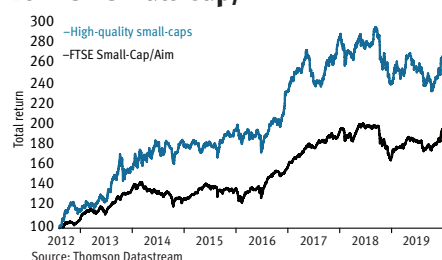




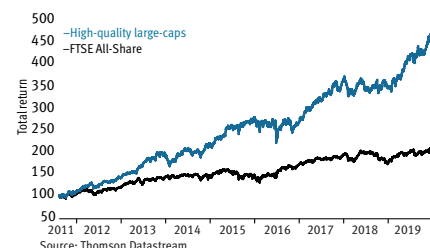
AlphaScreens: the quest for Quality

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.

- Boosted by stimulus and easing of lockdown measures, the FTSE All-Share has broadly maintained an upward trajectory in the past few weeks, but on a cautionary note, quality stocks are still looking expensive. So, while our screen is flagging several quality stalwarts, investors should take note of the tests that high-ranking companies fail as forecasting profits growth to justify high share prices is incredibly difficult right now.
- No company passes all nine of our tests designed for larger companies. The best (passing 8/9) are gold miner **Polymetal International (POLY)** – which fails our return on equity growth test; pharma giant **GlaxoSmithKline (GSK)** which fails on forecast earnings growth; and comparison website **Moneysupermarket.com (MONY)** which also fails on forecast EPS growth.
- Our tests for smaller companies are proving a tough ask for companies listed on the main market. Aim, however – which is once again close to being valued at £100bn in aggregate – is flagging a load of shares. These include celebrated fashion business **boohoo.com (BOO)** whose shares were recently subject to a short-seller attack, a reminder that it's always worth looking behind the numbers before investing, too.

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	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
Moneysupermarket.com	LSE:MONY	£1,870m	348p	20	3.4%	-6.2%	14.9%	12.8%	-10m	GBP	8	/Fwd EPS grth/
Polymetal International	LSE:POLY	£6,676m	1,415p	10	3.4%	38.5%	1.3%	8.1%	-1,504m	USD	8	/RoE grth/
GlaxoSmithKline	LSE:GSK	£81,509m	1,638p	14	4.9%	-4.6%	2.2%	2.3%	-27,151m	GBP	8	/Fwd EPS grth/
EVRAZ	LSE:EVR	£4,576m	314p	12	28.8%	97.4%	-1.8%	16.3%	-3,433m	USD	7	/RoE grth/Fwd EPS grth/
XP Power	LSE:XP	£729m	3,760p	25	-	3.8%	13.3%	18.1%	-47m	GBP	7	/RoE grth/Marg grth/
Diageo	LSE:DGE	£67,696m	2,900p	25	2.4%	-14.8%	9.9%	4.8%	-13,008m	GBP	7	/PEG/Fwd EPS grth/
FDM	LSE:FDM	£1,029m	942p	29	3.9%	-17.2%	14.6%	7.6%	14m	GBP	7	/PEG/Fwd EPS grth/
HomeServe	LSE:HSV	£4,397m	1,314p	31	1.8%	2.1%	14.2%	10.0%	-509m	GBP	7	/RoE grth/PE/
RELX	LSE:REL	£36,751m	1,910p	21	2.4%	-2.9%	11.2%	2.4%	-6,281m	GBP	7	/RoE grth/Fwd EPS grth/
Sage	LSE:SGE	£7,529m	690p	26	2.4%	-8.4%	4.9%	2.1%	-238m	GBP	7	/PEG/Fwd EPS grth/
IMI	LSE:IMI	£2,708m	1,000p	17	4.1%	-21.3%	21.7%	3.0%	-434m	GBP	7	/RoE grth/Fwd EPS grth/
Smith & Nephew	LSE:SN.	£15,170m	1,736p	29	1.7%	-35.9%	61.5%	0.2%	-1,770m	USD	7	/RoE grth/Fwd EPS grth/
NEXT	LSE:NXT	£6,988m	5,480p	69	-	-83.1%	328.6%	-0.8%	-2,410m	GBP	7	/PEG/Fwd EPS grth/
Unilever	LSE:ULVR	£127,016m	4,409p	-	-	-0.1%	8.2%	-0.1%	-22,977m	EUR	7	/Fwd EPS grth/PE/
Diploma	LSE:DPLM	£2,134m	1,885p	32	-	-13.1%	13.4%	0.5%	-65m	GBP	7	/PEG/Fwd EPS grth/
Mondi	LSE:MNDI	£7,619m	1,572p	16	4.7%	-36.3%	24.2%	-2.4%	-2,202m	EUR	7	/PEG/Fwd EPS grth/
Marshalls	LSE:MSLH	£1,404m	708p	39	-	-37.1%	52.1%	-0.8%	-59m	GBP	7	/PEG/Fwd EPS grth/
PayPoint	LSE:PAY	£513m	759p	17	7.6%	-32.2%	35.5%	-8.4%	23m	GBP	7	/PEG/Fwd EPS grth/
Medica	LSE:MGP	£148m	133p	23	-	-29.8%	50.8%	-7.4%	4m	GBP	7	/RoE grth/Fwd EPS grth/
Imperial Brands	LSE:IMB	£14,158m	1,507p	6	13.7%	-6.6%	3.3%	-8.7%	-13,666m	GBP	7	/RoE grth/Fwd EPS grth/
Hollywood Bowl	LSE:BOWL	£291m	185p	49	-	-73.9%	195.2%	-13.7%	-191m	GBP	7	/PEG/Fwd EPS grth/
Taylor Wimpey	LSE:TW.	£5,283m	161p	13	-	-39.7%	34.0%	-17.2%	518m	GBP	7	/PEG/Fwd EPS grth/
Barratt Developments	LSE:BDEV	£5,583m	550p	11	-	-35.1%	20.0%	-23.9%	375m	GBP	7	/PEG/Fwd EPS grth/
Vp	LSE:VP.	£301m	760p	8	4.0%	1.4%	-0.4%	-19.4%	-262m	GBP	7	/RoE grth/Fwd EPS grth/
Photo-Me International	LSE:PHTM	£200m		6	-	-2.7%	5.0%	-36.5%	8m	GBP	7	/RoE grth/Fwd EPS grth/

Source: S&P CapitalIQ, 8 June 2020

Continued on the next page

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
Medica	LSE:MGP	£148m	133p	23	-	-29.8%	50.8%	-7.4%	4m	GBP	7	/RoE grth/Fwd EPS grth/
Hollywood Bowl	LSE:BOWL	£291m	185p	49	-	-73.9%	195.2%	-13.7%	-191m	GBP	7	/PEG/Fwd EPS grth/
Vp	LSE:VP	£301m	760p	8	4.0%	1.4%	-0.4%	-19.4%	-262m	GBP	7	/RoE grth/Fwd EPS grth/
Photo-Me International	LSE:PHTM	£200m	53p	6	-	-2.7%	5.0%	-36.5%	8m	GBP	7	/RoE grth/Fwd EPS grth/

Source: S&P CapitalIQ, 8 June 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
Caledonia Mining	AIM:CMCL	£253m	1,200p	-	-	33.1%	39.5%	47.0%	12m	USD	9	na
Arcontech	AIM:ARC	£24m	184p	22	1.1%	8.6%	11.8%	4.3%	4m	GBP	9	na
MTI Wireless Edge	AIM:MWE	£34m	39p	12	4.1%	19.8%	11.9%	11.6%	8m	USD	9	na
Elecosoft	AIM:ELCO	£73m	90p	20	-	9.8%	16.1%	26.9%	-1m	GBP	8	/RoE grth/
Bioventix	AIM:BVXP	£221m	4,250p	34	3.0%	11.6%	8.6%	10.5%	6m	GBP	8	/Int Cov/
Focusrite	AIM:TUNE	£372m	645p	27	-	10.9%	1.3%	21.7%	-20m	GBP	8	/RoE grth/
boohoo	AIM:BOO	£4,448m	383p	58	-	12.9%	35.8%	34.4%	225m	GBP	8	/PE/
James Halstead	AIM:JHD	£1,095m	526p	29	2.7%	1.0%	4.4%	8.1%	57m	GBP	8	/RoE grth/
Tristel	AIM:TSTL	£222m	490p	42	1.1%	5.6%	6.5%	6.5%	0m	GBP	8	/RoE grth/
dotdigital	AIM:DOTD	£308m	104p	26	0.6%	20.2%	-3.0%	0.4%	17m	GBP	8	/Fwd EPS grth/
Belvoir	AIM:BLV	£49m	141p	23	-	-57.9%	153.8%	-0.4%	-7m	GBP	8	/Fwd EPS grth/
Gamma Communications	AIM:GAMA	£1,187m	1,250p	27	0.8%	12.3%	10.2%	4.1%	41m	GBP	8	/RoE grth/
Anpario	AIM:ANP	£82m	355p	20	2.3%	-3.3%	6.4%	1.4%	14m	GBP	8	/Fwd EPS grth/
Team17	AIM:TM17	£682m	527p	36	-	7.0%	13.1%	-4.3%	40m	GBP	8	/RoE grth/
Sylvania Platinum	AIM:SLP	£128m	47p	3	1.7%	168.8%	-23.0%	-11.3%	33m	USD	8	/Fwd EPS grth/
M Winkworth	AIM:WINK	£16m	128p	13	6.6%	6.3%	-	-8.9%	3m	GBP	8	/Fwd EPS grth/
ULS Technology	AIM:ULS	£31m	48p	8	-	-17.4%	-	-7.8%	-5m	GBP	8	/Fwd EPS grth/
Tracsis	AIM:TRCS	£196m	673p	21	0.3%	17.8%	16.3%	-14.3%	24m	GBP	8	/RoE grth/
Serica Energy	AIM:SOZ	£340m	127p	14	2.4%	-49.7%	72.0%	47.0%	102m	GBP	7	/PEG/Fwd EPS grth/
Tandem	AIM:TND	£13m	250p	-	1.8%	-	-	41.7%	2m	GBP	7	/RoE grth/Fwd EPS grth/
Craneware	AIM:CRW	£487m	1,840p	37	1.4%	3.1%	5.9%	11.9%	42m	USD	7	/RoE grth/Int Cov/
Concurrent Technologies	AIM:CNC	£79m	108p	19	2.3%	-	-	13.4%	10m	GBP	7	/PEG/Fwd EPS grth/
Judges Scientific	AIM:JDG	£323m	5,160p	35	1.0%	-31.9%	20.6%	3.3%	-5m	GBP	7	/PEG/Fwd EPS grth/
UniVision Engineering	AIM:UVEL	£5m	1p	-	4.2%	-	-	13.0%	0m	GBP	7	/Fwd EPS grth/FCF/
Solid State	AIM:SOLI	£47m	550p	12	2.3%	25.3%	-	15.8%	-1m	GBP	7	/PEG/Fwd EPS grth/
Nucleus Financial	AIM:NUC	£115m	151p	39	-	-50.2%	91.4%	3.1%	14m	GBP	7	/PEG/Fwd EPS grth/
Advanced Medical Solutions	AIM:AMS	£549m	255p	34	0.6%	-24.0%	48.0%	-1.7%	54m	GBP	7	/RoE grth/Fwd EPS grth/
Central Asia Metals	AIM:CAML	£269m	156p	10	-	-31.0%	58.7%	-6.0%	-81m	USD	7	/RoE grth/Fwd EPS grth/
Somero Enterprises	AIM:SOM	£124m	220p	8	6.7%	-5.0%	2.7%	-6.1%	22m	USD	7	/RoE grth/Fwd EPS grth/
Quartix	AIM:QTX	£173m	360p	32	3.4%	1.3%	8.4%	-6.6%	6m	GBP	7	/RoE grth/Marg grth/
James Latham	AIM:LTHM	£167m	860p	-	2.1%	-	-	-0.9%	12m	GBP	7	/RoE grth/Fwd EPS grth/
Prime People	AIM:PRP	£8m	67p	-	-	-	-	-6.3%	2m	GBP	7	/Fwd EPS grth/Int Cov/
Keystone Law	AIM:KEYS	£153m	490p	48	-	-32.4%	45.4%	-8.5%	2m	GBP	7	/PEG/Fwd EPS grth/
SDI Group	AIM:SDI	£51m	53p	15	-	23.2%	-	-12.2%	-3m	GBP	7	/PEG/Fwd EPS grth/
Andrews Sykes	AIM:ASY	£197m	467p	-	4.5%	-	-	-18.8%	12m	GBP	7	/RoE grth/Fwd EPS grth/
Billington	AIM:BILN	£40m	333p	-	-	-	-	-12.2%	16m	GBP	7	/PEG/Fwd EPS grth/
Quixant	AIM:QXT	£69m	104p	7	-	26.9%	5.0%	-20.0%	15m	USD	7	/RoE grth/Marg grth/
Gateley	AIM:GTLY	£161m	137p	10	-	-2.4%	5.4%	-25.9%	-27m	GBP	7	/RoE grth/Fwd EPS grth/
Churchill China	AIM:CHH	£130m	1,180p	-	-	-	-	-30.8%	15m	GBP	7	/PEG/Fwd EPS grth/
Watkin Jones	AIM:WJG	£436m	172p	11	-	-2.9%	16.7%	-32.2%	-108m	GBP	7	/RoE grth/Fwd EPS grth/

Source: S&P CapitalIQ, 8 June 2020

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