

## AlphaScreens: the quest for quality

12 April 2021

### Quality shares for the big reopening

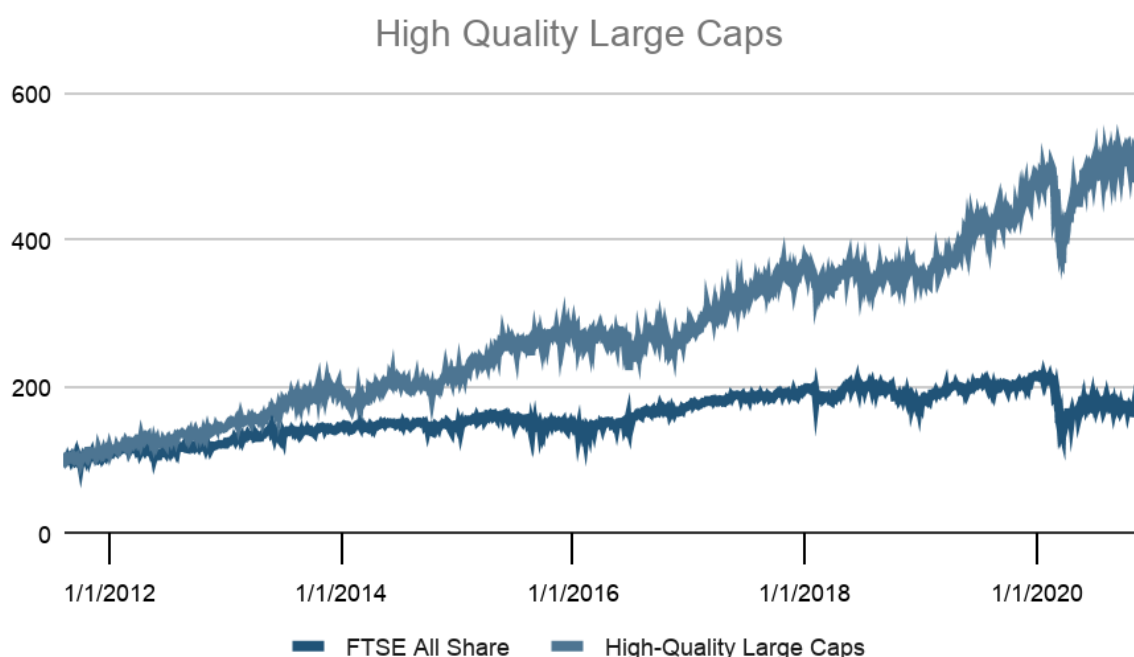
*The holy grail for buy-and-hold investors is to find a business that is capable of generating a high return on capital and sustaining it while reinvesting profits. This screen looks for shares that display these quality characteristics and can potentially deliver significant compounded returns over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

#### Comment by Alpha editor:

- Britain is starting to re-open for business in the hope that the worst of the Covid-19 nightmare has passed. The stock market is efficient at pricing in the potential rebounds in sales, so early value may have been had. However, the strategy of picking quality companies is one for the long term and some good businesses are not yet looking too expensive.
- On the main market, three companies pass 9/9 quality tests this month. **Hikma Pharmaceuticals (HIK)** has been a good share to own in the pandemic and it has long-term opportunities from the manufacture of generic medicines. The other companies to score full marks are precious metals miner **Polymetal International (POLY)** and **Spirent Communications (SPT)**, which specialises in digital connectivity.
- Other quality favourites like **Games Workshop (GAW)**, **Britvic (BVIC)** and **Diageo (DGE)** have scored highly. There are also a few housebuilders high on the list, although these are companies investors should approach with caution and discernment given the many uncertainties the sector will face in the next 18 months.

## The dream company

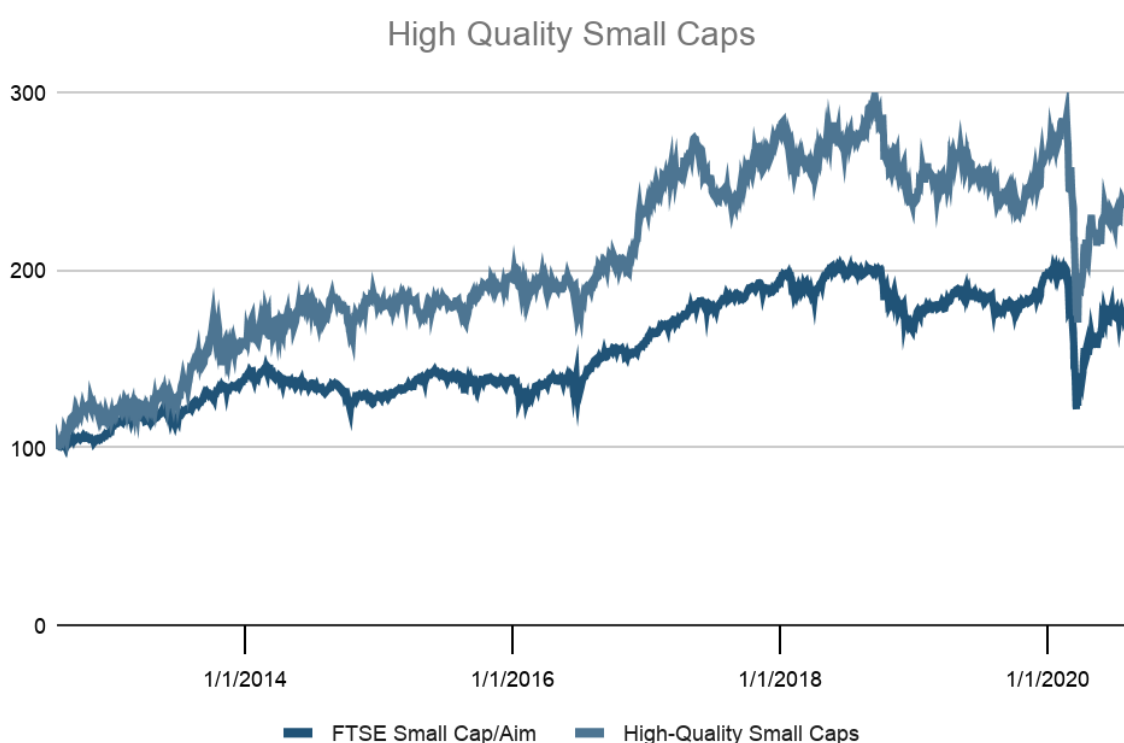
The holy grail for buy-and-hold investors is to find a business that is capable of generating high returns on its capital and is able to reinvest all its profits for decades to come, while maintaining those returns. The compound-ing effect of such an investment is what every long-term investor's dreams 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
Spirent Comms	SPT	£1,529m	250p	22	1.8%	6.9%	5.7%	-3.7%	-156m	USD	9	na
Hikma Pharmaceuticals	HIK	£5,608m	2,433p	18	1.5%	9.4%	15.7%	-9.1%	425m	USD	9	na
Polymetal International	POLY	£6,884m	1,459p	8	6.5%	4.0%	12.9%	-17.6%	1,012m	USD	9	na
KAZ Minerals	KAZ	£4,107m	869p	6	1.1%	57.9%	6.8%	23.0%	1,903m	USD	8	/RoE grth/
Diploma	DPLM	£3,413m	2,740p	34	1.1%	35.7%	10.4%	22.5%	-173m	GBP	8	/RoE grth/
Britvic	BVIC	£2,310m	865p	17	2.5%	8.5%	20.9%	5.9%	635m	GBP	8	/RoE grth/
Dunelm	DNLM	£2,782m	1,373p	23	0.9%	17.0%	23.7%	2.7%	182m	GBP	8	/RoE grth/
Games Workshop	GAW	£3,441m	10,500p	28	1.8%	61.4%	9.6%	-10.1%	-51m	GBP	8	/RoE grth/
Avast	AVST	£4,816m	468p	17	2.5%	7.4%	7.0%	-14.7%	529m	USD	8	/RoE grth/
Bellway	BWY	£4,504m	3,651p	10	2.3%	60.1%	10.0%	19.8%	-346m	GBP	7	/RoE grth/Marg grth/
Persimmon	PSN	£10,243m	3,210p	13	7.3%	10.7%	5.9%	11.8%	-872m	GBP	7	/RoE grth/Marg grth/
Redrow	RDW	£2,357m	669p	9	0.9%	99.3%	12.9%	17.5%	101m	GBP	7	/RoE grth/Marg grth/
Anglo American	AAL	£42,025m	3,083p	7	2.4%	145.8%	-22.2%	9.2%	4,382m	USD	7	/RoE grth/Fwd EPS grth/
Barratt Developments	BDEV	£8,092m	795p	12	0.9%	66.1%	9.0%	10.4%	-1,058m	GBP	7	/RoE grth/Marg grth/
Ferrexpo	FXPO	£2,144m	364p	4	8.0%	39.4%	-28.4%	7.1%	-3m	USD	7	/Fwd EPS grth/PE/
Diageo	DGE	£74,480m	3,183p	26	2.2%	2.7%	11.5%	4.8%	12,430m	GBP	7	/PEG/RoE grth/
Rotork	ROR	£3,168m	362p	28	2.8%	0.8%	8.4%	4.9%	-178m	GBP	7	/PEG/RoE grth/
Spirax-Sarco Eng.	SPX	£9,025m	12,240p	42	1.0%	12.2%	7.5%	4.4%	263m	GBP	7	/PEG/RoE grth/
Howden Joinery	HWDN	£4,540m	760p	22	1.2%	31.3%	16.5%	6.0%	150m	GBP	7	/RoE grth/Marg grth/
Intertek	ITRK	£9,771m	6,054p	31	1.7%	12.1%	11.1%	3.7%	644m	GBP	7	/RoE grth/Marg grth/
Croda International	CRDA	£8,714m	6,612p	32	1.4%	15.4%	8.7%	0.0%	801m	GBP	7	/RoE grth/Marg grth/
Mondi	MNDI	£9,262m	1,908p	16	4.2%	5.1%	14.3%	1.7%	1,598m	EUR	7	/RoE grth/Marg grth/
Rightmove	RMV	£5,369m	618p	30	0.7%	60.3%	10.7%	-2.6%	-84m	GBP	7	/RoE grth/Marg grth/
AG BARR	BAG	£570m	509p	21	0.0%	7.2%	8.8%	-0.2%	-48m	GBP	7	/RoE grth/Marg grth/
Berkeley	BKG	£5,636m	4,634p	14	2.5%	4.0%	4.1%	-2.2%	-951m	GBP	7	/RoE grth/Marg grth/
Victrex	VCT	£2,019m	2,326p	26	2.0%	10.4%	14.4%	-5.0%	-66m	GBP	7	/RoE grth/Marg grth/
Imperial Brands	IMB	£14,594m	1,542p	6	8.9%	-2.5%	1.2%	-5.9%	10,325m	GBP	7	/PEG/Fwd EPS grth/
Experian	EXPX	£24,337m	2,653p	32	1.4%	21.4%	13.8%	-7.8%	3,222m	USD	7	/RoE grth/Marg grth/
Rio Tinto	RIO	£70,656m	5,663p	7	6.0%	54.7%	-27.7%	-10.3%	565m	USD	7	/RoE grth/Fwd EPS grth/
FDM	FDM	£1,149m	1,052p	33	4.4%	6.4%	13.2%	-6.1%	-45m	GBP	7	/RoE grth/Marg grth/
Smith & Nephew	SN	£12,305m	1,400p	21	2.0%	36.7%	18.8%	-13.6%	1,410m	USD	7	/RoE grth/Marg grth/
Coats Group	COA	£837m	58p	14	1.6%	128.3%	25.9%	-14.4%	180m	USD	7	/RoE grth/Marg grth/

Source: FactSet, 12 April 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
Trealt	TET	£571m	958p	38	0.6%	33.3%	9.7%	22.8%	0m	GBP	7	/RoE grth/FCF/

Source: FactSet, 12 April 2021

Continued on next page



## 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
SDI Group	SDI	£182m	186p	27	0.0%		114.8%	28.2%	42.7%	3m	GBP	9	na
RWS	RWS	£2,591m	666p	27	1.4%		15.8%	17.3%	24.5%	38m	GBP	9	na
Cerillion	CER	£149m	505p	27	1.1%		38.9%	15.9%	18.5%	-2m	GBP	9	na
Gamma Communications	GAMA	£1,698m	1,780p	29	0.7%		15.4%	14.1%	13.4%	-35m	GBP	9	na
EMIS	EMIS	£742m	1,172p	21	2.7%		6.6%	6.5%	4.5%	-46m	GBP	9	na
Renew	RNWH	£450m	572p	12	1.5%		7.6%	12.3%	7.5%	15m	GBP	9	na
Caledonia Mining Corp.	CMCL	£123m	1,115p	5	2.7%		40.1%	28.2%	-18.0%	-13m	USD	9	na
Pan African Resources	PAF	£337m	17p	4	3.9%		90.3%	21.8%	-29.3%	62m	USD	9	na
Best of the Best	BOTB	£301m	3,200p	23	0.1%		234.4%	14.3%	124.6%	-11m	GBP	8	/Int Cov/
Sylvania Platinum	SLP	£324m	119p	3	1.3%		162.6%	25.0%	32.2%	-49m	USD	8	/PE/
Kape Technologies	KAPE	£656m	293p	16	0.0%		62.2%	22.7%	49.6%	-6m	USD	8	/Marg grth/
K3 Capital	K3C	£213m	310p	20	2.2%		11.9%	17.4%	27.0%	-8m	GBP	8	/RoE grth/
Franchise Brands	FRAN	£132m	138p	25	0.8%		20.1%	23.4%	39.6%	-5m	GBP	8	/RoE grth/
Atalaya Mining	ATYM	£459m	332p	8	0.0%		106.4%	21.4%	26.2%	-29m	EUR	8	/RoE grth/
Watkin Jones	WJG	£589m	230p	14	3.2%		6.2%	11.3%	23.4%	40m	GBP	8	/RoE grth/
Tracsis	TRCS	£208m	710p	22	0.3%		9.0%	34.5%	21.2%	-19m	GBP	8	/RoE grth/
Fintel	FNTL	£203m	210p	16	1.4%		10.6%	8.2%	18.0%	25m	GBP	8	/RoE grth/
Anglo Asian Mining	AAZ	£158m	138p	8	5.1%		2.9%	21.0%	7.8%	-21m	USD	8	/Marg grth/
Alliance Pharma	APH	£505m	95p	16	1.7%		9.2%	13.5%	7.8%	113m	GBP	8	/RoE grth/
Sureserve Group	SUR	£125m	78p	12	1.3%		52.4%	11.1%	21.9%	-3m	GBP	8	/Marg grth/
Trans-Siberian Gold	TSG	£100m	115p	6	6.9%		127.9%	15.0%	8.5%	7m	USD	8	/Marg grth/
MP Evans	MPE	£391m	718p	18	3.1%		38.6%	13.6%	6.0%	57m	USD	8	/Marg grth/
Michelmersh Brick	MBH	£136m	145p	18	1.7%		59.6%	10.1%	7.4%	0m	GBP	8	/RoE grth/
Springfield Properties	SPR	£147m	145p	9	2.3%		50.4%	28.5%	8.6%	37m	GBP	8	/RoE grth/
Science	SAG	£128m	310p	16	1.9%		3.6%	3.1%	6.9%	-10m	GBP	8	/PEG/
CareTech	CTH	£610m	538p	11	2.4%		12.1%	11.4%	2.7%	352m	GBP	8	/Int Cov/
Learning Technologies	LTG	£1,219m	165p	32	0.5%		15.7%	16.4%	-2.8%	-61m	GBP	8	/PEG/
ASOS	ASC	£5,351m	5,360p	35	0.0%		17.1%	8.3%	2.8%	238m	GBP	8	/RoE grth/
Team17	TM17	£999m	760p	38	-		6.5%	10.3%	-9.5%	-60m	GBP	8	/PEG/
Frontier Developments	FDEV	£1,143m	2,905p	40	0.0%		15.9%	69.2%	-10.5%	-12m	GBP	8	/PEG/
boohoo	BOO	£4,341m	344p	31	0.0%		46.3%	26.2%	-5.0%	-331m	GBP	8	/Marg grth/
Enwell Energy	ENW	£69m	21p	11	0.0%		90.9%	131.6%	-15.4%	-44m	USD	8	/RoE grth/
Alumasc	ALU	£71m	197p	9	2.7%		150.9%	8.3%	72.8%	6m	GBP	7	/RoE grth/Marg grth/
Eleco	ELCO	£96m	115p	24	0.3%		-3.1%	8.5%	42.9%	-4m	GBP	7	/PEG/Fwd EPS grth/
Water Intelligence	WATR	£118m	760p	39	0.0%		100.8%	8.6%	46.2%	-1m	USD	7	/RoE grth/Marg grth/
Dewhurst	DWHT	£92m	1,725p	-	0.8%		-	-	35.8%	-15m	GBP	7	/PEG/Fwd EPS grth/
Tristel	TSTL	£320m	680p	51	1.0%		-3.6%	14.7%	22.5%	-1m	GBP	7	/PEG/Fwd EPS grth/
Anpario	ANP	£144m	620p	28	1.5%		3.7%	2.9%	22.8%	-16m	GBP	7	/PEG/RoE grth/
Begbies Traynor	BEG	£181m	120p	14	2.4%		12.3%	40.1%	26.8%	7m	GBP	7	/RoE grth/PE/
Amiad Water Systems	AFS	£106m	350p	41	0.0%		19.9%	19.8%	37.3%	-2m	USD	7	/Marg grth/Int Cov/
Alpha Fin. Mkts Consulting	AFM	£296m	278p	18	0.8%		2.6%	9.7%	19.8%	-30m	GBP	7	/PEG/Marg grth/
Tandem	TND	£33m	640p	-	1.3%		-	-	23.1%	-4m	GBP	7	/PEG/Fwd EPS grth/
Solid State	SOLI	£77m	900p	16	1.4%		2.5%	15.4%	29.5%	-2m	GBP	7	/PEG/Marg grth/
SigmaRoc	SRC	£224m	80p	18	0.0%		6.2%	9.7%	22.9%	47m	GBP	7	/PEG/Marg grth/
Amino Technologies	AMO	£126m	165p	17	1.1%		30.4%	13.7%	24.1%	-5m	USD	7	/RoE grth/Marg grth/
Wynnstay	WYN	£93m	465p	13	3.1%		22.6%	4.7%	34.8%	-8m	GBP	7	/RoE grth/Marg grth/
Netcall	NET	£95m	64p	43	0.4%		29.9%	22.2%	21.9%	-5m	GBP	7	/Marg grth/Int Cov/
CVS	CVSG	£1,290m	1,824p	28	0.3%		47.3%	6.6%	23.2%	143m	GBP	7	/RoE grth/Int Cov/
Dewhurst Class A	DWHA	£92m	725p	-	1.8%		-	-	16.9%	-15m	GBP	7	/PEG/Fwd EPS grth/
Nichols	NICL	£515m	1,395p	31	2.6%		62.4%	35.0%	14.8%	-44m	GBP	7	/RoE grth/Marg grth/
Focusrite	TUNE	£638m	1,088p	31	0.4%		18.4%	-17.3%	7.7%	-1m	GBP	7	/RoE grth/Fwd EPS grth/
Central Asia Metals	CAML	£485m	276p	9	5.1%		82.7%	-5.6%	0.9%	24m	USD	7	/RoE grth/Fwd EPS grth/
Volex	VLX	£572m	365p	20	0.9%		11.7%	18.7%	13.6%	-16m	USD	7	/PEG/Marg grth/
Advanced Med. Solutions	AMS	£545m	253p	26	0.7%		68.5%	17.5%	6.3%	-43m	GBP	7	/RoE grth/Marg grth/
James Halstead	JHD	£1,057m	508p	28	3.2%		5.8%	6.3%	3.3%	-66m	GBP	7	/RoE grth/Marg grth/
Breedon	BREE	£1,583m	94p	20	0.0%		56.5%	30.1%	8.6%	318m	GBP	7	/RoE grth/Marg grth/
Crimson Tide	TIDE	£15m	3p	-	-		-	0.0%	0.0%	-1m	GBP	7	/PEG/Fwd EPS grth/
Character	CCT	£99m	465p	6	1.1%		113.9%	141.0%	9.4%	-17m	GBP	7	/RoE grth/Marg grth/
Cohort	CHRT	£254m	620p	16	1.7%		-8.5%	14.9%	3.3%	13m	GBP	7	/PEG/Fwd EPS grth/
Keywords Studios	KWS	£2,083m	2,800p	42	0.0%		22.5%	13.3%	0.3%	-66m	EUR	7	/PEG/RoE grth/
Judges Scientific	JDS	£400m	6,340p	32	0.9%		9.9%	10.7%	-1.9%	11m	GBP	7	/PEG/RoE grth/
Mattioli Woods	MTW	£194m	690p	14	2.9%		-12.3%	17.8%	-8.0%	-15m	GBP	7	/PEG/Fwd EPS grth/
Gooch & Housego	GHH	£300m	1,200p	31	1.0%		14.6%	20.0%	0.4%	15m	GBP	7	/RoE grth/Marg grth/
Venture Life	VLG	£109m	87p	25	0.0%		-18.3%	5.5%	-10.3%	-31m	GBP	7	/PEG/Fwd EPS grth/
MTI Wireless Edge	MWE	£68m	77p	-	1.9%		-	-	-12.0%	-7m	USD	7	/PEG/Fwd EPS grth/

Source: FactSet, 12 April 2021

© The Financial Times Limited 2021. 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](http://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.