoE grth/Marg grth/
Persimmon	PSN	£8,702m	2,727p	10	8.6%	14.5%	5.5%	-5.9%	359m	7	/RoE grth/Marg grth/
Smith & Nephew	SN	£11,620m	1,322p	19	2.1%	33.3%	15.0%	-4.7%	54m	7	/RoE grth/Marg grth/
Coats	COA	£992m	68p	13	2.0%	175.3%	12.1%	-3.1%	-210m	7	/RoE grth/Marg grth/
Anglo American	AAL	£38,987m	2,891p	7	6.1%	208.9%	-29.9%	-15.0%	-1,139m	7	/RoE grth/Fwd EPS grth/
Rio Tinto	RIO	£56,941m	4,563p	7	10.8%	80.3%	-34.6%	-19.1%	1,061m	7	/RoE grth/Fwd EPS grth/
Mondi	MNDI	£9,056m	1,865p	13	2.8%	8.4%	17.7%	-9.0%	-893m	7	/RoE grth/Marg grth/
Berkeley	BKG	£4,849m	4,319p	12	0.2%	10.2%	2.8%	-18.8%	-254m	7	/RoE grth/Marg grth/
888	888	£1,331m	358p	15	3.3%	8.3%	16.3%	-11.2%	-77m	7	/RoE grth/PE/
A.G. BARR	BAG	£551m	492p	18	0.4%	13.9%	11.9%	-14.5%	4m	7	/RoE grth/Marg grth/

Source: FactSet, 14 November 2021

## Small-cap quality selection (passing at least 7 of 9 tests)

Name	TIDM	Mkt cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/debt(-) in £	Tests passed (out of 9)	Test failed
Norcros	NXR	£255m	315p	9	3.6%	10.2%	4.3%	12.5%	-76m	8	/RoE grth/
PayPoint	PAY	£470m	684p	13	4.7%	140.6%	5.3%	8.4%	-182m	7	/RoE grth/Marg grth/
Goodwin	GDWN	£279m	3,625p	-	2.8%	-	-	9.8%	-30m	7	/PEG/Fwd EPS grth/
Porvair	PRV	£314m	680p	26	0.8%	5.1%	17.6%	-1.4%	-13m	7	/PEG/RoE grth/
A.G. BARR	BAG	£551m	492p	18	0.4%	13.9%	11.9%	-14.5%	4m	7	/RoE grth/Marg grth/
Severfield	SFR	£221m	72p	9	4.1%	14.7%	12.1%	-10.5%	-60m	7	/RoE grth/Marg grth/

Source: FactSet, 14 November 2021

## Aim quality selection (passing at least 7 of 9 tests)

Name	TIDM	Mkt cap	Price	Fwd NTMPE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/debt(-) in £	Tests passed (out of 9)	Test failed
Pan African Resources	PAF	£383m	20p	6	3.5%	21.6%	7.0%	19.1%	-51m	9	na
Caledonia Mining	CMCL	£128m	1,025p	5	3.5%	8.9%	48.1%	13.6%	7m	9	na
iEnergizer	IBPO	£605m	318p	11	5.2%	34.5%	22.8%	10.4%	11m	9	na
Alumasc	ALU	£88m	243p	10	3.9%	1.2%	6.8%	10.2%	-19m	9	na
Keystone Law	KEYS	£244m	780p	36	1.9%	31.4%	5.8%	5.4%	-8m	9	na
Eckoh	ECK	£147m	58p	34	1.1%	41.5%	20.0%	-0.9%	-7m	9	na
Water Intelligence	WATR	£196m	1,200p	51	0.0%	52.6%	18.3%	-3.6%	-3m	9	na
MTI Wireless Edge	MWE	£66m	75p	20	1.9%	20.5%	12.5%	-5.7%	0m	9	na
Gamma Comm.	GAMA	£1,760m	1,828p	27	0.7%	20.1%	11.4%	-16.5%	-21m	9	na
Steppe Cement	STCM	£89m	41p	7	8.6%	46.2%	4.5%	-22.1%	-3m	9	na
Kape Technologies	KAPE	£1,268m	421p	15	0.0%	71.2%	61.6%	18.6%	-22m	8	/Marg grth/
Judges Scientific	JDG	£508m	8,040p	36	0.7%	20.6%	6.9%	21.8%	-7m	8	/RoE grth/
Mattioli Woods	MTW	£423m	835p	16	2.5%	21.3%	17.7%	15.6%	-3m	8	/RoE grth/
Craneware	CRW	£906m	2,550p	42	1.1%	18.0%	8.1%	9.4%	135m	8	/RoE grth/
SDI Group	SDI	£210m	211p	35	0.0%	15.6%	-23.9%	10.5%	-12m	8	/Fwd EPS grth/
Fonix Mobile	FNX	£162m	162p	21	3.2%	8.6%	9.2%	7.0%	-21m	8	/FCF/
Solid State	SOLI	£101m	1,180p	20	1.4%	9.2%	-1.3%	13.2%	-9m	8	/Fwd EPS grth/
Spectra Systems	SPSY	£70m	155p	17	4.3%	4.1%	0.0%	1.0%	8m	8	/Int Cov/
Alpha Fin. Mkts Consulting	AFM	£409m	365p	20	1.9%	15.9%	13.7%	5.8%	4m	8	/RoE grth/
Cerillion	CER	£257m	870p	38	0.7%	63.6%	13.2%	1.8%	-2m	8	/Marg grth/
EMIS	EMIS	£869m	1,372p	24	2.4%	4.9%	7.7%	1.6%	-10m	8	/PEG/
Keywords Studios	KWS	£2,225m	2,928p	38	0.0%	36.4%	7.9%	4.1%	11m	8	/RoE grth/
Central Asia Metals	CAML	£427m	243p	7	6.6%	91.6%	2.7%	-3.2%	-14m	8	/RoE grth/
Science	SAG	£208m	455p	18	1.3%	32.9%	-1.8%	2.2%	-1m	8	/Fwd EPS grth/
Gateley	GTLY	£262m	220p	15	3.4%	6.3%	10.9%	1.9%	-13m	8	/RoE grth/
RWS	RWS	£2,358m	606p	21	1.5%	17.5%	19.2%	1.8%	-13m	8	/Marg grth/
Knights	KGH	£338m	405p	17	0.0%	20.4%	15.3%	-0.5%	-36m	8	/RoE grth/
Finsbury Food	FIF	£127m	98p	9	2.5%	19.2%	0.5%	5.4%	-57m	8	/Marg grth/
Renew	RNWH	£644m	818p	15	1.6%	22.8%	5.6%	4.3%	-197m	8	/Marg grth/
Alliance Pharma	APH	£553m	103p	16	1.6%	8.9%	14.0%	-5.5%	-1m	8	/RoE grth/
K3 Capital	K3C	£247m	338p	16	2.7%	12.7%	23.3%	-4.9%	-	8	/RoE grth/
Frontier Developments	FDEV	£967m	2,455p	32	0.0%	32.0%	22.4%	-5.6%	24m	8	/RoE grth/
CareTech	CTH	£690m	609p	12	2.2%	15.6%	5.9%	-5.7%	-54m	8	/Marg grth/
Franchise Brands	FRAN	£137m	144p	23	1.0%	27.6%	19.3%	-3.4%	-1m	8	/RoE grth/
SigmaRoc	SRC	£616m	97p	15	0.0%	20.5%	31.0%	-3.5%	-23m	8	/RoE grth/
Springfield Properties	SPR	£151m	148p	9	3.9%	5.7%	15.0%	-4.8%	-71m	8	/RoE grth/
Michelmersh Brick	MBH	£118m	124p	14	2.9%	61.6%	8.7%	-9.2%	-2m	8	/RoE grth/
CVS	CVSG	£1,662m	2,345p	28	0.3%	9.0%	6.9%	-6.0%	-65m	8	/PEG/
Team17	TM17	£876m	666p	32	-	3.9%	10.9%	-15.7%	44m	8	/PEG/
Learning Technologies	LTG	£1,485m	189p	28	0.4%	14.5%	43.7%	-11.7%	6m	8	/PEG/
Sureserve	SUR	£143m	89p	11	1.1%	66.4%	18.4%	-8.2%	-38m	8	/Marg grth/
Tristel	TSTL	£224m	475p	45	1.4%	26.2%	3.9%	-21.5%	4m	8	/RoE grth/
Lok'nStore	LOK	£282m	942p	28	1.6%	193.6%	11.0%	25.6%	2m	7	/RoE grth/FCF/
Atalaya Mining	ATYM	£551m	399p	6	7.3%	300.8%	-10.2%	26.7%	-77m	7	/RoE grth/Fwd EPS grth/
Cake Box	CBOX	£158m	394p	26	1.6%	48.6%	12.8%	20.1%	0m	7	/RoE grth/Marg grth/
M.P. Evans	MPE	£456m	834p	14	3.2%	166.2%	-21.7%	15.5%	-32m	7	/Marg grth/Fwd EPS grth/
Advanced Medical Sol.	AMS	£721m	334p	32	0.5%	71.5%	13.4%	19.3%	39m	7	/RoE grth/Marg grth/
Next Fifteen Comm.	NFC	£1,123m	1,210p	22	0.9%	24.2%	8.8%	33.8%	-85m	7	/RoE grth/PE/
Griffin Mining	GFM	£184m	106p	7	0.0%	287.7%	12.7%	11.7%	-19m	7	/RoE grth/Marg grth/
YouGov plc	YOU	£1,670m	1,500p	57	0.4%	22.0%	22.0%	22.0%	-32m	7	/PEG/RoE grth/
FRP Advisory	FRP	£311m	128p	17	3.2%	3.4%	7.6%	4.9%	-	7	/PEG/Marg grth/
Volex	VLX	£651m	410p	20	0.8%	-9.4%	12.4%	13.7%	-86m	7	/PEG/Fwd EPS grth/
Oxford Metrics	OMG	£153m	121p	38	1.5%	95.7%	25.8%	11.1%	5m	7	/RoE grth/Marg grth/
Begbies Traynor	BEG	£220m	145p	15	2.1%	32.1%	10.7%	9.5%	-31m	7	/RoE grth/PE/
Somero Enterprises, Inc.	SOM	£280m	500p	11	5.8%	77.4%	8.6%	1.4%	17m	7	/RoE grth/Marg grth/
Midwich	MIDW	£589m	664p	25	0.9%	94.8%	23.6%	23.0%	-125m	7	/RoE grth/Marg grth/
James Latham	LTHM	£256m	1,285p	-	1.6%	-	-	7.5%	-7m	7	/PEG/Fwd EPS grth/
Netcall	NET	£124m	83p	49	0.4%	150.0%	18.7%	6.4%	-4m	7	/Marg grth/Int Cov/
Driver	DRV	£34m	66p	14	2.3%	16.7%	60.6%	12.8%	-2m	7	/RoE grth/Marg grth/
Cohort	CHRT	£246m	598p	17	1.9%	2.1%	8.8%	7.7%	-26m	7	/PEG/RoE grth/
James Halstead	JHD	£1,170m	562p	28	2.7%	2.6%	3.7%	-0.9%	14m	7	/PEG/RoE grth/

Continued...

## Aim quality selection (passing at least 7 of 9 tests)

Name	TIDM	Mkt cap	Price	Fwd NTMPE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/debt(-) in £	Tests passed (out of 9)	Test failed
Concurrent Tech.	CNC	£62m	85p	18	3.1%	25.3%	-	-1.2%	8m	7	/RoE grth/Fwd EPS grth/
GB Group	GBG	£1,703m	865p	40	0.7%	-17.6%	8.3%	-0.9%	-69m	7	/PEG/Fwd EPS grth/
Watkin Jones	WJG	£610m	238p	13	4.2%	5.9%	10.4%	-1.0%	14m	7	/RoE grth/Marg grth/
Anexo	ANX	£159m	137p	8	1.1%	28.8%	18.9%	-3.2%	-41m	7	/RoE grth/FCF/
SEC Newgate SpA	SECN	£24m	98p	16	0.5%	36.5%	12.1%	-0.5%	-8m	7	/RoE grth/Int Cov/
Epwin	EPWN	£161m	111p	13	2.5%	82.1%	23.4%	-2.8%	-66m	7	/RoE grth/Marg grth/
RBG	RBGP	£122m	128p	12	2.7%	5.1%	38.4%	-7.3%	8m	7	/PEG/Marg grth/
Anglo Asian Mining	AAZ	£135m	118p	10	4.9%	-28.8%	21.4%	-11.3%	14m	7	/PEG/Fwd EPS grth/
Clinigen	CLIN	£780m	585p	10	1.3%	-1.8%	10.7%	-6.4%	-95m	7	/PEG/Fwd EPS grth/
Breedon	BREE	£1,666m	99p	16	0.5%	72.2%	28.1%	-7.0%	-283m	7	/RoE grth/Marg grth/
Nichols	NICL	£469m	1,270p	23	1.5%	82.9%	18.7%	-8.1%	26m	7	/RoE grth/Marg grth/
Crimson Tide	TIDE	£18m	3p	-	0.0%	-	0.0%	-9.8%	0m	7	/PEG/Fwd EPS grth/
Time Finance	TIME	£21m	22p	6	0.0%	56.8%	65.5%	-10.1%	-	7	/RoE grth/Marg grth/
Appreciate	APP	£48m	26p	7	3.9%	199.8%	33.1%	-5.3%	-11m	7	/RoE grth/Marg grth/
Anpario	ANP	£131m	565p	25	1.6%	3.0%	2.8%	-18.7%	11m	7	/PEG/RoE grth/
Gooch & Housego	GHH	£288m	1,150p	27	0.4%	23.2%	11.9%	-13.2%	-5m	7	/RoE grth/Marg grth/
ECO Animal Health	EAH	£166m	245p	21	0.4%	-18.0%	28.0%	-21.0%	1m	7	/PEG/Fwd EPS grth/
Eleco	ELCO	£90m	108p	36	0.6%	-11.8%	-33.9%	-18.8%	-2m	7	/PEG/Fwd EPS grth/
Arcontech	ARC	£17m	128p	17	2.2%	0.8%	19.4%	-26.1%	4m	7	/PEG/RoE grth/
Mission Group	TMG	£64m	70p	8	1.1%	500.0%	43.3%	-13.0%	-43m	7	/RoE grth/Marg grth/
Xpediator	XPD	£89m	63p	14	2.5%	11.5%	6.2%	-14.9%	-63m	7	/RoE grth/FCF/
Character	CCT	£114m	535p	13	1.7%	123.6%	0.2%	-22.7%	-11m	7	/RoE grth/Marg grth/
ASOS	ASC	£2,860m	2,862p	29	0.0%	-25.2%	31.6%	-28.0%	-335m	7	/PEG/Fwd EPS grth/
boohoo	BOO	£2,535m	200p	19	0.0%	0.0%	31.7%	-29.1%	-10m	7	/PEG/FCF/
Gattaca	GATC	£57m	175p	11	0.9%	60.4%	52.0%	-31.1%	-39m	7	/Marg grth/FCF/

Source: FactSet, 14 November 2021

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