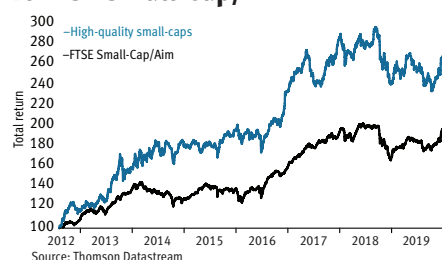




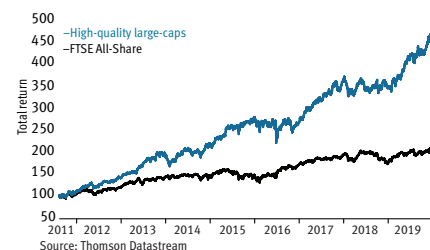
AlphaScreens: the quest for Quality

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.

- Investors' gold rush is reflected in another of our Alpha screens this week, with gold mining stocks **Polymetal International (POLY)** and **Trans-Siberian Gold (TSG)** topping our FTSE All-Share and Aim quality screens, respectively.
- The other main market stock to get full marks is consumer goods giant **Unilever (ULVR)**, which although not cheap has once again demonstrated its defensive characteristics in the pandemic.
- All-Share companies that only fail one test include IT company **Kainos (KNOS)**, which although richly valued cheered investors recently with a special dividend. It fails our return on equity growth test, which is also the only test credit data specialist **Experian (EXPN)** fails.
- Steel and mining business **Evrz (EVR)** also comes up short against the ROE test. In any case, its high debt and high dividend model makes this company conspicuous in our quality screen.

Analyst: Algy Hall
algy.hall@ft.com

Alpha Production Editor: Sameera Hai Baig

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	POLY	£9,493m	2,012p	12	2.5%	54.7%	17.7%	22.4%	1,141m	USD	9	na
Unilever	ULVR	£53,040m	4,539p	20	3.3%	2.2%	5.7%	11.2%	20,770m	EUR	9	na
Kainos	KNOS	£1,389m	1,136p	54	0.3%	24.5%	5.4%	49.5%	-37m	GBP	8	/RoE grth/
Evrz	EVR	£4,521m	310p	7	14.9%	109.2%	26.4%	14.9%	2,984m	USD	8	/RoE grth/
Experian	EXPN	£25,349m	2,766p	36	1.3%	22.5%	13.2%	6.3%	3,323m	USD	8	/RoE grth/
FDM Group	FDM	£1,133m	1,038p	33	1.8%	-23.5%	10.0%	34.5%	-36m	GBP	7	/PEG/Fwd EPS grth/
XP Power	XPP	£854m	4,350p	27	0.9%	4.0%	13.6%	48.0%	41m	GBP	7	/PEG/RoE grth/
Next	NXT	£7,597m	5,714p	20	1.0%	-59.4%	99.2%	17.0%	2,400m	GBP	7	/PEG/Fwd EPS grth/
HomeServe	HSV	£4,586m	1,365p	31	1.7%	2.9%	14.9%	19.0%	509m	GBP	7	/PEG/RoE grth/
Mondi	MNDI	£7,215m	1,486p	13	3.0%	-26.9%	13.9%	9.2%	1,863m	EUR	7	/PEG/Fwd EPS grth/
Diploma	DPLM	£2,200m	1,943p	32	1.5%	-13.2%	11.6%	9.8%	65m	GBP	7	/PEG/Fwd EPS grth/
Marshalls	MSLH	£1,307m	654p	32	0.7%	-49.8%	65.5%	8.9%	60m	GBP	7	/PEG/Fwd EPS grth/
Trealt	TET	£317m	534p	27	1.1%	12.9%	7.5%	5.5%	-6m	GBP	7	/RoE grth/FCF/
Hollywood Bowl	BOWL	£218m	139p	15	5.4%	-76.7%	211.9%	-1.8%	191m	GBP	7	/PEG/Fwd EPS grth/
Moneysupermarket.com	MONY	£1,654m	308p	20	3.8%	-23.4%	22.1%	-5.7%	-8m	GBP	7	/PEG/Fwd EPS grth/
Diageo	DGE	£60,003m	2,567p	22	2.7%	4.0%	12.4%	-7.6%	13,857m	GBP	7	/PEG/RoE grth/
PayPoint	PAY	£435m	636p	12	9.1%	-22.2%	14.3%	-9.5%	-23m	GBP	7	/PEG/Fwd EPS grth/
Taylor Wimpey	TW	£4,355m	119p	12	0.0%	-64.3%	73.0%	-21.3%	-473m	GBP	7	/PEG/Fwd EPS grth/

Source: Factset, 10 August 2020

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
Trealt	TET	£317m	534p	27	1.1%	12.9%	7.5%	5.5%	-6m	GBP	7	/RoE grth/FCF/
Aptitude Software	APTD	£242m	430p	35	1.3%	16.6%	-7.4%	2.4%	-31m	GBP	7	/RoE grth/Fwd EPS grth/
Hollywood Bowl	BOWL	£218m	139p	15	5.4%	-76.7%	211.9%	-1.8%	191m	GBP	7	/PEG/Fwd EPS grth/

Source: Factset, 10 August 2020

Continued on the next page

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
Trans-Siberian Gold	TSG	£93m	107p	6	3.4%	94.2%	44.3%	26.6%	12m	USD	9	na
SDI	SDI	£61m	63p	17	0.0%	44.5%	10.8%	31.3%	7m	GBP	9	na
Cello Health	CLL	£172m	161p	17	1.3%	104.9%	7.9%	37.6%	4m	GBP	9	na
Churchill China	CHH	£105m	960p	10	1.1%	8.7%	13.1%	-31.4%	-15m	GBP	9	na
boohoo	BOO	£3,516m	287p	34	0.0%	26.2%	31.6%	-17.4%	-225m	GBP	9	na
Caledonia Mining Corp	CMCL	£207m	1,780p	7	0.7%	34.6%	67.5%	75.8%	-10m	USD	8	/PE/
Anglo Asian Mining	AAZ	£185m	162p	8	4.0%	39.9%	-2.9%	35.1%	-9m	USD	8	/Fwd EPS grth/
EKF Diagnostics	EKF	£255m	56p	24	1.8%	172.4%	-50.1%	45.1%	-10m	GBP	8	/Fwd EPS grth/
Gamma Communications	GAMA	£1,598m	1,680p	33	0.6%	18.2%	11.5%	34.4%	-41m	GBP	8	/RoE grth/
Arcontech	ARC	£24m	185p	21	1.1%	8.6%	12.8%	7.6%	-4m	GBP	8	/Marg grth/
Venture Life	VLG	£68m	81p	14	0.0%	157.4%	20.2%	24.6%	-4m	GBP	8	/Marg grth/
Water Intelligence	WATR	£47m	319p	23	0.0%	49.8%	6.4%	17.1%	-1m	USD	8	/RoE grth/
Alpha Financial Mkts Consulting	AFM	£207m	196p	14	1.1%	0.7%	10.0%	7.4%	-18m	GBP	8	/PEG/
Flowtech Fluidpower	FLO	£44m	72p	9	3.0%	0.0%	62.3%	-1.4%	25m	GBP	8	/RoE grth/
Begbies Traynor	BEG	£118m	93p	14	3.0%	5.0%	32.0%	-14.7%	10m	GBP	8	/Marg grth/
Oxford Metrics	OMG	£102m	82p	14	2.2%	33.3%	35.8%	-19.7%	-9m	GBP	8	/Marg grth/
Best of the Best	BOTB	£150m	1,600p	23	0.2%	86.4%	-	174.7%	-5m	GBP	7	/Fwd EPS grth/Int Cov/
ULS Technology	ULS	£40m	62p	27	2.0%	-81.3%	444.4%	47.7%	5m	GBP	7	/PEG/Fwd EPS grth/
Team17	TM17	£870m	662p	42	-	10.6%	9.6%	24.9%	-40m	GBP	7	/PEG/RoE grth/
YouGov	YOU	£916m	850p	47	0.5%	14.0%	13.5%	30.8%	-17m	GBP	7	/PEG/Marg grth/
Highland Gold Mining	HGM	£1,073m	295p	-	4.6%	-	-	18.0%	189m	USD	7	/PEG/Fwd EPS grth/
Crimson Tide	TIDE	£14m	3p	31	0.0%	25.0%	0.0%	27.1%	0m	GBP	7	/RoE grth/Marg grth/
Serica Energy	SOZ	£316m	118p	10	2.5%	-64.3%	83.5%	12.4%	-101m	GBP	7	/PEG/Fwd EPS grth/
Vianet	VNET	£26m	91p	-	6.3%	-	-	15.9%	1m	GBP	7	/PEG/Fwd EPS grth/
Focusrite	TUNE	£413m	710p	28	0.5%	29.7%	-8.3%	17.4%	20m	GBP	7	/RoE grth/Fwd EPS grth/
Judges Scientific	JDG	£316m	5,040p	29	1.0%	-29.9%	22.6%	12.1%	5m	GBP	7	/PEG/Fwd EPS grth/
Steppe Cement	STCM	£51m	24p	9	12.8%	-43.5%	53.1%	11.9%	6m	USD	7	/PEG/Fwd EPS grth/
Solid State	SOLI	£52m	608p	-	2.1%	-	-	25.4%	-2m	GBP	7	/PEG/Fwd EPS grth/
Keystone Law	KEYS	£158m	505p	59	0.6%	-64.0%	113.0%	17.4%	-2m	GBP	7	/PEG/Fwd EPS grth/
iomart	IOM	£388m	356p	21	1.8%	1.2%	5.5%	12.3%	58m	GBP	7	/PEG/RoE grth/
Cohort	CHRT	£274m	670p	19	1.5%	-6.6%	9.8%	18.8%	12m	GBP	7	/PEG/Fwd EPS grth/
CareTech	CTH	£506m	447p	10	2.7%	8.7%	15.3%	9.6%	373m	GBP	7	/RoE grth/Int Cov/
Bioventix	BVXP	£221m	4,250p	31	3.0%	11.3%	9.6%	1.6%	-6m	GBP	7	/Marg grth/Int Cov/
Cerillion	CER	£82m	277p	24	1.8%	-8.0%	13.5%	2.2%	1m	GBP	7	/PEG/Fwd EPS grth/
EMIS	EMIS	£665m	1,050p	21	3.0%	-7.6%	8.7%	1.7%	-27m	GBP	7	/PEG/Fwd EPS grth/
Eckoh	ECK	£160m	63p	37	1.0%	-3.2%	-	9.6%	-11m	GBP	7	/PEG/Fwd EPS grth/
Anpario	ANP	£88m	380p	20	2.1%	-3.3%	6.4%	2.7%	-14m	GBP	7	/PEG/Fwd EPS grth/
Mattioli Woods	MTW	£189m	703p	17	3.0%	62.3%	-18.6%	1.1%	-17m	GBP	7	/Marg grth/Fwd EPS grth/
Mission Group	TMG	£56m	61p	13	3.6%	-95.6%	1825.0%	11.9%	14m	GBP	7	/PEG/Fwd EPS grth/
Michelmersh Brick	MBH	£89m	95p	-	3.5%	-	-	-1.6%	8m	GBP	7	/PEG/Fwd EPS grth/
Enwell Energy	ENW	£47m	15p	-	0.0%	-	-	-9.5%	-46m	USD	7	/PEG/Fwd EPS grth/
Amino Technologies	AMO	£104m	137p	12	1.2%	24.3%	14.0%	1.5%	-1m	USD	7	/RoE grth/Marg grth/
Volex	VLX	£221m	145p	12	2.1%	-20.0%	22.2%	3.9%	-17m	USD	7	/PEG/Fwd EPS grth/
Franchise Brands	FRAN	£86m	90p	20	1.1%	-7.7%	22.8%	-8.2%	-3m	GBP	7	/PEG/Fwd EPS grth/
MTI Wireless Edge	MWE	£29m	33p	-	4.2%	-	-	-13.2%	-7m	USD	7	/PEG/Fwd EPS grth/
Billington	BILN	£39m	300p	-	4.3%	-	-	-10.4%	-16m	GBP	7	/PEG/Fwd EPS grth/
Midwich	MIDW	£350m	395p	14	4.0%	-9.5%	19.3%	-14.2%	70m	GBP	7	/PEG/Fwd EPS grth/

Source: Factset, 10 August 2020

© The Financial Times Limited 2020. 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. Many of the charts in the magazine are based on material supplied by Thomson Datastream 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.