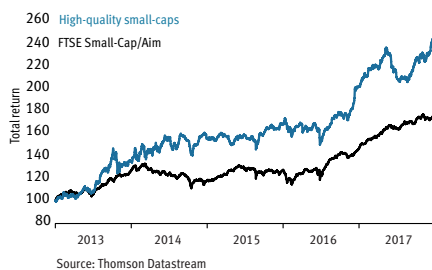




AlphaScreens: the quest for Quality

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.

- Once again, there is little movement in the large-cap companies cutting the mustard by our quality screen. Luxury goods and fashion group **Burberry (BRBY)**, equipment rental firm **Ashtead (AHT)** and engineer **Spirax-Sarco (SPX)** still pass all the tests, as do **Diageo (DGE)** and **Imperial Brands (IMB)**, flying the quality flag for booze and fags, respectively.
- One notable faller is consumer goods giant **Unilever (ULVR)** – sales growth expectations were missed when it reported half-year results at the end of July and the company now fails the forward earnings and PE tests.
- A lot of companies fail just one test, with many falling down on return on equity (ROE) growth over the past two years or expected EPS growth over the next two years.
- On Aim, the notable faller is **Fevertree drinks (FEVR)**, which now fails ROE growth – a 20 per cent drop in its share price in the past three months suggests investors are already questioning the sustainability of its growth story.

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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 (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	Mkt 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
Sirius Real Estate	LSE:SRE	£714m	70p	16	4.5%	5.1%	12.9%	9.3%	-296m	EUR	9	na
RELX	LSE:REL	£37,362m	1,929p	20	2.2%	9.5%	7.2%	8.7%	-6,757m	GBP	9	na
Burberry	LSE:BRBY	£8,644m	2,109p	23	2.0%	7.2%	9.7%	21.2%	837m	GBP	9	na
Ashtead	LSE:AHT	£9,750m	2,118p	10	1.9%	18.0%	8.5%	7.2%	-3,745m	GBP	9	na
Diageo	LSE:DGE	£81,464m	3,443p	24	2.0%	8.6%	7.3%	4.6%	-11,639m	GBP	9	na
Moneysupermarket.com	LSE:MONEY	£1,926m	359p	19	3.1%	5.8%	8.0%	-0.2%	-13m	GBP	9	na
Imperial Brands	LSE:IMB	£19,681m	2,082p	7	9.0%	3.9%	2.0%	-1.9%	-12,807m	GBP	9	na
Diploma	LSE:DPLM	£1,644m	1,453p	22	1.8%	10.6%	9.4%	-0.5%	22m	GBP	9	na
Games Workshop	LSE:GAW	£1,400m	4,306p	20	2.9%	3.7%	4.6%	-4.2%	29m	GBP	9	na
MJ Gleeson	LSE:GLE	£475m	870p	14	3.7%	8.8%	9.8%	-2.5%	28m	GBP	9	na
SpiraxSarco Engineering	LSE:SPX	£5,779m	7,850p	29	1.3%	4.6%	7.9%	-6.3%	-433m	GBP	9	na
Countryside Properties	LSE:CSP	£1,299m	291p	7	3.7%	12.0%	9.8%	-5.2%	-40m	GBP	9	na
PayPoint	LSE:PAY	£614m	909p	14	7.7%	2.7%	4.1%	-14.0%	37m	GBP	9	na
Polypipe	LSE:PLP	£760m	382p	13	3.0%	8.1%	6.1%	-10.0%	-192m	GBP	9	na
FDM Group (Holdings)	LSE:FDM	£828m	759p	19	4.2%	5.8%	6.4%	-23.0%	4m	GBP	9	na
Polymetal Int'l	LSE:POLY	£5,151m	1,096p	11	3.6%	16.4%	10.7%	34.2%	-1,520m	USD	8	/RoE grth/
SEGRO	LSE:SGRO	£8,221m	752p	29	2.5%	10.4%	8.6%	6.0%	-1,897m	GBP	8	/RoE grth/
GlaxoSmithKline	LSE:GSK	£82,461m	1,666p	14	4.8%	-2.5%	2.0%	8.7%	-29,253m	GBP	8	/Fwd EPS grth/
Halma	LSE:HLMA	£7,422m	1,957p	34	0.8%	9.3%	7.2%	10.2%	-182m	GBP	8	/PE/
Intertek	LSE:ITRK	£8,716m	5,416p	24	1.8%	8.0%	6.4%	9.2%	-1,082m	GBP	8	/RoE grth/
Photo-Me Int'l	LSE:PHTM	£374m	99p	11	8.5%	6.5%	3.6%	6.1%	15m	GBP	8	/RoE grth/
Ten Entertainment	LSE:TEG	£158m	243p	12	4.5%	25.2%	12.5%	5.9%	-11m	GBP	8	/RoE grth/
Smiths Group	LSE:SMIN	£6,197m	1,565p	16	2.8%	6.8%	8.5%	7.0%	-938m	GBP	8	/RoE grth/
Barratt Developments	LSE:BDEV	£6,332m	623p	9	7.2%	6.7%	-0.5%	4.8%	379m	GBP	8	/Fwd EPS grth/
Reckitt Benckiser	LSE:RB.	£43,749m	6,170p	18	2.8%	1.6%	4.0%	-0.8%	-10,602m	GBP	8	/RoE grth/
Safestore	LSE:SAFE	£1,326m	631p	21	2.6%	5.9%	6.9%	-2.4%	-426m	GBP	8	/RoE grth/
Rightmove	LSE:RMV	£4,590m	520p	25	1.3%	8.9%	8.6%	-5.9%	42m	GBP	8	/RoE grth/
Redrow	LSE:RDW	£1,901m	553p	6	5.5%	0.9%	1.8%	-3.3%	101m	GBP	8	/RoE grth/
Mondi	LSE:MNDI	£7,596m	1,567p	10	4.8%	-6.7%	1.6%	-3.3%	-2,341m	EUR	8	/Fwd EPS grth/
Domino's Pizza	LSE:DOM	£1,049m	228p	14	4.2%	-2.7%	9.1%	-2.8%	-250m	GBP	8	/Fwd EPS grth/
HomeServe	LSE:HSV	£3,654m	1,092p	27	2.0%	8.8%	9.0%	-5.0%	-305m	GBP	8	/RoE grth/
Renishaw	LSE:RSW	£2,607m	3,582p	23	1.7%	27.4%	4.8%	-8.1%	96m	GBP	8	/RoE grth/
Rio Tinto	LSE:RIO	£65,118m	4,010p	8	5.8%	31.5%	-10.8%	-13.9%	-4,544m	USD	8	/Fwd EPS grth/
On the Beach	LSE:OTB	£490m	374p	15	0.9%	3.9%	20.0%	-14.0%	-1m	GBP	8	/FCF/
Forterra	LSE:FORT	£523m	268p	9	3.9%	5.1%	5.5%	-11.5%	-50m	GBP	8	/RoE grth/
Henry Boot	LSE:BOOT	£312m	235p	8	3.8%	-0.2%	2.3%	-9.3%	-18m	GBP	8	/Fwd EPS grth/
Medica Group	LSE:MGP	£134m	121p	15	1.9%	8.1%	10.8%	-20.6%	1m	GBP	8	/RoE grth/
Taylor Wimpey	LSE:TW.	£4,732m	145p	7	12.7%	-4.0%	1.1%	-17.1%	366m	GBP	8	/Fwd EPS grth/
Kainos Group	LSE:KNOS	£617m	508p	29	1.8%	24.5%	11.5%	-13.1%	42m	GBP	8	/Int Cov/
Aptitude Software	LSE:APTD	£354m	560p	54	1.2%	-51.6%	4.7%	48.0%	67m	GBP	7	/PEG/Fwd EPS grth/
Smith & Nephew	LSE:SN.	£16,728m	1,917p	22	1.5%	-0.1%	7.0%	19.0%	-2,042m	USD	7	/RoE grth/Fwd EPS grth/
Experian	LSE:EXPN	£22,595m	2,506p	29	1.5%	8.3%	9.6%	10.2%	-3,318m	USD	7	/RoE grth/PE/
The Unilever	LSE:ULVR	£134,461m	5,070p	-	-	-	-	7.6%	-24,161m	EUR	7	/Fwd EPS grth/PE/
Howden Joinery	LSE:HWDN	£3,175m	530p	16	2.2%	6.3%	7.9%	3.4%	217m	GBP	7	/RoE grth/Int Cov/
Ferrexpo	LSE:FXPO	£1,289m	220p	3	7.4%	72.2%	-33.4%	-2.0%	-282m	USD	7	/RoE grth/Fwd EPS grth/
IMI	LSE:IMI	£2,544m	940p	13	4.3%	-2.6%	6.4%	1.0%	-513m	GBP	7	/Marg grth/Fwd EPS grth/
NEXT	LSE:NXT	£7,216m	5,648p	12	2.9%	5.1%	4.0%	-2.5%	-1,135m	GBP	7	/RoE grth/Marg grth/
Bellway.	LSE:BWY	£3,460m	2,810p	6	5.1%	3.2%	-0.1%	-4.0%	-27m	GBP	7	/RoE grth/Fwd EPS grth/
The Sage Group	LSE:SGE	£7,581m	698p	23	2.4%	-8.4%	7.8%	-6.3%	-422m	GBP	7	/PEG/Fwd EPS grth/
Croda International	LSE:CRDA	£5,916m	4,636p	23	1.9%	-1.7%	7.1%	-6.9%	-604m	GBP	7	/RoE grth/Fwd EPS grth/
Crest Nicholson Holdings	LSE:CRST	£886m	345p	7	9.6%	-13.5%	1.0%	-6.8%	-66m	GBP	7	/RoE grth/Fwd EPS grth/
Persimmon	LSE:PSN	£5,842m	1,847p	7	12.7%	-4.8%	0.7%	-11.5%	824m	GBP	7	/PEG/Fwd EPS grth/
Anglo American	LSE:AAL	£23,711m	1,716p	7	4.8%	20.7%	-11.6%	-11.2%	-3,225m	USD	7	/RoE grth/Fwd EPS grth/
XP Power Limited	LSE:XPP	£427m	2,230p	14	3.8%	-11.8%	12.4%	-9.2%	-56m	GBP	7	/RoE grth/Fwd EPS grth/
Ibstock	LSE:IBST	£861m	210p	11	4.5%	-3.0%	8.2%	-15.6%	-99m	GBP	7	/RoE grth/Fwd EPS grth/
Alfa Financial Software	LSE:ALFA	£252m	84p	13	-	3.8%	9.5%	-39.9%	45m	GBP	7	/Marg grth/Int Cov/
NMC Health	LSE:NMC	£3,883m	1,860p	15	1.0%	29.4%	17.9%	-21.0%	-1,552m	USD	7	/RoE grth/Int Cov/

Source: S&P CapitalIQ, 22 August 2019

Alpha Quality screen: small-cap results

Name	TIDM	Mkt 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
Sirius Real Estate	LSE:SRE	£714m	70p	16	4.5%	5.1%	12.9%	9.3%	-296m	EUR	9	na
MJ Gleeson	LSE:GLE	£475m	870p	14	3.7%	8.8%	9.8%	-2.5%	28m	GBP	9	na
Devro	LSE:DVO	£317m	190p	11	4.7%	14.9%	4.6%	-14.2%	-149m	GBP	9	na
Treatt	LSE:TET	£268m	454p	26	1.1%	1.4%	5.0%	13.8%	9m	GBP	8	/RoE grth/
Photo-Me Int'l	LSE:PHTM	£374m	99p	11	8.5%	6.5%	3.6%	6.1%	15m	GBP	8	/RoE grth/
Ten Entertainment	LSE:TEG	£158m	243p	12	4.5%	25.2%	12.5%	5.9%	-11m	GBP	8	/RoE grth/
Vp	LSE:VP	£304m	766p	8	3.9%	7.7%	4.2%	7.3%	-168m	GBP	8	/RoE grth/
Forterra	LSE:FORT	£523m	268p	9	3.9%	5.1%	5.5%	-11.5%	-50m	GBP	8	/RoE grth/
On the Beach	LSE:OTB	£490m	374p	15	0.9%	3.9%	20.0%	-14.0%	-1m	GBP	8	/FCF/
Henry Boot	LSE:BOOT	£312m	235p	8	3.8%	-0.2%	2.3%	-9.3%	-18m	GBP	8	/Fwd EPS grth/
Medica Group	LSE:MGP	£134m	121p	15	1.9%	8.1%	10.8%	-20.6%	1m	GBP	8	/RoE grth/
Aptitude Software	LSE:APTD	£354m	560p	54	1.2%	-51.6%	4.7%	48.0%	67m	GBP	7	/PEG/Fwd EPS grth/
XP Power	LSE:XPP	£427m	2,230p	14	3.8%	-11.8%	12.4%	-9.2%	-56m	GBP	7	/RoE grth/Fwd EPS grth/
Zotefoams	LSE:ZTF	£259m	540p	26	1.1%	11.3%	18.5%	-14.2%	-23m	GBP	7	/RoE grth/FCF/
Alfa Financial Software	LSE:ALFA	£252m	84p	13	-	3.8%	9.5%	-39.9%	45m	GBP	7	/Marg grth/Int Cov/

Source: S&P CapitalIQ, 22 August 2019

Alpha Quality screen: Aim results

Name	TIDM	Mkt 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
Johnson Service	Aim:JSG	£626m	167p	17	1.9%	8.8%	4.8%	11.3%	-99m	GBP	9	na
Bioventix	Aim:BVXP	£198m	3,785p	34	3.2%	4.4%	12.0%	-0.9%	5m	GBP	9	na
Churchill China	Aim:CHH	£175m	1,580p	-	1.8%	8.6%	9.9%	2.2%	17m	GBP	9	na
Tracsis	Aim:TRCS	£180m	620p	23	0.3%	5.0%	7.5%	-9.1%	18m	GBP	9	na
The Character Group	Aim:CCT	£113m	523p	11	5.0%	6.6%	10.9%	-7.0%	20m	GBP	9	na
Gamma Communications	Aim:GAMA	£983m	1,025p	28	0.9%	21.7%	9.4%	-8.0%	31m	GBP	9	na
Water Intelligence	Aim:WATR	£46m	319p	25	-	34.4%	12.2%	-7.1%	3m	USD	9	na
Billington Holdings	Aim:BILN	£38m	306p	9	4.2%	1.5%	3.7%	-9.0%	8m	GBP	9	na
Quixant	Aim:QXT	£207m	311p	14	1.0%	1.4%	11.8%	25.8%	10m	USD	8	/RoE grth/
iomart Group	Aim:IOM	£384m	343p	17	2.2%	6.2%	8.2%	1.1%	-39m	GBP	8	/RoE grth/
Nichols	Aim:NICL	£653m	1,780p	24	2.1%	4.3%	5.5%	-2.3%	30m	GBP	8	/RoE grth/
Arcontech	Aim:ARC	£21m	154p	24	0.8%	54.8%	3.4%	-4.6%	3m	GBP	8	/Int Cov/
The Property Franchise	Aim:TPFG	£42m	164p	12	5.1%	0.8%	5.1%	-7.9%	2m	GBP	8	/RoE grth/
D4t4 Solutions	Aim:D4T4	£95m	235p	17	1.3%	2.2%	3.4%	-7.2%	11m	GBP	8	/PEG/
Gateley (Holdings)	Aim:GTLY	£179m	160p	11	5.0%	6.3%	7.1%	-5.3%	-3m	GBP	8	/RoE grth/
Redde	Aim:REDD	£342m	111p	8	10.5%	9.8%	-0.8%	-1.1%	-41m	GBP	8	/Fwd EPS grth/
dotdigital	Aim:DOTD	£266m	89p	25	0.7%	9.2%	9.7%	-8.4%	17m	GBP	8	/Int Cov/
Elecosoft	Aim:ELCO	£60m	74p	17	0.9%	14.7%	10.9%	-7.0%	-2m	GBP	8	/RoE grth/
Tribal	Aim:TRB	£134m	66p	15	1.7%	1.6%	8.9%	-4.9%	2m	GBP	8	/Marg grth/
Belvoir	Aim:BLV	£35m	99p	8	7.3%	6.8%	13.4%	-15.6%	-10m	GBP	8	/FCF/
Serica Energy	Aim:SQZ	£296m	112p	3	-	259.4%	-30.9%	-18.4%	35m	USD	8	/Fwd EPS grth/
Fevertree Drinks	Aim:FEVR	£2,671m	2,207p	36	0.7%	7.2%	13.0%	-20.1%	102m	GBP	8	/RoE grth/
Inspiration Healthcare	Aim:IHC	£18m	62p	18	-	2.9%	19.2%	-10.4%	3m	GBP	8	/Int Cov/
Somero Enterprises	Aim:SOM	£159m	271p	10	5.8%	-9.5%	3.1%	-22.6%	28m	USD	8	/Fwd EPS grth/
XLMedia	Aim:XLM	£131m	72p	7	8.1%	3.5%	4.7%	44.4%	41m	USD	7	/RoE grth/FCF/
Quartix Holdings	Aim:QTX	£161m	337p	28	3.7%	-19.0%	5.1%	26.8%	5m	GBP	7	/PEG/Fwd EPS grth/
Secure Income REIT	Aim:SIR	£1,414m	431p	26	3.6%	13.2%	3.8%	9.2%	-1,007m	GBP	7	/RoE grth/Int Cov/
ECO Animal Health	Aim:EAH	£263m	385p	16	2.9%	1.0%	8.2%	5.1%	16m	GBP	7	/RoE grth/FCF/
Hotel Chocolat	Aim:HOTC	£418m	370p	40	0.6%	3.9%	13.6%	10.8%	22m	GBP	7	/PEG/RoE grth/
ULS Technology	Aim:ULS	£42m	64p	10	3.8%	-5.8%	4.6%	1.4%	-3m	GBP	7	/RoE grth/Fwd EPS grth/
James Halstead	Aim:JHD	£1,057m	486p	26	2.8%	6.0%	3.8%	-0.4%	63m	GBP	7	/RoE grth/Int Cov/
Fulcrum Utility Services	Aim:FCRM	£60m	27p	7	7.8%	1.5%	-8.2%	1.1%	10m	GBP	7	/RoE grth/Fwd EPS grth/
AB Dynamics	Aim:ABDP	£533m	2,360p	44	0.2%	41.4%	15.7%	-2.6%	19m	GBP	7	/Int Cov/PE/
M Winkworth	Aim:WINK	£15m	113p	12	6.7%	4.9%	6.1%	-2.5%	3m	GBP	7	/Marg grth/Int Cov/
Best of the Best	Aim:BOTB	£25m	270p	16	0.7%	-3.5%	11.6%	-1.8%	3m	GBP	7	/Fwd EPS grth/Int Cov/
Watkin Jones	Aim:WJG	£555m	217p	13	3.5%	2.0%	10.4%	-2.9%	18m	GBP	7	/RoE grth/FCF/
boohoo	Aim:BOO	£2,654m	230p	43	-	21.9%	22.4%	-4.3%	191m	GBP	7	/RoE grth/PE/
Mind Gym	Aim:MIND	£121m	122p	16	2.6%	9.4%	11.2%	-8.3%	8m	GBP	7	/RoE grth/Int Cov/
Central Asia Metals	Aim:CAML	£321m	185p	7	7.8%	-1.9%	21.2%	-16.8%	-110m	USD	7	/RoE grth/Fwd EPS grth/
Tristel	Aim:TSTL	£119m	273p	26	1.7%	40.5%	11.7%	-13.3%	4m	GBP	7	/RoE grth/Int Cov/
Keystone Law	Aim:KEYS	£136m	422p	30	2.1%	3.6%	15.4%	-10.7%	6m	GBP	7	/RoE grth/Marg grth/
Craneware	Aim:CRW	£492m	1,870p	36	1.4%	6.4%	6.2%	-39.1%	39m	USD	7	/PEG/Int Cov/

Source: S&P CapitalIQ, 22 August 2019

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