

## AlphaScreens: the quest for quality

20 December 2021

### Quality shares Christmas Top of the Pops

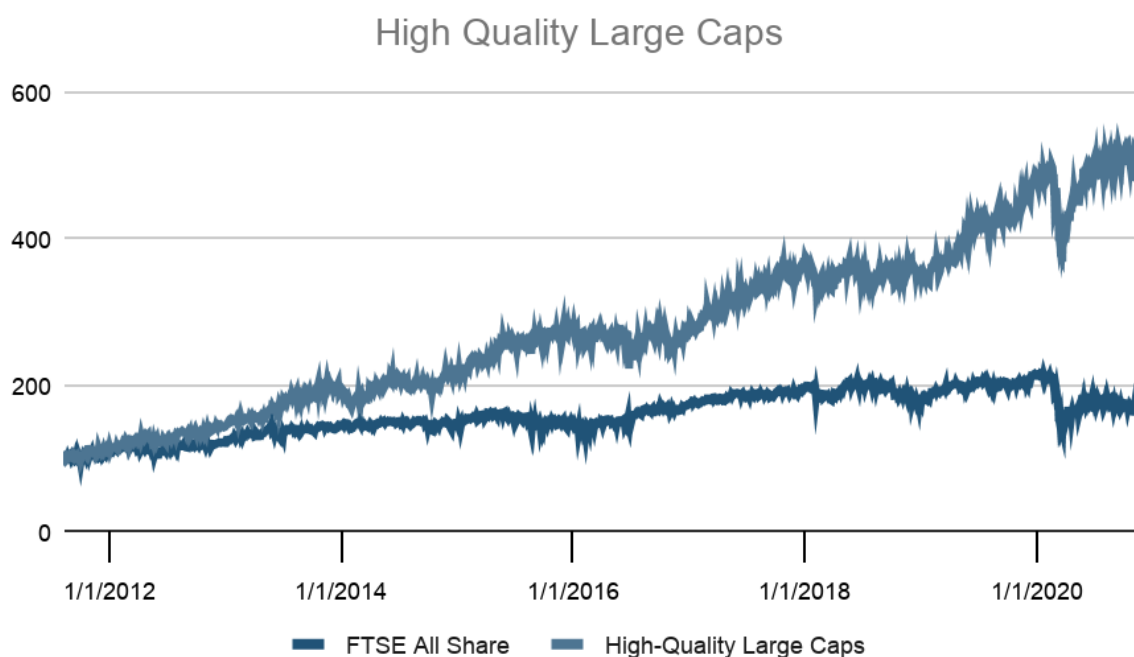
*The holy grail for buy-and-hold investors is to find a business that is capable of generating a high return on capital and sustaining it while reinvesting profits. This screen looks for shares that display these quality characteristics and can potentially deliver significant compounded returns over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

#### Comment by Alpha editor:

- In our final AlphaScreen before Christmas, several of the names that have done well on our quality UK shares criteria are flagged once more. Right at the top of the All Share screen, data business Experian (EXPN) still passes 9/9 tests, as does Hikma Pharmaceuticals (HIK), and IT network specialist Spirent Communications (SPT). The quality characteristics of these companies makes them worth researching as potential long-term holdings and with the softening of markets on fears the Omicron coronavirus variant will hit growth, cheaper entry points could be attractive.
- Precious metal miner Polymetal International (POLY) also scores 9/9 and with central bank policies now signalling the view that inflation will be persistent rather than transitory, there is certainly a narrative to support the business. The same cannot be said for the final FTSE All Share company to get full marks. Big tobacco companies were accorded pariah status even before environment, social and governance (ESG) became front and centre of investment decision making. Imperial Brands (IMB) offers an 8.8 per cent dividend yield and is rated on only six times next twelve months' earnings. That's food for thought, as investors are definitely being offered a risk premium.
- We have separate tests just for small companies and it is on Aim where our screens are flagging the most ideas. Miners feature prominently again with Pan African Resources (PAF) and Caledonia Mining Corporation (CMCL) getting full marks and ranking highly on a combination of margin and momentum. Companies like Cerillion (CER) that are seeking to capture growth in demand for software innovations also do well.
- Our Aim Christmas number one on the screen is iEnergizer (IBPO) a software as a service (SaaS) solutions provider that has seen its shares spike upwards since November.

## The dream company

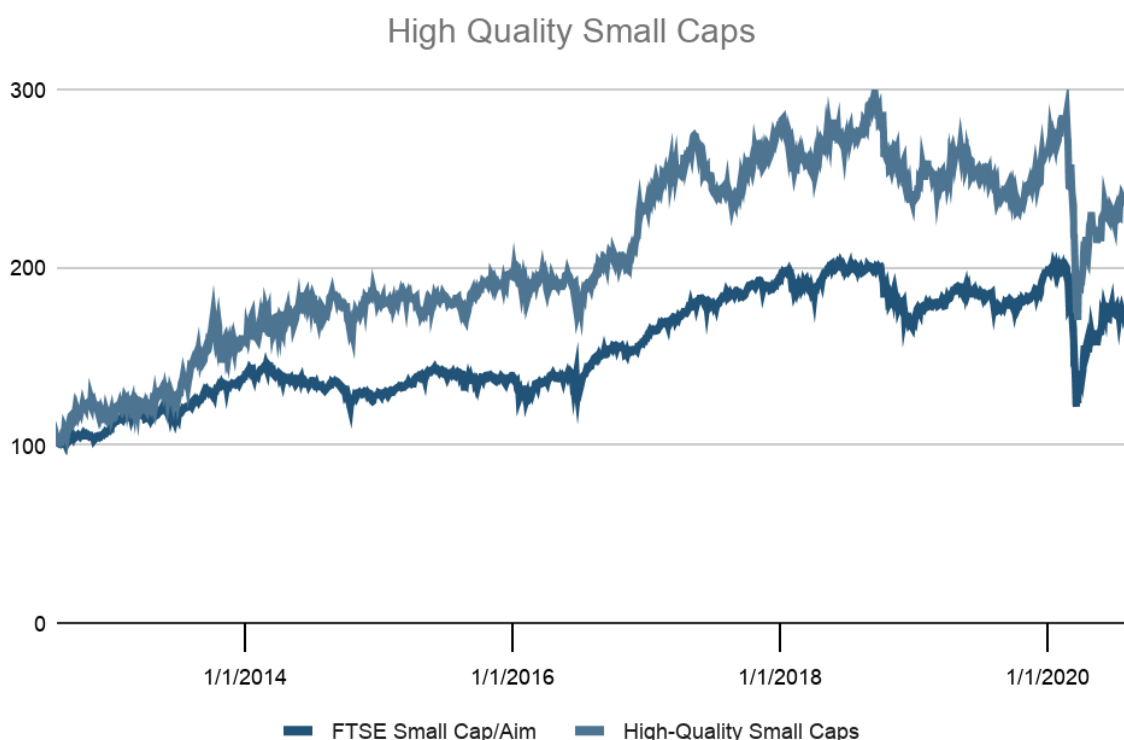
The holy grail for buy-and-hold investors is to find a business that is capable of generating high returns on its capital and is able to reinvest all its profits for decades to come, while maintaining those returns. The compounding effect of such an investment is what every long-term investor's dreams 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

## Alpha Quality screen: large-cap results

Name	TIDM	Mkt cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth mom.	Net cash/debt(-) in £	Tests passed (out of 9)	Test failed
Experian	EXPN	£32,420m	3,513p	34	1.0%	28.4%	13.6%	6.1%	-1,606m	9	na
Imperial Brands	IMB	£15,029m	1,588p	6	8.8%	0.9%	5.5%	3.4%	-9,521m	9	na
Polymetal International	POLY	£6,164m	1,302p	7	7.4%	0.6%	13.2%	-1.3%	-180m	9	na
Hikma Pharmaceuticals	HIK	£5,139m	2,220p	13	1.7%	19.1%	16.2%	-8.4%	-495m	9	na
Spirent Communications	SPT	£1,643m	269p	21	1.7%	18.1%	6.5%	-10.0%	63m	9	na
BHP Group	BHP	£46,033m	2,180p	9	10.0%	5.9%	-25.1%	16.3%	-835m	8	/Fwd EPS grth/
Diageo	DGE	£92,597m	3,977p	28	1.8%	16.4%	12.1%	15.0%	-4,272m	8	/Marg grth/
Oxford Instruments	OXIG	£1,484m	2,575p	30	0.7%	8.2%	2.2%	5.1%	-46m	8	/PEG/
Britvic	BVIC	£2,454m	918p	17	2.6%	22.9%	9.4%	2.8%	-494m	8	/Marg grth/
Ferrexpo	FXPO	£1,792m	304p	5	23.5%	93.0%	-55.0%	-5.8%	-19m	8	/Fwd EPS grth/
IMI	IMI	£4,445m	1,705p	17	1.3%	13.5%	12.1%	-5.4%	-376m	8	/RoE grth/
Games Workshop	GAW	£3,239m	9,865p	25	2.2%	3.7%	5.5%	-11.8%	41m	8	/PEG/
Dunelm	DNLM	£2,753m	1,358p	19	7.4%	13.3%	5.8%	-7.3%	-107m	8	/RoE grth/
Auto Trader	AUTO	£6,813m	719p	27	1.1%	89.7%	10.9%	18.7%	21m	7	/RoE grth/Marg grth/
Anglo American	AAL	£39,560m	2,943p	8	6.0%	201.1%	-31.5%	13.6%	-1,139m	7	/RoE grth/Fwd EPS grth/
Croda International	CRDA	£13,843m	9,922p	39	1.0%	35.4%	8.2%	10.7%	-239m	7	/RoE grth/Marg grth/
Avast	AVST	£6,374m	614p	21	1.9%	9.8%	7.1%	6.9%	-327m	7	/PEG/RoE grth/
Rightmove	RMV	£6,498m	767p	32	1.0%	70.9%	12.0%	5.0%	74m	7	/RoE grth/Marg grth/
Sage Group	SGE	£8,326m	813p	31	2.2%	11.9%	12.2%	9.5%	-827m	7	/PEG/Marg grth/
Berkeley	BKG	£5,296m	4,725p	12	0.2%	15.4%	1.3%	3.1%	-254m	7	/RoE grth/Marg grth/
Electrocomponents	ECM	£5,543m	1,177p	24	1.9%	44.2%	12.5%	8.2%	-433m	7	/RoE grth/Marg grth/
Rio Tinto plc	RIO	£60,859m	4,876p	7	10.1%	81.6%	-36.2%	1.0%	1,061m	7	/RoE grth/Fwd EPS grth/
Halma plc	HLMA	£11,648m	3,068p	45	0.6%	8.0%	10.4%	1.5%	-114m	7	/PEG/RoE grth/
Persimmon Plc	PSN	£8,766m	2,747p	10	8.6%	14.1%	4.5%	-1.2%	359m	7	/RoE grth/Marg grth/
Victrex plc	VCT	£2,072m	2,382p	24	2.5%	16.6%	9.7%	-4.1%	56m	7	/RoE grth/Marg grth/
A.G. BARR p.l.c.	BAG	£586m	523p	18	0.4%	20.6%	9.2%	-3.1%	4m	7	/RoE grth/Marg grth/
Next plc	NXT	£10,333m	7,772p	14	0.0%	128.8%	9.3%	-4.3%	-578m	7	/RoE grth/Marg grth/
Spirax-Sarco Engineering	SPX	£11,322m	15,380p	45	0.8%	28.2%	5.1%	-5.0%	18m	7	/RoE grth/PE/
Mondi	MNDI	£8,820m	1,817p	13	2.9%	7.3%	16.9%	-4.6%	-893m	7	/RoE grth/Marg grth/
Smith & Nephew	SN	£10,909m	1,240p	18	2.2%	34.6%	14.1%	-6.7%	54m	7	/RoE grth/Marg grth/
PayPoint	PAY	£416m	605p	11	5.6%	134.0%	6.3%	-12.3%	-182m	7	/RoE grth/Marg grth/
Kainos	KNOS	£2,195m	1,776p	44	1.3%	4.0%	8.4%	-10.5%	8m	7	/PEG/PE/
Coats	COA	£979m	67p	13	2.0%	165.3%	17.5%	-11.7%	-210m	7	/RoE grth/Marg grth/
888 Holdings	888	£1,088m	292p	14	4.1%	8.3%	2.5%	-30.5%	-77m	7	/RoE grth/PE/

Source: FactSet, 20 December 2021

## Alpha Quality screen: small-cap results

Name	TIDM	Mkt cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth mom.	Net cash/debt(-) in £	Tests passed (out of 9)	Test failed
Norcros	NXR	£252m	311p	9	3.6%	10.2%	4.3%	4.7%	-76m	8	/RoE grth/
Up Global Sourcing	UPGS	£174m	195p	14	2.6%	31.6%	6.8%	-8.5%	-39m	8	/RoE grth/
A.G. BARR	BAG	£586m	523p	18	0.4%	20.6%	9.2%	-3.1%	4m	7	/RoE grth/Marg grth/
PayPoint	PAY	£416m	605p	11	5.6%	134.0%	6.3%	-12.3%	-182m	7	/RoE grth/Marg grth/
Goodwin	GDWN	£238m	3,100p	-	3.3%	-	-	-9.6%	-30m	7	/PEG/Fwd EPS grth/
RM	RM	£172m	205p	10	2.3%	15.9%	34.5%	-18.0%	-59m	7	/RoE grth/Marg grth/

Source: FactSet, 20 December 2021

## Alpha Quality screen: Aim results

Name	TIDM	Mkt cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth mom.	Net cash/debt(-) in £	Tests passed (out of 9)	Test Failed
iEnergizer	IBPO	£612m	322p	11	5.1%	35.8%	22.8%	17.5%	11m	9	na
Pan African Resources	PAF	£394m	18p	5	4.8%	19.8%	4.2%	8.9%	-51m	9	na
Cerillion	CER	£246m	835p	27	0.9%	18.3%	19.9%	7.1%	3m	9	na
Caledonia Mining	CMCL	£105m	895p	4	4.1%	8.5%	47.7%	-0.6%	7m	9	na
Eckoh	ECK	£138m	54p	29	1.1%	37.3%	39.6%	-1.8%	-7m	9	na
Keystone Law	KEYS	£253m	810p	38	1.9%	31.4%	5.8%	-5.8%	-8m	9	na
Alumasc	ALU	£81m	225p	9	4.2%	1.2%	6.8%	-6.3%	-19m	9	na
Gamma Comm.	GAMA	£1,543m	1,602p	23	0.8%	20.5%	11.9%	-13.7%	-21m	9	na
CareTech	CTH	£651m	574p	11	2.5%	8.1%	8.3%	-13.2%	-67m	9	na
Steppe Cement	STCM	£89m	41p	7	8.6%	47.7%	4.5%	-18.2%	-3m	9	na
Water Intelligence	WATR	£169m	975p	41	0.0%	54.1%	18.3%	-17.4%	-3m	9	na
Central Asia Metals	CAML	£429m	244p	7	6.6%	95.6%	4.2%	5.6%	-14m	8	/RoE grth/
Team17	TM17	£1,006m	765p	36	-	4.6%	11.3%	6.3%	44m	8	/PEG/
Alpha Financial Mkts	AFM	£468m	418p	22	1.9%	23.0%	11.5%	17.7%	4m	8	/RoE grth/
Mattioli Woods	MTW	£426m	840p	15	2.5%	21.3%	17.7%	5.7%	-3m	8	/RoE grth/
Craneware	CRW	£849m	2,390p	37	1.2%	24.9%	8.6%	0.4%	135m	8	/RoE grth/
Solid State	SOLI	£100m	1,165p	20	1.5%	9.2%	-1.3%	13.7%	-9m	8	/Fwd EPS grth/
Alliance Pharma	APH	£562m	104p	16	1.6%	8.9%	14.0%	-0.6%	-1m	8	/RoE grth/
Franchise Brands	FRAN	£140m	147p	23	1.0%	27.6%	19.3%	7.7%	-1m	8	/RoE grth/
Fonix Mobile	FNX	£157m	157p	20	3.3%	8.6%	9.2%	0.3%	-21m	8	/FCF/
Kape Technologies	KAPE	£1,438m	412p	14	0.0%	73.4%	61.4%	-1.9%	-22m	8	/Marg grth/
Knights	KGH	£343m	409p	17	0.0%	21.0%	15.9%	-2.6%	-36m	8	/RoE grth/
Spectra Systems	SPSY	£70m	155p	15	4.3%	16.6%	2.5%	-8.0%	8m	8	/Int Cov/
Character	CCT	£129m	605p	15	2.5%	2.1%	0.4%	0.8%	-5m	8	/Marg grth/
Michelmersh Brick	MBH	£123m	129p	15	2.8%	69.7%	3.6%	-5.8%	-2m	8	/RoE grth/
Sureserve	SUR	£151m	92p	12	1.1%	66.4%	20.6%	3.4%	-38m	8	/Marg grth/
SDI	SDI	£189m	190p	32	0.0%	15.6%	-23.9%	-6.9%	-12m	8	/Fwd EPS grth/
Finsbury Food	FIF	£123m	95p	9	2.5%	19.2%	0.5%	-0.5%	-57m	8	/Marg grth/
Springfield Properties	SPR	£151m	148p	9	3.9%	9.6%	17.7%	-4.2%	-71m	8	/RoE grth/
Renew	RNWH	£622m	790p	14	2.0%	7.8%	2.8%	-2.5%	-230m	8	/RoE grth/
Gateley	GTLY	£270m	227p	15	3.3%	6.5%	10.2%	-7.3%	-13m	8	/RoE grth/
RWS	RWS	£2,393m	615p	22	1.5%	16.1%	10.5%	-7.6%	-98m	8	/RoE grth/
EMIS	EMIS	£808m	1,276p	22	2.6%	4.9%	7.7%	-11.4%	-10m	8	/PEG/
CVS	CVSG	£1,619m	2,285p	27	0.3%	8.2%	6.7%	-8.2%	-65m	8	/PEG/
Science	SAG	£202m	442p	18	1.4%	32.9%	-1.7%	-9.8%	-1m	8	/Fwd EPS grth/
Tristel	TSTL	£231m	490p	45	1.3%	20.7%	20.3%	-20.3%	4m	8	/RoE grth/
Keywords Studios	KWS	£1,911m	2,510p	33	0.0%	36.3%	7.6%	-18.9%	11m	8	/RoE grth/
Learning Technologies	LTG	£1,291m	164p	22	0.5%	14.2%	53.3%	-27.1%	6m	8	/PEG/
SigmaRoc	SRC	£533m	84p	13	0.0%	19.9%	27.3%	-25.8%	-23m	8	/RoE grth/
Lok'nStore	LOK	£277m	925p	27	1.6%	193.6%	11.0%	13.2%	2m	7	/RoE grth/FCF/
Advanced Medical Solutions	AMS	£702m	325p	31	0.5%	71.5%	13.4%	17.1%	39m	7	/RoE grth/Marg grth/
Clinigen	CLIN	£1,227m	920p	16	0.8%	-2.2%	10.3%	49.8%	-95m	7	/PEG/Fwd EPS grth/
M.P. Evans	MPE	£459m	840p	14	3.2%	186.3%	-24.4%	6.6%	-32m	7	/Marg grth/Fwd EPS grth/
Judges Scientific	JDG	£531m	8,400p	38	0.7%	20.6%	6.9%	15.4%	-7m	7	/PEG/RoE grth/
Cake Box	CBOX	£143m	358p	23	1.7%	48.6%	12.8%	3.8%	0m	7	/RoE grth/Marg grth/
Next Fifteen Comm.	NFC	£1,151m	1,240p	22	0.9%	31.7%	7.0%	7.4%	-85m	7	/RoE grth/PE/
Anpario	ANP	£144m	618p	28	1.5%	3.1%	2.6%	2.1%	11m	7	/PEG/RoE grth/
Oxford Metrics	OMG	£148m	117p	36	1.7%	34.8%	17.3%	5.4%	10m	7	/RoE grth/Marg grth/
James Halstead	JHD	£1,157m	556p	28	2.7%	2.6%	3.7%	0.4%	14m	7	/PEG/RoE grth/
Jubilee Metals	JLP	£380m	16p	6	0.0%	-15.8%	73.7%	-2.2%	-20m	7	/PEG/Fwd EPS grth/
Begbies Traynor	BEG	£208m	136p	15	2.3%	31.7%	9.9%	4.8%	-31m	7	/RoE grth/PE/
Aferian	AFRN	£136m	160p	16	1.8%	24.8%	9.3%	6.0%	-13m	7	/RoE grth/Marg grth/
Watkin Jones	WJG	£648m	253p	14	3.9%	5.6%	10.5%	1.2%	14m	7	/RoE grth/Marg grth/
YouGov	YOU	£1,559m	1,400p	51	0.4%	24.7%	25.5%	0.0%	-32m	7	/PEG/RoE grth/
James Latham	LTHM	£258m	1,295p	-	1.7%	-	-	0.8%	-7m	7	/PEG/Fwd EPS grth/
Nichols	NICL	£520m	1,410p	26	1.3%	82.9%	18.7%	2.4%	26m	7	/RoE grth/Marg grth/
Somero Enterprises	SOM	£286m	510p	11	5.7%	85.5%	8.0%	-7.3%	17m	7	/RoE grth/Marg grth/
K3 Capital	K3C	£256m	350p	17	2.6%	8.4%	22.6%	-6.0%	-	7	/PEG/RoE grth/
Dewhurst Class A	DWHA	£80m	645p	-	2.2%	-	-	-4.4%	12m	7	/PEG/Fwd EPS grth/

Continued...

## Alpha Quality screen: Aim results

Name	TIDM	Mkt cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth mom.	Net cash/debt(-) in £	Tests passed (out of 9)	Test failed
MTI Wireless Edge	MWE	£68m	77p	28	1.9%	-12.2%	12.5%	-1.9%	0m	7	/PEG/Fwd EPS grth/
Midwich	MIDW	£568m	640p	23	1.0%	119.5%	11.4%	6.0%	-125m	7	/RoE grth/Marg grth/
Breedon	BREE	£1,615m	96p	16	0.5%	76.6%	25.0%	-3.9%	-283m	7	/RoE grth/Marg grth/
Focusrite	TUNE	£889m	1,515p	31	0.3%	-15.5%	2.9%	-9.0%	-8m	7	/PEG/Fwd EPS grth/
Anglo Asian Mining	AAZ	£126m	110p	9	5.3%	-28.8%	21.4%	-10.6%	14m	7	/PEG/Fwd EPS grth/
Crimson Tide	TIDE	£19m	3p	-	0.0%	-	0.0%	-6.6%	0m	7	/PEG/Fwd EPS grth/
Time Finance	TIME	£22m	24p	6	0.0%	51.4%	67.9%	-6.9%	-	7	/RoE grth/Marg grth/
Anexo	ANX	£148m	128p	7	1.2%	29.0%	19.0%	-11.1%	-41m	7	/RoE grth/FCF/
SEC Newgate SpA	SECN	£22m	90p	14	0.6%	35.8%	12.1%	-6.3%	-8m	7	/RoE grth/Int Cov/
Driver	DRV	£26m	50p	11	3.0%	16.7%	60.6%	-5.7%	-2m	7	/RoE grth/Marg grth/
Epwin	EPWN	£149m	103p	11	2.7%	80.9%	29.1%	-11.4%	-66m	7	/RoE grth/Marg grth/
GB	GBG	£1,795m	715p	34	0.9%	-19.6%	9.1%	-22.5%	-69m	7	/PEG/Fwd EPS grth/
Netcall	NET	£102m	68p	39	0.5%	150.0%	18.7%	-18.6%	-4m	7	/Marg grth/Int Cov/
RBG	RBGP	£107m	113p	10	3.1%	5.1%	38.4%	-21.9%	8m	7	/PEG/Marg grth/
Mission	TMG	£58m	64p	8	1.3%	500.0%	43.3%	-15.8%	-43m	7	/RoE grth/Marg grth/
Dewhurst	DWHT	£80m	1,490p	-	0.9%	-	-	-25.5%	12m	7	/PEG/Fwd EPS grth/
Eleco	ELCO	£78m	94p	33	0.6%	-11.8%	-33.9%	-27.0%	-2m	7	/PEG/Fwd EPS grth/
dotDigital	DOTD	£549m	184p	43	0.5%	2.3%	9.1%	-30.6%	22m	7	/PEG/RoE grth/
Mind Gym	MIND	£150m	150p	76	0.0%	60.0%	435.4%	-21.1%	2m	7	/RoE grth/Marg grth/
ECO Animal Health	EAH	£105m	155p	23	0.6%	-51.7%	24.6%	-50.4%	1m	7	/PEG/Fwd EPS grth/
Volex	VLX	£519m	327p	15	1.0%	-8.5%	12.4%	-28.7%	-86m	7	/PEG/Fwd EPS grth/
ASOS	ASC	£2,208m	2,209p	22	0.0%	-28.1%	31.3%	-30.7%	-335m	7	/PEG/Fwd EPS grth/
Xpediator	XPD	£57m	40p	9	3.9%	11.5%	6.2%	-41.2%	-63m	7	/RoE grth/FCF/

Source: FactSet, 20 December 2021

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