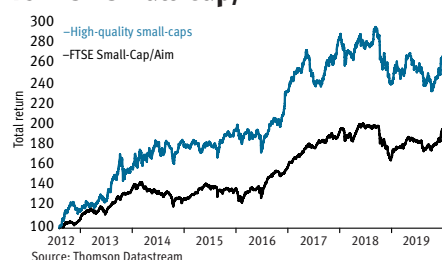




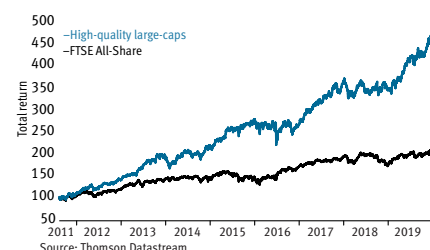
AlphaScreens: the quest for Quality

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.

- Our quality screen can be thought of as serving a dual purpose. On the one hand it highlights larger companies that fit the traditional mould of a quality long-term holding; and on the other, it provides a sense check before investing in smaller companies or those in more volatile sectors.
- High ranking companies such as consumer staples giant **Unilever (ULVR)** or data business **Experian (EXPN)** fall firmly in the former camp. Unilever no longer passes 9/9 (it now looks expensive on our price-to-earnings growth criteria), but although it will never shoot the lights out as a growth stock, its defensive characteristics remain attractive as there is plenty of economic uncertainty.
- The screen is also a useful starting point for monitoring potential recovery stories. Of course, common sense should apply – it would be bold indeed to buy indoor entertainment business **Hollywood Bowl (BOWL)** on the strength of this screen – but quality signals are reassuring should the trading environment improve and provide a catalyst for shares to re-rate.

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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
Polymetal International	POLY	£9,054m	1,919p	11	3.4%	63.0%	21.5%	28.2%	1,398m	USD	9	na
Kainos	KNOS	£1,270m	1,038p	47	0.3%	32.3%	0.1%	17.7%	-37m	GBP	8	/RoE grth/
Evrz	EVR	£4,767m	327p	7	14.1%	118.0%	26.8%	8.3%	2,984m	USD	8	/RoE grth/
Unilever	ULVR	£51,719m	4,426p	20	3.4%	1.4%	5.3%	0.6%	20,770m	EUR	8	/PEG/
Experian	EXPN	£24,480m	2,670p	34	1.4%	21.4%	13.1%	-8.4%	3,323m	USD	8	/RoE grth/
XP Power	XPP	£868m	4,420p	26	0.9%	4.6%	15.1%	23.1%	41m	GBP	7	/PEG/RoE grth/
FDM	FDM	£1,125m	1,030p	33	1.8%	-23.8%	8.9%	10.6%	-36m	GBP	7	/PEG/Fwd EPS grth/
Next	NXT	£7,575m	5,698p	19	1.0%	-60.5%	108.9%	5.5%	2,400m	GBP	7	/PEG/Fwd EPS grth/
Diploma	DPLM	£2,051m	1,811p	29	1.6%	-12.7%	11.3%	-2.7%	65m	GBP	7	/PEG/Fwd EPS grth/
Marshalls	MSLH	£1,324m	662p	31	0.7%	-49.8%	65.5%	-3.4%	60m	GBP	7	/PEG/Fwd EPS grth/
HomeServe	HSV	£4,183m	1,245p	28	1.9%	3.2%	14.8%	-5.3%	509m	GBP	7	/PEG/RoE grth/
Mondi	MNDI	£6,987m	1,439p	12	3.1%	-26.1%	11.7%	-9.2%	1,863m	EUR	7	/PEG/Fwd EPS grth/
Moneysupermarket.com	MONY	£1,596m	297p	19	3.9%	-23.9%	22.3%	-13.5%	-8m	GBP	7	/PEG/Fwd EPS grth/
Hollywood Bowl	BOWL	£240m	153p	15	4.9%	-76.7%	211.9%	-12.9%	191m	GBP	7	/PEG/Fwd EPS grth/
PayPoint	PAY	£433m	632p	12	9.1%	-23.2%	15.8%	-17.1%	-23m	GBP	7	/PEG/Fwd EPS grth/
Taylor Wimpey	TW	£4,186m	115p	11	0.0%	-68.5%	90.9%	-27.7%	-473m	GBP	7	/PEG/Fwd EPS grth/

Source: FactSet, 7 September 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
Aptitude Software	APTD	£253m	450p	37	1.2%	16.6%	-7.4%	16.5%	-31m	GBP	7	/RoE grth/Fwd EPS grth/
Hollywood Bowl	BOWL	£240m	153p	15	4.9%	-76.7%	211.9%	-12.9%	191m	GBP	7	/PEG/Fwd EPS grth/

Source: FactSet, 7 September 2020

Continued on the next page

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	SDI	£66m	68p	18	0.0%	44.5%	10.8%	33.3%	7m	GBP	9	na
Trans-Siberian Gold	TSG	£112m	102p	6	3.6%	91.9%	44.3%	20.8%	12m	USD	9	na
Caledonia Mining Corporation	CMCL	£167m	1,410p	5	0.9%	43.6%	80.2%	10.6%	-9m	USD	9	na
boohoo	BOO	£3,696m	301p	35	0.0%	25.4%	31.1%	-21.1%	-225m	GBP	9	na
Alpha Financial Mkts Consulting	AFM	£221m	209p	15	1.0%	0.7%	10.0%	19.4%	-18m	GBP	8	/PEG/
Gamma Communications	GAMA	£1,422m	1,495p	29	0.7%	18.2%	11.5%	21.5%	-41m	GBP	8	/RoE grth/
Venture Life Group	VLG	£76m	91p	15	0.0%	157.4%	20.2%	35.8%	-4m	GBP	8	/Marg grth/
Anglo Asian Mining	AAZ	£161m	141p	7	4.6%	39.9%	-2.9%	6.0%	-9m	USD	8	/Fwd EPS grth/
Water Intelligence	WATR	£49m	334p	24	0.0%	48.0%	6.4%	16.0%	-1m	USD	8	/RoE grth/
EKF Diagnostics	EKF	£234m	52p	24	1.9%	172.4%	-50.1%	6.2%	-10m	GBP	8	/Fwd EPS grth/
Best of the Best	BOTB	£148m	1,575p	23	0.2%	86.4%	-	89.2%	-5m	GBP	7	/Fwd EPS grth/Int Cov/
Sylvania Platinum	SLP	£178m	66p	4	1.2%	37.5%	12.3%	35.3%	-25m	USD	7	/Marg grth/PE/
Atalaya Mining	ATYM	£255m	186p	5	0.0%	-23.7%	164.9%	53.3%	-11m	EUR	7	/PEG/Fwd EPS grth/
Team17	TM17	£881m	670p	42	-	11.3%	9.0%	26.4%	-40m	GBP	7	/PEG/RoE grth/
Crimson Tide	TIDE	£15m	3p	32	0.0%	25.0%	0.0%	45.5%	0m	GBP	7	/RoE grth/Marg grth/
ULS Technology	ULS	£38m	59p	22	2.1%	-81.3%	444.4%	24.0%	5m	GBP	7	/PEG/Fwd EPS grth/
Enwell Energy	ENW	£54m	17p	-	0.0%	-	-	10.5%	-46m	USD	7	/PEG/Fwd EPS grth/
YouGov	YOU	£964m	895p	49	0.4%	14.2%	11.6%	17.8%	-17m	GBP	7	/PEG/Marg grth/
MTI Wireless Edge	MWE	£41m	47p	-	3.0%	-	-	20.8%	-6m	USD	7	/PEG/Fwd EPS grth/
One Media iP	OMIP	£11m	7p	24	0.8%	15.4%	0.0%	7.4%	1m	GBP	7	/RoE grth/Int Cov/
Anpario	ANP	£92m	400p	21	2.0%	-3.3%	6.5%	11.1%	-14m	GBP	7	/PEG/Fwd EPS grth/
Volex	VLX	£291m	191p	16	1.6%	-21.0%	22.2%	27.8%	-17m	USD	7	/PEG/Fwd EPS grth/
CareTech	CTH	£486m	429p	9	2.8%	8.7%	15.3%	8.3%	373m	GBP	7	/RoE grth/Int Cov/
Cohort	CHRT	£252m	615p	17	1.6%	-6.6%	9.8%	10.6%	12m	GBP	7	/PEG/Fwd EPS grth/
Solid State	SOLI	£51m	600p	-	2.1%	-	-	15.4%	-2m	GBP	7	/PEG/Fwd EPS grth/
Bioventix	BVXP	£219m	4,200p	31	3.0%	11.3%	9.6%	-2.3%	-6m	GBP	7	/Marg grth/Int Cov/
Concurrent Technologies	CNC	£81m	110p	19	2.3%	30.1%	-	0.5%	-10m	GBP	7	/Fwd EPS grth/Int Cov/
EMIS	EMIS	£665m	1,050p	21	3.0%	-7.6%	8.7%	-1.3%	-27m	GBP	7	/PEG/Fwd EPS grth/
Judges Scientific	JDG	£320m	5,100p	29	1.0%	-29.9%	22.6%	-1.0%	5m	GBP	7	/PEG/Fwd EPS grth/
Michelmersh Brick	MBH	£95m	101p	-	1.1%	-	-	-1.9%	8m	GBP	7	/PEG/Fwd EPS grth/
Cerillion	CER	£87m	295p	25	1.7%	-7.8%	13.1%	-5.1%	1m	GBP	7	/PEG/Fwd EPS grth/
Inspired Energy	INSE	£158m	17p	9	1.3%	9.5%	-	-5.5%	37m	GBP	7	/RoE grth/Fwd EPS grth/
Serica Energy	SQZ	£297m	111p	10	2.7%	-69.6%	76.7%	-9.5%	-101m	GBP	7	/PEG/Fwd EPS grth/
Eckoh	ECK	£156m	62p	36	0.0%	-3.2%	-	-1.6%	-11m	GBP	7	/PEG/Fwd EPS grth/
Mattioli Woods	MTW	£196m	705p	17	2.8%	-15.6%	16.5%	-9.3%	-23m	GBP	7	/PEG/Fwd EPS grth/
Steppe Cement	STCM	£53m	24p	9	12.5%	-44.2%	53.1%	-7.7%	6m	USD	7	/PEG/Fwd EPS grth/
iomart	IOM	£371m	340p	20	1.9%	1.2%	5.5%	-6.8%	58m	GBP	7	/PEG/RoE grth/
Vianet	VNET	£27m	92p	-	1.8%	-	-	-6.6%	1m	GBP	7	/PEG/Fwd EPS grth/
Keystone Law	KEYS	£137m	438p	46	0.7%	-58.4%	89.2%	-5.9%	-2m	GBP	7	/PEG/Fwd EPS grth/
FRP Advisory	FRP	£274m	116p	20	0.6%	543.7%	14.3%	-4.9%	-17m	GBP	7	/Marg grth/PE/
Billington	BILN	£40m	308p	-	0.0%	-	-	-4.3%	-16m	GBP	7	/PEG/Fwd EPS grth/
Churchill China	CHH	£115m	1,043p	34	0.0%	-86.9%	281.1%	-11.7%	-16m	GBP	7	/PEG/Fwd EPS grth/
Midwich	MIDW	£359m	405p	15	3.9%	-19.5%	30.1%	-5.9%	70m	GBP	7	/PEG/Fwd EPS grth/
Clinigen	CLIN	£871m	656p	10	1.1%	17.0%	1.6%	-26.2%	322m	GBP	7	/RoE grth/Marg grth/
Franchise Brands	FRAN	£85m	89p	19	1.1%	-7.7%	22.8%	-15.7%	-3m	GBP	7	/PEG/Fwd EPS grth/
Mission	TMG	£56m	62p	12	1.3%	-95.6%	1825.0%	-13.4%	14m	GBP	7	/PEG/Fwd EPS grth/

Source: FactSet, 7 September 2020

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