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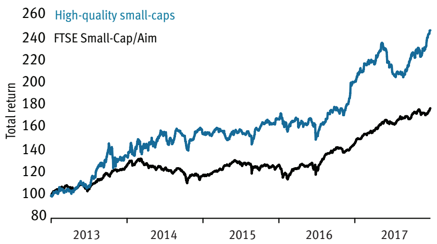
AlphaScreens: the quest for Quality

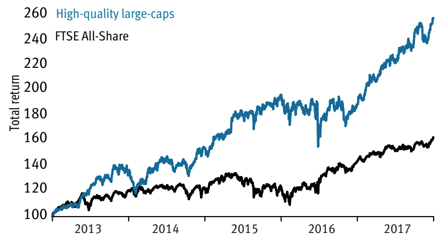
The holy grail for buy-and-hold investors is to find a business that is capable of generating a high return on its capital and sustaining it while reinvesting profits. This screen looks for shares that demonstrate these 'quality' characteristics and can deliver significant compounded returns over time

High-quality small-caps vs FTSE Small-Cap/Aim



Source: Thomson Datastream

High-quality large-caps vs FTSE All-Share



Source: Thomson Datastream

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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 have flocked to buy quality shares in the past few years. With the rate of return low on government bonds, the earnings yield on the most consistently performing companies has looked attractive, so long as it can surpass the risk-free yield on government paper.

■ There are 18 FTSE All-Share companies that pass all nine of our quality tests this month, with larger companies including **Unilever (ULVR)**, **Diageo (DGE)** and **RELX (REL)**.

■ On Aim, **Fevertree Drinks (FEVR)**, is still scoring 9/9 on the screen, although the recent share price performance suggests investors are becoming sceptical that the gin boom, which has buoyed the company, can continue to support the same level of profits growth. *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

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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-mth momentum	Net Cash/ Debt(-)	Cur	Tests passed (out of 9)	Test failed
Games Workshop	LSE:GAW	£1,570m	4,830p	24	2.7%	8.0%	4.7%	29.8%	25m	GBP	9	na
Moneysupermarket.com	LSE:MONY	£2,180m	406p	22	2.7%	6.3%	7.9%	18.5%	30m	GBP	9	na
RELX	LSE:REL	£37,612m	1,940p	21	2.2%	8.4%	6.6%	18.4%	-6,267m	GBP	9	na
Unilever	LSE:ULVR	£123,660m	5,003p	22	2.7%	6.9%	8.9%	15.0%	-20,688m	EUR	9	na
Diageo	LSE:DGE	£80,296m	3,391p	25	1.9%	9.2%	7.1%	8.7%	-10,577m	GBP	9	na
Spirax-Sarco Engineering	LSE:SPX	£6,401m	8,695p	33	1.2%	4.8%	7.4%	9.3%	-236m	GBP	9	na
Ashtead	LSE:AHT	£10,455m	2,258p	11	1.8%	18.6%	8.0%	8.1%	-3,745m	GBP	9	na
Halma	LSE:HLMA	£7,548m	1,990p	35	0.8%	8.0%	6.5%	14.0%	-182m	GBP	9	na
Domino's Pizza	LSE:DOM	£1,199m	261p	16	3.6%	3.5%	8.1%	3.9%	-203m	GBP	9	na
Sirius Real Estate	LSE:SRE	£672m	66p	15	4.7%	5.3%	12.7%	0.6%	-296m	EUR	9	na
PayPoint	LSE:PAY	£615m	910p	14	7.7%	3.4%	5.0%	-0.3%	37m	GBP	9	na
Barratt Developments	LSE:BDEV	£6,371m	627p	9	7.1%	6.0%	0.1%	1.2%	379m	GBP	9	na
Burberry	LSE:BRBY	£8,218m	2,005p	24	2.1%	1.9%	10.9%	0.9%	837m	GBP	9	na
Polypipe	LSE:PLP	£841m	422p	14	2.7%	8.5%	6.3%	-1.0%	-165m	GBP	9	na
MJ Gleeson	LSE:GLE	£432m	792p	13	4.0%	8.8%	9.7%	-7.1%	28m	GBP	9	na
Diploma	LSE:DPLM	£1,669m	1,475p	22	1.7%	11.0%	9.6%	-5.7%	22m	GBP	9	na
Countryside Properties	LSE:CSP	£1,335m	299p	8	3.6%	12.0%	9.8%	-7.2%	-40m	GBP	9	na
Imperial Brands	LSE:IMB	£19,266m	2,033p	7	9.2%	4.0%	3.5%	-19.8%	-12,807m	GBP	9	na
Polymetal International	LSE:POLY	£4,565m	971p	11	3.9%	13.1%	9.4%	23.0%	-1,520m	USD	8	/RoE grth/
Smith & Nephew	LSE:SN.	£15,095m	1,729p	21	1.7%	0.2%	6.9%	17.6%	-1,103m	USD	8	/RoE grth/
Reckitt Benckiser	LSE:RB.	£46,760m	6,595p	19	2.6%	1.8%	5.1%	12.0%	-10,421m	GBP	8	/RoE grth/
Experian	LSE:EXPN	£21,424m	2,375p	28	1.6%	8.5%	10.2%	10.5%	-3,318m	USD	8	/RoE grth/
Ten Entertainment	LSE:TEG	£163m	250p	12	4.4%	25.3%	12.4%	10.2%	-11m	GBP	8	/RoE grth/
On the Beach	LSE:OTB	£626m	477p	18	0.7%	10.1%	19.0%	6.3%	-1m	GBP	8	/FCF/
Kainos	LSE:KNOS	£750m	620p	36	1.5%	24.5%	11.5%	10.3%	42m	GBP	8	/Int Cov/
Intertek	LSE:ITRK	£8,868m	5,510p	26	1.8%	5.8%	7.3%	6.9%	-778m	GBP	8	/RoE grth/
AG Barr	LSE:BAG	£984m	871p	26	1.9%	4.3%	4.0%	5.6%	22m	GBP	8	/RoE grth/
Photo-Me International	LSE:PHTM	£355m	94p	10	9.0%	-5.1%	14.2%	4.9%	31m	GBP	8	/Fwd EPS grth/
Smiths	LSE:SMIN	£6,306m	1,593p	16	2.8%	7.5%	8.8%	5.4%	-938m	GBP	8	/RoE grth/
HomeServe	LSE:HSV	£3,875m	1,158p	28	1.8%	8.8%	9.0%	5.3%	-305m	GBP	8	/RoE grth/
Rightmove	LSE:RMV	£4,679m	528p	26	1.2%	9.4%	8.3%	-0.2%	7m	GBP	8	/RoE grth/
Safestore	LSE:SAFE	£1,342m	638p	22	2.5%	5.9%	6.8%	-0.9%	-426m	GBP	8	/RoE grth/
Mondi	LSE:MNDI	£8,593m	1,774p	11	3.8%	-3.8%	2.8%	-0.7%	-2,218m	EUR	8	/Fwd EPS grth/
FDM Group	LSE:FDM	£990m	907p	24	3.4%	6.4%	7.3%	-3.2%	34m	GBP	8	/Int Cov/
Croda International	LSE:CRDA	£6,113m	4,790p	24	1.9%	1.8%	7.3%	-6.7%	-426m	GBP	8	/RoE grth/
Bellway	LSE:BWY	£3,478m	2,825p	6	5.1%	3.3%	0.4%	-11.5%	-27m	GBP	8	/RoE grth/
Redrow	LSE:RDW	£1,901m	553p	6	5.5%	1.6%	2.1%	-13.8%	101m	GBP	8	/RoE grth/
Medica	LSE:MGP	£140m	126p	15	1.8%	8.2%	10.7%	-20.3%	1m	GBP	8	/RoE grth/
The Sage Group	LSE:SGE	£8,765m	807p	25	2.0%	-5.3%	6.9%	14.6%	-422m	GBP	7	/PEG/Fwd EPS grth/
Aptitude Software	LSE:APTD	£284m	460p	45	1.4%	-52.1%	4.4%	19.5%	17m	GBP	7	/PEG/Fwd EPS grth/
GlaxoSmithKline	LSE:GSK	£80,335m	1,624p	14	4.9%	-5.4%	4.2%	5.3%	-27,544m	GBP	7	/Fwd EPS grth/FCF/
Next	LSE:NXT	£6,964m	5,436p	12	3.0%	2.6%	3.5%	-4.4%	-1,135m	GBP	7	/RoE grth/Marg grth/
IMI	LSE:IMI	£2,683m	991p	14	4.1%	-0.4%	6.4%	-2.5%	-401m	GBP	7	/Marg grth/Fwd EPS grth/
Ferrexpo	LSE:FXPO	£1,543m	263p	4	8.0%	53.0%	-19.4%	-9.8%	-339m	USD	7	/RoE grth/Fwd EPS grth/
NMC Health	LSE:NMC	£4,645m	2,225p	18	0.8%	29.3%	18.7%	-8.8%	-1,552m	USD	7	/RoE grth/Int Cov/
Persimmon	LSE:PSN	£6,294m	1,990p	7	11.8%	-3.9%	0.9%	-14.9%	1,048m	GBP	7	/PEG/Fwd EPS grth/
Renishaw	LSE:RSW	£2,782m	3,822p	26	1.6%	-22.7%	22.4%	-12.6%	101m	GBP	7	/PEG/Fwd EPS grth/
Howden Joinery	LSE:HWDN	£2,920m	487p	15	2.4%	5.5%	7.9%	-6.9%	231m	GBP	7	/RoE grth/Int Cov/
Taylor Wimpey	LSE:TW.	£5,354m	164p	8	11.2%	-3.9%	1.7%	-13.6%	617m	GBP	7	/RoE grth/Fwd EPS grth/
Alfa Financial Software	LSE:ALFA	£328m	109p	17	-	3.8%	9.5%	-20.4%	45m	GBP	7	/Marg grth/Int Cov/
Crest Nicholson	LSE:CRST	£945m	368p	8	9.0%	-13.5%	1.0%	-8.5%	-66m	GBP	7	/RoE grth/Fwd EPS grth/
XP Power	LSE:XPP	£402m	2,100p	12	4.0%	-1.5%	8.5%	-17.6%	-52m	GBP	7	/Fwd EPS grth/FCF/
BT	LSE:BT.A	£18,844m	192p	8	8.0%	-7.4%	3.7%	-17.0%	-11,996m	GBP	7	/Marg grth/Fwd EPS grth//

Source: S&P CapitalIQ, 15 July 2019

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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-month momentum	Net Cash/ Debt(-)	Cur	Tests passed (out of 9)	Test failed
Sirius Real Estate	LSE:SRE	£672m	66p	15	4.7%	5.3%	12.7%	0.6%	-296m	EUR	9	na
MJ Gleeson	LSE:GLE	£432m	792p	13	4.0%	8.8%	9.7%	-7.1%	28m	GBP	9	na
Ten Entertainment	LSE:TEG	£163m	250p	12	4.4%	25.3%	12.4%	10.2%	-11m	GBP	8	/RoE grth/
Treatt	LSE:TET	£270m	460p	26	1.1%	1.4%	5.0%	12.7%	9m	GBP	8	/RoE grth/
On the Beach	LSE:OTB	£626m	477p	18	0.7%	10.1%	19.0%	6.3%	-1m	GBP	8	/FCF/
Vp	LSE:VP.	£342m	862p	9	3.5%	7.7%	5.1%	8.9%	-168m	GBP	8	/RoE grth/
Photo-Me International	LSE:PHTM	£355m	94p	10	9.0%	-5.1%	14.2%	4.9%	31m	GBP	8	/Fwd EPS grth/
Medica	LSE:MGP	£140m	126p	15	1.8%	8.2%	10.7%	-20.3%	1m	GBP	8	/RoE grth/
Henry Boot	LSE:BOOT	£327m	246p	9	3.7%	-0.2%	2.3%	-13.5%	-18m	GBP	8	/Fwd EPS grth/
Aptitude Software	LSE:APTD	£284m	460p	45	1.4%	-52.1%	4.4%	19.5%	17m	GBP	7	/PEG/Fwd EPS grth/
Avon Rubber	LSE:AVON	£422m	1,382p	18	1.2%	-1.4%	4.8%	3.6%	47m	GBP	7	/RoE grth/Fwd EPS grth/
Alfa Financial Software	LSE:ALFA	£328m	109p	17	-	3.8%	9.5%	-20.4%	45m	GBP	7	/Marg grth/Int Cov/
XP Power	LSE:XPP	£402m	2,100p	12	4.0%	-1.5%	8.5%	-17.6%	-52m	GBP	7	/Fwd EPS grth/FCF/

Source: S&P CapitalIQ, 15 July 2019

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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-month momentum	Net Cash/ Debt(-)	Cur	Tests passed (out of 9)	Test failed
Johnson Service	AIM:JSG	£620m	168p	17	1.8%	7.9%	4.2%	19.9%	-99m	GBP	9	na
Tracsis	AIM:TRCS	£187m	650p	24	0.2%	5.0%	7.5%	5.6%	18m	GBP	9	na
Water Intelligence	AIM:WATR	£52m	351p	29	-	28.5%	9.4%	12.1%	3m	USD	9	na
Churchill China	AIM:CHH	£176m	1,600p	21	1.8%	8.6%	9.9%	4.3%	17m	GBP	9	na
The Character Group	AIM:CCT	£124m	580p	12	4.5%	6.6%	10.9%	5.5%	20m	GBP	9	na
Bioventix	AIM:BVXP	£195m	3,785p	34	3.2%	4.4%	12.0%	-3.2%	5m	GBP	9	na
Billington	AIM:BILN	£38m	315p	9	4.1%	1.5%	3.7%	7.4%	8m	GBP	9	na
D4t4 Solutions	AIM:D4T4	£101m	252p	18	1.2%	2.2%	3.4%	-3.9%	11m	GBP	9	na
Gamma Communications	AIM:GAMA	£990m	1,050p	29	0.9%	19.4%	10.6%	-5.7%	31m	GBP	9	na
Fevertree Drinks	AIM:FEVR	£2,563m	2,207p	36	0.7%	11.1%	13.6%	-28.4%	84m	GBP	9	na
Arcontech	AIM:ARC	£23m	171p	26	0.8%	54.8%	3.4%	26.3%	3m	GBP	8	/Int Cov/
dotdigital	AIM:DOTD	£296m	100p	25	0.6%	18.8%	10.9%	13.6%	17m	GBP	8	/Int Cov/
The Property Franchise Group	AIM:TPFG	£43m	168p	13	5.0%	0.8%	5.1%	5.1%	2m	GBP	8	/RoE grth/
Serica Energy	AIM:SQZ	£317m	119p	3	-	297.5%	-20.2%	2.5%	35m	USD	8	/Fwd EPS grth/
Belvoir Lettings	AIM:BLV	£40m	115p	9	6.3%	6.8%	13.4%	0.9%	-10m	GBP	8	/FCF/
Nichols	AIM:NICL	£627m	1,700p	23	2.2%	4.8%	4.9%	1.5%	39m	GBP	8	/RoE grth/
Inspiration Healthcare	AIM:IHC	£21m	69p	20	-	2.9%	19.2%	3.8%	3m	GBP	8	/Int Cov/
Hotel Chocolat	AIM:HOTC	£399m	354p	38	0.6%	3.6%	14.0%	-0.9%	22m	GBP	8	/RoE grth/
Scientific Digital Imaging	AIM:SDI	£48m	50p	19	-	8.1%	24.2%	-3.3%	1m	GBP	8	/RoE grth/
Elecosoft	AIM:ELCO	£63m	78p	18	0.9%	14.7%	10.9%	-5.4%	-2m	GBP	8	/RoE grth/
Quixant	AIM:QXT	£167m	252p	12	1.2%	1.4%	11.8%	-6.6%	10m	USD	8	/RoE grth/
iomart	AIM:IOM	£348m	320p	16	2.3%	6.2%	8.2%	-10.5%	-39m	GBP	8	/RoE grth/
Redde	AIM:REDD	£342m	111p	8	10.5%	9.8%	-0.7%	-6.5%	-41m	GBP	8	/Fwd EPS grth/
Somero Enterprises	AIM:SOM	£157m	279p	10	5.4%	-9.5%	3.1%	-23.1%	28m	USD	8	/Fwd EPS grth/
Pennant International	AIM:PEN	£32m	88p	9	-	3.0%	8.3%	-27.9%	2m	GBP	8	/Marg grth/
AB Dynamics	AIM:ABDP	£568m	2,585p	48	0.1%	41.4%	15.7%	35.6%	19m	GBP	7	/Int Cov/PE/
SafeCharge International	AIM:SCH	£664m	434p	27	3.4%	20.5%	12.8%	36.3%	93m	USD	7	/RoE grth/Int Cov/
James Halstead	AIM:JHD	£1,074m	516p	27	2.6%	7.6%	2.7%	8.6%	63m	GBP	7	/RoE grth/Int Cov/
Best of the Best	AIM:BOTB	£28m	295p	17	0.7%	-3.5%	11.6%	10.4%	3m	GBP	7	/Fwd EPS grth/Int Cov/
Keystone Law	AIM:KEYS	£159m	509p	37	1.8%	3.6%	15.4%	13.0%	6m	GBP	7	/RoE grth/Marg grth/
ECO Animal Health	AIM:EAH	£283m	420p	18	2.6%	1.0%	8.2%	2.2%	16m	GBP	7	/RoE grth/FCF/
Gateley (Holdings)	AIM:GTLY	£182m	164p	13	4.3%	26.1%	5.2%	1.7%	-8m	GBP	7	/RoE grth/Marg grth/
Secure Income REIT	AIM:SIR	£1,272m	394p	24	3.3%	13.2%	3.8%	-3.4%	-1,007m	GBP	7	/RoE grth/Int Cov/
boohoo	AIM:BOO	£2,438m	210p	39	-	21.7%	18.9%	5.5%	191m	GBP	7	/RoE grth/PE/
M Winkworth	AIM:WINK	£15m	115p	12	6.6%	4.9%	6.1%	-3.4%	3m	GBP	7	/Marg grth/Int Cov/
Tristel	AIM:TSTL	£134m	300p	29	1.5%	39.2%	12.0%	-3.2%	4m	GBP	7	/RoE grth/Int Cov/
Mind Gym	AIM:MIND	£121m	122p	16	2.6%	9.4%	11.2%	-0.8%	8m	GBP	7	/RoE grth/Int Cov/
Watkin Jones	AIM:WJG	£509m	200p	12	3.8%	2.0%	10.4%	-9.0%	18m	GBP	7	/RoE grth/FCF/
Central Asia Metals	AIM:CAML	£355m	207p	9	7.0%	-1.9%	21.2%	-17.1%	-110m	USD	7	/RoE grth/Fwd EPS grth/
Dart	AIM:DTG	£1,280m	861p	10	1.2%	-15.9%	-0.4%	-7.9%	291m	GBP	7	/PEG/Fwd EPS grth/
Craneware	AIM:CRW	£496m	1,885p	38	1.4%	6.4%	6.2%	-28.2%	39m	USD	7	/PEG/Int Cov/
Portmeirion	AIM:PMP	£104m	980p	14	3.8%	-8.1%	9.5%	-17.0%	2m	GBP	7	/RoE grth/Fwd EPS grth/
Fulcrum Utility Services	AIM:FCRM	£52m	24p	6	8.9%	1.5%	-8.2%	-30.6%	10m	GBP	7	/RoE grth/Fwd EPS grth/

Source: S&P CapitalIQ, 15 July 2019