



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.

- Large-cap shares getting full marks on our quality screen this month include **Diageo (DGE)**, **Burberry (BRBY)**, **RELX (REL)** and **Spirax-Sarco (SPX)**.
- When quality companies have been on a good run, they can get very expensive on trailing measures, but that may be because investors believe in the business. This seems to be the case with **Avon Rubber (AVON)**, which makes specialist security and military equipment. It’s too expensive on our trailing PE test, but the forecast for earnings is up. It also fails the criteria of having to grow return on equity over the past two years. That said, its ROE is consistently high in absolute terms.
- On Aim, trends in quality tests are a guide to sense-check a potential investment. Last month we questioned the timing of getting back into the cheap shares of vehicle replacement specialist **Redde (REDD)**, which had full marks on the screen. This month it fails the forecast EPS growth test, suggesting there need to be more signs of a turnaround to seriously consider buying the shares. *JN*

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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
Sirius Real Estate	LSE:SRE	£874m	85p	20	3.5%	5.2%	12.6%	21.0%	-278m	EUR	9	na
Games Workshop	LSE:GAW	£1,879m	5,750p	25	2.2%	13.1%	4.4%	21.8%	29m	GBP	9	na
Polypipe	LSE:PLP	£1,031m	518p	18	2.2%	2.2%	7.6%	32.6%	-192m	GBP	9	na
Kainos	LSE:KNOS	£763m	628p	34	1.5%	11.7%	12.2%	44.4%	37m	GBP	9	na
FDM	LSE:FDM	£1,036m	949p	24	3.4%	5.2%	6.0%	21.7%	4m	GBP	9	na
Diploma	LSE:DPLM	£2,175m	1,922p	27	1.5%	10.3%	3.7%	16.7%	-15m	GBP	9	na
Spirax-Sarco Engineering	LSE:SPX	£6,515m	8,850p	33	1.1%	4.0%	6.8%	8.9%	-433m	GBP	9	na
PayPoint	LSE:PAY	£662m	980p	15	8.6%	2.7%	4.1%	6.8%	21m	GBP	9	na
RELX	LSE:REL	£35,314m	1,829p	19	2.3%	9.8%	6.6%	-7.1%	-6,757m	GBP	9	na
Diageo	LSE:DGE	£72,625m	3,101p	22	2.2%	7.6%	6.4%	-10.4%	-11,639m	GBP	9	na
Moneysupermarket.com	LSE:MONY	£1,759m	328p	17	3.4%	5.4%	6.7%	-12.4%	-13m	GBP	9	na
Burberry	LSE:BRBY	£8,542m	2,100p	23	2.0%	6.9%	10.8%	-6.7%	-416m	GBP	9	na
Rightmove	LSE:RMV	£5,524m	630p	30	1.1%	9.0%	8.6%	15.9%	42m	GBP	8	/RoE grth/
Safestore	LSE:SAFE	£1,614m	767p	26	2.1%	5.7%	6.5%	15.3%	-426m	GBP	8	/RoE grth/
Domino's Pizza	LSE:DOM	£1,412m	307p	20	3.1%	-6.2%	8.3%	26.7%	-250m	GBP	8	/Fwd EPS grth/
CountrySide Properties	LSE:CSP	£1,945m	435p	10	3.7%	9.6%	7.2%	40.5%	78m	GBP	8	/FCF/
SEGRO	LSE:SGRO	£9,627m	878p	34	2.1%	10.9%	8.2%	11.2%	-1,897m	GBP	8	/RoE grth/
Taylor Wimpey	LSE:TW	£5,792m	177p	9	10.4%	-4.3%	0.8%	17.9%	366m	GBP	8	/Fwd EPS grth/
Avon Rubber	LSE:AVON	£596m	1,952p	21	1.1%	2.0%	13.3%	16.2%	48m	GBP	8	/RoE grth/
Barratt Developments	LSE:BDEV	£6,767m	669p	9	6.9%	-0.1%	0.3%	9.1%	758m	GBP	8	/Fwd EPS grth/
Vp	LSE:VP	£341m	860p	8	3.5%	6.3%	4.9%	10.3%	-262m	GBP	8	/RoE grth/
Ashtead	LSE:AHT	£10,778m	2,376p	11	1.7%	17.4%	8.6%	3.9%	-5,161m	GBP	8	/RoE grth/
Wizz Air	LSE:WIZZ	£2,880m	3,955p	15	-	19.2%	18.7%	9.6%	-385m	EUR	8	/FCF/
Polymetal International	LSE:POLY	£5,621m	1,196p	12	3.3%	14.6%	21.2%	3.0%	-1,736m	USD	8	/RoE grth/
HomeServe	LSE:HSV	£4,173m	1,247p	30	1.7%	9.6%	10.6%	8.0%	-451m	GBP	8	/RoE grth/
The Sage Group	LSE:SGE	£7,898m	725p	25	2.3%	4.6%	7.4%	2.0%	-394m	GBP	8	/RoE grth/
Rio Tinto	LSE:RIO	£71,114m	4,217p	9	6.1%	21.8%	-12.9%	-0.5%	-4,544m	USD	8	/Fwd EPS grth/
MJ Gleeson	LSE:GLE	£453m	820p	12	4.2%	9.4%	9.5%	-1.0%	30m	GBP	8	/FCF/
Intertek	LSE:ITRK	£8,800m	5,468p	25	1.8%	6.1%	6.1%	-2.6%	-1,082m	GBP	8	/RoE grth/
Experian	LSE:EXPN	£22,457m	2,472p	29	1.4%	7.4%	10.5%	-6.0%	-4,212m	USD	8	/RoE grth/
The Unilever Group	LSE:ULVR	£127,463m	4,551p	-	-	6.9%	8.7%	-12.3%	-24,161m	EUR	8	/PE/
Smith & Nephew	LSE:SN	£14,641m	1,677p	21	1.6%	0.1%	7.4%	-15.2%	-2,042m	USD	8	/RoE grth/
Photo-Me International	LSE:PHTM	£325m	86p	9	9.8%	6.5%	3.6%	-12.6%	15m	GBP	8	/RoE grth/
Persimmon	LSE:PSN	£7,988m	2,525p	9	9.3%	-5.3%	-0.1%	32.1%	824m	GBP	7	/PEG/Fwd EPS grth/
Ibstock	LSE:IBST	£1,094m	267p	14	3.6%	-4.2%	7.0%	22.9%	-99m	GBP	7	/RoE grth/Fwd EPS grth/
On the Beach	LSE:OTB	£590m	450p	18	0.7%	19.8%	12.7%	22.5%	55m	GBP	7	/RoE grth/FCF/
Redrow	LSE:RDW	£2,336m	681p	7	4.5%	2.6%	-2.4%	14.3%	124m	GBP	7	/RoE grth/Fwd EPS grth/
Victrex	LSE:VCT	£2,054m	2,380p	21	2.5%	7.5%	3.9%	10.9%	73m	GBP	7	/RoE grth/Int Cov/
Howden Joinery	LSE:HWDN	£3,821m	638p	19	1.8%	6.4%	7.5%	15.8%	217m	GBP	7	/RoE grth/Int Cov/
Anglo American	LSE:AAL	£25,528m	2,068p	10	3.7%	14.9%	-8.3%	11.9%	-3,225m	USD	7	/RoE grth/Fwd EPS grth/
Bellway	LSE:BWY	£4,179m	3,394p	8	4.4%	-5.7%	2.8%	12.1%	186m	GBP	7	/RoE grth/Fwd EPS grth/
QinetiQ	LSE:QQ	£1,910m	340p	17	1.9%	-1.8%	9.0%	18.2%	173m	GBP	7	/RoE grth/Fwd EPS grth/
NEXT	LSE:NXT	£8,783m	6,874p	15	2.4%	5.8%	4.4%	12.1%	-2,576m	GBP	7	/RoE grth/Marg grth/
IMI	LSE:IMI	£3,085m	1,139p	16	3.6%	-2.8%	5.8%	11.7%	-513m	GBP	7	/Marg grth/Fwd EPS grth/
Forterra	LSE:FORT	£584m	294p	11	3.6%	-1.4%	5.5%	5.9%	-50m	GBP	7	/RoE grth/Fwd EPS grth/
Halma	LSE:HLMA	£8,036m	2,119p	35	0.7%	10.4%	6.4%	5.0%	-310m	GBP	7	/RoE grth/PE/
Croda International	LSE:CRDA	£6,270m	4,906p	25	1.8%	-2.2%	6.5%	2.0%	-604m	GBP	7	/RoE grth/Fwd EPS grth/
Mondi	LSE:MNDI	£8,064m	1,664p	12	4.1%	-9.2%	-6.0%	3.0%	-2,341m	EUR	7	/PEG/Fwd EPS grth/
GlaxoSmithKline	LSE:GSK	£85,596m	1,729p	14	4.6%	2.3%	-1.0%	0.8%	-28,658m	GBP	7	/RoE grth/Fwd EPS grth/
NMC Health	LSE:NMC	£5,285m	2,530p	19	0.7%	27.9%	22.7%	-8.5%	-2,228m	USD	7	/RoE grth/Int Cov/
Aptitude Software	LSE:APTD	£338m	602p	41	1.3%	-46.7%	20.8%	-11.3%	67m	GBP	7	/PEG/Fwd EPS grth/

Source: S&P CapitalIQ, 9 December 2019

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
Devro	LSE:DVO	£283m	170p	10	5.3%	9.9%	4.7%	-10.4%	-149m	GBP	9	na
Vp	LSE:VP	£341m	860p	8	3.5%	6.3%	4.9%	10.3%	-262m	GBP	8	/RoE grth/
Treant	LSE:TET	£275m	460p	25	1.2%	6.7%	7.2%	9.5%	16m	GBP	8	/RoE grth/
MJ Gleeson	LSE:GLE	£453m	820p	12	4.2%	9.4%	9.5%	-1.0%	30m	GBP	8	/FCF/
Photo-Me International	LSE:PHTM	£325m	86p	9	9.8%	6.5%	3.6%	-12.6%	15m	GBP	8	/RoE grth/
On the Beach	LSE:OTB	£590m	450p	18	0.7%	19.8%	12.7%	22.5%	55m	GBP	7	/RoE grth/FCF/
Avon Rubber	LSE:AVON	£596m	1,952p	21	1.1%	2.0%	13.3%	16.2%	48m	GBP	7	/RoE grth/PE/
Forterra	LSE:FORT	£584m	294p	11	3.6%	-1.4%	5.5%	5.9%	-50m	GBP	7	/RoE grth/Fwd EPS grth/
Aptitude Software	LSE:APTD	£338m	602p	41	1.3%	-46.7%	20.8%	-11.3%	67m	GBP	7	/PEG/Fwd EPS grth/

Source: S&P CapitalIQ, 9 December 2019

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
Churchill China	AIM:CHH	£200m	1,820p	24	1.6%	9.6%	14.6%	17.8%	13m	GBP	9	na
Sigma Capital	AIM:SGM	£90m	101p	8	2.0%	0.6%	10.7%	-0.5%	13m	GBP	9	na
Gamma Communications	AIM:GAMA	£1,156m	1,220p	29	0.8%	31.5%	7.7%	4.7%	36m	GBP	9	na
Judges Scientific	AIM:JDG	£314m	5,040p	24	0.8%	14.2%	1.1%	46.3%	5m	GBP	8	/PEG/
The Property Franchise Group	AIM:TPFG	£49m	192p	13	4.4%	9.8%	4.3%	17.1%	3m	GBP	8	/RoE grth/
Cerillion	AIM:CER	£62m	211p	17	2.3%	61.5%	-0.2%	31.9%	5m	GBP	8	/Fwd EPS grth/
Dart	AIM:DTG	£2,275m	1,528p	15	0.7%	1.4%	5.8%	107.2%	455m	GBP	8	/RoE grth/
Hotel Chocolat	AIM:HOC	£487m	422p	39	0.4%	12.8%	14.2%	13.9%	6m	GBP	8	/RoE grth/
Belvoir	AIM:BLV	£46m	125p	10	5.8%	6.4%	10.1%	4.2%	-10m	GBP	8	/FCF/
Gateley	AIM:GTLY	£197m	171p	12	4.7%	5.6%	7.1%	7.2%	-3m	GBP	8	/RoE grth/
James Halstead	AIM:JHD	£1,061m	510p	27	2.7%	4.4%	4.0%	0.4%	68m	GBP	8	/RoE grth/
dotdigital	AIM:DOTD	£272m	92p	23	0.7%	20.6%	7.9%	-1.1%	19m	GBP	8	/Int Cov/
Johnson Service	AIM:JSG	£681m	185p	18	1.7%	10.6%	3.8%	4.4%	-131m	GBP	8	/RoE grth/
Oxford Metrics	AIM:OMG	£120m	96p	22	1.9%	11.7%	31.0%	3.8%	14m	GBP	8	/Marg grth/
Elecosoft	AIM:ELCO	£63m	77p	18	0.9%	5.6%	15.0%	1.3%	-3m	GBP	8	/RoE grth/
Anpario	AIM:ANP	£77m	330p	17	2.2%	5.6%	6.5%	0.0%	13m	GBP	8	/Int Cov/
Nichols	AIM:NICL	£587m	1,590p	21	2.4%	4.2%	5.0%	-6.5%	30m	GBP	8	/RoE grth/
Bioventix	AIM:BVXP	£171m	3,325p	27	3.6%	11.6%	8.6%	-14.4%	7m	GBP	8	/Int Cov/
boohoo	AIM:BOO	£3,217m	276p	44	-	35.3%	16.5%	-2.4%	190m	GBP	8	/PE/
Tribal	AIM:TRB	£114m	58p	13	1.9%	1.6%	8.9%	-6.9%	2m	GBP	8	/Marg grth/
Redde	AIM:REDD	£330m	107p	8	10.8%	6.2%	-0.5%	-10.6%	-35m	GBP	8	/Fwd EPS grth/
K3 Capital	AIM:K3C	£77m	182p	13	4.2%	50.6%	0.5%	22.6%	6m	GBP	7	/RoE grth/Int Cov/
Concurrent Technologies	AIM:CNC	£54m	74p	14	3.1%	29.9%	-17.1%	18.4%	10m	GBP	7	/Fwd EPS grth/Int Cov/
M Winkworth	AIM:WINK	£17m	131p	13	5.8%	4.9%	6.0%	15.9%	3m	GBP	7	/Marg grth/Int Cov/
Arcotech	AIM:ARC	£26m	194p	24	1.0%	11.4%	10.1%	12.2%	4m	GBP	7	/FCF/Int Cov/
Central Asia Metals	AIM:CAML	£358m	209p	8	7.0%	-4.0%	18.7%	11.0%	-101m	USD	7	/RoE grth/Fwd EPS grth/
Best of the Best	AIM:BOTB	£29m	306p	18	0.7%	-3.5%	11.6%	13.3%	3m	GBP	7	/Fwd EPS grth/Int Cov/
Watkin Jones	AIM:WJG	£615m	241p	15	3.2%	1.9%	10.4%	9.0%	18m	GBP	7	/RoE grth/FCF/
Somero Enterprises	AIM:SOM	£114m	203p	8	7.1%	-12.8%	0.8%	1.8%	13m	USD	7	/RoE grth/Fwd EPS grth/
Shoe Zone	AIM:SHOE	£73m	146p	8	7.9%	-7.5%	0.4%	13.2%	3m	GBP	7	/Fwd EPS grth/Int Cov/
Prime People	AIM:PRP	£11m	94p	-	5.6%	-	-	6.9%	2m	GBP	7	/Fwd EPS grth/Int Cov/
Quartix	AIM:QTX	£160m	334p	28	3.7%	-19.5%	4.8%	-0.3%	5m	GBP	7	/PEG/Fwd EPS grth/
Fevertree Drinks	AIM:FEVR	£2,500m	2,153p	37	0.7%	3.9%	10.7%	-8.3%	102m	GBP	7	/PEG/RoE grth/
ULS Technology	AIM:ULS	£30m	46p	8	5.4%	-13.0%	-23.2%	-14.8%	-5m	GBP	7	/PEG/Fwd EPS grth/
AB Dynamics	AIM:ABDP	£488m	2,175p	33	0.2%	19.2%	16.4%	-18.5%	36m	GBP	7	/RoE grth/Int Cov/

Source: S&P CapitalIQ, 9 December 2019

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