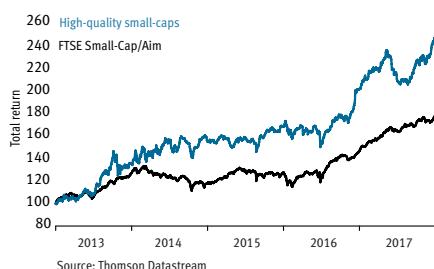




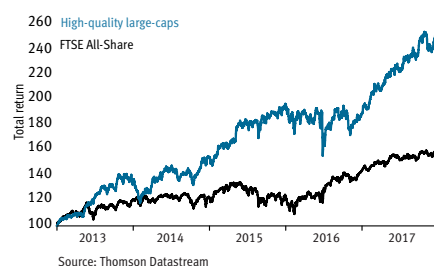
AlphaScreens: the quest for Quality

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.

- This month, 14 FTSE All-Share companies pass all nine of our quality tests. Four of these have been well appreciated by the market over the past three months: **Games Workshop (GAW)**, **Countryside Properties (CSP)**, **Polypipe Group (PLP)**, and technical products business **Diploma (DPLM)** have all enjoyed double-digit share price gains.
- It's also useful to look at the companies failing just one or two tests, to give clues where to focus next-stage research. Ten companies fail just our return on equity criteria and four fail the forward earnings forecast test.
- Small companies' share prices are usually more volatile, and doing well on a quality screen is not a signal of long-term stability, rather it's a way of assessing whether the risks are likely to pay off over time. Specialist food business **Devro (DVO)** gets 9/9 on the small-cap screen, but the shares have lost nearly 20 per cent in the past three months.
- On Aim, road insurance services business **Redde (REDD)** has had its troubles this year but does well on our screen – although potential investors may want to wait for signs of a turnaround. Table-top goods specialist **Churchill China (CHH)** and cloud communications business **Gamma Communications (GAMA)** also get top marks. *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
Games Workshop	LSE:GAW	£1,747m	5,375p	24	2.3%	13.2%	4.4%	19.2%	29m	GBP	9	na
Countryside Properties	LSE:CSP	£1,576m	353p	9	3.1%	12.4%	9.8%	24.1%	-40m	GBP	9	na
Polypipe	LSE:PLP	£931m	467p	16	2.5%	7.3%	6.8%	14.8%	-192m	GBP	9	na
Diploma	LSE:DPLM	£1,913m	1,690p	25	1.5%	12.4%	10.1%	14.8%	22m	GBP	9	na
Sirius Real Estate	LSE:SRE	£769m	75p	18	4.0%	8.4%	9.4%	6.8%	-296m	EUR	9	na
Spirax-Sarco Engineering	LSE:SPX	£6,214m	8,440p	31	1.2%	4.2%	7.3%	4.7%	-433m	GBP	9	na
Kainos	LSE:KNOS	£622m	512p	28	1.8%	13.1%	10.8%	2.3%	37m	GBP	9	na
PayPoint	LSE:PAY	£615m	910p	14	7.7%	2.7%	3.8%	-0.9%	37m	GBP	9	na
Moneysupermarket.com	LSE:MONY	£1,851m	345p	18	3.2%	5.4%	7.0%	-2.7%	-13m	GBP	9	na
RELX	LSE:REL	£35,757m	1,850p	19	2.3%	9.8%	6.8%	-5.4%	-6,757m	GBP	9	na
FDM	LSE:FDM	£825m	756p	19	4.2%	5.2%	6.0%	-3.7%	4m	GBP	9	na
Diageo	LSE:DGE	£72,510m	3,090p	22	2.2%	8.4%	6.6%	-8.8%	-11,639m	GBP	9	na
Halma	LSE:HLMA	£7,233m	1,907p	33	0.8%	9.7%	7.0%	-4.1%	-182m	GBP	9	na
Burberry	LSE:BRBY	£8,337m	2,044p	23	2.1%	7.6%	9.4%	-10.5%	837m	GBP	9	na
Safestore	LSE:SAFE	£1,468m	698p	24	2.3%	5.6%	6.4%	15.3%	-426m	GBP	8	/RoE grth/
Rightmove	LSE:RMV	£5,185m	591p	28	1.2%	8.9%	8.5%	13.0%	42m	GBP	8	/RoE grth/
Segro	LSE:SGRO	£9,165m	836p	33	2.2%	11.0%	8.2%	8.9%	-1,897m	GBP	8	/RoE grth/
Polymetal International	LSE:POLY	£5,689m	1,210p	12	3.3%	14.9%	21.6%	11.4%	-1,736m	USD	8	/RoE grth/
Taylor Wimpey	LSE:TW	£5,480m	168p	8	11.0%	-4.4%	1.5%	12.9%	366m	GBP	8	/Fwd EPS grth/
Domino's Pizza	LSE:DOM	£1,246m	271p	17	3.5%	-5.7%	9.2%	15.8%	-250m	GBP	8	/Fwd EPS grth/
On the Beach	LSE:OTB	£567m	432p	18	0.8%	1.8%	20.1%	11.4%	-1m	GBP	8	/FCF/
Ashtead	LSE:AHT	£10,743m	2,359p	11	1.7%	17.7%	9.5%	6.1%	-5,161m	GBP	8	/RoE grth/
Rio Tinto	LSE:RIO	£71,475m	4,206p	9	6.2%	21.3%	-13.6%	1.0%	-4,544m	USD	8	/Fwd EPS grth/
HomeServe	LSE:HSV	£3,895m	1,164p	28	1.8%	9.0%	9.2%	3.1%	-305m	GBP	8	/RoE grth/
MJ Gleeson	LSE:GLE	£452m	828p	13	4.2%	9.4%	9.6%	0.6%	30m	GBP	8	/FCF/
Barratt Developments	LSE:BDEV	£6,343m	627p	9	7.4%	-0.2%	0.9%	-2.1%	758m	GBP	8	/Fwd EPS grth/
The Unilever Group	LSE:ULVR	£143,182m	4,675p	-	-	7.1%	8.7%	-5.0%	-24,161m	EUR	8	/PE/
Experian	LSE:EXPN	£21,482m	2,388p	29	1.5%	8.7%	8.6%	-7.1%	-3,318m	USD	8	/RoE grth/
Intertek	LSE:ITRK	£8,449m	5,250p	24	1.9%	7.2%	6.6%	-8.2%	-1,082m	GBP	8	/RoE grth/
Photo-Me International	LSE:PHTM	£348m	92p	10	9.2%	6.5%	3.6%	-10.8%	15m	GBP	8	/RoE grth/
Smith & Nephew	LSE:SN	£14,413m	1,651p	20	1.7%	0.3%	6.8%	-13.3%	-2,042m	USD	8	/RoE grth/
Persimmon	LSE:PSN	£7,459m	2,358p	9	10.0%	-5.1%	-0.1%	24.3%	824m	GBP	7	/PEG/Fwd EPS grth/
Bodycote	LSE:BOY	£1,533m	809p	15	4.8%	-6.6%	4.4%	16.5%	-112m	GBP	7	/PEG/Fwd EPS grth/
Ibstock	LSE:IBST	£1,035m	253p	13	3.8%	-3.7%	7.3%	13.9%	-99m	GBP	7	/RoE grth/Fwd EPS grth/
IMI	LSE:IMI	£3,033m	1,120p	15	3.6%	-3.5%	5.7%	17.3%	-513m	GBP	7	/Marg grth/Fwd EPS grth/
Bellway	LSE:BWY	£3,900m	3,168p	8	4.7%	-4.2%	2.3%	11.7%	201m	GBP	7	/RoE grth/Fwd EPS grth/
Redrow	LSE:RDW	£2,072m	604p	6	5.0%	2.9%	-2.2%	9.5%	124m	GBP	7	/RoE grth/Fwd EPS grth/
NMC Health	LSE:NMC	£4,842m	2,318p	17	0.8%	27.9%	22.8%	10.2%	-2,228m	USD	7	/RoE grth/Int Cov/
Anglo American	LSE:AAL	£25,551m	2,065p	9	3.8%	17.3%	-10.8%	8.6%	-3,225m	USD	7	/RoE grth/Fwd EPS grth/
Howden Joinery	LSE:HWDN	£3,479m	581p	17	2.0%	6.1%	7.2%	9.4%	217m	GBP	7	/RoE grth/Int Cov/
Next	LSE:NXT	£8,433m	6,600p	14	2.5%	5.8%	4.4%	7.9%	-2,576m	GBP	7	/RoE grth/Marg grth/
The Sage Group	LSE:SGE	£7,991m	734p	24	2.2%	-9.3%	7.5%	3.3%	-422m	GBP	7	/PEG/Fwd EPS grth/
GlaxoSmithKline	LSE:GSK	£85,965m	1,737p	14	4.6%	1.2%	-0.7%	3.1%	-28,658m	GBP	7	/RoE grth/Fwd EPS grth/
Mondi	LSE:MNDI	£8,284m	1,709p	12	4.1%	-9.4%	-6.4%	4.3%	-2,341m	EUR	7	/PEG/Fwd EPS grth/
Forterra	LSE:FORT	£548m	280p	11	3.8%	-1.3%	5.7%	3.6%	-50m	GBP	7	/RoE grth/Fwd EPS grth/
Croda International	LSE:CRDA	£6,109m	4,780p	24	1.9%	-2.1%	7.0%	0.2%	-604m	GBP	7	/RoE grth/Fwd EPS grth/
Aptitude Software	LSE:APTD	£327m	588p	45	1.3%	-46.7%	20.8%	-8.9%	67m	GBP	7	/PEG/Fwd EPS grth/
Imperial Brands	LSE:IMB	£16,685m	1,774p	6	11.6%	0.7%	4.0%	-16.8%	-11,350m	GBP	7	/RoE grth/Marg grth/

Source: S&P CapitalIQ, 11 November 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	£264m	158p	10	5.7%	9.9%	4.7%	-19.8%	-149m	GBP	9	na
On the Beach	LSE:OTB	£567m	432p	18	0.8%	1.8%	20.1%	11.4%	-1m	GBP	8	/FCF/
Avon Rubber	LSE:AVON	£562m	1,842p	21	0.9%	8.8%	8.6%	18.6%	47m	GBP	8	/RoE grth/
Vp	LSE:VP	£349m	880p	9	3.4%	7.7%	4.2%	12.8%	-168m	GBP	8	/RoE grth/
MJ Gleeson	LSE:GLE	£452m	828p	13	4.2%	9.4%	9.6%	0.6%	30m	GBP	8	/FCF/
Trealt	LSE:TET	£248m	420p	23	1.2%	3.1%	6.1%	-5.1%	9m	GBP	8	/RoE grth/
Photo-Me International	LSE:PHITM	£348m	92p	10	9.2%	6.5%	3.6%	-10.8%	15m	GBP	8	/RoE grth/
Forterra	LSE:FORT	£548m	280p	11	3.8%	-1.3%	5.7%	3.6%	-50m	GBP	7	/RoE grth/Fwd EPS grth/
Aptitude Software	LSE:APTD	£327m	588p	45	1.3%	-46.7%	20.8%	-8.9%	67m	GBP	7	/PEG/Fwd EPS grth/

Source: S&P CapitalIQ, 11 November 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
Gamma Communications	AIM:GAMA	£1,151m	1,215p	29	0.8%	31.5%	7.7%	10.8%	36m	GBP	9	na
Churchill China	AIM:CHH	£177m	1,610p	21	1.8%	9.6%	14.6%	0.3%	13m	GBP	9	na
Redde	AIM:REDD	£331m	108p	8	10.8%	5.5%	1.8%	-7.5%	-35m	GBP	9	na
Belvoir	AIM:BLV	£45m	122p	10	5.9%	6.4%	10.1%	13.2%	-10m	GBP	8	/FCF/
Hotel Chocolat	AIM:HOC	£507m	440p	41	0.4%	12.8%	14.2%	18.1%	6m	GBP	8	/RoE grth/
iomart	AIM:IOM	£386m	355p	18	2.1%	4.2%	7.9%	9.4%	-39m	GBP	8	/RoE grth/
D4t4 Solutions	AIM:D4T4	£95m	236p	17	1.3%	2.2%	3.4%	3.6%	11m	GBP	8	/PEG/
boohoo	AIM:BOO	£3,054m	262p	42	-	35.5%	16.2%	10.5%	190m	GBP	8	/PE/
Elecosoft	AIM:ELCO	£63m	77p	18	0.9%	5.6%	15.0%	1.3%	-3m	GBP	8	/RoE grth/
dotdigital	AIM:DOTD	£265m	89p	22	0.8%	22.1%	6.6%	-2.3%	19m	GBP	8	/Int Cov/
Johnson Service	AIM:JSG	£632m	171p	17	1.8%	10.8%	3.9%	0.3%	-131m	GBP	8	/RoE grth/
James Halstead	AIM:JHD	£1,049m	504p	27	2.8%	4.4%	4.0%	-3.1%	68m	GBP	8	/RoE grth/
Gateley	AIM:GTY	£186m	162p	12	5.0%	6.3%	7.0%	-1.5%	-3m	GBP	8	/RoE grth/
The Property Franchise Group	AIM:TPFG	£39m	153p	10	5.5%	9.8%	4.3%	-11.1%	3m	GBP	8	/RoE grth/
Bioventix	AIM:BVXP	£169m	3,280p	26	3.7%	11.6%	8.6%	-14.5%	7m	GBP	8	/Int Cov/
Nichols	AIM:NICL	£583m	1,580p	21	2.4%	4.2%	5.0%	-14.7%	30m	GBP	8	/RoE grth/
Fevertree Drinks	AIM:FEVR	£2,070m	1,783p	29	0.8%	6.9%	12.3%	-19.2%	102m	GBP	8	/RoE grth/
Tribal	AIM:TRB	£120m	61p	14	1.8%	1.6%	8.9%	-18.2%	2m	GBP	8	/Marg grth/
The Character Group	AIM:CCT	£81m	378p	9	6.9%	-7.4%	0.0%	-31.3%	20m	GBP	8	/Fwd EPS grth/
Judges Scientific	AIM:JDG	£286m	4,595p	22	0.9%	14.4%	-0.8%	27.9%	5m	GBP	7	/PEG/Fwd EPS grth/
Arcontech	AIM:ARC	£25m	187p	23	1.1%	11.4%	10.1%	11.3%	4m	GBP	7	/FCF/Int Cov/
Central Asia Metals	AIM:CAML	£366m	213p	8	6.8%	-3.2%	20.3%	9.8%	-101m	USD	7	/RoE grth/Fwd EPS grth/
Concurrent Technologies	AIM:CNC	£55m	75p	14	3.1%	29.9%	-17.1%	15.4%	10m	GBP	7	/Fwd EPS grth/Int Cov/
M Winkworth	AIM:WINK	£16m	123p	12	6.2%	4.9%	6.0%	7.0%	3m	GBP	7	/Marg grth/Int Cov/
Best of the Best	AIM:BOTB	£27m	290p	17	0.7%	-3.5%	11.6%	4.9%	3m	GBP	7	/Fwd EPS grth/Int Cov/
Watkin Jones	AIM:WJG	£588m	231p	14	3.3%	2.0%	10.4%	2.9%	18m	GBP	7	/RoE grth/FCF/
Quartix	AIM:QTX	£154m	322p	27	3.9%	-19.0%	5.1%	-1.8%	5m	GBP	7	/PEG/Fwd EPS grth/
Tracsis	AIM:TRCS	£170m	590p	-	0.3%	-	-	-1.6%	18m	GBP	7	/PEG/Fwd EPS grth/
K3 Capital	AIM:K3C	£61m	146p	10	5.2%	50.6%	0.5%	-5.3%	6m	GBP	7	/RoE grth/Int Cov/
AdEPT Technology	AIM:ADT	£89m	375p	12	2.6%	8.1%	3.4%	-1.3%	-33m	GBP	7	/RoE grth/Int Cov/
AB Dynamics	AIM:ABDP	£535m	2,385p	45	0.2%	41.2%	18.9%	-6.8%	19m	GBP	7	/Int Cov/PE/
Andrews Sykes	AIM:ASY	£229m	543p	-	4.4%	-	-	-18.9%	8m	GBP	7	/RoE grth/Fwd EPS grth/
Somero Enterprises	AIM:SOM	£108m	191p	7	7.8%	-12.8%	0.8%	-31.3%	13m	USD	7	/RoE grth/Fwd EPS grth/
ECO Animal Health	AIM:EAH	£241m	357p	15	3.1%	1.0%	8.2%	-36.3%	16m	GBP	7	/RoE grth/FCF/
Shoe Zone	AIM:SHOE	£66m	133p	8	8.6%	-7.5%	0.4%	-33.8%	3m	GBP	7	/Fwd EPS grth/Int Cov/

Source: S&P CapitalIQ, 11 November 2019

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