

## AlphaScreens: the quest for quality

21 June 2021

### Aim's quality dozen

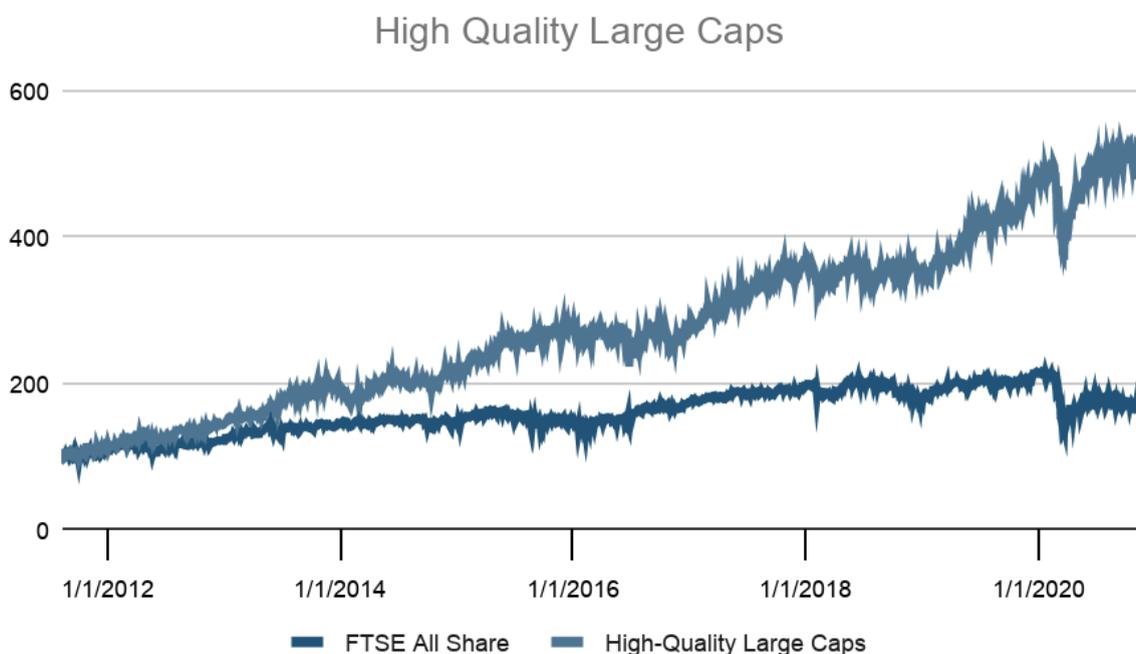
*The holy grail for buy-and-hold investors is to find a business that is capable of generating a high return on capital and sustaining it while reinvesting profits. This screen looks for shares that display these quality characteristics and can potentially deliver significant compounded returns over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

#### Comment by Alpha editor:

- Freedom day may have been postponed but the UK's junior stock market is showing plenty of cause for optimism with 12 companies passing all nine of our quality shares tests.
- **Boohoo Group (BOO)** is still one of our screen-toppers but the company has continued to face uncomfortable questions about its supply chain management and ethics.
- New Aim companies to pass all nine tests include **Cerillion (CER)**. The specialist software provider for the telecommunications industry also wowed on our earnings upgrade screen last week, so looks worth investigating further.
- **Caretech Holdings (CTH)** is another new company to pass all nine tests. The social care technology company has recently raised its interim dividend.
- The main market quality screen highlights many bastions of reliability for UK investors. The likes of data business **Experian (EXPN)**, **Hikma Pharmaceuticals (HIK)** and **Spirent Communications (SPT)** have all featured regularly as high scorers on this screen.

## 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.



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 (-)	Cur	Tests passed (out of 9)	Test Failed
Experian	EXPN	£25,453m	2,757p	31	1.2%	18.1%	12.8%	13.0%	2,998m	USD	9	na
Hikma Pharmaceuticals	HIK	£5,525m	2,387p	17	1.5%	10.6%	14.4%	8.2%	425m	USD	9	na
Polymetal International	POLY	£7,499m	1,584p	9	5.9%	1.1%	9.8%	5.0%	1,012m	USD	9	na
Spirent Communications	SPT	£1,457m	238p	21	1.9%	7.8%	5.0%	-0.5%	-156m	USD	9	na
Oxford Instruments	OXIG	£1,327m	2,310p	28	0.7%	4.7%	2.9%	29.6%	-90m	GBP	8	/PEG/
IMI	IMI	£4,532m	1,685p	19	1.3%	7.7%	10.9%	27.7%	313m	GBP	8	/RoE grth/
Spirax-Sarco Engineering	SPX	£9,781m	13,260p	41	0.9%	23.7%	6.2%	17.9%	263m	GBP	8	/RoE grth/
Britvic	BVIC	£2,481m	929p	17	3.0%	8.4%	23.1%	13.2%	664m	GBP	8	/RoE grth/
Dunelm Group	DNLM	£2,789m	1,376p	21	0.9%	36.8%	13.5%	3.6%	182m	GBP	8	/RoE grth/
Kainos Group	KNOS	£1,639m	1,335p	36	1.6%	0.3%	4.6%	-1.8%	-59m	GBP	8	/PEG/
Games Workshop Group	GAW	£3,671m	11,200p	29	1.8%	70.8%	4.9%	17.1%	-51m	GBP	7	/RoE grth/Marg grth/
Treant	TET	£731m	1,225p	44	0.5%	47.8%	7.2%	20.7%	5m	GBP	7	/RoE grth/FCF/
Rightmove	RMV	£5,582m	650p	31	0.7%	60.4%	10.5%	14.4%	-84m	GBP	7	/RoE grth/Marg grth/
Halma	HLMA	£10,250m	2,700p	43	0.7%	4.3%	9.9%	18.6%	256m	GBP	7	/PEG/RoE grth/
Croda International	CRDA	£9,897m	7,094p	34	1.3%	15.8%	9.2%	13.5%	801m	GBP	7	/RoE grth/Marg grth/
Diploma	DPLM	£3,587m	2,880p	33	1.5%	46.7%	7.6%	16.6%	236m	GBP	7	/RoE grth/PE/
Auto Trader	AUTO	£6,103m	631p	26	0.8%	76.5%	11.6%	9.9%	-11m	GBP	7	/RoE grth/Marg grth/
Imperial Brands	IMB	£14,953m	1,580p	6	8.7%	-3.3%	1.1%	9.8%	10,490m	GBP	7	/PEG/Fwd EPS grth/
Ferrexpo	FXPO	£2,452m	417p	4	15.1%	72.4%	-22.8%	8.0%	-3m	USD	7	/Fwd EPS grth/PE/
Coats	COA	£994m	68p	15	1.4%	144.3%	19.0%	12.9%	180m	USD	7	/RoE grth/Marg grth/
Smith & Nephew	SN	£13,437m	1,529p	22	1.8%	36.1%	20.3%	10.1%	1,410m	USD	7	/RoE grth/Marg grth/
Avast	AVST	£5,088m	494p	18	2.4%	4.2%	7.7%	5.2%	529m	USD	7	/PEG/RoE grth/
Rio Tinto	RIO	£72,482m	5,809p	7	5.9%	71.3%	-27.3%	4.5%	565m	USD	7	/RoE grth/Fwd EPS grth/
Berkeley	BKG	£5,516m	4,535p	13	2.6%	3.8%	4.1%	3.3%	-951m	GBP	7	/RoE grth/Marg grth/
PayPoint	PAY	£413m	601p	12	5.4%	133.6%	6.6%	2.4%	48m	GBP	7	/RoE grth/Marg grth/
Howden Joinery	HWDN	£4,665m	781p	21	1.2%	39.2%	14.2%	5.7%	150m	GBP	7	/RoE grth/Marg grth/
Persimmon	PSN	£9,595m	3,007p	12	7.8%	12.0%	6.5%	1.8%	-872m	GBP	7	/RoE grth/Marg grth/
Redrow	RDW	£2,234m	634p	9	0.9%	98.6%	14.4%	3.2%	101m	GBP	7	/RoE grth/Marg grth/
Intertek	ITRK	£8,941m	5,540p	27	1.9%	12.3%	11.6%	0.7%	644m	GBP	7	/RoE grth/Marg grth/
FDM	FDM	£1,101m	1,008p	30	4.6%	9.6%	13.7%	-0.2%	-45m	GBP	7	/RoE grth/Marg grth/
QinetiQ	QQ	£1,970m	340p	15	2.0%	1.5%	6.4%	1.3%	-164m	GBP	7	/PEG/RoE grth/
Mondi	MNDI	£8,954m	1,844p	15	4.4%	3.9%	18.5%	-0.4%	1,598m	EUR	7	/RoE grth/Marg grth/
Bellway	BWY	£4,157m	3,369p	9	2.5%	65.0%	9.2%	-1.3%	-346m	GBP	7	/RoE grth/Marg grth/
Airtel Africa	AAF	£3,018m	80p	10	3.7%	29.7%	19.9%	-7.7%	2,233m	USD	7	/RoE grth/Int Cov/
Anglo American	AAL	£37,043m	2,718p	6	2.7%	164.2%	-21.2%	-6.4%	4,382m	USD	7	/RoE grth/Fwd EPS grth/
Rotork	ROR	£2,955m	338p	26	3.0%	1.9%	7.5%	-8.0%	-178m	GBP	7	/PEG/RoE grth/
Barratt Developments	BDEV	£7,208m	708p	9	1.1%	75.6%	10.9%	-7.7%	-1,058m	GBP	7	/RoE grth/Marg grth/

Source: FactSet, 21 June 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 (-)	Cur	Tests passed (out of 9)	Test Failed
Severfield	SFR	£244m	79p	10	3.7%	15.0%	11.9%	2.6%	7m	GBP	8	/RoE grth/
RM	RM	£198m	236p	12	1.3%	11.7%	57.0%	10.8%	24m	GBP	7	/RoE grth/Marg grth/
PayPoint	PAY	£413m	601p	12	5.4%	133.6%	6.6%	2.4%	48m	GBP	7	/RoE grth/Marg grth/
Porvair	PRV	£259m	560p	23	0.9%	1.4%	19.2%	-1.4%	9m	GBP	7	/PEG/RoE grth/
Henry Boot	BOOT	£344m	258p	14	2.1%	76.4%	44.9%	-7.9%	-27m	GBP	7	/RoE grth/Marg grth/

Source: FactSet, 21 June 2021

## Aim 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 (-)	Cur	Tests passed (out of 9)	Test Failed
Cerillion	CER	£254m	860p	38	0.7%	46.4%	33.0%	107.2%	-3m	GBP	9	na
Water Intelligence	WATR	£147m	950p	47	0.0%	46.7%	8.9%	54.5%	1m	USD	9	na
Gamma Communications	GAMA	£1,876m	1,960p	30	0.6%	18.0%	14.6%	22.5%	-35m	GBP	9	na
Science Group	SAG	£173m	419p	19	1.4%	15.4%	2.7%	32.2%	-10m	GBP	9	na
Renew	RNWH	£535m	680p	14	1.9%	12.0%	12.1%	26.9%	33m	GBP	9	na
CareTech	CTH	£682m	602p	12	2.2%	17.9%	9.3%	9.9%	378m	GBP	9	na
EMIS	EMIS	£714m	1,128p	20	2.8%	6.6%	6.5%	1.6%	-46m	GBP	9	na
Pan African Resources	PAF	£340m	18p	4	3.9%	102.8%	16.1%	-0.5%	62m	USD	9	na
Eckoh	ECK	£170m	67p	44	0.9%	38.1%	21.1%	2.3%	-10m	GBP	9	na
Keystone Law	KEYS	£200m	640p	35	2.7%	13.6%	11.8%	1.6%	-6m	GBP	9	na
boohoo	BOO	£4,126m	327p	29	0.0%	21.4%	26.5%	0.0%	-258m	GBP	9	na
RWS	RWS	£2,188m	562p	21	1.6%	15.3%	20.2%	-8.8%	37m	GBP	9	na
Steppe Cement	STCM	£97m	45p	8	5.6%	56.9%	-3.8%	27.1%	2m	USD	8	/Fwd EPS grth/
MP Evans	MPE	£402m	738p	17	3.0%	56.2%	7.8%	18.6%	57m	USD	8	/Marg grth/
SDI	SDI	£204m	206p	29	0.0%	136.3%	16.5%	17.7%	3m	GBP	8	/Marg grth/
Franchise Brands	FRAN	£148m	155p	27	0.7%	20.1%	23.4%	24.1%	-5m	GBP	8	/RoE grth/
Alliance Pharma	APH	£523m	98p	16	1.6%	9.2%	13.5%	12.9%	113m	GBP	8	/RoE grth/
Learning Technologies	LTG	£1,380m	186p	35	0.4%	16.7%	14.8%	15.9%	-61m	GBP	8	/PEG/
Jubilee Metals	JLP	£415m	19p	6	0.0%	115.7%	78.9%	8.8%	1m	GBP	8	/Marg grth/
Sureserve	SUR	£134m	83p	11	1.2%	65.8%	17.4%	20.3%	1m	GBP	8	/Marg grth/
Kape Technologies	KAPE	£676m	302p	14	0.0%	76.6%	23.7%	8.2%	-6m	USD	8	/Marg grth/
Sylvania Platinum	SLP	£336m	123p	3	1.3%	144.2%	46.2%	-0.9%	-49m	USD	8	/PE/
Enwell Energy	ENW	£71m	22p	10	0.0%	89.9%	131.6%	1.8%	-44m	USD	8	/RoE grth/
Watkin Jones	WJG	£549m	215p	13	4.6%	5.9%	11.4%	0.5%	100m	GBP	8	/RoE grth/
Team17	TM17	£924m	703p	35	-	5.5%	9.6%	-5.0%	-60m	GBP	8	/PEG/
Michelmersh Brick	MBH	£134m	143p	17	1.8%	59.6%	10.1%	-1.7%	0m	GBP	8	/RoE grth/
Atalaya Mining	ATYM	£430m	311p	6	0.0%	163.2%	7.8%	-6.0%	-5m	EUR	8	/RoE grth/
Caledonia Mining Corp.	CMCL	£106m	1,005p	4	3.0%	31.2%	36.1%	-12.2%	-9m	USD	8	/FCF/
Solid State	SOLI	£76m	885p	16	1.4%	10.7%	6.8%	-1.7%	-2m	GBP	8	/Marg grth/
IG Design	IGR	£519m	536p	19	1.6%	48.8%	9.5%	-8.5%	27m	USD	8	/RoE grth/
ASOS	ASC	£4,742m	4,750p	29	0.0%	21.4%	7.9%	-15.1%	238m	GBP	8	/RoE grth/
Alpha Fin. Mkts Consulting	AFM	£412m	355p	21	0.6%	3.9%	18.0%	37.6%	-30m	GBP	7	/PEG/Marg grth/
K3 Capital	K3C	£250m	364p	21	1.9%	33.2%	5.4%	23.9%	-8m	GBP	7	/RoE grth/Marg grth/
RBG	RBGP	£138m	145p	17	2.1%	0.0%	25.0%	50.5%	2m	GBP	7	/PEG/Marg grth/
Alumasc	ALU	£94m	260p	11	2.0%	167.3%	7.9%	52.0%	6m	GBP	7	/RoE grth/Marg grth/
Eleco	ELCO	£111m	134p	28	0.3%	-3.8%	9.9%	30.2%	-4m	GBP	7	/PEG/Fwd EPS grth/
Character	CCT	£146m	685p	15	1.3%	143.9%	4.2%	47.3%	-33m	GBP	7	/RoE grth/Marg grth/
Somero Enterprises	SOM	£258m	460p	15	5.6%	21.8%	7.5%	17.9%	-25m	USD	7	/RoE grth/Marg grth/
Instem	INS	£160m	735p	30	0.0%	9.3%	34.8%	25.6%	-25m	GBP	7	/PEG/RoE grth/
Next Fifteen Comms	NFC	£809m	872p	18	0.8%	15.0%	8.8%	34.2%	29m	GBP	7	/RoE grth/PE/
SigmaRoc	SRC	£274m	98p	20	0.0%	15.5%	9.4%	31.5%	44m	GBP	7	/RoE grth/Int Cov/
Nichols	NICL	£554m	1,503p	30	2.4%	71.6%	28.4%	27.3%	-44m	GBP	7	/RoE grth/Marg grth/
EKF Diagnostics	EKF	£355m	78p	36	1.4%	12.1%	-43.9%	15.6%	-20m	GBP	7	/RoE grth/Fwd EPS grth/
Fintel	FNTL	£230m	237p	19	1.2%	10.6%	-	17.3%	25m	GBP	7	/RoE grth/Fwd EPS grth/
Distil	DIS	£12m	2p	-	0.0%	-	-	28.9%	-	GBP	7	/PEG/Fwd EPS grth/
Advanced Med. Solutions	AMS	£615m	285p	29	0.6%	67.2%	17.5%	21.3%	-43m	GBP	7	/RoE grth/Marg grth/
Xpediator	XPD	£101m	71p	16	2.1%	13.3%	6.9%	46.4%	25m	GBP	7	/RoE grth/Int Cov/
CVS	CVSG	£1,595m	2,255p	30	0.0%	62.3%	8.8%	24.0%	143m	GBP	7	/RoE grth/Int Cov/
Dewhurst	DWHT	£100m	2,020p	-	0.7%	-	-	15.4%	-13m	GBP	7	/PEG/Fwd EPS grth/
Anpario	ANP	£153m	660p	30	2.3%	3.7%	2.8%	12.8%	-16m	GBP	7	/PEG/RoE grth/
Focusrite	TUNE	£723m	1,233p	32	0.4%	35.2%	-18.0%	8.1%	-19m	GBP	7	/RoE grth/Fwd EPS grth/
Oxford Metrics	OMG	£137m	109p	39	1.7%	58.7%	55.0%	14.2%	-14m	GBP	7	/RoE grth/Marg grth/
Marshall Motor	MMH	£150m	192p	9	0.0%	5.7%	2.9%	23.9%	71m	GBP	7	/RoE grth/Int Cov/
Venture Life	VLG	£122m	97p	25	0.0%	-13.9%	17.7%	12.3%	-31m	GBP	7	/PEG/Fwd EPS grth/
Amiad Water Systems	AFS	£93m	305p	35	0.0%	19.2%	19.8%	17.3%	-2m	USD	7	/Marg grth/Int Cov/
Volex	VLX	£601m	383p	21	0.9%	-15.5%	10.6%	14.2%	20m	USD	7	/PEG/Fwd EPS grth/
Gooch & Housego	GHH	£351m	1,400p	35	0.3%	19.6%	15.3%	12.9%	12m	GBP	7	/RoE grth/Marg grth/
Trans-Siberian Gold	TSG	£107m	117p	-	6.8%	-	-	1.7%	-5m	USD	7	/PEG/Fwd EPS grth/
Springfield Properties	SPR	£168m	165p	11	2.0%	76.9%	6.7%	10.7%	37m	GBP	7	/RoE grth/Marg grth/
Breedon	BREE	£1,736m	103p	21	0.0%	46.4%	43.0%	12.7%	318m	GBP	7	/RoE grth/Marg grth/
Driver	DRV	£30m	58p	14	2.6%	17.4%	59.1%	15.0%	-5m	GBP	7	/RoE grth/Marg grth/
Tandem	TND	£31m	585p	-	1.5%	-	-	5.4%	-4m	GBP	7	/PEG/Fwd EPS grth/
Anexo	ANX	£164m	142p	9	1.1%	24.8%	18.5%	1.1%	40m	GBP	7	/RoE grth/FCF/

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

GB Group	GBG	£1,649m	840p	42	0.8%	-22.0%	13.4%	1.9%	-17m	GBP	7	/PEG/Fwd EPSgrth/
Keywords Studios	KWS	£1,851m	2,454p	36	0.0%	23.1%	14.1%	4.5%	-66m	EUR	7	/PEG/RoE grth/
Tristel	TSTL	£278m	590p	59	1.1%	-32.8%	21.1%	-2.8%	-1m	GBP	7	/PEG/Fwd EPSgrth/
Anglo Asian Mining	AAZ	£164m	144p	-	4.2%	-	-	-5.0%	-27m	USD	7	/PEG/Fwd EPSgrth/
Central Asia Metals	CAML	£418m	238p	7	5.9%	86.7%	-5.9%	-8.8%	24m	USD	7	/RoE grth/Fwd EPSgrth/
Concurrent Technologies	CNC	£69m	94p	19	2.7%	33.3%	-	-6.9%	-11m	GBP	7	/RoE grth/Fwd EPSgrth/
Amino Technologies	AMO	£138m	166p	17	1.1%	26.2%	15.5%	-0.9%	-5m	USD	7	/RoE grth/Marg grth/
Dewhurst plc Class A	DWHA	£100m	700p	-	1.9%	-	-	-6.0%	-13m	GBP	7	/PEG/Fwd EPSgrth/
Judges Scientific	JDG	£381m	6,040p	30	0.9%	9.9%	10.7%	-5.0%	11m	GBP	7	/PEG/RoE grth/
Titon Holdings	TON	£15m	137p	15	2.6%	1323.1%	31.1%	1.5%	-4m	GBP	7	/RoE grth/Marg grth/
Frontier Developments	FDEV	£923m	2,345p	33	0.0%	13.4%	58.7%	-14.7%	-12m	GBP	7	/PEG/Marg grth/
Griffin Mining	GFM	£180m	103p	8	0.0%	262.7%	14.7%	-21.9%	-12m	USD	7	/RoE grth/Marg grth/
Best of the Best	BOTB	£193m	2,050p	14	0.2%	16.9%	15.7%	-34.9%	-	GBP	7	/RoE grth/Int Cov/
MTI Wireless Edge	MWE	£62m	71p	2084	2.0%	-98.8%	11.2%	-21.2%	-7m	USD	7	/PEG/Fwd EPSgrth/

Source: FactSet, 21 June 2021

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