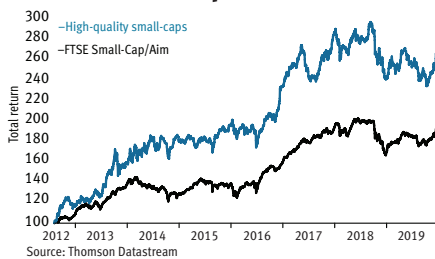




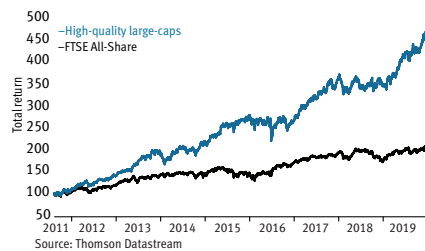
# AlphaScreens: the quest for Quality

*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.

- IT services business **FDM Group (FDM)** tops our first FTSE All-Share quality screen of the year. Larger companies that also pass 9/9 tests include high-end fashion house **Burberry (BRBY)**, **Spirax-Sarco Engineering (SPX)**, equipment rental company **Ashtead (AHT)**, drinks giant **Diageo (DGE)** and publishing, data and events business **RELX (REL)**.
- These names have been by-words for quality long-term investments and several have seen their shares make double-digit gains in the past three months, demonstrating the popularity of quality strategies.
- Further down the scale, our small-cap-only screen is still highlighting entertainments business **Hollywood Bowl (BOWL)** and food products specialist **Devro (DVO)**.
- On Aim, four smaller companies pass all our quality tests. Of course, when looking at these companies, the quality screen is just a first step in a potential investor’s due diligence, but doing well against the criteria makes for a promising start. *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
FDM Group	LSE:FDM	£1,103m	1,010p	26	3.2%	5.2%	6.0%	43.7%	4m	GBP	9	na
Hollywood Bowl	LSE:BOWL	£453m	302p	20	4.0%	4.2%	4.9%	32.5%	-2m	GBP	9	na
Sirius Real Estate	LSE:SRE	£927m	89p	20	3.4%	8.2%	11.5%	21.5%	-278m	EUR	9	na
Spirax-Sarco Engineering	LSE:SPX	£6,755m	9,175p	34	1.1%	4.0%	6.4%	22.3%	-433m	GBP	9	na
PayPoint	LSE:PAY	£735m	1,088p	17	7.7%	2.5%	3.9%	20.2%	21m	GBP	9	na
Ashtead	LSE:AHT	£11,536m	2,554p	12	1.6%	13.0%	7.8%	18.5%	-5,237m	GBP	9	na
Burberry	LSE:BRBY	£9,440m	2,329p	25	1.8%	6.7%	9.8%	24.1%	-416m	GBP	9	na
Barratt Developments	LSE:BDEV	£8,090m	799p	11	5.8%	0.4%	3.4%	18.6%	758m	GBP	9	na
Polypipe	LSE:PLP	£1,053m	526p	18	2.2%	2.2%	7.6%	19.0%	-192m	GBP	9	na
RELX	LSE:REL	£38,663m	2,004p	21	2.1%	9.9%	6.0%	15.2%	-6,757m	GBP	9	na
Diploma	LSE:DPLM	£2,192m	1,937p	27	1.5%	9.8%	4.7%	15.2%	-15m	GBP	9	na
Diageo	LSE:DGE	£76,665m	3,281p	24	2.1%	6.2%	5.9%	5.3%	-11,639m	GBP	9	na
Moneysupermarket.com	LSE:MONY	£1,785m	333p	18	3.3%	5.3%	6.4%	-2.1%	-13m	GBP	9	na
Games Workshop	LSE:GAW	£2,289m	7,005p	30	1.8%	16.7%	4.3%	52.7%	5m	GBP	8	/RoE grth/
Rightmove	LSE:RMV	£5,798m	663p	32	1.0%	8.1%	8.8%	18.5%	42m	GBP	8	/RoE grth/
Taylor Wimpey	LSE:TW.	£6,944m	212p	10	8.7%	-4.2%	1.0%	28.3%	366m	GBP	8	/Fwd EPS grth/
Kainos	LSE:KNOS	£1,004m	824p	45	1.1%	11.6%	12.3%	66.1%	37m	GBP	8	/PE/
Countryside Properties	LSE:CSP	£2,230m	499p	11	3.3%	9.4%	7.2%	36.1%	78m	GBP	8	/FCF/
Rio Tinto	LSE:RIO	£78,547m	4,651p	10	5.6%	22.3%	-13.3%	17.4%	-4,544m	USD	8	/Fwd EPS grth/
Vp	LSE:VR	£412m	1,040p	10	2.9%	6.5%	3.0%	30.0%	-262m	GBP	8	/RoE grth/
MJ Gleeso	LSE:GLE	£542m	980p	15	3.5%	9.3%	9.3%	22.2%	30m	GBP	8	/FCF/
Redrow	LSE:RDW	£2,655m	774p	8	3.9%	1.6%	0.3%	19.3%	124m	GBP	8	/RoE grth/
Intertek	LSE:ITRK	£9,585m	5,956p	27	1.7%	6.3%	5.4%	20.7%	-1,082m	GBP	8	/RoE grth/
Halma	LSE:HLMA	£8,173m	2,155p	36	0.7%	10.3%	6.7%	16.2%	-310m	GBP	8	/RoE grth/
HomeServe	LSE:HSV	£4,467m	1,335p	32	1.6%	9.8%	10.6%	16.5%	-451m	GBP	8	/RoE grth/
Experian	LSE:EXPN	£24,068m	2,650p	31	1.4%	7.6%	10.0%	11.8%	-4,212m	USD	8	/RoE grth/
Segro	LSE:SGRO	£9,908m	904p	35	2.1%	11.3%	8.1%	8.2%	-1,897m	GBP	8	/RoE grth/
Domino's Pizza	LSE:DOM	£1,397m	304p	20	3.1%	-6.3%	7.8%	10.8%	-250m	GBP	8	/Fwd EPS grth/
Polymetal International	LSE:POLY	£5,873m	1,249p	13	3.1%	15.0%	22.7%	6.5%	-1,736m	USD	8	/RoE grth/
The Sage Group	LSE:SGE	£8,011m	734p	25	2.3%	4.9%	8.0%	6.4%	-394m	GBP	8	/RoE grth/
Wizz Air	LSE:WIZZ	£3,103m	4,254p	16	-	20.2%	19.5%	9.5%	-385m	EUR	8	/FCF/
Smith & Nephew	LSE:SN.	£16,524m	1,892p	23	1.5%	0.0%	7.4%	3.4%	-2,042m	USD	8	/RoE grth/
Photo-Me International	LSE:PHTM	£350m	93p	10	9.1%	7.3%	3.2%	1.3%	8m	GBP	8	/RoE grth/
The Unilever Group	LSE:ULVR	£131,340m	4,400p	-	-	5.7%	7.5%	-4.9%	-24,161m	EUR	8	/PE/
On the Beach	LSE:OTB	£573m	437p	17	0.8%	18.6%	13.6%	0.0%	55m	GBP	8	/RoE grth/
Avon Rubber	LSE:AVON	£752m	2,465p	26	0.8%	5.3%	15.4%	45.5%	48m	GBP	7	/RoE grth/PE/
Persimmon	LSE:PSN	£9,151m		11	8.1%	-5.3%	0.0%	20.5%	824m	GBP	7	/PEG/Fwd EPS grth/
Howden Joinery	LSE:HWDN	£4,177m	698p	21	1.7%	6.6%	6.6%	22.4%	217m	GBP	7	/RoE grth/Int Cov/
Anglo American	LSE:AAL	£27,661m	2,246p	10	3.4%	13.8%	-6.7%	18.2%	-3,225m	USD	7	/RoE grth/Fwd EPS grth/
Bellway	LSE:BWY	£4,931m	4,004p	10	3.8%	-6.0%	3.4%	18.5%	186m	GBP	7	/RoE grth/Fwd EPS grth/
IMI	LSE:IMI	£3,192m	1,179p	16	3.4%	-2.6%	6.0%	21.7%	-513m	GBP	7	/Marg grth/Fwd EPS grth/
Victrex	LSE:VCT	£2,097m	2,428p	22	2.5%	3.7%	6.5%	12.6%	73m	GBP	7	/RoE grth/Int Cov/
Forterra	LSE:FORT	£687m	345p	13	3.0%	-1.4%	5.5%	15.6%	-50m	GBP	7	/RoE grth/Fwd EPS grth/
QinetiQ	LSE:QQ.	£2,039m	363p	18	1.8%	-1.8%	9.1%	17.9%	173m	GBP	7	/RoE grth/Fwd EPS grth/
lbstock	LSE:IBST	£1,199m	293p	15	3.2%	-4.7%	6.6%	13.6%	-99m	GBP	7	/RoE grth/Fwd EPS grth/
GlaxoSmithKline	LSE:GSK	£91,372m	1,846p	15	4.3%	4.7%	-3.6%	12.1%	-28,658m	GBP	7	/RoE grth/Fwd EPS grth/
Renishaw plc	LSE:RSW	£2,685m	3,690p	46	1.6%	-33.6%	57.8%	13.7%	96m	GBP	7	/RoE grth/Fwd EPS grth/
Imperial Brands	LSE:IMB	£19,186m	2,046p	8	10.1%	-1.4%	1.2%	9.8%	-11,350m	GBP	7	/RoE grth/Fwd EPS grth/
Aptitude Software	LSE:APTD	£359m	638p	51	1.2%	-53.2%	4.3%	6.3%	67m	GBP	7	/PEG/Fwd EPS grth/
Mondi	LSE:MNDI	£7,775m	1,604p	11	4.3%	-9.3%	-7.6%	4.3%	-2,341m	EUR	7	/PEG/Fwd EPS grth/
NEXT	LSE:NXT	£8,864m	6,938p	15	2.4%	5.6%	3.7%	3.0%	-2,576m	GBP	7	/RoE grth/Marg grth/
NMC Health	LSE:NMC	£3,251m	1,558p	12	1.2%	25.5%	22.1%	-41.2%	-2,228m	USD	7	/RoE grth/Int Cov/

Source: S&amp;P CapitalIQ, 20 January 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	£453m	302p	20	4.0%	4.2%	4.9%	32.5%	-2m	GBP	9	na
Devro	LSE:DVO	£286m	171p	11	5.3%	6.7%	4.3%	1.4%	-149m	GBP	9	na
Vp	LSE:VP	£412m	1,040p	10	2.9%	6.5%	3.0%	30.0%	-262m	GBP	8	/RoE grth/
MJ Gleeson	LSE:GLE	£542m	980p	15	3.5%	9.3%	9.3%	22.2%	30m	GBP	8	/FCF/
Treatt	LSE:TET	£304m	512p	27	1.1%	6.7%	7.2%	19.6%	16m	GBP	8	/RoE grth/
Photo-Me International	LSE:PHTM	£350m	93p	10	9.1%	7.3%	3.2%	1.3%	8m	GBP	8	/RoE grth/
On the Beach	LSE:OTB	£573m	437p	17	0.8%	18.6%	13.6%	0.0%	55m	GBP	8	/RoE grth/
Avon Rubber	LSE:AVON	£752m	2,465p	26	0.8%	5.3%	15.4%	45.5%	48m	GBP	7	/RoE grth/PE/
Henry Boot	LSE:BOOT	£454m	342p	12	2.6%	2.2%	2.5%	39.0%	-50m	GBP	7	/RoE grth/FCF/
Forterra	LSE:FORT	£687m	345p	13	3.0%	-1.4%	5.5%	15.6%	-50m	GBP	7	/RoE grth/Fwd EPS grth/
Aptitude Software	LSE:APTID	£359m	638p	51	1.2%	-53.2%	4.3%	6.3%	67m	GBP	7	/PEG/Fwd EPS grth/

Source: S&P CapitalIQ, 20 January 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	£85m	88p	24	-	23.2%	15.8%	58.6%	-3m	GBP	9	na
Churchill China	AIM:CHH	£222m	2,020p	26	1.4%	13.2%	11.1%	28.3%	13m	GBP	9	na
Sigma Capital	AIM:SGM	£105m	117p	9	1.7%	0.6%	10.7%	8.3%	13m	GBP	9	na
Gamma Communications	AIM:GAMA	£1,270m	1,340p	31	0.7%	33.6%	7.0%	20.2%	36m	GBP	9	na
Judges Scientific	AIM:JDG	£312m	5,000p	24	0.8%	16.0%	0.9%	12.9%	5m	GBP	9	na
The Property Franchise Group	AIM:TPFG	£55m	213p	15	3.9%	9.8%	4.3%	39.2%	3m	GBP	8	/RoE grth/
Belvoir	AIM:BLV	£54m	144p	12	5.0%	6.4%	13.8%	24.7%	-10m	GBP	8	/FCF/
Gateley	AIM:GTLY	£246m	213p	15	3.8%	6.1%	6.9%	31.9%	-27m	GBP	8	/RoE grth/
Cerillion	AIM:CER	£71m	241p	19	2.0%	61.5%	-0.2%	27.9%	5m	GBP	8	/Fwd EPS grth/
Dart	AIM:DTG	£2,668m	1,792p	17	0.6%	7.2%	5.2%	45.0%	455m	GBP	8	/RoE grth/
Tracsis	AIM:TRCS	£210m	728p	24	0.2%	10.3%	5.4%	23.3%	24m	GBP	8	/RoE grth/
Bioentix	AIM:BVXP	£203m	3,950p	32	3.0%	11.6%	8.6%	11.0%	7m	GBP	8	/Int Cov/
Oxford Metrics	AIM:OMG	£141m	112p	26	1.6%	10.2%	30.3%	22.4%	14m	GBP	8	/Marg grth/
Hotel Chocolat	AIM:HOTC	£573m	496p	49	0.4%	7.0%	15.1%	22.5%	6m	GBP	8	/RoE grth/
Elecosoft	AIM:ELCO	£71m	87p	20	0.8%	5.6%	15.0%	16.0%	-3m	GBP	8	/RoE grth/
Johnson Service	AIM:JSG	£759m	206p	20	1.5%	11.8%	4.0%	19.4%	-131m	GBP	8	/RoE grth/
Billington Holdings	AIM:BLIN	£46m	379p	10	3.4%	7.4%	-2.0%	22.7%	8m	GBP	8	/Fwd EPS grth/
boohoo	AIM:BOO	£3,823m	328p	52	-	35.7%	17.3%	20.5%	190m	GBP	8	/PE/
James Halstead	AIM:JHD	£1,161m	558p	29	2.5%	4.4%	4.0%	7.7%	68m	GBP	8	/RoE grth/
dotdigital	AIM:DOTD	£299m	101p	25	0.7%	21.9%	6.2%	4.7%	19m	GBP	8	/Int Cov/
Tribal	AIM:TRB	£138m	70p	16	1.6%	1.6%	8.9%	12.1%	2m	GBP	8	/Marg grth/
Watkin Jones	AIM:WJG	£651m	255p	14	3.3%	8.2%	10.7%	8.1%	77m	GBP	8	/RoE grth/
Anpario	AIM:ANP	£79m	340p	18	2.1%	5.6%	6.5%	3.0%	13m	GBP	8	/Int Cov/
Fevertree Drinks	AIM:FEVR	£2,317m	1,995p	34	0.7%	3.9%	10.8%	-6.1%	102m	GBP	8	/RoE grth/
Redde	AIM:REDD	£330m	108p	8	10.8%	6.2%	-0.5%	-5.9%	-35m	GBP	8	/Fwd EPS grth/
K3 Capital	AIM:K3C	£98m	233p	16	3.3%	50.6%	0.5%	57.4%	6m	GBP	7	/RoE grth/Int Cov/
Somero Enterprises	AIM:SOM	£147m	261p	10	5.6%	-12.8%	5.1%	30.5%	13m	USD	7	/RoE grth/Fwd EPS grth/
Prime People	AIM:PRP	£17m	142p	-	3.7%	-	-	59.9%	2m	GBP	7	/Fwd EPS grth/Int Cov/
Best of the Best	AIM:BOTB	£38m	400p	24	0.5%	-3.5%	11.6%	42.9%	3m	GBP	7	/Fwd EPS grth/Int Cov/
Arcontech	AIM:ARC	£30m	225p	28	0.9%	11.4%	10.1%	23.6%	4m	GBP	7	/FCF/Int Cov/
M Winkworth	AIM:WINK	£19m	148p	15	5.7%	4.9%	6.0%	22.9%	3m	GBP	7	/Marg grth/Int Cov/
ULS Technology	AIM:JLS	£41m	63p	11	3.9%	-13.0%	-23.2%	25.0%	-5m	GBP	7	/PEG/Fwd EPS grth/
Quartix	AIM:QTX	£181m	377p	32	3.3%	-18.1%	-0.5%	14.9%	5m	GBP	7	/PEG/Fwd EPS grth/
Central Asia Metals	AIM:CAML	£386m	225p	9	6.5%	-3.6%	9.4%	9.0%	-101m	USD	7	/RoE grth/Fwd EPS grth/
Concurrent Technologies	AIM:CNC	£58m	80p	15	2.9%	29.9%	-17.1%	7.4%	10m	GBP	7	/Fwd EPS grth/Int Cov/
RWS	AIM:RWS	£1,702m	619p	28	1.2%	4.7%	8.7%	7.7%	-37m	GBP	7	/PEG/RoE grth/
AB Dynamics	AIM:ABDP	£501m	2,230p	34	0.2%	17.5%	15.5%	-4.1%	36m	GBP	7	/RoE grth/Int Cov/
Andrews Sykes	AIM:ASY	£214m	507p	-	4.7%	-	-	-9.5%	8m	GBP	7	/RoE grth/Fwd EPS grth/
UniVision Engineering	AIM:UVEL	£6m	2p	-	3.4%	-	-	-20.0%	0m	GBP	7	/Fwd EPS grth/FCF/
Joules	AIM:JOU	£151m	169p	13	1.2%	-4.3%	14.2%	-38.3%	6m	GBP	7	/RoE grth/Fwd EPS grth/

Source: S&P CapitalIQ, 20 January 2020

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