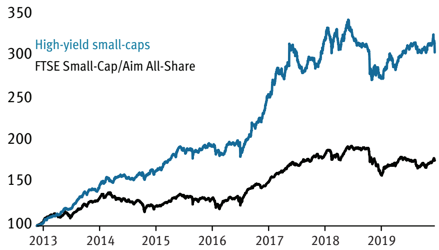
investors CHRONICLE alpha

1 June 2020

AlphaScreens: Finding dividend diamonds

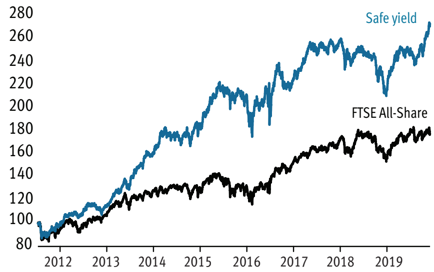
Dividends are an important source of returns and also a useful valuation measure that can be used to identify shares with the potential for capital growth. But it's important to screen out potential value traps when using yield as a guide

High-yield small-caps



Source: Thomson Datastream

Safe yields (large-caps)



Source: Thomson Datastream

Algy Hall's view:

Investors neglect dividends at their peril. Over the 25 years to the end of 2019, the average annual return from the FTSE All-Share based on share price alone stood at 4.15 per cent, compared with a 7.4 per cent total return once dividends are factored in. And the benefit of reinvesting dividends over the long term makes the difference even more pronounced, with the 25-year cumulative total return from the FTSE All-Share standing at 497 per cent, compared with 176 per cent ignoring dividends. As well as providing income, a good yield can suggest a company has attractive qualities that could support share price performance, and a robust dividend record can indicate a company in good financial health with a strong and stable business.

Foreword by Alpha Editor:

- Sifting through the rubble for dividend paying shares is a challenging task and not a single FTSE All-Share company passes all our tests this month. Companies showing up include **Imperial Brands (IMB)**. Although the tobacco firm cut its pay out last month, going forward – although it won't match the 14 per cent trailing yield shown on our screen – the yield should still be substantial.
- Other companies that pass at least two tests include **Wm Morrison Supermarkets (MRW)**, mining giant **Rio Tinto (RIO)** and defence and aerospace business **BAE Systems (BA.)**. Recruiter **Hays (HAS)** also ranks well, but it operates in a sector that will be under pressure in the recession.
- For income investors daunted by the task of picking shares with safe dividends, buying income-focused investment trusts is often a good way to spread risk across an expert manager's portfolio, and shares in a handful of closed-ended funds score well on our FTSE All-Share and FTSE All Small Companies screens this month.

Analyst: Algy Hall
algy.hall@ft.com

Alpha Production Editor: Sameera Hai Baig

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Large-cap dividend diamonds criteria

Our large-cap screen is tilted towards companies that show signs of having stable prospects associated with dividend staying power. To help assess this, we use a measure of historic share price volatility against the wider market called beta. Betas of below one indicate that a stock has been less sensitive to market movements and suggest it could boast some defensive qualities. The large-cap Alpha dividend yield screen is conducted on all FTSE All-Share stocks using the following criteria:

- A dividend yield higher than the median (mid-rank) average of all dividend-paying shares screened.
- Dividend covered at least twice by earnings.
- Earnings growth forecast in each of the next two financial years (ie dividend cover is not expected to dramatically fall).
- Operating cash conversion of 100 per cent or more (ie earnings are being tuned into cash with which to pay dividends).
- Interest payments covered at least five times by operating profits (ie interest payments on borrowings are not likely be a significant threat to maintaining dividend cover).
- Return on equity of 12.5 per cent or more (i.e. an indicator that the business may be of decent quality [if the interest cover test is also met, it suggests high returns on equity are not overly dependent on high debt levels]).
- A beta of 0.75 or lower.
- No dividend cut in the past three years.

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 dividend yield test to feature in the table that follows. Special dividends are included in the yield calculation used by the screen, and where a special dividend has been paid, it is highlighted in the table's 'Special dividend' column. 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 a combination of dividend yield and dividend cover.

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Small-cap dividend diamonds criteria

The small-cap Alpha dividend yield screen is more growth-focused than our large-cap screen, and is conducted separately on the FTSE All-Small and FTSE Aim All-Share indices, with the results presented in two separate tables. While the screen's dividend yield test is more aggressive than the one used by our large-cap screen, the lower average yields from small-caps mean little difference in the absolute level of yield both screens require. The screen uses the following criteria:

- A dividend yield among the top third of all dividend-paying shares screened.
- Dividend covered at least one-and-a-half times by earnings.
- Earnings growth forecast in each of the next two financial years and average growth of 5 per cent or more (ie rising earnings to support dividend growth and maintain or improve dividend cover).
- Positive free cash flow (ie a weak test that earnings are turned into cash with which to pay dividends).
- Interest payments covered at least five times by operating profits (ie interest payments on borrowings are not likely to be a significant threat to maintaining dividend cover).
- A three-year compound annual dividend growth rate of 5 per cent or more.
- A three-year compound annual earnings growth rate of 5 per cent or more.
- A market capitalisation of more than £10m (ie not severely illiquid).

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 that follows, followed by those failing one test, then those failing two tests as detailed in the 'Tests passed' column. All stocks must pass the dividend yield test to feature in the table. Special dividends are included in the yield calculation used by the screen, and where a special dividend has been paid this highlighted in the table's 'Special dividend' column. 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 their attractiveness based on a combination of dividend yield and dividend cover.

Stock screen methodology formulated and explained by Algy Hall

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Large-cap dividend diamonds selection (passing at least 6 out of 8 tests)

Name	TIDM	Market cap	Price	Fwd NTM PE	Dividend yield	EPS grth FY+1	EPS grth FY+2	3-month momentum	Net cash/ debt (-)	Currency	Test Failed	Special dividend	Tests passed (out of 8)
Vp	LSE:VP.	£280m	706p	8	4.3%	1.4%	-0.4%	-29.1%	-262m	GBP	/EPSGrth/	NO	7
JPMorgan Claverhouse IT	LSE:JCH	£328m	564p	-	5.1%	-	-	-14.2%	-41m	GBP	/EPSGrth/CashConv/	NO	6
Hays	LSE:HAS	£1,891m	113p	25	8.3%	-62.4%	-33.4%	-16.0%	-215m	GBP	/EPSGrth/Beta	YES	6
Chesnara	LSE:CSN	£479m	320p	16	6.7%	-62.3%	-41.1%	16.0%	16m	GBP	/EPSGrth/CashConv/	NO	6
Norcros	LSE:NXR	£116m	144p	5	5.8%	-9.0%	-17.5%	-30.2%	-71m	GBP	/EPSGrth/Beta	NO	6
JPMorgan Global Grth & Inc.	LSE:JGGI	£462m	328p	-	4.0%	-	-	9.9%	7m	GBP	/EPSGrth/CashConv/	NO	6
Robert Walters	LSE:RWA	£249m	345p	23	4.5%	-68.4%	84.5%	-37.3%	10m	GBP	/EPSGrth/Beta	NO	6
Mondi	LSE:MNDI	£7,309m	1,508p	15	5.0%	-36.3%	24.2%	-3.0%	-2,202m	EUR	/EPSGrth/Beta	NO	6
Rio Tinto	LSE:RIO	£72,341m	4,313p	11	8.1%	-22.1%	-17.2%	22.9%	-3,476m	USD	/DivCov/EPSGrth/	YES	6
Wm Morrison Supermarkets	LSE:MRW	£4,464m	187p	14	4.7%	4.9%	4.0%	9.5%	-2,459m	GBP	/IntCov/RoE/	YES	6
BAE Systems	LSE:BA.	£15,940m	496p	11	4.7%	-4.0%	13.9%	-18.3%	-2,221m	GBP	/EPSGrth/Beta	NO	6
Imperial Brands	LSE:IMB	£13,782m	1,467p	6	14.1%	-6.3%	3.5%	-3.7%	-13,666m	GBP	/DivCov/EPSGrth/	YES	6

Source: S&P Capital IQ, 1 June 2020

Continued on the next page

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FTSE All-Small dividend diamonds selection (passing at least 6 out of 8 tests)

Name	TIDM	Market cap	Price	Fwd NTM PE	Dividend yield	EPS grth FY+1	EPS grth FY+2	3-month momentum	Net cash/ debt (-)	Currency	Test failed	Special dividend	Tests passed (out of 8)
BlackRock Latin American IT	LSE:BRLA	£121m	308p	-	9.2%	-	-	-22.9%	-18m	USD	/FwdEPSGrth/EPSGrth/	NO	6
Henderson High Income Trust	LSE:HHI	£185m	144p	-	6.9%	-	-	-10.5%	-55m	GBP	/FwdEPSGrth/DivGrth/	NO	6
The Merchants Trust	LSE:MRCH	£458m	388p	-	7.0%	-	-	-16.6%	-56m	GBP	/FwdEPSGrth/DivGrth/	NO	6
S&U	LSE:SUS	£198m	1,630p	6	7.4%	5.7%	12.2%	-27.3%	-119m	GBP	/IntCov/FCF/	NO	6
Norcros	LSE:NXR	£116m	144p	5	5.8%	-9.0%	-17.5%	-30.2%	-71m	GBP	/FwdEPSGrth/EPSGrth/	NO	6
SThree	LSE:STEM	£307m	234p	14	6.5%	-46.4%	25.5%	-24.7%	11m	GBP	/FwdEPSGrth/DivGrth/	NO	6
City of London Investment	LSE:CLIG	£79m	316p	9	8.6%	-4.7%	8.8%	-24.0%	11m	GBP	/FwdEPSGrth/DivCov/	NO	6
Record	LSE:REC	£72m	37p	14	8.1%	-4.8%	-34.5%	13.2%	22m	GBP	/FwdEPSGrth/DivCov/	YES	6
Bluefield Solar Income Fund	LSE:BSIF	£489m	132p	-	6.3%	-	-	-3.0%	1m	GBP	/FwdEPSGrth/IntCov/	YES	6
Impact Healthcare REIT	LSE:IHR	£300m	94p	15	6.7%	21.6%	9.8%	-10.6%	24m	GBP	/DivGrth/EPSGrth/	NO	6
GCP Asset Backed Inc. Fund	LSE:GABI	£389m	88p	-	7.3%	-	-	-13.7%	453m	GBP	/FwdEPSGrth/DivCov/	NO	6

Source: S&P Capital IQ, 1 June 2020

Aim dividend diamonds selection (passing at least 6 out of 8 tests)

Name	TIDM	Market cap	Price	Fwd NTM PE	Dividend yield	EPS grth FY+1	EPS grth FY+2	3-month momentum	Net cash/ debt (-)	Currency	Test failed	Special dividend	Tests passed (out of 8)
The Mission Group	AIM:TMG	£52m	58p	6	4.0%	10.0%	7.3%	-20.8%	-14m	GBP	na	NO	8
Highland Gold Mining	AIM:HGM	£945m	260p	10	5.2%	-33.0%	13.9%	24.4%	-250m	USD	/FwdEPSGrth/	NO	7
Ramsdens Holdings	AIM:RFX	£47m	151p	15	5.0%	-49.7%	119.0%	-18.6%	2m	GBP	/FwdEPSGrth/	NO	7
MTI Wireless Edge	AIM:MWE	£34m	39p	-	4.2%	-	-	24.2%	8m	USD	/FwdEPSGrth/	NO	7
Polar Capital	AIM:POLR	£399m	421p	12	7.8%	-19.9%	-36.3%	-13.8%	120m	GBP	/FwdEPSGrth/	NO	7
Trans-Siberian Gold	AIM:TSG	£75m	86p	-	7.9%	-	-	63.8%	-10m	USD	/FwdEPSGrth/DivGrth/	YES	6
Northern Bear	AIM:NTBR	£11m	58p	-	7.0%	-	-	-17.9%	-2m	GBP	/FwdEPSGrth/FCF/	YES	6
STM	AIM:STM	£19m	32p	9	4.7%	-	-	23.1%	15m	GBP	/FwdEPSGrth/DivGrth/	NO	6
Vianet	AIM:VNET	£23m	83p	8	6.9%	31.3%	-10.1%	-37.6%	-1m	GBP	/FwdEPSGrth/DivGrth/	NO	6
Anglo Asian Mining	AIM:AAZ	£145m	127p	-	5.1%	-	-	6.7%	12m	USD	/FwdEPSGrth/DivGrth/	NO	6
Wynnstay	AIM:WYN	£58m	293p	9	4.8%	0.3%	5.9%	7.3%	4m	GBP	/FwdEPSGrth/EPSGrth/	NO	6
RBG	AIM:RBGP	£59m	68p	8	8.8%	17.9%	6.6%	-18.6%	-5m	GBP	/DivGrth/EPSGrth/	YES	6
Somero Enterprises	AIM:SOM	£114m	203p	7	7.5%	-5.0%	2.7%	-10.6%	22m	USD	/FwdEPSGrth/DivCov/	NO	6

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