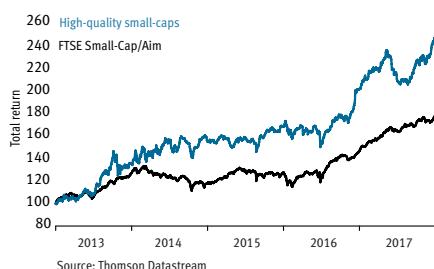




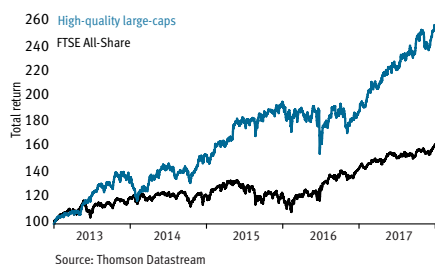
# AlphaScreens: the quest for Quality

*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.

- The FTSE All-Share screen still sees large companies such as **Diageo (DGE)**, **Unilever (ULVR)** and **Reckitt Benckiser (RB.)** score well against our quality criteria.
- **Taylor Wimpey (TW.)**, which now passes the ‘return on equity growth’ test, also scores 9/9 in the All-Share screen. **Domino’s Pizza (DOM)** is a new entry in the 9/9 club, but other indicators, such as its negative three-month share price momentum, suggest the investment case requires careful appraisal.
- There are no companies that pass all nine tests in our FTSE All Small Companies screen. Of companies that had previously met all the criteria, the interest cover test is now failed by **MJ Gleeson (GLE)**, **XP Power (XPP)** now fails the free cash flow test and **PhotoMe (PHTM)** falls short on forward EPS growth forecasts.
- The Aim screen has just one new entry to the ‘perfect nine’ club – online clothing retailer **Quiz (QUIZ)**. This company has had a good first year since it listed, but as ever screens are only a starting point for research and faltering share price momentum reflects headwinds for the retail sector in the UK more generally.

Analyst: Algy Hall  
algy.hall@ft.com

Alpha Production Editor: Sameera Hai Baig

**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
Victrex	LSE:VCT	£2,662m	3,098p	24	1.7%	12.5%	0.4%	11.8%	92m	GBP	9	na
Reckitt Benckiser	LSE:RB.	£47,928m	6,783p	20	2.4%	4.5%	7.9%	14.2%	-10,769m	GBP	9	na
Spirax-Sarco	LSE:SPX	£5,239m	7,120p	28	1.2%	12.8%	5.7%	17.0%	-373m	GBP	9	na
HomeServe	LSE:HSV	£3,335m	1,005p	27	1.9%	9.1%	9.1%	19.7%	-238m	GBP	9	na
RELX	LSE:REL	£33,761m	1,714p	20	2.3%	4.8%	5.9%	5.9%	-6,274m	GBP	9	na
Diageo	LSE:DGE	£68,579m	2,794p	22	2.3%	6.9%	7.5%	3.9%	-9,228m	GBP	9	na
Halma	LSE:HLMA	£5,344m	1,410p	29	1.0%	8.4%	6.8%	8.2%	-220m	GBP	9	na
Unilever	LSE:ULVR	£117,184m	4,415p	20	2.9%	2.7%	8.7%	6.7%	-24,764m	EUR	9	na
Ashtead	LSE:AHT	£11,253m	2,322p	14	1.4%	29.7%	8.3%	2.2%	-2,712m	GBP	9	na
Diploma	LSE:DPLM	£1,482m	1,310p	23	1.8%	9.9%	4.6%	5.7%	18m	GBP	9	na
Barratt Developments	LSE:BDEV	£5,437m	537p	8	8.0%	7.7%	4.4%	-3.5%	166m	GBP	9	na
The Sage Group	LSE:SGE	£7,215m	666p	19	2.3%	10.0%	7.2%	-7.2%	-656m	GBP	9	na
Persimmon	LSE:PSN	£7,704m	2,462p	9	9.5%	9.9%	2.0%	-13.3%	1,303m	GBP	9	na
Bellway	LSE:BWY	£3,555m	2,894p	7	4.2%	14.2%	4.7%	-14.3%	-131m	GBP	9	na
Redrow	LSE:RDW	£1,922m	533p	7	4.1%	14.8%	8.2%	-14.7%	-35m	GBP	9	na
Taylor Wimpey	LSE:TW.	£5,577m	171p	8	9.1%	7.6%	2.0%	-16.4%	496m	GBP	9	na
Polypipe	LSE:PLP	£735m	368p	13	3.0%	5.3%	6.9%	-12.6%	-147m	GBP	9	na
Domino's Pizza	LSE:DOM	£1,356m	288p	17	3.1%	3.1%	10.7%	-21.4%	-196m	GBP	9	na
British American Tobacco	LSE:BATS	£89,308m	4,203p	14	4.6%	3.1%	9.0%	10.9%	-46,199m	GBP	8	/PE/
Croda International	LSE:CRDA	£6,708m	5,138p	26	1.6%	7.7%	7.7%	10.5%	-393m	GBP	8	/RoE grth/
The Unite Group	LSE:UTG	£2,303m	875p	24	2.6%	13.8%	11.7%	4.6%	-412m	GBP	8	/RoE grth/
Segro	LSE:SGRO	£6,649m	658p	28	2.5%	11.6%	8.0%	2.8%	-2,115m	GBP	8	/Int Cov/
Rightmove	LSE:RMV	£4,440m	4,930p	26	1.2%	10.8%	9.0%	2.3%	14m	GBP	8	/RoE grth/
Safestore	LSE:SAFE	£1,155m	550p	20	2.5%	13.6%	5.6%	2.8%	-423m	GBP	8	/RoE grth/
Experian	LSE:EXPN	£17,169m	1,902p	24	1.8%	5.5%	9.3%	4.5%	-3,475m	USD	8	/Marg grth/
AG Barr	LSE:BAG	£767m	675p	21	2.3%	4.3%	5.0%	0.7%	15m	GBP	8	/RoE grth/
Whitbread	LSE:WTB	£7,275m	3,979p	15	2.5%	1.8%	7.1%	-3.6%	-841m	GBP	8	/RoE grth/
IMI	LSE:IMI	£3,094m	1,149p	15	3.4%	10.4%	8.6%	-2.1%	-449m	GBP	8	/Marg grth/
MJ Gleeson	LSE:GLE	£393m	722p	13	3.3%	11.3%	8.9%	-4.4%	27m	GBP	8	/Int Cov/
FDM Group (Holdings)	LSE:FDM	£1,028m	950p	27	3.1%	8.6%	7.2%	-4.7%	30m	GBP	8	/Int Cov/
Polymetal International	LSE:POLY	£2,917m	645p	9	5.4%	2.5%	29.6%	-6.4%	-1,420m	USD	8	/RoE grth/
Moneysupermarket.com	LSE:MONEY	£1,542m	288p	16	3.7%	-0.5%	7.6%	-9.0%	24m	GBP	8	/Fwd EPS grth/
Smiths Group	LSE:SMIN	£6,299m	1,592p	16	2.7%	-5.4%	12.4%	-5.8%	-961m	GBP	8	/Fwd EPS grth/
XP Power	LSE:XPP	£603m	3,150p	17	2.5%	19.2%	10.5%	-10.0%	-47m	GBP	8	/FCF/
Card Factory	LSE:CARD	£606m	178p	10	13.7%	-7.6%	3.5%	-19.2%	-161m	GBP	8	/Fwd EPS grth/
Photo-Me International	LSE:PHTM	£449m	119p	13	7.1%	-2.5%	8.9%	-26.4%	25m	GBP	8	/Fwd EPS grth/
Games Workshop	LSE:GAW	£1,089m	3,365p	23	3.9%	-21.2%	4.2%	27.2%	29m	GBP	7	/PEG/Fwd EPS grth/
Vp	LSE:VP.	£462m	1,168p	12	2.2%	18.4%	5.4%	29.7%	-179m	GBP	7	/RoE grth/FCF/
BT Group	LSE:BT.A	£22,246m	226p	9	6.8%	-8.0%	-0.6%	11.5%	-10,725m	GBP	7	/RoE grth/Fwd EPS grth/
Imperial Brands	LSE:IMB	£28,371m	2,988p	11	5.7%	-0.7%	2.9%	7.6%	-12,448m	GBP	7	/Fwd EPS grth/Int Cov/
Tarsus Group	LSE:TRS	£348m	308p	18	3.3%	-38.6%	69.8%	-0.2%	-95m	GBP	7	/RoE grth/Fwd EPS grth/
NEXT	LSE:NXT	£7,363m	5,460p	13	2.9%	3.6%	4.3%	-5.0%	-1,047m	GBP	7	/RoE grth/Marg grth/
Sirius Real Estate	LSE:SRE	£578m	57p	11	5.0%	49.4%	-3.2%	-11.6%	-288m	EUR	7	/RoE grth/Fwd EPS grth/
The Berkeley Group	LSE:BKG	£4,929m	3,737p	10	2.4%	-31.0%	-18.5%	-11.3%	687m	GBP	7	/PEG/Fwd EPS grth/
Howden Joinery	LSE:HWDN	£2,837m	472p	15	2.4%	7.5%	7.8%	-8.0%	213m	GBP	7	/RoE grth/Int Cov/
Ibstock	LSE:IBST	£995m	245p	12	3.7%	-9.5%	9.4%	-17.6%	-136m	GBP	7	/RoE grth/Fwd EPS grth/
Dairy Crest	LSE:DCG	£723m	468p	13	4.8%	-0.1%	4.0%	-11.5%	-271m	GBP	7	/Fwd EPS grth/FCF/
Kainos Group	LSE:KNOS	£422m	354p	28	1.9%	30.7%	10.2%	-12.4%	29m	GBP	7	/RoE grth/PE/

Source: S&P CapitalIQ, 20 August 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
MJ Gleeson plc	LSE:GLE	£393m	722p	13	3.3%	11.3%	8.9%	-4.4%	27m	GBP	8	/Int Cov/
XP Power Limited	LSE:XPP	£603m	3,150p	17	2.5%	19.2%	10.5%	-10.0%	-47m	GBP	8	/FCF/
Photo-Me International plc	LSE:PHTM	£449m	119p	13	7.1%	-2.5%	8.9%	-26.4%	25m	GBP	8	/Fwd EPS grth/
Vp plc	LSE:VP.	£462m	1,168p	12	2.2%	18.4%	5.4%	29.7%	-179m	GBP	7	/RoE grth/FCF/
Tarsus Group plc	LSE:TRS	£348m	308p	18	3.3%	-38.6%	69.8%	-0.2%	-95m	GBP	7	/RoE grth/Fwd EPS grth/
Trealtt plc	LSE:TET	£276m	475p	26	1.0%	1.3%	6.0%	-3.1%	6m	GBP	7	/RoE grth/FCF/
Sirius Real Estate Limited	LSE:SRE	£578m	57p	11	5.0%	49.4%	-3.2%	-11.6%	-288m	EUR	7	/RoE grth/Fwd EPS grth/
Henry Boot PLC	LSE:BOOT	£359m	271p	10	3.0%	-11.8%	1.6%	-8.4%	-29m	GBP	7	/PEG/Fwd EPS grth/
Kainos Group plc	LSE:KNOS	£422m	354p	28	1.9%	30.7%	10.2%	-12.4%	29m	GBP	7	/RoE grth/PE/

Source: S&P CapitalIQ, 20 August 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	£64m	83p	23	0.7%	44.0%	11.6%	12.7%	1m	GBP	9	na
IG Design	AIM:IGR	£338m	529p	21	1.1%	14.4%	7.9%	11.4%	4m	GBP	9	na
Belvoir Lettings	AIM:BLV	£36m	104p	9	6.8%	2.7%	5.0%	-2.8%	-5m	GBP	9	na
Focusrite	AIM:TUNE	£261m	459p	28	0.6%	10.1%	5.0%	-2.7%	20m	GBP	9	na
Quixant	AIM:QXT	£279m	420p	22	0.6%	5.9%	14.4%	-6.3%	4m	USD	9	na
Somero Enterprises	AIM:SOM	£211m	375p	13	3.2%	21.6%	4.6%	-11.7%	19m	USD	9	na
QUIZ	AIM:QUIZ	£183m	147p	19	0.5%	19.0%	21.5%	-11.1%	9m	GBP	9	na
Redde	AIM:REDD	£482m	159p	13	6.7%	8.4%	3.7%	-12.4%	-23m	GBP	9	na
Craneware	AIM:CRW	£613m	2,300p	48	0.9%	9.4%	17.7%	26.8%	52m	USD	8	/Int Cov/
Fevertree Drinks	AIM:FEVR	£3,992m	3,439p	65	0.3%	25.4%	12.7%	21.6%	56m	GBP	8	/PE/
Inspired Energy	AIM:INSE	£126m	21p	13	2.6%	6.5%	11.4%	16.7%	-15m	GBP	8	/RoE grth/
Advanced Medical Solutions	AIM:AMS	£766m	359p	35	0.3%	8.0%	7.9%	10.8%	62m	GBP	8	/Int Cov/
Tracsis	AIM:TRCS	£179m	633p	26	0.2%	2.6%	5.5%	9.4%	18m	GBP	8	/PEG/
iomart	AIM:IOM	£441m	408p	20	2.4%	10.7%	10.8%	0.3%	-27m	GBP	8	/RoE grth/
SafeCharge International	AIM:SCH	£478m	323p	21	4.1%	12.9%	11.4%	-1.4%	109m	USD	8	/Int Cov/
Portmeirion	AIM:PMP	£124m	1,160p	16	3.0%	11.1%	6.5%	-0.5%	-1m	GBP	8	/RoE grth/
The Property Franchise Group	AIM:TPFG	£35m	137p	11	5.5%	9.4%	2.7%	-8.1%	0m	GBP	8	/RoE grth/
Patisserie Holdings	AIM:CAKE	£441m	425p	22	0.8%	14.2%	8.7%	-6.9%	29m	GBP	8	/RoE grth/
Churchill China	AIM:CHH	£110m	1,005p	16	2.4%	11.9%	6.9%	-6.5%	16m	GBP	8	/Int Cov/
Billington Holdings	AIM:BILN	£33m	272p	9	4.2%	3.4%	-	-1.1%	6m	GBP	8	/Fwd EPS grth/
Fulcrum Utility Services	AIM:FCRM	£139m	64p	14	3.3%	15.8%	0.2%	-7.6%	9m	GBP	8	/RoE grth/
Van Elle Holdings	AIM:VANL	£72m	90p	8	4.1%	7.1%	9.0%	-4.9%	-6m	GBP	8	/RoE grth/
Telford Homes	AIM:TEF	£317m	421p	8	4.0%	12.7%	2.6%	-8.4%	-100m	GBP	8	/FCF/
Caledonia Mining Corporation	AIM:CMCL	£99m	585p	-	-	18.3%	15.4%	-16.9%	5m	USD	8	/FCF/
Tristel P	AIM:TSTL	£116m	265p	32	1.5%	5.1%	13.7%	-17.6%	5m	GBP	8	/Int Cov/
Central Asia Metals	AIM:CAML	£363m	212p	6	7.8%	63.0%	-6.7%	-22.7%	-139m	USD	8	/Fwd EPS grth/
XLMedia	AIM:XLM	£247m	112p	11	5.4%	-9.7%	10.8%	-41.1%	38m	USD	8	/Fwd EPS grth/
Arcontech	AIM:ARC	£15m	117p	25	0.9%	11.4%	15.2%	38.1%	3m	GBP	7	/RoE grth/Int Cov/
Zytronic p	AIM:ZYT	£83m	515p	19	3.7%	-4.5%	15.4%	22.8%	14m	GBP	7	/RoE grth/Fwd EPS grth/
Bioventix	AIM:BVXP	£158m	3,065p	31	3.1%	5.2%	0.8%	14.2%	6m	GBP	7	/PEG/Int Cov/
Andrews Sykes	AIM:ASY	£254m	603p	-	4.0%	-	-	17.0%	20m	GBP	7	/PEG/Fwd EPS grth/
D4t4 Solutions	AIM:D4T4	£61m	161p	14	1.6%	8.1%	10.9%	13.9%	4m	GBP	7	/RoE grth/FCF/
AdEPT Telecom	AIM:ADT	£84m	353p	-	2.5%	-	-	20.2%	-24m	GBP	7	/PEG/Fwd EPS grth/
Alliance Pharma	AIM:APH	£483m	94p	21	1.4%	-16.5%	15.8%	8.3%	-72m	GBP	7	/PEG/Fwd EPS grth/
Dewhurst	AIM:DWHT	£66m	1,135p	20	1.1%	9.8%	27.6%	20.1%	18m	GBP	7	/RoE grth/Int Cov/
dotDigital	AIM:DOTD	£277m	93p	27	0.6%	24.8%	22.8%	3.3%	10m	GBP	7	/RoE grth/Int Cov/
Gamma Communications	AIM:GAMA	£742m	790p	28	1.1%	15.2%	9.7%	8.9%	32m	GBP	7	/RoE grth/Int Cov/
Gateley (Holdings)	AIM:GTLY	£176m	159p	13	4.4%	15.2%	7.1%	-0.9%	-1m	GBP	7	/RoE grth/Marg grth/
Nichols	AIM:NICL	£524m	1,420p	21	2.4%	2.0%	4.7%	-2.9%	37m	GBP	7	/RoE grth/Int Cov/
boohoo g	AIM:BOO	£2,220m	193p	47	-	26.9%	18.7%	-2.1%	133m	GBP	7	/FCF/PE/
Shoe Zone	AIM:SHOE	£84m	168p	10	6.1%	2.7%	1.2%	-1.5%	6m	GBP	7	/Marg grth/Int Cov/
NAHL Group	AIM:NAH	£49m	105p	6	15.1%	-16.2%	4.6%	-15.2%	-12m	GBP	7	/RoE grth/Fwd EPS grth/
Gama Aviation	AIM:GMAA	£126m	198p	10	1.4%	-15.7%	35.1%	-7.1%	-13m	USD	7	/RoE grth/Fwd EPS grth/
United Carpets	AIM:UCG	£6m	8p	-	5.5%	-	-	-7.5%	3m	GBP	7	/RoE grth/Fwd EPS grth/
Petards	AIM:PEG	£14m	24p	12	-	43.9%	8.8%	-9.4%	1m	GBP	7	/RoE grth/FCF/
Hunters Property	AIM:HUNT	£15m	49p	-	4.5%	-	-	-16.7%	-2m	GBP	7	/RoE grth/Fwd EPS grth/
Walker Greenbank	AIM:WGB	£55m	77p	7	5.7%	-26.5%	0.2%	-33.0%	-5m	GBP	7	/PEG/Fwd EPS grth/

Source: S&P CapitalIQ, 20 August 2018

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