



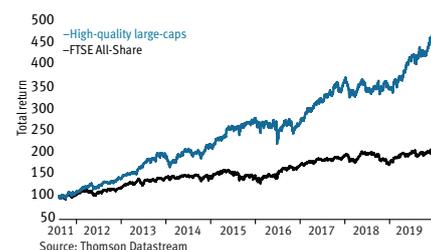
AlphaScreens: the quest for Quality

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.

- Gold miner **Polymetal International (POLY)** remains the only company scoring full marks on our large-cap quality screen. The price of gold has potential to pull-back and be volatile, but owning a slice of a company that pays a 3.8 per cent dividend, seems a decent way to play the secular trend of decline in fiat currency.
- Reliable shares that score 8/9 include consumer goods giant **Unilever (ULVR)**, hobby (and perhaps now intellectual property) star **Games Workshop (GAW)**, IT firm **Kainos Group (KNOS)** and data business **Experian (EXPN)**.
- Steel business **Evrz (EVR)** is the share that sticks out in the 8/9 group. The high debt and dividend combination a risk that makes its high-ranking in our quality screen seem slightly incongruous.
- When looking at companies listed on Aim, it is vital to do further research and not just buy on the strength of a stock screen. Some of the ideas flagged are quality companies, but the tests they fail are a good indicator where to ask more questions. For example, **YouGov (YOU)** is a great data business, but our screen flags it has become more expensive relative to growth.

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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
Polymetal International	POLY	£8,061m	1,708p	8	3.8%	77.0%	26.6%	6.6%	1,398m	USD	9	na
Games Workshop	GAW	£3,425m	10,480p	39	1.5%	17.2%	12.1%	27.5%	-21m	GBP	8	/RoE grth/
Evrz	EVR	£5,197m	357p	7	12.9%	137.2%	25.5%	23.8%	2,984m	USD	8	/RoE grth/
Kainos	KNOS	£1,270m	1,038p	46	0.3%	33.9%	2.0%	34.8%	-37m	GBP	8	/RoE grth/
Unilever	ULVR	£56,639m	4,847p	21	3.1%	2.6%	4.6%	15.0%	20,770m	EUR	8	/PEG/
Experian	EXPN	£27,204m	2,966p	37	1.3%	25.4%	13.4%	6.3%	3,323m	USD	8	/RoE grth/
Next	NXT	£8,586m	6,458p	19	0.0%	-54.3%	88.3%	37.4%	2,115m	GBP	7	/PEG/Fwd EPS grth/
XP Power	XPP	£923m	4,700p	28	0.8%	4.9%	15.2%	30.6%	41m	GBP	7	/PEG/RoE grth/
Mondi	MNDI	£8,048m	1,658p	14	2.7%	-25.5%	12.1%	15.3%	1,863m	EUR	7	/PEG/Fwd EPS grth/
FDM	FDM	£1,144m	1,048p	32	1.8%	-23.2%	10.7%	12.7%	-36m	GBP	7	/PEG/Fwd EPS grth/
Rio Tinto	RIO	£59,848m	4,801p	10	6.2%	3.6%	-4.7%	4.1%	6,352m	USD	7	/RoE grth/Fwd EPS grth/
Berkeley	BKG	£5,610m	4,463p	14	4.6%	0.5%	7.6%	1.4%	-1,136m	GBP	7	/RoE grth/Marg grth/
HomeServe	HSV	£4,116m	1,225p	27	1.9%	2.7%	14.8%	-2.1%	509m	GBP	7	/PEG/RoE grth/
Moneysupermarket.com	MONY	£1,455m	271p	17	4.3%	-23.9%	22.0%	-9.5%	-8m	GBP	7	/PEG/Fwd EPS grth/
PayPoint	PAY	£357m	522p	10	11.0%	-29.2%	18.7%	-12.9%	-23m	GBP	7	/PEG/Fwd EPS grth/
Taylor Wimpey	TW	£4,381m	120p	11	0.0%	-72.0%	111.7%	-16.2%	-473m	GBP	7	/PEG/Fwd EPS grth/

Source: FactSet, 12 October 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
Aptitude Software	APTD	£248m	440p	36	1.2%	16.6%	-7.4%	10.0%	-31m	GBP	7	/RoE grth/Fwd EPS grth/
PayPoint	PAY	£357m	522p	10	11.0%	-29.2%	18.7%	-12.9%	-23m	GBP	7	/PEG/Fwd EPS grth/

Source: FactSet, 12 October 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
Frontier Developments	FDEV	£1,031m	2,630p	48	0.0%	14.6%	60.0%	45.6%	-22m	GBP	9	na
SDI	SDI	£64m	65p	17	0.0%	44.5%	10.8%	20.7%	7m	GBP	9	na
Caledonia Mining	CMCL	£174m	1,440p	5	1.5%	46.8%	61.5%	9.3%	-9m	USD	9	na
boohoo	BOO	£4,409m	350p	37	0.0%	37.5%	29.3%	22.4%	-331m	GBP	9	na
Trans-Siberian Gold	TSG	£108m	99p	5	8.1%	51.3%	83.1%	8.2%	7m	USD	9	na
EKF Diagnostics	EKF	£266m	58p	30	0.0%	147.4%	-45.0%	28.6%	-15m	GBP	8	/Fwd EPS grth/
Pan African Resources	PAF	£527m	24p	4	2.8%	175.4%	-1.6%	18.9%	53m	USD	8	/Fwd EPS grth/
Venture Life	VLG	£85m	101p	18	0.0%	146.8%	18.8%	24.7%	2m	GBP	8	/Marg grth/
Water Intelligence	WATR	£61m	415p	30	0.0%	50.4%	6.4%	31.7%	-1m	USD	8	/RoE grth/
Gamma Communications	GAMA	£1,588m	1,665p	31	0.7%	20.0%	11.2%	19.8%	-25m	GBP	8	/RoE grth/
Gateley	GTLY	£148m	126p	9	4.3%	7.6%	5.6%	-8.4%	26m	GBP	8	/RoE grth/
Sylvania Platinum	SLP	£172m	63p	4	2.5%	59.3%	-16.4%	52.3%	-45m	USD	7	/Fwd EPS grth/PE/
MTI Wireless Edge	MWE	£43m	49p	-	2.8%	-	-	48.5%	-6m	USD	7	/PEG/Fwd EPS grth/
Tristel	TSTL	£230m	495p	39	1.2%	11.0%	3.3%	23.4%	0m	GBP	7	/RoE grth/Marg grth/
Crimson Tide	TIDE	£17m	4p	38	0.0%	25.0%	0.0%	28.8%	-1m	GBP	7	/RoE grth/Marg grth/
YouGov	YOU	£1,018m	945p	49	0.5%	6.9%	23.8%	22.7%	-26m	GBP	7	/PEG/RoE grth/
Volex	VLX	£297m	195p	-	1.5%	-	-	36.8%	-17m	USD	7	/PEG/Fwd EPS grth/
Alpha Financial Mkts Consulting	AFM	£223m	211p	15	1.0%	-0.5%	10.8%	12.5%	-18m	GBP	7	/PEG/Fwd EPS grth/
Keywords Studios	KWS	£1,626m	2,198p	42	0.0%	6.3%	22.0%	18.0%	-63m	EUR	7	/PEG/RoE grth/
Inspiration Healthcare	IHC	£47m	69p	14	0.3%	35.5%	-4.1%	9.6%	-6m	GBP	7	/RoE grth/Fwd EPS grth/
Atalaya Mining	ATYM	£239m	174p	4	0.0%	-13.4%	131.7%	7.1%	-11m	EUR	7	/PEG/Fwd EPS grth/
ULS Technology	ULS	£36m	56p	17	2.2%	-68.9%	226.7%	5.7%	5m	GBP	7	/PEG/Fwd EPS grth/
Solid State	SOLI	£54m	633p	-	2.0%	-	-	14.1%	-2m	GBP	7	/PEG/Fwd EPS grth/
Steppe Cement	STCM	£57m	26p	9	11.5%	-43.3%	53.1%	2.0%	-1m	USD	7	/PEG/Fwd EPS grth/
Bioventix	BVXP	£210m	4,040p	30	3.1%	11.3%	9.6%	-2.7%	-6m	GBP	7	/Marg grth/Int Cov/
Alumasc	ALU	£29m	79p	5	6.3%	73.8%	14.5%	11.3%	10m	GBP	7	/RoE grth/Marg grth/
Eckoh	ECK	£170m	67p	-	0.0%	-	-	7.2%	-11m	GBP	7	/PEG/Fwd EPS grth/
iomart	IOM	£369m	337p	20	1.9%	0.4%	4.3%	0.6%	58m	GBP	7	/PEG/RoE grth/
Franchise Brands	FRAN	£100m	104p	23	0.9%	-7.7%	22.8%	7.2%	-3m	GBP	7	/PEG/Fwd EPS grth/
James Halstead	JHD	£1,057m	508p	29	2.8%	5.8%	6.3%	-1.7%	-61m	GBP	7	/RoE grth/Marg grth/
EMIS	EMIS	£665m	1,050p	20	3.0%	-3.1%	6.7%	-4.5%	-37m	GBP	7	/PEG/Fwd EPS grth/
Cohort	CHRT	£250m	610p	17	1.7%	-6.6%	9.8%	3.4%	12m	GBP	7	/PEG/Fwd EPS grth/
Judges Scientific	JDG	£320m	5,100p	29	1.0%	-31.0%	23.2%	-3.8%	8m	GBP	7	/PEG/Fwd EPS grth/
Learning Technologies	LTG	£873m	118p	28	0.6%	-14.1%	5.5%	-3.6%	-66m	GBP	7	/PEG/Fwd EPS grth/
Mattioli Woods	MTW	£183m	655p	15	3.1%	-15.6%	16.5%	-8.4%	-23m	GBP	7	/PEG/Fwd EPS grth/
Anglo Asian Mining	AAZ	£142m	124p	-	5.7%	-	-	-11.4%	-21m	USD	7	/PEG/Fwd EPS grth/
Churchill China	CHH	£114m	1,030p	31	0.0%	-86.9%	281.1%	-5.5%	-16m	GBP	7	/PEG/Fwd EPS grth/
Vianet	VNET	£24m	84p	-	2.0%	-	-	-7.2%	1m	GBP	7	/PEG/Fwd EPS grth/
Michelmersh Brick	MBH	£87m	93p	14	0.0%	-40.4%	32.2%	-8.9%	8m	GBP	7	/PEG/Fwd EPS grth/
Concurrent Technologies	CNC	£77m	104p	18	2.4%	30.1%	-	-12.2%	-10m	GBP	7	/Fwd EPS grth/Int Cov/
FRP Advisory	FRP	£275m	115p	18	0.6%	566.7%	17.2%	-6.9%	-17m	GBP	7	/Marg grth/PE/
One Media iP	OMIP	£14m	6p	21	0.9%	15.4%	0.0%	-18.7%	1m	GBP	7	/RoE grth/Int Cov/
Mission	TMG	£57m	63p	10	0.0%	-95.6%	1825.0%	-4.5%	11m	GBP	7	/PEG/Fwd EPS grth/

Source: FactSet, 12 October 2020

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