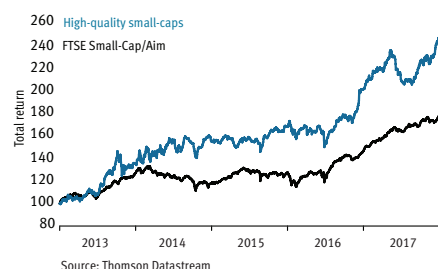




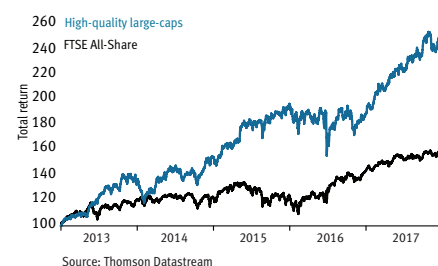
## AlphaScreens: the quest for Quality

*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.

#### Monthly forward from Alpha Editor:

- Overall, 21 constituent companies of the FTSE All-Share Index score 9/9 on our true quality tests screen. Housebuilders are well represented once again but, as we have repeatedly stated, investors need to consider the special circumstances that have seen this sector do so well in recent years.
- The sell-off in October might be a chance to buy into some of the traditionally quality companies that score well on our screen. For example, **Spirax-Sarco Engineering (SPX)** is considerably below its high at the start of October. Although, given the premium investors have paid for quality in recent years, it may still not be cheap.
- On Aim, 14 companies pass all nine tests. It is unsurprising to see companies such as **Bioventix (BVXP)** score well on quality metrics, but like their counterparts on the main market, the question with all these companies is: to what extent is quality priced in? *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	Forward NTM PE	DY	FY EPS Grth +1	FY EPS Grth +2	3-month momentum	Net cash/debt(-)	Currency	Tests passed (out of 9)	Tests failed
Redrow	LSE:RDW	£2,029m	562p	6	5.0%	6.3%	6.4%	4.7%	63m	GBP	9	na
Polypipe	LSE:PLP	£774m	388p	13	2.9%	5.2%	9.0%	7.9%	-147m	GBP	9	na
Moneysupermarket.com	LSE:MONY	£1,650m	308p	17	3.4%	1.0%	8.1%	-0.6%	24m	GBP	9	na
Diploma	LSE:DPLM	£1,556m	1,375p	24	1.7%	10.9%	8.5%	4.2%	18m	GBP	9	na
Diageo	LSE:DGE	£66,732m	2,747p	22	2.4%	6.3%	7.6%	-2.6%	-9,228m	GBP	9	na
Barratt Developments	LSE:BDEV	£5,512m	544p	8	8.1%	4.3%	5.0%	-1.4%	791m	GBP	9	na
Persimmon	LSE:PSN	£7,537m	2,386p	9	9.8%	11.7%	2.8%	-5.8%	1,155m	GBP	9	na
Taylor Wimpey	LSE:TW	£5,483m	168p	8	9.3%	7.2%	2.0%	-5.0%	496m	GBP	9	na
Domino's Pizza	LSE:DOM	£1,389m	297p	17	3.0%	3.4%	10.7%	-4.8%	-196m	GBP	9	na
HomeServe	LSE:HSV	£3,203m	965p	26	2.0%	9.0%	9.7%	-4.3%	-238m	GBP	9	na
Unilever	LSE:ULVR	£108,538m	4,147p	20	3.1%	2.6%	7.6%	-5.1%	-24,764m	EUR	9	na
MJ Gleeson	LSE:GLE	£376m	690p	12	4.6%	7.7%	10.2%	-6.2%	41m	GBP	9	na
RELX	LSE:REL	£30,656m	1,559p	18	2.5%	4.9%	7.0%	-7.3%	-6,274m	GBP	9	na
Reckitt Benckiser	LSE:RB	£44,230m	6,255p	18	2.6%	3.5%	7.7%	-7.9%	-10,769m	GBP	9	na
Halma	LSE:HLMA	£4,992m	1,317p	27	1.1%	9.1%	7.0%	-7.0%	-220m	GBP	9	na
Spirax-Sarco Engineering	LSE:SPX	£4,801m	6,525p	25	1.3%	13.6%	5.9%	-10.4%	-373m	GBP	9	na
Victrex	LSE:VCT	£2,313m	2,692p	21	2.0%	12.4%	0.3%	-16.0%	92m	GBP	9	na
The Sage Group	LSE:SGE	£5,984m	551p	16	2.8%	10.8%	5.9%	-18.3%	-656m	GBP	9	na
Ashtead	LSE:AHT	£9,118m	1,900p	11	1.7%	32.1%	9.7%	-19.9%	-3,033m	GBP	9	na
Burberry	LSE:BRBY	£7,244m	1,774p	21	2.3%	0.6%	3.6%	-19.1%	647m	GBP	9	na
Renishaw	LSE:RSW	£2,916m	4,006p	22	1.5%	8.4%	9.0%	-30.1%	104m	GBP	9	na
Polymetal International	LSE:POLY	£3,246m	712p	9	5.1%	2.6%	24.0%	9.0%	-1,652m	USD	8	/RoE grth/
Sirius Real Estate	LSE:SRE	£594m	59p	16	4.7%	6.9%	11.5%	2.1%	-288m	EUR	8	/RoE grth/
Safestore Holdings	LSE:SAFE	£1,176m	560p	20	2.5%	15.3%	5.8%	1.0%	-423m	GBP	8	/RoE grth/
Bellway	LSE:BWY	£3,723m	3,031p	7	4.7%	5.3%	5.7%	2.7%	99m	GBP	8	/RoE grth/
Card Factory	LSE:CARD	£650m	190p	11	7.5%	-8.4%	4.2%	1.7%	-160m	GBP	8	/Fwd EPS grth/
The Unite Group	LSE:UTG	£2,276m	864p	23	2.6%	14.6%	11.6%	-2.2%	-412m	GBP	8	/RoE grth/
Photo-Me International	LSE:PHTM	£442m	117p	12	7.2%	-2.3%	8.0%	-1.9%	25m	GBP	8	/Fwd EPS grth/
Segro	LSE:SGRO	£6,404m	632p	27	2.7%	12.3%	8.2%	-6.5%	-2,115m	GBP	8	/Int Cov/
Experian	LSE:EXPN	£16,307m	1,815p	23	1.9%	4.9%	10.3%	-4.8%	-3,475m	USD	8	/Marg grth/
Rightmove	LSE:RMV	£4,019m	450p	24	1.3%	9.9%	9.2%	-9.1%	14m	GBP	8	/RoE grth/
Croda International	LSE:CRDA	£6,269m	4,802p	24	1.7%	8.0%	8.2%	-7.3%	-393m	GBP	8	/RoE grth/
FDM Group	LSE:FDM	£980m	905p	26	3.2%	8.6%	7.2%	-10.5%	30m	GBP	8	/Int Cov/
Centamin	LSE:CEY	£1,122m	97p	14	9.9%	-15.7%	21.8%	-16.1%	254m	USD	8	/Fwd EPS grth/
British American Tobacco	LSE:BATS	£70,430m	3,315p	11	5.9%	2.9%	8.1%	-28.1%	-46,199m	GBP	8	/PE/
XP Power	LSE:XPP	£473m	2,470p	13	3.2%	18.8%	9.5%	-21.1%	-47m	GBP	8	/FCF/
Bodycote	LSE:BOY	£1,493m	785p	14	2.2%	8.6%	5.9%	-22.9%	6m	GBP	8	/Int Cov/
IMI	LSE:IMI	£2,538m	942p	13	4.2%	11.1%	7.2%	-18.8%	-449m	GBP	8	/Marg grth/
AG Barr	LSE:BAG	£899m	795p	25	2.0%	1.9%	9.5%	16.6%	4m	GBP	7	/RoE grth/Int Cov/
Kainos	LSE:KNOS	£500m	403p	29	1.6%	46.9%	4.4%	11.9%	29m	GBP	7	/RoE grth/PE/
Howden Joinery	LSE:HWDN	£2,949m	484p	15	2.3%	7.2%	7.7%	0.6%	213m	GBP	7	/RoE grth/Int Cov/
Games Workshop	LSE:GAW	£1,040m	3,200p	19	4.1%	-7.6%	4.4%	-3.4%	29m	GBP	7	/PEG/Fwd EPS grth/
The Berkeley Group	LSE:BKG	£4,686m	3,640p	9	2.5%	-30.2%	-20.1%	-3.3%	687m	GBP	7	/PEG/Fwd EPS grth/
Ibstock	LSE:IBST	£942m	232p	12	3.9%	-10.4%	10.3%	-4.1%	-136m	GBP	7	/RoE grth/Fwd EPS grth/
NEXT	LSE:NXT	£7,315m	5,424p	12	2.9%	5.2%	2.2%	-5.9%	-1,182m	GBP	7	/RoE grth/Marg grth/
Tarsus	LSE:TRS	£342m	280p	16	3.6%	-36.8%	69.3%	-8.3%	-95m	GBP	7	/RoE grth/Fwd EPS grth/
Dairy Crest	LSE:DCG	£687m	445p	12	5.1%	-0.4%	3.3%	-8.8%	-234m	GBP	7	/RoE grth/Fwd EPS grth/
Vp	LSE:VP	£399m	1,010p	11	2.6%	18.8%	5.7%	-10.3%	-179m	GBP	7	/RoE grth/FCF/
Wizz Air	LSE:WIZZ	£2,152m	2,958p	13	-	5.9%	22.0%	-14.0%	1,125m	EUR	7	/RoE grth/FCF/

Source: S&amp;P CapitalIQ, 12 November 2018

**Alpha Quality screen: small-cap results**

Name	TIDM	Market cap	Price	Forward NTM PE	DY	FY EPS Grth +1	FY EPS Grth +2	3-month momentum	Net cash/debt(-)	Currency	Tests passed (out of 9)	Tests failed
MJ Gleeson	LSE:GLE	£376m	690p	12	4.6%	7.7%	10.2%	-6.2%	41m	GBP	9	na
Sirius Real Estate	LSE:SRE	£594m	59p	16	4.7%	6.9%	11.5%	2.1%	-288m	EUR	8	/RoE grth/
MedicX Fund	LSE:MXF	£355m	80p	21	7.5%	4.0%	4.8%	-1.7%	-362m	GBP	8	/Int Cov/
Photo-Me International	LSE:PHTM	£442m	117p	12	7.2%	-2.3%	8.0%	-1.9%	25m	GBP	8	/Fwd EPS grth/
XP Power	LSE:XPP	£473m	2,470p	13	3.2%	18.8%	9.5%	-21.1%	-47m	GBP	8	/FCF/
Kainos	LSE:KNOS	£500m	403p	29	1.6%	46.9%	4.4%	11.9%	29m	GBP	7	/RoE grth/PE/
Picton Property Income	LSE:PCTN	£470m	87p	20	4.0%	3.2%	4.0%	-3.6%	-181m	GBP	7	/RoE grth/Int Cov/
Henry Boot	LSE:BOOT	£347m	262p	9	3.1%	-12.5%	2.5%	-2.8%	-26m	GBP	7	/PEG/Fwd EPS grth/
Tarsus	LSE:TRS	£342m	280p	16	3.6%	-36.8%	69.3%	-8.3%	-95m	GBP	7	/RoE grth/Fwd EPS grth/
Vp	LSE:VP	£399m	1,010p	11	2.6%	18.8%	5.7%	-10.3%	-179m	GBP	7	/RoE grth/FCF/

Source: S&amp;P CapitalIQ, 12 November 2018

**Alpha Quality screen: Aim results**

Name	TIDM	Market cap	Price	Forward NTM PE	DY	FY EPS Grth +1	FY EPS Grth +2	3-month momentum	Net cash/debt(-)	Currency	Tests passed (out of 9)	Tests failed
AdEPT Telecom	AIM:ADT	£94m	395p	13	2.5%	6.5%	3.5%	14.7%	-24m	GBP	9	na
Bioventix	AIM:BVXP	£153m	2,970p	26	3.9%	4.4%	12.0%	-1.6%	7m	GBP	9	na
Redde	AIM:REDD	£561m	183p	13	6.4%	10.4%	5.5%	11.4%	-8m	GBP	9	na
IG Design	AIM:IGR	£477m	609p	24	1.0%	18.8%	18.3%	13.7%	4m	GBP	9	na
Taptica International	AIM:TAP	£211m	310p	8	2.0%	11.2%	4.6%	8.6%	42m	USD	9	na
Belvoir Lettings	AIM:BLV	£34m	98p	8	7.2%	2.7%	5.0%	-6.7%	-4m	GBP	9	na
Central Asia Metals	AIM:CAML	£367m	214p	7	7.7%	36.6%	2.9%	-7.4%	-128m	USD	9	na
ECO Animal Health	AIM:EAH	£305m	455p	19	2.0%	24.3%	7.2%	-5.1%	21m	GBP	9	na
Elecosoft	AIM:ELCO	£58m	75p	21	0.8%	44.0%	14.8%	-4.6%	3m	GBP	9	na
Somero Enterprises	AIM:SOM	£200m	355p	12	3.4%	21.6%	4.6%	-8.0%	21m	USD	9	na
Focusrite	AIM:TUNE	£239m	420p	25	0.6%	10.1%	5.0%	-10.9%	20m	GBP	9	na
Johnson Service	AIM:JSG	£464m	127p	14	2.2%	6.3%	6.6%	-9.3%	-91m	GBP	9	na
Advanced Medical Solutions	AIM:AMS	£625m	293p	28	0.4%	7.9%	6.9%	-17.5%	71m	GBP	9	na
Judges Scientific	AIM:JDG	£152m	2,460p	16	1.3%	17.5%	2.2%	-10.9%	-2m	GBP	9	na
Arcontech	AIM:ARC	£18m	134p	21	1.0%	54.8%	3.4%	15.9%	3m	GBP	8	/Int Cov/
Churchill China	AIM:CHH	£131m	1,198p	19	2.1%	13.2%	7.3%	26.1%	14m	GBP	8	/Int Cov/
RWS Holdings	AIM:RWS	£1,395m	510p	29	1.3%	23.9%	11.3%	14.1%	-83m	GBP	8	/RoE grth/
Fulcrum Utility Services	AIM:FCRM	£146m	66p	15	3.2%	15.8%	0.2%	3.5%	9m	GBP	8	/RoE grth/
The Property Franchise Group	AIM:TPFG	£35m	137p	11	5.5%	9.4%	2.7%	-1.4%	1m	GBP	8	/RoE grth/
Gamma Communications	AIM:GAMA	£777m	828p	29	1.0%	17.9%	15.9%	5.5%	31m	GBP	8	/RoE grth/
Scapa	AIM:SCPA	£681m	441p	23	0.5%	5.2%	7.2%	4.1%	-4m	GBP	8	/PEG/
iomart	AIM:IOM	£444m	410p	21	2.4%	9.6%	10.3%	-0.4%	-27m	GBP	8	/RoE grth/
Tracsis	AIM:TRCS	£170m	600p	23	0.2%	3.3%	6.6%	-1.8%	22m	GBP	8	/PEG/
James Halstead	AIM:JHD	£801m	385p	20	3.5%	9.1%	2.8%	-3.3%	50m	GBP	8	/RoE grth/
Scientific Digital Imaging	AIM:SDI	£37m	42p	17	-	-0.2%	12.1%	-3.2%	1m	GBP	8	/Fwd EPS grth/
dotDigital	AIM:DOTD	£256m	86p	23	0.7%	20.1%	11.6%	-6.3%	15m	GBP	8	/Int Cov/
Van Elle Holdings	AIM:VANL	£66m	83p	7	4.5%	7.1%	9.0%	-4.7%	-6m	GBP	8	/RoE grth/
Portmeirion	AIM:PMP	£114m	1,068p	15	3.2%	11.1%	6.5%	-6.5%	-1m	GBP	8	/RoE grth/
Tristel	AIM:TSTL	£107m	245p	25	1.9%	33.7%	7.6%	-12.1%	7m	GBP	8	/Int Cov/
Fevertree Drinks	AIM:FEVR	£3,395m	2,924p	54	0.4%	25.3%	15.5%	-17.1%	56m	GBP	8	/PE/
Quixant	AIM:QXT	£246m	370p	19	0.7%	1.6%	15.6%	-14.0%	3m	USD	8	/RoE grth/
Telford Homes	AIM:TEF	£249m	330p	6	5.2%	11.0%	2.8%	-18.5%	-100m	GBP	8	/FCF/
Caledonia Mining Corporation	AIM:CMCL	£88m	460p	-	-	26.5%	10.6%	-27.0%	5m	USD	8	/FCF/
Craneware	AIM:CRW	£854m	3,200p	61	0.8%	14.4%	18.0%	39.4%	53m	USD	7	/Int Cov/PE/
D4t4 Solutions	AIM:D4T4	£82m	216p	18	1.2%	8.1%	10.9%	38.5%	4m	GBP	7	/RoE grth/FCF/
boohoo	AIM:BOO	£2,473m	213p	46	-	28.0%	19.4%	6.2%	156m	GBP	7	/RoE grth/PE/
Nichols	AIM:NICL	£518m	1,405p	20	2.4%	2.1%	4.7%	-2.6%	37m	GBP	7	/RoE grth/Int Cov/
Gateley (Holdings)	AIM:GTLY	£171m	155p	13	4.5%	16.7%	7.3%	-2.5%	-1m	GBP	7	/RoE grth/Marg grth/
LPA	AIM:LPA	£13m	108p	8	2.5%	10.8%	3.0%	0.5%	-3m	GBP	7	/RoE grth/FCF/
Andrews Sykes	AIM:ASY	£230m	545p	-	4.4%	-	-	-6.0%	17m	GBP	7	/RoE grth/Fwd EPS grth/
FWThorpe	AIM:TFW	£334m	288p	-	1.9%	-	-	-7.6%	42m	GBP	7	/PEG/Fwd EPS grth/
Sigma Capital	AIM:SGM	£115m	129p	11	-	178.8%	8.2%	-10.4%	-3m	GBP	7	/RoE grth/Marg grth/
Abcam	AIM:ABC	£2,516m	1,229p	37	1.0%	3.3%	7.1%	-16.2%	90m	GBP	7	/PEG/Int Cov/
Hotel Chocolat	AIM:HOTC	£343m	304p	32	0.7%	6.9%	18.3%	-9.6%	0m	GBP	7	/RoE grth/FCF/
SafeCharge International	AIM:SCH	£423m	278p	19	4.7%	11.3%	11.5%	-15.7%	86m	USD	7	/RoE grth/Int Cov/
Swallowfield	AIM:SWL	£45m	260p	10	2.4%	22.5%	7.7%	-10.5%	-12m	GBP	7	/RoE grth/FCF/
Dewhurst	AIM:DWHT	£61m	950p	16	1.3%	9.8%	27.6%	-19.4%	18m	GBP	7	/RoE grth/Int Cov/
Hunters Property	AIM:HUNT	£12m	39p	-	5.7%	-	-	-26.0%	-3m	GBP	7	/RoE grth/Fwd EPS grth/
QUIZ	AIM:QUIZ	£58m	47p	9	1.7%	-21.0%	15.8%	-70.6%	9m	GBP	7	/PEG/Fwd EPS grth/

Source: S&amp;P CapitalIQ, 12 November 2018

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