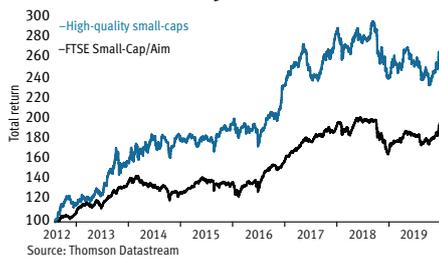




AlphaScreens: the quest for Quality

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

High-quality small-caps vs FTSE Small-Cap/Aim



High-quality large-caps vs FTSE All-Share



Screen 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.

- Forecasting earnings per share (EPS) growth for companies is a tricky call for analysts to make now and it is unsurprising that EPS upgrade tests are commonly failed on our FTSE All-Share quality screen. No company passed all nine of our tests focused on large companies, although looking beyond a tough next 12 months, some quality businesses are flagged.
- **Moneysupermarket.com (MONY)**, pharmaceutical giant **GlaxoSmithKline (GSK)** and international technical products and services business **Diploma (DPLM)** only fail on the one-year EPS growth forecast.
- Gold miner **Polymetal (POLY)** misses out on full marks because its return on equity (ROE) isn’t higher than two years ago. However, the stock has gone up almost 28 per cent in the past three months as investors have sought out gold-related investments as the world braces itself for the full impact of recession.

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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.

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

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 – ie before the impact of debt.

- An operating margin higher than the median average (mid-ranking) stock in each of the past three years (ie 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 (ie again, quality that shows some signs of persistence).
- RoE higher than it was two years ago (ie quality is improving as well as persistent).
- Operating margin higher than it was two years ago (ie 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 (ie not a suspiciously cheap or dangerously expensive valuation).
- Interest cover of more than five (ie 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 methodology formulated and explained by Algy Hall

Alpha Quality screen: large-cap results

Name	TIDM	Market cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-month momentum	Net cash/debt(-)	Cur	Tests passed (out of 9)	Test failed
Polymetal International	LSE:POLY	£7,756m	1,644p	12	3.1%	34.5%	2.7%	27.8%	-1,504m	USD	8	/RoE grth/
Moneysupermarket.com	LSE:MONY	£1,754m	327p	19	3.6%	-3.1%	12.4%	-1.0%	-10m	GBP	8	/Fwd EPS grth/
GlaxoSmithKline	LSE:GSK	£83,338m	1,675p	14	4.8%	-5.7%	2.4%	-2.5%	-27,151m	GBP	8	/Fwd EPS grth/
Diploma	LSE:DPLM	£2,002m	1,769p	30	1.6%	-7.3%	12.2%	-9.5%	-15m	GBP	8	/Fwd EPS grth/
Kainos	LSE:KNOS	£928m	760p	43	-	11.2%	4.3%	-12.4%	37m	GBP	8	/PE/
Sirius Real Estate	LSE:SRE	£685m	66p	16	4.7%	8.2%	-4.8%	-27.3%	-278m	EUR	8	/Fwd EPS grth/
Segro	LSE:SGRO	£9,108m	822p	33	2.5%	2.1%	9.6%	-10.0%	-1,886m	GBP	7	/RoE grth/Int Cov/
Avon Rubber	LSE:AVON	£816m	2,675p	28	0.8%	6.1%	24.8%	1.1%	48m	GBP	7	/RoE grth/PE/
Diageo	LSE:DGE	£64,817m	2,778p	23	2.5%	-13.5%	11.1%	-11.4%	-13,008m	GBP	7	/PEG/Fwd EPS grth/
RELX	LSE:REL	£35,777m	1,859p	21	2.5%	-3.0%	11.8%	-10.4%	-6,281m	GBP	7	/RoE grth/Fwd EPS grth/
Games Workshop	LSE:GAW	£1,959m	5,995p	30	2.1%	1.0%	0.5%	-15.7%	5m	GBP	7	/PEG/RoE grth/
Smith & Nephew	LSE:SN.	£14,471m	1,658p	23	1.8%	-13.7%	24.4%	-11.2%	-1,770m	USD	7	/RoE grth/Fwd EPS grth/
Unilever	LSE:ULVR	£119,653m	4,083p	-	-	-0.4%	8.5%	-12.9%	-22,977m	EUR	7	/Fwd EPS grth/PE/
Imperial Brands	LSE:IMB	£15,261m	1,627p	6	12.7%	-4.2%	3.5%	-11.9%	-11,350m	GBP	7	/RoE grth/Fwd EPS grth/
Sage	LSE:SGE	£7,000m	642p	24	2.6%	-5.4%	7.1%	-17.0%	-394m	GBP	7	/RoE grth/Fwd EPS grth/
Medica Group	LSE:MGP	£141m	127p	23	-	-31.0%	64.4%	-17.0%	4m	GBP	7	/RoE grth/Fwd EPS grth/
HomeServe	LSE:HSV	£3,838m	1,147p	28	1.9%	9.5%	7.4%	-13.0%	-451m	GBP	7	/RoE grth/PE/
Mondi	LSE:MNDI	£6,596m	1,361p	13	5.3%	-27.3%	13.5%	-18.2%	-2,202m	EUR	7	/PEG/Fwd EPS grth/
QinetiQ Group	LSE:QQ.	£1,734m	309p	16	2.1%	-2.0%	3.7%	-17.8%	173m	GBP	7	/RoE grth/Fwd EPS grth/
FDM Group	LSE:FDM	£843m	772p	24	4.8%	-17.2%	14.6%	-24.5%	14m	GBP	7	/PEG/Fwd EPS grth/
PayPoint	LSE:PAY	£475m	703p	11	11.9%	1.1%	-17.3%	-27.6%	21m	GBP	7	/PEG/Fwd EPS grth/
MJ Gleeson	LSE:GLE	£425m	732p	18	-	-34.0%	49.7%	-22.1%	27m	GBP	7	/RoE grth/Fwd EPS grth/
Countryside Properties	LSE:CSP	£1,717m	385p	10	-	-6.5%	8.5%	-23.5%	78m	GBP	7	/Fwd EPS grth/FCF/
Next	LSE:NXT	£6,225m	4,882p	37	-	-71.7%	180.1%	-29.0%	-2,410m	GBP	7	/PEG/Fwd EPS grth/
Taylor Wimpey	LSE:TW.	£4,972m	152p	10	-	-21.1%	8.2%	-30.3%	518m	GBP	7	/PEG/Fwd EPS grth/
IMI	LSE:IMI	£2,226m	822p	15	5.0%	-23.3%	25.2%	-26.2%	-434m	GBP	7	/RoE grth/Fwd EPS grth/
Marshalls	LSE:MSLH	£1,190m	600p	26	-	-19.5%	20.5%	-27.4%	-59m	GBP	7	/PEG/Fwd EPS grth/
Burberry	LSE:BRBY	£5,583m	1,385p	22	3.1%	-21.1%	-12.0%	-30.6%	-416m	GBP	7	/PEG/Fwd EPS grth/
Evrax	LSE:EVR	£3,934m	270p	8	34.6%	101.2%	-3.7%	-30.6%	-3,433m	USD	7	/RoE grth/Fwd EPS grth/
Barratt Developments	LSE:BDEV	£5,386m	531p	9	-	-25.0%	5.4%	-35.6%	375m	GBP	7	/PEG/Fwd EPS grth/
Vp	LSE:VP.	£270m	682p	7	4.4%	1.4%	-0.4%	-31.1%	-262m	GBP	7	/RoE grth/Fwd EPS grth/
On the Beach	LSE:OTB	£362m	276p	138	-	-90.7%	1025.1%	-34.2%	55m	GBP	7	/RoE grth/Fwd EPS grth/
Hollywood Bowl	LSE:BOWL	£222m	141p	24	-	-59.0%	122.7%	-48.0%	-2m	GBP	7	/PEG/Fwd EPS grth/
Photo-Me International	LSE:PHTM	£166m		5	-	-2.7%	5.0%	-48.8%	8m	GBP	7	/RoE grth/Fwd EPS grth/

Source: S&P CapitalIQ, 11 May 2020

Continued on the next page

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
Treatt	LSE:TET	£301m	506p	27	1.1%	6.1%	7.1%	-4.5%	16m	GBP	7	/RoE grth/PE/
Medica	LSE:MGP	£141m	127p	23	-	-31.0%	64.4%	-17.0%	4m	GBP	7	/RoE grth/Fwd EPS grth/
MJ Gleeson	LSE:GLE	£425m	732p	18	-	-34.0%	49.7%	-22.1%	27m	GBP	7	/RoE grth/Fwd EPS grth/
Vp	LSE:VP	£270m	682p	7	4.4%	1.4%	-0.4%	-31.1%	-262m	GBP	7	/RoE grth/Fwd EPS grth/
On the Beach	LSE:OTB	£362m	276p	138	-	-90.7%	1025.1%	-34.2%	55m	GBP	7	/RoE grth/Fwd EPS grth/
Hollywood Bowl	LSE:BOWL	£222m	141p	24	-	-59.0%	122.7%	-48.0%	-2m	GBP	7	/PEG/Fwd EPS grth/
Photo-Me International	LSE:PHTM	£166m	44p	5	-	-2.7%	5.0%	-48.8%	8m	GBP	7	/RoE grth/Fwd EPS grth/

Source: S&P CapitalIQ, 11 May 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
Cerillion	AIM:CER	£80m	271p	24	1.8%	47.5%	4.1%	22.6%	5m	GBP	9	na
dotdigital	AIM:DOTD	£289m	97p	24	0.7%	20.2%	1.7%	-11.0%	17m	GBP	9	na
Arcontech	AIM:ARC	£23m	172p	21	1.2%	8.6%	11.8%	-24.9%	4m	GBP	9	na
Caledonia Mining	AIM:CMCL	£219m	1,013p	-	-	7.6%	49.9%	26.6%	6m	USD	8	/FCF/
Bioventix	AIM:BVPX	£218m	4,185p	34	3.0%	11.6%	8.6%	13.1%	6m	GBP	8	/Int Cov/
Team17	AIM:TM17	£686m	530p	38	-	1.7%	14.8%	10.4%	40m	GBP	8	/RoE grth/
Sylvania Platinum	AIM:SLP	£120m	44p	3	1.8%	172.9%	-23.3%	0.0%	33m	USD	8	/Fwd EPS grth/
Anpario	AIM:ANP	£85m	370p	21	2.2%	-3.3%	6.4%	8.8%	14m	GBP	8	/Fwd EPS grth/
James Halstead	AIM:JHD	£1,041m	500p	27	0.9%	1.0%	4.4%	-7.1%	57m	GBP	8	/RoE grth/
boohoo group	AIM:BOO	£4,053m	347p	58	-	2.3%	35.2%	7.2%	225m	GBP	8	/PE/
Elecosoft	AIM:ELCO	£60m	74p	17	-	4.3%	11.8%	-6.9%	-3m	GBP	8	/RoE grth/
Gamma Communications	AIM:GAMA	£1,186m	1,250p	27	0.8%	12.4%	10.2%	-7.1%	41m	GBP	8	/RoE grth/
MTI Wireless Edge	AIM:MWE	£33m	38p	-	4.3%	-	-	-9.5%	7m	USD	8	/Fwd EPS grth/
Oxford Metrics	AIM:OMG	£128m	102p	24	1.8%	10.2%	30.3%	-14.3%	14m	GBP	8	/Marg grth/
Gateley	AIM:GTY	£187m	159p	11	-	2.6%	8.4%	-26.4%	-27m	GBP	8	/RoE grth/
M Winkworth	AIM:WINK	£14m	113p	11	7.5%	6.3%	-	-29.9%	3m	GBP	8	/Fwd EPS grth/
Tracsis	AIM:TRCS	£166m	570p	18	0.3%	17.8%	16.3%	-27.4%	24m	GBP	8	/RoE grth/
ULS Technology	AIM:ULS	£27m	42p	7	-	-17.4%	-	-31.9%	-5m	GBP	8	/Fwd EPS grth/
Belvoir	AIM:BLV	£38m	109p	18	-	-57.9%	153.8%	-39.4%	-7m	GBP	8	/Fwd EPS grth/
Watkin Jones	AIM:WJG	£408m	161p	9	-	6.2%	5.4%	-35.3%	77m	GBP	8	/RoE grth/
Andrews Sykes	AIM:ASY	£230m	545p	-	4.4%	-	-	0.9%	8m	GBP	7	/RoE grth/Fwd EPS grth/
Serica Energy	AIM:SQZ	£281m	105p	11	2.9%	-49.7%	72.0%	-2.4%	102m	GBP	7	/PEG/Fwd EPS grth/
Craneware	AIM:CRW	£453m	1,710p	33	1.6%	3.1%	7.1%	-11.4%	42m	USD	7	/RoE grth/Int Cov/
Focusrite	AIM:TUNE	£347m	605p	27	0.6%	4.4%	4.9%	-13.6%	15m	GBP	7	/RoE grth/Int Cov/
UniVision Engineering	AIM:UVEL	£5m	1p	-	4.0%	-	-	-6.9%	0m	GBP	7	/Fwd EPS grth/FCF/
Judges Scientific	AIM:JDG	£281m	4,495p	29	1.1%	-29.1%	18.0%	-18.0%	-5m	GBP	7	/PEG/Fwd EPS grth/
Quartix	AIM:QTX	£147m	307p	27	4.0%	1.3%	8.4%	-24.6%	6m	GBP	7	/RoE grth/Marg grth/
James Latham	AIM:LTHM	£158m	810p	-	2.2%	-	-	-15.2%	12m	GBP	7	/RoE grth/Fwd EPS grth/
Nucleus Financial	AIM:NUC	£103m	136p	35	-	-50.2%	91.4%	-22.9%	14m	GBP	7	/PEG/Fwd EPS grth/
Tandem	AIM:TND	£9m	170p	-	2.7%	-	-	-19.0%	2m	GBP	7	/RoE grth/Fwd EPS grth/
Somero Enterprises	AIM:SOM	£104m	185p	7	8.2%	-5.0%	2.7%	-31.5%	22m	USD	7	/RoE grth/Fwd EPS grth/
Central Asia Metals	AIM:CAML	£236m	137p	7	-	-20.2%	40.7%	-34.0%	-81m	USD	7	/RoE grth/Fwd EPS grth/
Churchill China	AIM:CHH	£154m	1,400p	-	-	-	-	-29.6%	15m	GBP	7	/PEG/Fwd EPS grth/
Solid State	AIM:SOLI	£41m	485p	11	2.6%	25.3%	-	-23.9%	-1m	GBP	7	/PEG/Fwd EPS grth/
Keystone Law	AIM:KEYS	£134m	430p	34	-	-16.7%	30.6%	-30.1%	2m	GBP	7	/PEG/Fwd EPS grth/
SDI	AIM:SDI	£47m	48p	13	-	23.2%	-	-37.7%	-3m	GBP	7	/PEG/Fwd EPS grth/
Prime People	AIM:PRP	£7m	57p	-	-	-	-	-46.4%	2m	GBP	7	/Fwd EPS grth/Int Cov/
Quixant	AIM:QXT	£62m	94p	7	-	26.9%	5.0%	-47.9%	15m	USD	7	/RoE grth/Marg grth/
Hunters Property	AIM:HUNT	£12m	37p	-	6.6%	-	-	-47.5%	-6m	GBP	7	/Fwd EPS grth/Int Cov/
Dart	AIM:DTG	£839m	564p	4	-	43.5%	-	-69.7%	455m	GBP	7	/RoE grth/Fwd EPS grth/

Source: S&P CapitalIQ, 11 May 2020

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