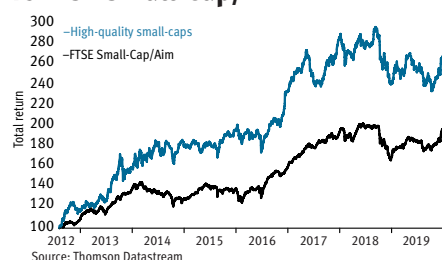




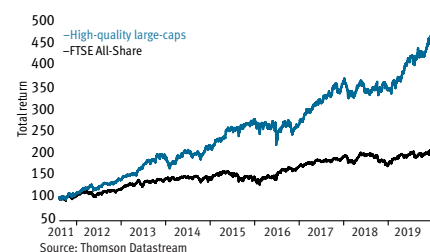
AlphaScreens: the quest for Quality

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.

■ Luxury fashion business **Burberry (BRBY)** set out how it expects coronavirus to impact its sizeable Chinese sales last week. Unsurprisingly the outbreak has coincided with falls in its share price. Taking a three-month view, the shares are only down 7 per cent, which is testimony to positive sentiment before COVID-19 reared its ugly head. The shares still score 9/9 on our quality screen so, Burberry could well be a share with rebound potential later in the year.

■ One star that has fallen out of the full-marks club is data, publishing and events business **RELX (REL)**. The company doesn't meet our test on return on equity (ROE) growth momentum but it had to keep up with some phenomenal numbers. With trailing 12-month ROE still around 66 per cent, failing the one test really isn't cause for concern and for a deeper dive into the business, it was covered in Phil Oakley's *Alpha round-up* on 14 February.

■ For all shares, especially those in small-cap and Aim companies, our quality screen is a first step for further analysis – doing well against the tests isn't a buy signal on its own. That said, it's always exciting when a smaller company comes from nowhere. That is what's happened with Aim-listed **Solid State (SOLI)**, which makes electronic components and materials. You should never pile into a £53m market-cap business on the strength of a screen, but it would be interesting to understand why it now scores 9/9. *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
Sirius Real Estate	LSE:SRE	£965m	93p	21	3.2%	8.4%	10.9%	24.3%	-278m	EUR	9	na
Barratt Developments	LSE:BDEV	£8,834m	871p	11	5.4%	3.3%	2.8%	33.6%	375m	GBP	9	na
FDM Group	LSE:FDM	£1,101m	1,008p	26	3.2%	4.8%	6.0%	27.1%	4m	GBP	9	na
Hollywood Bowl	LSE:BOWL	£423m	282p	19	4.2%	4.5%	4.7%	22.6%	-2m	GBP	9	na
Polypipe	LSE:PLP	£1,208m	603p	21	1.9%	2.2%	7.4%	26.5%	-192m	GBP	9	na
Ashtead	LSE:AHT	£12,056m	2,679p	13	1.5%	13.0%	7.6%	12.3%	-5,237m	GBP	9	na
Diploma	LSE:DPLM	£2,256m	1,993p	28	1.5%	9.9%	4.7%	17.2%	-15m	GBP	9	na
Spirax-Sarco Engineering	LSE:SPX	£6,828m	9,275p	35	1.1%	3.8%	5.7%	10.1%	-433m	GBP	9	na
Marshalls	LSE:MSLH	£1,667m	841p	29	1.4%	9.8%	5.7%	15.1%	-98m	GBP	9	na
PayPoint	LSE:PAY	£644m	953p	15	8.8%	2.1%	3.3%	2.1%	21m	GBP	9	na
Diageo	LSE:DGE	£71,874m	3,080p	22	2.2%	3.3%	6.1%	-0.5%	-13,008m	GBP	9	na
Moneysupermarket.com	LSE:MONY	£1,762m	328p	18	3.4%	4.7%	6.2%	-7.0%	-13m	GBP	9	na
Burberry	LSE:BRBY	£8,061m	1,999p	22	2.1%	5.0%	8.9%	-7.1%	-416m	GBP	9	na
Rotork	LSE:ROR	£2,673m	307p	23	1.9%	2.1%	6.4%	-9.7%	43m	GBP	9	na
Games Workshop	LSE:GAW	£2,255m	6,900p	29	1.8%	16.7%	4.3%	22.4%	5m	GBP	8	/RoE grth/
Taylor Wimpey	LSE:TW.	£7,579m	232p	11	7.9%	-4.0%	0.9%	35.1%	366m	GBP	8	/Fwd EPS grth/
Rightmove	LSE:RMV	£6,009m	688p	33	1.0%	8.7%	8.7%	15.8%	42m	GBP	8	/RoE grth/
Redrow	LSE:RDW	£2,837m	827p	9	3.7%	2.7%	2.1%	27.6%	14m	GBP	8	/RoE grth/
Kainos	LSE:KNOS	£1,043m	856p	46	1.1%	11.5%	12.9%	52.9%	37m	GBP	8	/PE/
Countryside Properties	LSE:CSP	£2,339m	525p	12	3.1%	9.3%	8.7%	41.2%	78m	GBP	8	/FCF/
MJ Gleeson	LSE:GLE	£540m	976p	15	3.5%	8.8%	9.3%	21.4%	27m	GBP	8	/RoE grth/
RELX	LSE:REL	£39,937m	2,073p	21	2.2%	5.3%	6.1%	12.1%	-6,276m	GBP	8	/RoE grth/
HomeServe	LSE:HSV	£4,427m	1,323p	32	1.6%	9.5%	11.1%	14.7%	-451m	GBP	8	/RoE grth/
Intertek Group	LSE:ITRK	£9,489m	5,896p	27	1.7%	6.2%	5.1%	12.3%	-1,082m	GBP	8	/RoE grth/
Vp	LSE:VP.	£400m	1,010p	10	3.0%	6.5%	3.0%	14.8%	-262m	GBP	8	/RoE grth/
Polymetal International	LSE:POLY	£5,984m	1,273p	12	3.1%	17.7%	19.9%	8.8%	-1,736m	USD	8	/RoE grth/
Smith & Nephew	LSE:SN.	£15,889m	1,819p	22	1.5%	0.1%	6.5%	9.9%	-2,042m	USD	8	/RoE grth/
The Sage Group	LSE:SGE	£8,554m	784p	27	2.2%	4.5%	7.7%	6.3%	-394m	GBP	8	/RoE grth/
Domino's Pizza	LSE:DOM	£1,445m	314p	20	3.0%	-5.3%	6.6%	8.3%	-250m	GBP	8	/Fwd EPS grth/
Rio Tinto Group	LSE:RIO	£70,883m	4,197p	10	6.2%	20.5%	-14.5%	1.0%	-4,544m	USD	8	/Fwd EPS grth/
The Unilever	LSE:ULVR	£140,867m	4,606p	-	-	7.4%	6.7%	0.8%	-23,111m	EUR	8	/PE/
Photo-Me International	LSE:PHTM	£325m	86p	9	9.8%	7.3%	3.2%	-5.9%	8m	GBP	8	/RoE grth/
On the Beach Group	LSE:OTB	£560m	427p	18	0.8%	10.7%	19.4%	-4.0%	55m	GBP	8	/RoE grth/
Persimmon	LSE:PSN	£10,225m	3,230p	12	7.3%	-5.3%	0.6%	30.3%	824m	GBP	7	/PEG/Fwd EPS grth/
Bellway	LSE:BWY	£5,210m	4,231p	10	3.6%	-6.0%	3.5%	28.3%	186m	GBP	7	/RoE grth/Fwd EPS grth/
Avon Rubber	LSE:AVON	£825m	2,705p	28	0.8%	5.2%	16.1%	40.0%	48m	GBP	7	/RoE grth/PE/
Forterra	LSE:FORT	£713m	358p	14	2.9%	-1.7%	2.4%	29.1%	-50m	GBP	7	/RoE grth/Fwd EPS grth/
Howden Joinery	LSE:HWDN	£4,356m	728p	21	1.6%	7.0%	7.1%	22.5%	217m	GBP	7	/RoE grth/Int Cov/
Experian	LSE:EXPN	£25,386m	2,823p	33	1.3%	7.7%	10.3%	15.8%	-4,212m	USD	7	/RoE grth/PE/
Halma	LSE:HLMA	£8,336m	2,198p	36	0.7%	10.3%	6.9%	16.9%	-310m	GBP	7	/RoE grth/PE/
SEGRO	LSE:SGRO	£10,249m	935p	35	2.0%	9.3%	7.1%	9.2%	-1,811m	GBP	7	/RoE grth/Int Cov/
QinetiQ	LSE:QQ.	£2,128m	379p	19	1.7%	-1.6%	10.0%	11.8%	173m	GBP	7	/RoE grth/Fwd EPS grth/
NEXT	LSE:NXT	£9,087m	7,128p	15	2.3%	5.5%	4.2%	7.3%	-2,576m	GBP	7	/RoE grth/Marg grth/
Imperial Brands	LSE:IMB	£17,118m	1,825p	7	11.3%	-3.6%	2.8%	5.3%	-11,350m	GBP	7	/RoE grth/Fwd EPS grth/
Anglo American	LSE:AAL	£25,723m	2,094p	10	3.7%	-	-	2.7%	-3,225m	USD	7	/RoE grth/Fwd EPS grth/
Victrex	LSE:VCT	£1,997m	2,312p	21	2.6%	2.6%	5.4%	-1.9%	73m	GBP	7	/RoE grth/Int Cov/
GlaxoSmithKline	LSE:GSK	£83,039m	1,669p	14	4.8%	-6.6%	3.9%	-1.8%	-25,722m	GBP	7	/RoE grth/Fwd EPS grth/
Mondi	LSE:MNDI	£8,059m	1,663p	12	4.1%	-9.4%	-11.3%	-0.8%	-2,341m	EUR	7	/PEG/Fwd EPS grth/
IMI	LSE:IMI	£2,966m	1,095p	15	3.7%	-2.7%	5.5%	-1.6%	-513m	GBP	7	/Marg grth/Fwd EPS grth/
Aptitude Software	LSE:APTD	£299m	532p	49	1.4%	-53.2%	-38.3%	-9.7%	67m	GBP	7	/PEG/Fwd EPS grth/
NMC Health	LSE:NMC	£1,617m	775p	6	2.3%	27.2%	22.4%	-67.3%	-2,228m	USD	7	/RoE grth/Int Cov/

Source: S&P CapitalIQ, 17 February 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
Hollywood Bowl	LSE:BOWL	£423m	282p	19	4.2%	4.5%	4.7%	22.6%	-2m	GBP	9	na
Devro	LSE:DVO	£279m	167p	11	5.4%	5.3%	4.9%	5.2%	-149m	GBP	9	na
MJ Gleeson	LSE:GLE	£540m	976p	15	3.5%	8.8%	9.3%	21.4%	27m	GBP	8	/RoE grth/
Treatt	LSE:TET	£318m	536p	29	1.0%	6.7%	7.2%	23.4%	16m	GBP	8	/RoE grth/
Porvair	LSE:PRV	£339m	738p	28	0.7%	3.7%	8.4%	25.1%	4m	GBP	8	/RoE grth/
Vp	LSE:VP	£400m	1,010p	10	3.0%	6.5%	3.0%	14.8%	-262m	GBP	8	/RoE grth/
Photo-Me International	LSE:PHTM	£325m	86p	9	9.8%	7.3%	3.2%	-5.9%	8m	GBP	8	/RoE grth/
On the Beach	LSE:OTB	£560m	427p	18	0.8%	10.7%	19.4%	-4.0%	55m	GBP	8	/RoE grth/
Avon Rubber	LSE:AVON	£825m	2,705p	28	0.8%	5.2%	16.1%	40.0%	48m	GBP	7	/RoE grth/PE/
Forterra	LSE:FORT	£713m	358p	14	2.9%	-1.7%	2.4%	29.1%	-50m	GBP	7	/RoE grth/Fwd EPS grth/
Aptitude Software Group	LSE:APTD	£299m	532p	49	1.4%	-53.2%	-38.3%	-9.7%	67m	GBP	7	/PEG/Fwd EPS grth/

Source: S&P CapitalIQ, 17 February 2020

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
SDI	AIM:SDI	£79m	82p	23	-	23.2%	15.8%	27.8%	-3m	GBP	9	na
Churchill China	AIM:CHH	£219m	1,990p	25	1.5%	13.2%	11.1%	22.8%	13m	GBP	9	na
Sigma Capital	AIM:SGM	£103m	116p	9	1.7%	2.8%	2.2%	11.6%	13m	GBP	9	na
Solid State	AIM:SOLI	£53m	625p	15	2.0%	16.7%	3.5%	31.3%	-1m	GBP	9	na
Judges Scientific	AIM:JDG	£339m	5,430p	26	0.7%	17.9%	0.2%	11.6%	5m	GBP	9	na
Gamma Communications	AIM:GAMA	£1,256m	1,325p	31	0.7%	33.6%	7.1%	10.4%	36m	GBP	9	na
Belvoir Group	AIM:BLV	£65m	175p	14	4.1%	8.5%	16.2%	46.0%	-10m	GBP	8	/FCF/
The Property Franchise	AIM:TPFG	£56m	215p	15	3.9%	9.8%	4.3%	41.0%	3m	GBP	8	/RoE grth/
Gateley	AIM:GTLY	£247m	213p	15	3.8%	6.1%	6.9%	32.7%	-27m	GBP	8	/RoE grth/
Oxford Metrics	AIM:OMG	£153m	122p	29	1.5%	10.2%	30.3%	40.5%	14m	GBP	8	/Marg grth/
Bioventix	AIM:BVXP	£200m	3,855p	31	3.1%	11.6%	8.6%	18.6%	7m	GBP	8	/Int Cov/
dotdigital Group	AIM:DOTD	£320m	108p	27	0.6%	21.9%	6.2%	20.8%	19m	GBP	8	/Int Cov/
Tracsis	AIM:TRCS	£228m	790p	26	0.2%	10.3%	5.4%	26.4%	24m	GBP	8	/RoE grth/
Dart	AIM:DTG	£2,825m	1,897p	18	0.5%	7.2%	5.2%	43.2%	455m	GBP	8	/RoE grth/
Johnson Service	AIM:JSG	£792m	215p	21	1.4%	11.8%	4.0%	25.0%	-131m	GBP	8	/RoE grth/
Watkin Jones	AIM:WJG	£676m	265p	14	3.2%	10.6%	12.1%	22.1%	77m	GBP	8	/RoE grth/
Billington	AIM:BILN	£53m	443p	12	2.9%	7.4%	-2.0%	31.8%	8m	GBP	8	/Fwd EPS grth/
Cerillion	AIM:CER	£65m	220p	17	2.2%	61.5%	-0.2%	17.0%	5m	GBP	8	/Fwd EPS grth/
James Halstead	AIM:JHD	£1,132m	544p	29	2.6%	4.4%	4.0%	10.1%	68m	GBP	8	/RoE grth/
Tribal	AIM:TRB	£145m	71p	16	1.5%	1.6%	10.0%	17.8%	2m	GBP	8	/Marg grth/
Anpario	AIM:ANP	£79m	340p	18	2.1%	6.2%	5.9%	3.0%	13m	GBP	8	/Int Cov/
Elecosoft	AIM:ELCO	£63m	78p	18	0.9%	5.6%	15.0%	0.6%	-3m	GBP	8	/RoE grth/
Hotel Chocolat	AIM:HOC	£506m	438p	43	0.4%	7.5%	11.7%	3.4%	6m	GBP	8	/RoE grth/
RWS Holdings	AIM:RWS	£1,617m	588p	27	1.5%	4.1%	8.7%	-1.8%	-37m	GBP	8	/RoE grth/
Redde	AIM:REDD	£320m	104p	8	11.2%	6.2%	-0.5%	-2.1%	-35m	GBP	8	/Fwd EPS grth/
Quartix	AIM:QTX	£204m	425p	36	2.9%	-18.1%	-0.5%	32.4%	5m	GBP	7	/PEG/Fwd EPS grth/
Arcontech	AIM:ARC	£30m	230p	29	0.9%	11.4%	10.1%	24.3%	4m	GBP	7	/FCF/Int Cov/
ULS Technology	AIM:ULS	£42m	65p	11	3.9%	-13.0%	-23.2%	29.8%	-5m	GBP	7	/PEG/Fwd EPS grth/
Epwin Group	AIM:EPWN	£158m	111p	11	4.4%	0.7%	8.0%	31.1%	-88m	GBP	7	/RoE grth/Marg grth/
Central Asia Metals	AIM:CAML	£362m	210p	9	6.9%	-2.3%	3.7%	-0.9%	-101m	USD	7	/RoE grth/Fwd EPS grth/
Prime People	AIM:PRP	£12m	100p	-	5.2%	-	-	4.2%	2m	GBP	7	/Fwd EPS grth/Int Cov/
Andrews Sykes	AIM:ASY	£232m	550p	-	4.3%	-	-	-11.3%	8m	GBP	7	/RoE grth/Fwd EPS grth/
AB Dynamics	AIM:ABDP	£424m	1,890p	29	0.2%	17.5%	15.5%	-25.9%	36m	GBP	7	/RoE grth/Int Cov/
UniVision Engineering	AIM:UVEL	£6m	1p	-	3.7%	-	-	-27.5%	0m	GBP	7	/Fwd EPS grth/FCF/

Source: S&P CapitalIQ, 17 February 2020

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