



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.

- Quality companies tend to be durable and so it’s proving with our screen. There are 16 companies in the FTSE All-Share index that pass all nine of our tests but, of these, only one is new to the list. Safety products specialist **Halma (HLMA)** now fits the bill because its PEG (price-to-earnings-growth) ratio looks more attractive than last month.
- There is no change at the top of our screen from the FTSE All Small Companies index – **Air Partner (AIR)** and **XP Power (XPP)** are still the only companies with a perfect score.
- There is consistency emerging in our Aim screen results, too. Eleven companies meet all the screening criteria and 10 of them were also 9/9 on the tests last month. The new arrival is personal care and beauty products manufacturer **Swallowfield (SWL)**. The company did, however, have a disappointing trading update recently which triggered a sharp drop in its share price. Our last IC View moved the company to ‘Hold’ pending better news and an up-swing in momentum.

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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 (i.e. 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 less 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.

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
Spirax-Sarco Engineering	LSE:SPX	£4,966m	6,750p	28	1.3%	11.5%	6.0%	17.9%	-374m	GBP	9	na
Ashtead	LSE:AHT	£11,456m	2,355p	14	1.4%	29.6%	8.4%	15.3%	-2,712m	GBP	9	na
HomeServe	LSE:HSV	£3,117m	945p	26	2.0%	9.1%	9.1%	30.9%	-238m	GBP	9	na
Victrex	LSE:VCT	£2,534m	2,950p	23	1.8%	11.8%	0.6%	13.2%	92m	GBP	9	na
Diageo	LSE:DGE	£68,814m	2,804p	23	2.3%	7.0%	8.6%	13.6%	-9,105m	GBP	9	na
RELX	LSE:REL	£33,568m	1,703p	20	2.3%	4.4%	6.6%	12.6%	-4,775m	GBP	9	na
Halma	LSE:HLMA	£5,181m	1,367p	28	1.1%	8.4%	6.9%	14.0%	-220m	GBP	9	na
Diploma	LSE:DPLM	£1,486m	1,313p	23	1.8%	10.1%	4.3%	14.2%	18m	GBP	9	na
Reckitt Benckiser	LSE:RB.	£45,673m	6,465p	20	2.5%	4.2%	7.3%	7.6%	-10,736m	GBP	9	na
Unilever	LSE:ULVR	£112,473m	4,198p	20	3.1%	2.2%	9.3%	7.2%	-20,421m	EUR	9	na
The Sage Group	LSE:SGE	£6,712m	619p	18	2.5%	9.6%	7.3%	3.5%	-656m	GBP	9	na
XP Power	LSE:XPP	£687m	3,590p	20	2.2%	22.2%	8.2%	-0.5%	-9m	GBP	9	na
Persimmon	LSE:PSN	£7,766m	2,482p	9	9.5%	9.6%	2.2%	-7.3%	1,303m	GBP	9	na
Bellway	LSE:BWV	£3,637m	2,961p	7	4.1%	13.9%	5.5%	-8.2%	-131m	GBP	9	na
Barratt Developments	LSE:BDEV	£5,232m	517p	8	8.3%	6.9%	4.7%	-6.5%	166m	GBP	9	na
Redrow	LSE:RDW	£1,929m	535p	7	4.1%	14.7%	8.1%	-12.7%	-35m	GBP	9	na
Games Workshop	LSE:GAW	£1,035m	3,200p	20	4.1%	94.0%	-24.5%	33.7%	29m	GBP	8	/Fwd EPS grth/
Rightmove	LSE:RMV	£4,609m	5,106p	29	1.1%	10.1%	9.7%	16.9%	25m	GBP	8	/RoE grth/
Experian	LSE:EXPN	£17,268m	1,907p	25	1.8%	5.2%	9.8%	23.0%	-3,475m	USD	8	/Marg grth/
ITV	LSE:ITV	£7,001m	175p	11	4.5%	-3.4%	1.5%	21.8%	-932m	GBP	8	/Fwd EPS grth/
Renishaw	LSE:RSW	£4,076m	5,600p	32	0.9%	26.5%	7.2%	16.2%	69m	GBP	8	/PE/
Moneysupermarket.com	LSE:MONY	£1,662m	310p	19	3.4%	-1.1%	8.2%	11.0%	35m	GBP	8	/Fwd EPS grth/
Smiths Group	LSE:SMIN	£6,866m	1,735p	17	2.5%	-2.4%	11.1%	15.4%	-961m	GBP	8	/Fwd EPS grth/
Safestore Holdings	LSE:SAFE	£1,147m	546p	20	2.6%	13.6%	5.6%	8.9%	-423m	GBP	8	/RoE grth/
Polymetal International	LSE:POLY	£2,972m	657p	9	5.1%	7.9%	27.6%	7.4%	-1,420m	USD	8	/RoE grth/
Croda International	LSE:CRDA	£6,440m	4,933p	26	1.6%	6.3%	7.7%	6.6%	-382m	GBP	8	/RoE grth/
Wizz Air	LSE:WIZZ	£2,687m	3,694p	16	-	19.3%	18.9%	8.3%	947m	EUR	8	/RoE grth/
Mondi	LSE:MNDI	£9,816m	2,029p	14	2.7%	12.9%	4.6%	4.3%	-1,326m	EUR	8	/RoE grth/
British American Tobacco	LSE:BATS	£89,796m	3,926p	13	5.0%	3.5%	9.0%	-3.3%	-46,094m	GBP	8	/PE/
AG BARR	LSE:BAG	£770m	677p	21	2.3%	1.9%	9.7%	-2.0%	15m	GBP	8	/RoE grth/
FDM Group	LSE:FDM	£1,060m	980p	29	2.9%	6.4%	8.1%	-5.0%	37m	GBP	8	/Int Cov/
Whitbread	LSE:WTB	£7,312m	4,000p	15	2.5%	2.0%	7.1%	-4.9%	-841m	GBP	8	/RoE grth/
Taylor Wimpey	LSE:TW.	£5,744m	176p	8	8.6%	6.2%	3.2%	-7.8%	512m	GBP	8	/RoE grth/
Card Factory	LSE:CARD	£693m	203p	11	12.0%	-2.2%	4.0%	-16.6%	-161m	GBP	8	/Fwd EPS grth/
Photo-Me International	LSE:PHTM	£411m	109p	12	7.8%	-2.5%	8.9%	-34.7%	25m	GBP	8	/Fwd EPS grth/
NEXT	LSE:NXT	£8,248m	6,106p	14	2.6%	2.7%	4.5%	19.7%	-1,047m	GBP	7	/RoE grth/Marg grth/
Vp	LSE:VP.	£464m	1,173p	12	2.2%	18.4%	5.4%	29.9%	-179m	GBP	7	/RoE grth/FCF/
Imperial Brands	LSE:IMB	£27,246m	2,869p	11	6.0%	-0.8%	2.7%	17.7%	-12,448m	GBP	7	/Fwd EPS grth/Int Cov/
Howden Joinery	LSE:HWDN	£3,294m	537p	17	2.1%	7.6%	7.8%	14.8%	241m	GBP	7	/RoE grth/Int Cov/
Kainos	LSE:KNOS	£488m	413p	33	1.6%	30.7%	10.2%	16.5%	29m	GBP	7	/RoE grth/PE/
NMC Health	LSE:NMC	£7,683m	3,690p	34	0.4%	59.1%	12.4%	9.0%	-1,011m	USD	7	/Int Cov/PE/
IMI	LSE:IMI	£3,068m	1,139p	16	3.5%	7.2%	9.4%	9.4%	-251m	GBP	7	/RoE grth/Marg grth/
Sirius Real Estate	LSE:SRE	£614m	61p	8	4.6%	133.1%	-25.1%	2.7%	-288m	EUR	7	/RoE grth/Fwd EPS grth/
The Berkeley Group	LSE:BGK	£4,838m	3,620p	10	3.0%	-31.6%	-19.4%	-7.2%	687m	GBP	7	/PEG/Fwd EPS grth/
BT Group	LSE:BT.A	£21,906m	222p	9	6.9%	-6.0%	0.1%	-8.3%	-10,725m	GBP	7	/RoE grth/Fwd EPS grth/
Dairy Crest	LSE:DCG	£715m	463p	13	4.9%	-0.5%	4.2%	-12.4%	-271m	GBP	7	/Fwd EPS grth/FCF/

Source: S&P CapitalIQ, 16 July 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
Air Partner	LSE:AIR	£58m	111p	12	4.9%	13.3%	8.1%	16.7%	15m	GBP	9	na
XP Power	LSE:XPP	£687m	3,590p	20	2.2%	22.2%	8.2%	-0.5%	-9m	GBP	9	na
MJ Gleeson	LSE:GLE	£417m	766p	14	3.1%	10.9%	9.1%	6.2%	27m	GBP	8	/Int Cov/
Photo-Me International	LSE:PHTM	£411m	109p	12	7.8%	-2.5%	8.9%	-34.7%	25m	GBP	8	/Fwd EPS grth/
Vp	LSE:VP.	£464m	1,173p	12	2.2%	18.4%	5.4%	29.9%	-179m	GBP	7	/RoE grth/FCF/
Kainos	LSE:KNOS	£488m	413p	33	1.6%	30.7%	10.2%	16.5%	29m	GBP	7	/RoE grth/PE/
Treatt	LSE:TET	£262m	450p	25	1.1%	1.3%	6.0%	10.0%	6m	GBP	7	/RoE grth/FCF/
Sirius Real Estate	LSE:SRE	£614m	61p	8	4.6%	133.1%	-25.1%	2.7%	-288m	EUR	7	/RoE grth/Fwd EPS grth/
Henry Boot	LSE:BOOT	£374m	282p	10	2.8%	-11.3%	1.0%	-6.0%	-29m	GBP	7	/PEG/Fwd EPS grth/

Source: S&P CapitalIQ, 16 July 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
Elecosoft	AIM:ELCO	£65m	84p	24	0.7%	42.7%	10.1%	56.2%	1m	GBP	9	na
IG Design	AIM:IGR	£326m	510p	20	1.2%	14.4%	7.9%	21.7%	4m	GBP	9	na
Focusrite	AIM:TUNE	£266m	468p	29	0.6%	10.1%	5.0%	5.8%	20m	GBP	9	na
Belvoir Lettings	AIM:BLV	£38m	108p	9	6.5%	2.7%	5.0%	0.9%	-5m	GBP	9	na
Victoria	AIM:VCP	£961m	814p	27	-	21.8%	44.1%	10.1%	-97m	GBP	9	na
Quixant	AIM:QXT	£282m	425p	22	0.6%	8.9%	13.6%	3.5%	4m	USD	9	na
Scapa	AIM:SCPA	£650m	423p	22	0.6%	5.3%	7.9%	4.5%	-4m	GBP	9	na
Caledonia Mining Corporation	AIM:CMCL	£122m	610p	-	-	26.6%	10.6%	-0.9%	12m	USD	9	na
Somero Enterprises	AIM:SOM	£221m	393p	14	3.0%	21.6%	4.6%	-0.9%	19m	USD	9	na
Redde	AIM:REDD	£522m	172p	14	6.2%	8.4%	3.7%	1.0%	-23m	GBP	9	na
Swallowfield	AIM:SWL	£46m	268p	12	1.9%	41.4%	11.5%	-12.3%	-1m	GBP	9	na
Craneware plc	AIM:CRW	£607m	2,275p	50	0.9%	9.4%	17.7%	25.9%	52m	USD	8	/Int Cov/
Advanced Medical Solutions	AIM:AMS	£755m	354p	35	0.3%	8.0%	7.9%	15.5%	62m	GBP	8	/Int Cov/
Tristel	AIM:TSTL	£133m	308p	38	1.3%	5.1%	13.7%	11.6%	5m	GBP	8	/Int Cov/
Tracsis	AIM:TRCS	£171m	605p	25	0.2%	2.6%	5.5%	13.5%	18m	GBP	8	/PEG/
SafeCharge International	AIM:SCH	£490m	331p	22	3.9%	12.9%	11.4%	8.2%	109m	USD	8	/Int Cov/
Churchill China	AIM:CHH	£112m	1,018p	16	2.4%	11.9%	6.9%	8.8%	16m	GBP	8	/Int Cov/
Inspired Energy	AIM:INSE	£118m	20p	12	2.8%	7.2%	9.7%	4.1%	-15m	GBP	8	/RoE grth/
The Property Franchise Group	AIM:TPFG	£37m	143p	11	5.3%	9.4%	2.7%	1.8%	0m	GBP	8	/RoE grth/
iomart Group	AIM:IOM	£411m	380p	19	2.6%	10.7%	10.9%	3.1%	-27m	GBP	8	/RoE grth/
Patisserie Holdings	AIM:CAKE	£428m	420p	22	0.9%	14.4%	8.8%	2.5%	29m	GBP	8	/RoE grth/
Secure Income REIT	AIM:SIR	£1,228m	382p	25	3.3%	13.6%	3.7%	-0.4%	-878m	GBP	8	/Int Cov/
Breedon Group	AIM:BREE	£1,377m	82p	18	-	11.8%	14.3%	4.8%	-110m	GBP	8	/RoE grth/
RWS Holdings	AIM:RWS	£1,220m	446p	26	1.5%	23.0%	11.1%	1.0%	-83m	GBP	8	/RoE grth/
Portmeirion Group	AIM:PMP	£122m	1,148p	16	3.0%	11.1%	6.5%	3.2%	2m	GBP	8	/RoE grth/
Andrews Sykes	AIM:ASY	£213m	505p	-	4.7%	-	-	-7.3%	20m	GBP	8	/Fwd EPS grth/
Telford Homes	AIM:TEF	£300m	398p	7	4.3%	12.0%	3.2%	-6.5%	-100m	GBP	8	/FCF/
Fulcrum Utility Services	AIM:FCRM	£145m	67p	15	3.1%	15.8%	0.2%	-7.7%	9m	GBP	8	/RoE grth/
Billington	AIM:BILN	£33m	271p	9	4.2%	3.4%	-	-1.1%	6m	GBP	8	/Fwd EPS grth/
Central Asia Metals	AIM:CAML	£423m	247p	7	6.7%	68.8%	-6.5%	-23.4%	-139m	USD	8	/Fwd EPS grth/
Walker Greenbank	AIM:WGB	£77m	109p	8	4.0%	-1.1%	4.7%	-9.2%	-5m	GBP	8	/Fwd EPS grth/
XLMedia	AIM:XLM	£245m	111p	11	5.3%	-11.3%	10.9%	-28.7%	38m	USD	8	/Fwd EPS grth/
Fevertree Drinks	AIM:FEVR	£4,165m	3,605p	82	0.3%	12.5%	14.6%	34.0%	51m	GBP	7	/PEG/PE/
Arcontech Group	AIM:ARC	£14m	106p	22	0.9%	11.4%	15.2%	48.7%	3m	GBP	7	/RoE grth/Int Cov/
Alliance Pharma	AIM:APH	£507m	99p	22	1.3%	-16.0%	14.8%	27.4%	-72m	GBP	7	/PEG/Fwd EPS grth/
Bioventix	AIM:BVXP	£156m	3,030p	31	3.2%	5.2%	0.8%	20.8%	6m	GBP	7	/PEG/Int Cov/
boohoo group	AIM:BOO	£2,323m	202p	54	-	15.5%	22.3%	30.7%	133m	GBP	7	/FCF/PE/
Gamma Communications	AIM:GAMA	£738m	786p	28	1.1%	13.3%	8.9%	15.1%	32m	GBP	7	/RoE grth/Int Cov/
D4t4 Solutions	AIM:D4T4	£58m	153p	13	1.6%	8.1%	10.9%	7.8%	4m	GBP	7	/RoE grth/FCF/
Shoe Zone	AIM:SHOE	£93m	186p	11	5.5%	2.7%	1.2%	21.9%	6m	GBP	7	/Marg grth/Int Cov/
Gateley (Holdings)	AIM:GTLY	£180m	166p	15	4.0%	15.2%	9.0%	5.7%	-7m	GBP	7	/RoE grth/Marg grth/
AdEPT Telecom	AIM:ADT	£86m	361p	-	2.5%	-	-	7.8%	-24m	GBP	7	/PEG/Fwd EPS grth/
Abcam	AIM:ABC	£2,711m	1,327p	40	0.8%	24.2%	6.4%	3.3%	93m	GBP	7	/Int Cov/PE/
Nichols	AIM:NICL	£544m	1,475p	21	2.3%	2.1%	4.7%	3.8%	36m	GBP	7	/RoE grth/Int Cov/
James Halstead	AIM:JHD	£832m	400p	22	3.3%	3.5%	3.9%	1.3%	47m	GBP	7	/RoE grth/Int Cov/
Zytronic	AIM:ZYT	£71m	443p	16	4.3%	-4.5%	15.4%	-0.3%	14m	GBP	7	/RoE grth/Fwd EPS grth/
NAHL Group	AIM:NAH	£56m	121p	6	13.1%	-12.5%	3.1%	-11.6%	-12m	GBP	7	/RoE grth/Fwd EPS grth/
Gama Aviation	AIM:GMAA	£129m	203p	10	1.4%	-15.2%	39.7%	-2.7%	-13m	USD	7	/RoE grth/Fwd EPS grth/
dotDigital	AIM:DOTD	£216m	73p	21	0.8%	24.8%	22.8%	-18.8%	10m	GBP	7	/RoE grth/Int Cov/
United Carpets	AIM:UCG	£6m	8p	-	5.2%	-	-	-6.5%	2m	GBP	7	/RoE grth/Fwd EPS grth/
Petards	AIM:PEG	£14m	25p	12	-	43.9%	14.5%	-5.8%	1m	GBP	7	/RoE grth/FCF/
Dewhurst	AIM:DWHT	£59m	953p	16	1.3%	9.8%	27.6%	-13.3%	18m	GBP	7	/RoE grth/Int Cov/

Source: S&P CapitalIQ, 16 July 2018

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