

AlphaScreens: finding dividend diamonds

8 February 2021

Income stocks still struggle to meet our quality tests

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

Comment by Alpha editor:

- Larger companies are still struggling to score well against our quality income stock criteria. Again, miner **BHP Group (BHP)** is the biggest company passing at least 6/8 tests. The same score is also achieved by investment platform business **Hargreaves Lansdown (HL)** and private equity focussed investment company **3i Group (III)**.
- Spread betters **CMC Markets (CMCX)** and **IG Group (IG)** did slightly better - both passing seven large cap screen tests.
- The only company to score 8/8 was agricultural specialist **Carr's Group (CARR)** but it is much more appropriate to judge it against the small cap criteria. It fails to rank on the small cap screen, however, as it falls down on account of not being in the top third of small cap dividend payers by yield.
- On Aim the dividend yield is a good sign of a value but quality sanity checks are crucial. Miner **Pan African Resources (PAF)** and fund management business **Polar Capital Holdings (POLR)** reassuringly pass all our tests but, as ever, further research should be carried out before deciding to invest.

Dividends are crucial for UK investors

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.

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 (i.e. dividend cover is not expected to dramatically fall).
- Operating cash conversion of 100 per cent or more (i.e. earnings are being tuned into cash with which to pay dividends).
- Interest payments covered at least five times by operating profits (i.e. interest payments on borrowings are not likely to 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.

Small cap dividend diamonds criteria

The small-cap Alpha dividend yield screen is more growth-focused than our large-cap screen. It 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 (i.e. rising earnings to support dividend growth and maintain or improve dividend cover).
- Positive free cash flow (i.e. a weak test that earnings are turned into cash with which to pay dividends).
- Interest payments covered at least five times by operating profits (i.e. 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 (i.e. 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 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.

Stock screen and methodology by Algy Hall

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(-)	Cur	Test failed	Special dividend	Tests passed (out of 8)
Carr's	CARR	£126m	137p	11	3.5%	3.1%	7.3%	36.5%	33m	GBP	na	NO	8
CMC Markets	CMCX	£1,214m	418p	15	5.1%	86.5%	-56.8%	23.9%	-156m	GBP	/FwdEPSGrth/	NO	7
IG Group	IGG	£2,818m	761p	12	5.7%	10.6%	-15.2%	-1.2%	-456m	GBP	/FwdEPSGrth/	NO	7
Severfield	SFR	£220m	72p	11	4.1%	-22.1%	12.7%	28.6%	-9m	GBP	/FwdEPSGrth/	NO	7
Sirius Real Estate	SRE	£962m	91p	15	3.5%	32.1%	-1.2%	17.9%	349m	EUR	/FwdEPSGrth/	NO	7
Liontrust Asset Mgmt	LIO	£734m	1,205p	14	2.9%	19.7%	35.1%	-4.4%	-94m	GBP	/DivCov/	NO	7
Schroder Euro Real Est IT	SERE	£121m	91p	-	5.7%	-	-	18.1%	46m	EUR	/FwdEPSGrth/DivGrth/	NO	6
Ferrexpo	FXPO	£1,751m	297p	4	8.5%	10.9%	13.7%	47.1%	141m	USD	/DivGrth/EPSGrth/	NO	6
Impact Healthcare REIT	IHR	£354m	111p	15	5.6%	16.5%	19.6%	7.2%	3m	GBP	/EPSGrth/DivCov/	NO	6
City of London Investment	CLIG	£252m	497p	10	6.0%	60.8%	8.4%	19.2%	-13m	GBP	/EPSGrth/DivCov/	NO	6
Polymetal International	POLY	£7,707m	1,633p	8	3.9%	67.4%	17.4%	-10.8%	1,398m	USD	/DivGrth/EPSGrth/	NO	6
3i Infrastructure	3IN	£2,639m	296p	-	3.2%	-	-	0.3%	-355m	GBP	/FwdEPSGrth/DivGrth/	NO	6
BHP	BHP	£43,181m	2,045p	11	4.6%	46.5%	-7.4%	31.5%	10,995m	USD	/FwdEPSGrth/DivCov/	NO	6
3i Group	III	£11,425m	1,174p	7	3.0%	696.8%	-0.5%	13.2%	431m	GBP	/FwdEPSGrth/EPSGrth/	NO	6
JPMorgan Global Grh & Inc.	JGGI	£582m	398p	-	3.3%	-	-	9.3%	-7m	GBP	/FwdEPSGrth/EPSGrth/	NO	6
Hargreaves Lansdown	HL	£7,724m	1,629p	29	3.4%	2.1%	-9.0%	12.5%	-373m	GBP	/FwdEPSGrth/DivCov/	NO	6
Stock Spirits	STCK	£572m	286p	15	3.0%	-4.0%	6.1%	29.4%	21m	EUR	/FwdEPSGrth/DivCov/	NO	6
Berkeley Group	BKG	£5,402m	4,353p	13	4.7%	5.7%	4.6%	0.8%	-951m	GBP	/EPSGrth/DivCov/	NO	6

Source: FactSet, 8 February 2021

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(-)	Cur	Test failed	Special dividend	Tests passed (out of 8)
Schroder European Real Est IT	SERE	£121m	91p	-	5.7%	-	-	18.1%	46m	EUR	/FwdEPSGrth/DivGrth/	NO	6
City of London Investment	CLIG	£252m	497p	10	6.0%	60.8%	8.4%	19.2%	-13m	GBP	/EPSGrth/DivCov/	NO	6
Impact Healthcare REIT	IHR	£354m	111p	15	5.6%	16.5%	19.6%	7.2%	3m	GBP	/EPSGrth/DivCov/	NO	6

Source: FactSet, 8 February 2021

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(-)	Cur	Test failed	Special dividend	Tests passed (out of 8)
Pan African Resources	PAF	£436m	23p	5	3.0%	165.1%	5.0%	0.4%	53m	USD	na	NO	8
Wynnstay	WYN	£89m	445p	13	3.3%	22.6%	3.8%	53.4%	-8m	GBP	na	NO	8
Polar Capital	POLR	£638m	646p	11	5.3%	38.3%	6.4%	10.2%	-132m	GBP	/DivCov/	NO	7
Mattioli Woods	MTW	£209m	745p	17	2.7%	-15.9%	16.5%	13.7%	-23m	GBP	/FwdEPSGrth/	NO	7
K3 Capital	K3C	£180m	263p	19	2.9%	-17.4%	49.9%	76.8%	-7m	GBP	/FwdEPSGrth/	NO	7
Alumasc	ALU	£56m	154p	7	3.4%	150.9%	8.3%	57.9%	6m	GBP	/DivGrth/EPSGrth/	NO	6
NWF	NWF	£100m	205p	12	3.4%	-15.5%	5.2%	2.5%	42m	GBP	/FwdEPSGrth/DivGrth/	NO	6
Brickability	BRCK	£155m	67p	11	2.9%	14.1%	34.8%	68.1%	9m	GBP	/DivGrth/EPSGrth/	NO	6
Jarvis Securities	JIM	£93m	212p	4	3.7%	463.9%	2.8%	3.4%	-3m	GBP	/EPSGrth/DivCov/	NO	6
Tatton Asset Management	TAM	£179m	310p	21	3.2%	10.1%	10.8%	15.7%	-13m	GBP	/DivGrth/DivCov/	NO	6
Brooks Macdonald	BRK	£307m	1,900p	12	2.8%	19.6%	13.7%	29.7%	-43m	GBP	/EPSGrth/DivCov/	NO	6
Begbies Traynor	BEG	£143m	112p	14	2.6%	8.8%	39.1%	28.8%	7m	GBP	/EPSGrth/DivCov/	NO	6

Source: FactSet, 8 February 2021

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