

AlphaScreens: the quest for quality

21 December 2020

Quality shares to build back with in the New Year

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:

- Precious metals miner **Polymetal International (POLY)** tops our final quality screen of 2021; its share price momentum has come off slightly, looked at on a three-month basis, but analysts' forward estimates for profits are positive. As a dollar earner with exposure to the gold price, this business has its attractions for UK investors given the challenges facing sterling.
- Consumer goods giant **Unilever (ULVR)** also gets a maximum 9/9 score on our quality criteria. This is a business that has seen strong demand for its household products and trusted brands in the pandemic. Longer term, the rise in quality own brands is a threat, but this remains a quality stalwart and the 3.8 per cent dividend yield looks attractive in a world of low interest rates.
- Other companies that score well include some businesses that are more cyclical in nature and enjoying a good run. It's important to conduct further analysis on these businesses, with measures such as very high dividend yields worth questioning.

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 compound-ing 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.

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.

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.

Alpha Quality screen: large-cap results

Name	TIDM	cap	Market Price	PE	Fwd NTM DY	grth FY+1	Fwd EPS grth FY+2	Fwd EPS momentum	3-month debt(-)	Net cash/ Cur	Tests passed (out of 9)	Test failed
Polymetal International	POLY	£8,002m	1,696p	8	3.8%	72.4%	20.2%	-3.8%	1,398m	USD	9	na
Unilever	ULVR	£114,320m	4,348p	19	3.8%	5.2%	2.5%	-8.3%	20,770m	EUR	9	na
Evrast	EVR	£6,992m	480p	9	9.6%	147.3%	33.5%	38.1%	2,984m	USD	8	/RoE grth/
Rio Tinto	RIO	£70,500m	5,654p	10	5.3%	6.5%	10.0%	12.9%	6,352m	USD	8	/RoE grth/
Diploma	DPLM	£2,608m	2,094p	28	1.4%	29.4%	9.2%	16.3%	-173m	GBP	8	/RoE grth/
IMI	IMI	£3,261m	1,198p	16	2.8%	2.3%	1.7%	13.0%	416m	GBP	8	/RoE grth/
Games Workshop	GAW	£3,576m	10,910p	31	1.3%	55.9%	8.5%	8.0%	-21m	GBP	8	/RoE grth/
XP Power	XPP	£868m	4,420p	24	0.9%	16.5%	7.9%	-0.7%	41m	GBP	8	/RoE grth/
Experian	EXPN	£25,894m	2,823p	34	1.3%	24.1%	13.0%	-9.6%	3,222m	USD	8	/RoE grth/
Taylor Wimpey	TW	£5,886m	162p	11	0.0%	-70.0%	140.5%	53.4%	-473m	GBP	7	/PEG/Fwd EPS grth/
Kainos	KNOS	£1,532m	1,252p	42	0.5%	87.8%	-5.2%	23.2%	-59m	GBP	7	/RoE grth/Fwd EPS grth/
Diageo	DGE	£68,971m	2,949p	25	2.4%	2.9%	13.2%	14.8%	13,857m	GBP	7	/PEG/RoE grth/
Victrex	VCT	£1,981m	2,286p	27	2.0%	7.8%	13.4%	14.5%	-66m	GBP	7	/RoE grth/Marg grth/
Imperial Brands	IMB	£14,887m	1,573p	6	8.8%	-1.3%	4.0%	14.0%	10,325m	GBP	7	/PEG/Fwd EPS grth/
QinetiQ	QQ	£1,786m	311p	15	2.1%	2.4%	4.8%	18.6%	-143m	GBP	7	/PEG/RoE grth/
Next	NXT	£9,019m	6,784p	18	0.0%	-51.9%	85.6%	8.5%	2,115m	GBP	7	/PEG/Fwd EPS grth/
Mondi	MNDI	£8,480m	1,747p	15	2.6%	-25.0%	8.6%	9.9%	1,863m	EUR	7	/PEG/Fwd EPS grth/
PayPoint	PAY	£424m	617p	12	5.1%	-30.9%	13.9%	-0.5%	-21m	GBP	7	/PEG/Fwd EPS grth/
Berkeley Group	BKG	£5,457m	4,376p	13	4.7%	4.6%	5.0%	-1.8%	-951m	GBP	7	/RoE grth/Marg grth/
FDM Group	FDM	£1,098m	1,006p	31	1.8%	-24.4%	9.3%	-2.3%	-36m	GBP	7	/PEG/Fwd EPS grth/
Moneysupermarket.com	MONY	£1,344m	250p	16	4.7%	-28.5%	22.7%	-8.9%	-8m	GBP	7	/PEG/Fwd EPS grth/
HomeServe	HSV	£3,646m	1,085p	23	2.2%	4.2%	14.7%	-14.6%	587m	GBP	7	/PEG/RoE grth/
Britvic plc	BVIC	£2,109m	790p	15	2.7%	20.5%	11.6%	-6.1%	635m	GBP	7	/RoE grth/Marg grth/

Source: FactSet, 21 December 2020

Alpha Quality screen: small-cap results

Name	TIDM	Market cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/ debt(-)	Cur	Tests passed (out of 9)	Test failed
Treant	TET	£454m	762p	37	0.8%	13.1%	71%	29.6%	0m	GBP	7	/RoE grth/FCF/
PayPoint	PAY	£424m	617p	12	5.1%	-30.9%	13.9%	-0.5%	-21m	GBP	7	/PEG/Fwd EPS grth/

Source: FactSet, 21 December 2020

Alpha Quality screen: Aim results

Name	TIDM	Market cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/debt(-)	Cur	Tests passed (out of 9)	Test failed
SDI Group	SDI	£113m	115p	25	0.0%	75.8%	4.4%	82.0%	3m	GBP	9	na
Trans-Siberian Gold	TSG	£126m	115p	6	7.0%	128.0%	18.0%	27.2%	7m	USD	9	na
Cerillion	CER	£121m	410p	25	1.3%	25.2%	20.1%	27.3%	-2m	GBP	9	na
MTI Wireless Edge	MWE	£53m	60p	18	2.3%	10.5%	17.2%	26.6%	-6m	USD	9	na
Renew	RNWH	£416m	530p	12	1.6%	5.0%	7.6%	15.2%	15m	GBP	9	na
Cohort	CHRT	£248m	606p	9	1.7%	78.7%	6.5%	-2.9%	13m	GBP	9	na
RWSRWS		£2,075m	534p	23	1.7%	14.0%	-9.8%	38m	GBP	9	na	
Caledonia Mining Corporation	CMCL	£146m	1,240p	5	1.6%	14.9%	81.0%	-16.5%	-16m	USD	9	na
boohoo	BOO	£3,904m	310p	30	0.0%	41.0%	28.3%	-3.0%	-331m	GBP	9	na
Tristel	TSTL	£249m	535p	38	1.2%	7.3%	13.6%	27.4%	0m	GBP	8	/PEG/
Frontier Developments	FDEV	£1,238m	3,150p	52	0.0%	16.3%	60.2%	24.3%	-22m	GBP	8	/PEG/
Water Intelligence	WATR	£78m	505p	37	0.0%	44.9%	6.4%	25.5%	-1m	USD	8	/RoE grth/
EKF Diagnostics	EKF	£293m	65p	33	0.0%	194.4%	-46.7%	15.2%	-15m	GBP	8	/Fwd EPS grth/
CareTech	CTH	£556m	491p	10	2.4%	18.1%	10.8%	11.6%	353m	GBP	8	/Int Cov/
Alpha Financial Markets Cons	AFM	£241m	226p	15	0.9%	0.5%	10.8%	5.1%	-30m	GBP	8	/PEG/
Tracsis	TRCS	£181m	620p	21	0.3%	10.3%	33.3%	2.5%	-16m	GBP	8	/RoE grth/
Pan African Resources	PAF	£474m	25p	5	2.8%	195.8%	-4.7%	-0.8%	53m	USD	8	/Fwd EPS grth/
Gamma Communications	GAMA	£1,507m	1,580p	28	0.7%	17.2%	19.0%	-1.2%	-25m	GBP	8	/RoE grth/
Venture Life	VLG	£74m	86p	20	0.0%	98.1%	4.6%	-8.9%	2m	GBP	8	/Marg grth/
Steppe Cement	STCM	£71m	33p	11	7.7%	-45.3%	53.1%	30.0%	-1m	USD	7	/PEG/Fwd EPS grth/
Atalaya Mining	ATYM	£321m	234p	6	0.0%	-4.1%	87.2%	33.0%	-22m	EUR	7	/PEG/Fwd EPS grth/
Volex	VLX	£470m	309p	19	1.0%	-0.7%	24.8%	71.7%	-16m	USD	7	/PEG/Fwd EPS grth/
ULS Technology	ULS	£52m	80p	20	0.0%	-62.7%	172.2%	48.0%	3m	GBP	7	/PEG/Fwd EPS grth/
IMmobile	IMO	£487m	590p	35	0.0%	-3.0%	14.9%	46.6%	0m	GBP	7	/PEG/Fwd EPS grth/
Sylvania Platinum	SLP	£220m	81p	5	2.0%	65.9%	-10.9%	17.1%	-45m	USD	7	/Fwd EPS grth/PE/
Michelmersh Brick	MBH	£116m	124p	16	0.0%	-31.5%	24.3%	23.4%	8m	GBP	7	/PEG/Fwd EPS grth/
Alumasc	ALU	£41m	113p	7	4.4%	73.8%	14.5%	36.4%	10m	GBP	7	/RoE grth/Marg grth/
Learning Technologies	LTG	£1,266m	171p	38	0.4%	-11.3%	8.6%	21.6%	-66m	GBP	7	/PEG/Fwd EPS grth/
Judges Scientific	JDG	£389m	6,180p	33	0.8%	-31.0%	26.1%	19.3%	8m	GBP	7	/PEG/Fwd EPS grth/
SigmaRoc	SRC	£167m	60p	14	0.0%	2.2%	14.5%	21.9%	47m	GBP	7	/PEG/Marg grth/
YouGov	YOU	£1,091m	990p	50	0.5%	5.3%	25.0%	17.9%	-26m	GBP	7	/PEG/RoE grth/
Inspiration Healthcare	IHC	£52m	77p	16	0.3%	35.5%	-4.1%	18.6%	-6m	GBP	7	/RoE grth/Fwd EPS grth/
Keywords Studios	KWS	£1,999m	2,700p	46	0.0%	14.5%	21.2%	23.6%	-63m	EUR	7	/PEG/RoE grth/
Quartix	QTX	£186m	388p	38	0.9%	16.4%	-22.9%	11.8%	-9m	GBP	7	/RoE grth/Fwd EPS grth/
Mattioli Woods	MTW	£210m	750p	18	2.7%	-19.2%	17.8%	11.9%	-23m	GBP	7	/PEG/Fwd EPS grth/
Xpediator	XPDI	£47m	34p	8	1.3%	25.2%	19.2%	26.4%	22m	GBP	7	/RoE grth/Int Cov/
Churchill China	CHH	£134m	1,215p	-	0.0%	-	-	13.0%	-16m	GBP	7	/PEG/Fwd EPS grth/
Gooch & Housego	GHH	£303m	1,210p	32	1.0%	20.9%	16.3%	14.7%	15m	GBP	7	/RoE grth/Marg grth/
Concurrent Technologies	CNC	£78m	107p	18	2.4%	39.3%	-	6.5%	-10m	GBP	7	/Fwd EPS grth/Int Cov/
Dewhurst Class A	DWHA	£70m	635p	-	2.0%	-	-	8.5%	-15m	GBP	7	/PEG/Fwd EPS grth/
Solid State	SOLI	£57m	665p	15	1.9%	-6.9%	-	9.9%	-2m	GBP	7	/PEG/Fwd EPS grth/
Next Fifteen Communications	NFC	£458m	504p	12	0.0%	10.2%	9.7%	9.6%	51m	GBP	7	/RoE grth/PE/
Oxford Metrics	OMG	£113m	90p	40	2.0%	58.7%	55.0%	7.8%	-13m	GBP	7	/RoE grth/Marg grth/
James Halstead	JHD	£1,032m	496p	28	2.9%	5.8%	6.3%	-3.9%	-61m	GBP	7	/RoE grth/Marg grth/
EMIS Group	EMIS	£671m	1,060p	22	3.0%	-12.3%	7.8%	-7.5%	-37m	GBP	7	/PEG/Fwd EPS grth/
Anglo Asian Mining	AAZ	£145m	127p	-	5.5%	-	-	-10.9%	-21m	USD	7	/PEG/Fwd EPS grth/
Begbies Traynor	BEG	£113m	88p	12	3.3%	6.1%	28.2%	-3.2%	7m	GBP	7	/RoE grth/PE/
Eckoh	ECK	£164m	65p	35	0.0%	-9.6%	23.1%	-4.4%	-12m	GBP	7	/PEG/Fwd EPS grth/
Franchise Brands	FRAN	£98m	103p	-	0.9%	-	-	-4.7%	-3m	GBP	7	/PEG/Fwd EPS grth/
Crimson Tide	TIDE	£16m	3p	34	0.0%	25.0%	0.0%	-9.3%	-1m	GBP	7	/RoE grth/Marg grth/
Mission Group P	TMG	£56m	61p	8	0.0%	-95.6%	1825.0%	-4.7%	11m	GBP	7	/PEG/Fwd EPS grth/

Source: FactSet, 21 December 2020

© The Financial Times Limited 2020. Investors Chronicle is a trademark of The Financial Times Limited. "Financial Times" and "FT" are registered trademarks and service marks of The Financial Times Limited. All rights reserved. No part of this publication or information contained within it may be commercially exploited in any way without prior permission in writing from the editor.

Permitted Use: By purchasing this magazine, you agree that the intellectual property rights (including copyright and database rights) in its content belong to The Financial Times Limited and/or its licensors. This magazine is for your own personal, non-commercial use. You must not use any of the content as part of any commercial product or service, including without limitation any which reduces the need for third parties to use the Investors Chronicle magazine and/or website, or which creates revenue from the content, or which is to the detriment of our own ability to generate revenues from that content. For example, you must not use any of our content in any syndication, content aggregation, news aggregation, tips aggregation, library, archive or similar service, and you must not capture any such content, whether systematically, regularly or otherwise, in any form of database without our prior written permission. These contractual rights are without prejudice to our rights to protect our intellectual property rights under law.

Investors Chronicle adheres to a self-regulation regime under the FT Editorial Code of Practice: A link to the FT Editorial Code of Practice can be found at www.ft.com/editorialcode. Many of the charts in the magazine are based on material supplied by Thomson Datastream, FactSet and S&P Capital IQ.

Material (including tips) contained in this magazine is for general information only and is not intended to be relied upon by individual readers in making (or refraining from making) any specific investment decision. Appropriate independent advice should be obtained before making any such decisions. The Financial Times Limited does not accept any liability for any loss suffered by any reader as a result of any such decision.

ISSN 0261-3115.