

AlphaScreens: the quest for quality

15 July 2021

Are these Aim shares showing the hallmark of quality growth companies?

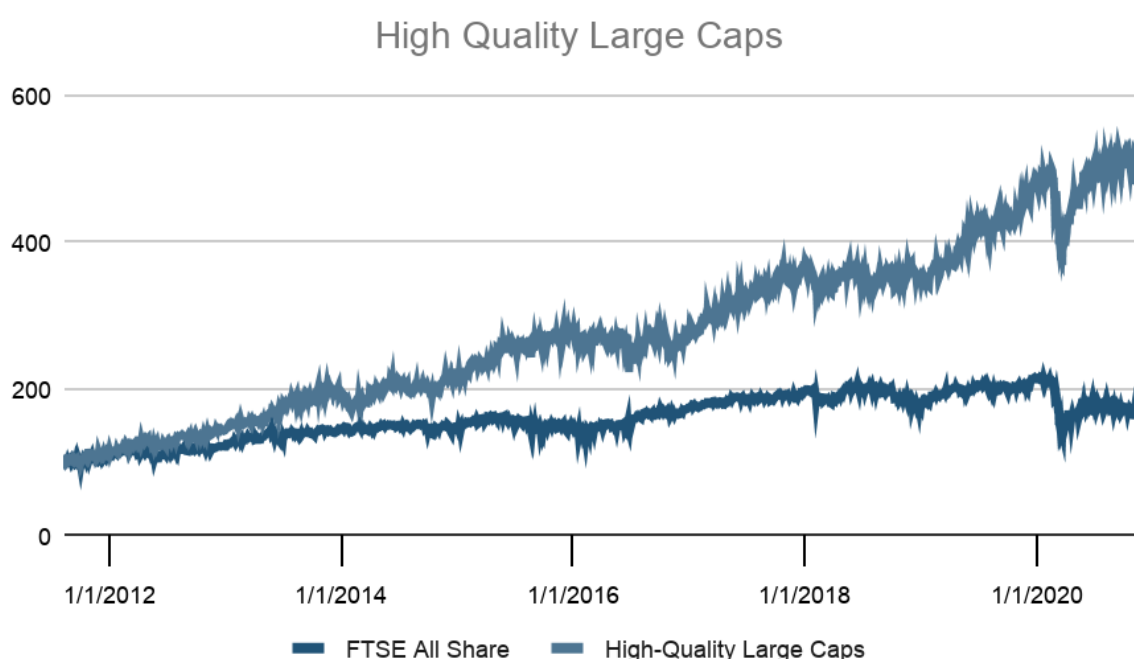
The holy grail for buy-and-hold investors is to find a business that is capable of generating a high return on capital and sustaining it while reinvesting profits. This screen looks for shares that display these quality characteristics and can potentially deliver significant compounded returns over time

Comment by Alpha editor:

- Some companies that have quality financial characteristics still suffered badly in the pandemic. This is especially true when it comes to small companies in vulnerable sectors. It's also worth remembering that screens are just a service-skim of ratios computed from a company's financial statements and analysts' forecasts, there is scope for mistakes. Still, they are an interesting idea generator, especially on Aim - although here it is doubly important to conduct further research.
- Oil exploration company **Enwell Energy (ENW)** only fails one quality test, namely that it should have had a higher return on equity over its most recent full financial year compared to two fiscal years prior. The oil price fall in 2020 clearly impacted that and now with Brent crude at around \$74 per barrel, conditions are more favourable. Still, potential investors should be wary of mistaking a recovery story (the shares are up almost 80 per cent in twelve months) for a sustainable quality play, however well a company scores on all of our tests.
- Quality signs without growth, or expected growth that is already expensively priced, can be a potential trap for investors. So with many of the Aim stocks that only fail one test disappointing on measures like our price to earnings growth (PEG) ratio, investors should definitely be sure to dig further into the prospects of the Aim companies flagged as high quality just going by the numbers.

The dream company

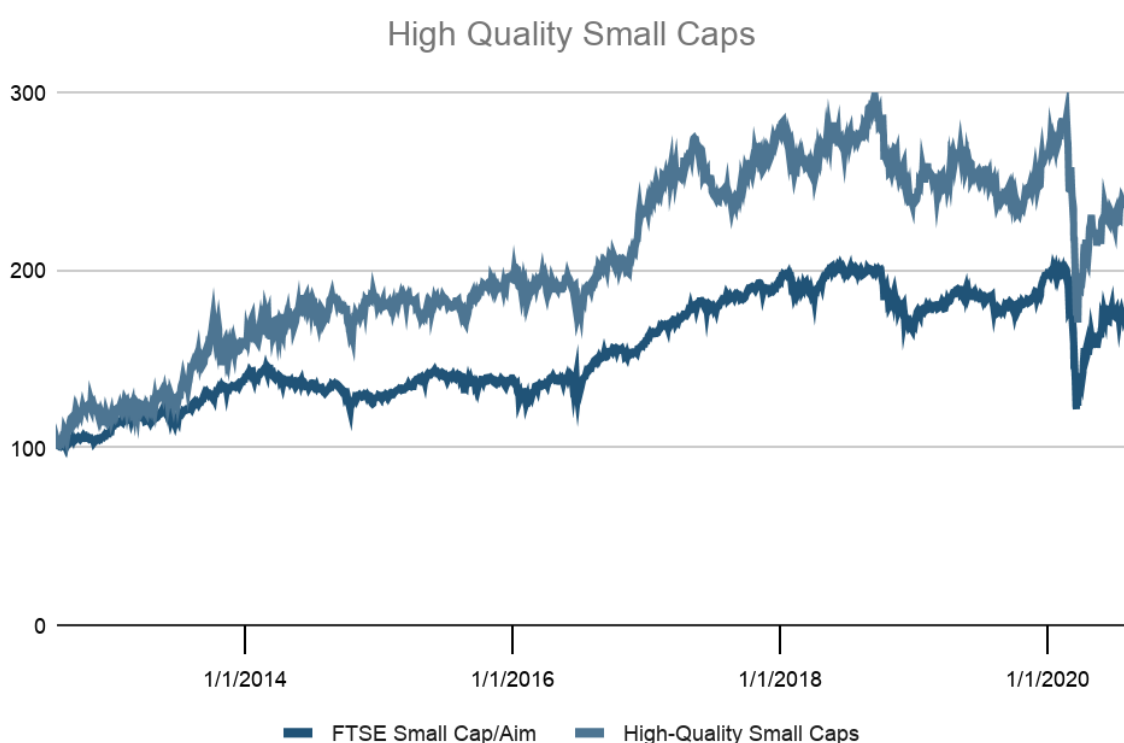
The holy grail for buy-and-hold investors is to find a business that is capable of generating high returns on its capital and is able to reinvest all its profits for decades to come, while maintaining those returns. The compound-ing effect of such an investment is what every long-term investor's dreams 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.



Source: Refinitiv, Investors' Chronicle

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.



Source: Refinitiv, Investors' Chronicle

Alpha Quality screening 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 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 – i.e. before the impact of debt.

- An operating margin higher than the median average (mid-ranking) stock in each of the past three years (i.e. 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 (i.e. again, quality that shows some signs of persistence).
- RoE higher than it was two years ago (i.e. 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 (i.e. not a suspiciously cheap or dangerously expensive valuation).
- Interest cover of more than five (i.e. 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 and methodology by Algy Hall

Large-cap quality selection (passing at least 7 of 9 tests)

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
Experian	EXPN	£27,871m	3,023p	34	1.1%	17.8%	12.8%	14.2%	2,998m	USD	9	na
Polymetal Int'l	POLY	£7,587m	1,602p	9	5.9%	3.4%	8.9%	6.8%	1,012m	USD	9	na
Spirent Communications	SPT	£1,637m	268p	23	1.7%	9.6%	7.6%	9.7%	-156m	USD	9	na
Hikma Pharmaceuticals	HIK	£6,039m	2,609p	18	1.4%	11.5%	18.2%	7.3%	425m	USD	9	na
IMI	IMI	£4,719m	1,761p	19	1.3%	9.1%	10.9%	29.7%	313m	GBP	8	/RoE grth/
Spirax-Sarco Engineering	SPX	£10,534m	14,280p	43	0.8%	24.3%	6.3%	18.4%	263m	GBP	8	/RoE grth/
Oxford Instruments	OXIG	£1,398m	2,425p	29	0.7%	5.6%	1.5%	11.5%	-90m	GBP	8	/PEG/
Britvic	BVIC	£2,641m	989p	18	2.8%	7.2%	24.2%	15.0%	664m	GBP	8	/RoE grth/
Kainos Group	KNOS	£1,929m	1,570p	42	1.4%	0.8%	5.8%	-6.5%	-59m	GBP	8	/PEG/
Ferrexpo	FXPO	£2,606m	443p	3	14.2%	99.2%	-21.7%	20.7%	-3m	USD	7	/Fwd EPS grth/PE/
Croda Int'l	CRDA	£10,860m	7,784p	35	1.2%	19.8%	8.7%	17.4%	801m	GBP	7	/RoE grth/Marg grth/
Auto Trader Group	AUTO	£6,358m	658p	27	0.8%	76.5%	11.6%	11.4%	-11m	GBP	7	/RoE grth/Marg grth/
Games Workshop Group	GAW	£3,812m	11,630p	30	1.8%	70.8%	4.9%	10.7%	-51m	GBP	7	/RoE grth/Marg grth/
Halma	HLMA	£10,820m	2,850p	45	0.6%	3.9%	10.4%	12.2%	256m	GBP	7	/PEG/RoE grth/
Rightmove	RMV	£5,727m	667p	31	0.7%	60.3%	11.2%	8.1%	-84m	GBP	7	/RoE grth/Marg grth/
Coats Group	COA	£985m	68p	14	1.4%	146.9%	19.2%	20.4%	180m	USD	7	/RoE grth/Marg grth/
Avast	AVST	£5,199m	504p	19	2.3%	4.0%	7.4%	6.9%	529m	USD	7	/PEG/RoE grth/
Rio Tinto	RIO	£75,815m	6,076p	7	5.6%	95.6%	-28.9%	6.6%	565m	USD	7	/RoE grth/Fwd EPS grth/
Howden Joinery Group	HWDN	£5,275m	883p	23	1.0%	47.4%	9.3%	12.6%	150m	GBP	7	/RoE grth/Marg grth/
Diploma	DPLM	£3,834m	3,078p	35	1.4%	48.3%	7.7%	11.0%	236m	GBP	7	/RoE grth/PE/
Smith & Nephew	SN	£13,772m	1,567p	22	1.8%	36.3%	20.3%	11.4%	1,410m	USD	7	/RoE grth/Marg grth/
QinetiQ Group	QQ	£2,015m	348p	15	2.0%	1.5%	6.4%	8.5%	-164m	GBP	7	/PEG/RoE grth/
Trealt	TET	£668m	1,120p	40	0.6%	47.8%	7.2%	4.7%	5m	GBP	7	/RoE grth/FCF/
Berkeley Group Hldgs	BKG	£5,750m	4,725p	13	2.5%	6.4%	3.5%	3.0%	-1,125m	GBP	7	/RoE grth/Marg grth/
Mondi	MNDI	£9,592m	1,975p	15	4.1%	3.7%	22.1%	4.7%	1,598m	EUR	7	/RoE grth/Marg grth/
Imperial Brands	IMB	£15,067m	1,592p	6	8.7%	-3.4%	0.9%	2.4%	10,490m	GBP	7	/PEG/Fwd EPS grth/
Electrocomponents	ECM	£5,029m	1,069p	25	1.5%	33.2%	13.9%	3.3%	123m	GBP	7	/RoE grth/Marg grth/
FDM Group (Hldgs)	FDM	£1,179m	1,080p	32	4.3%	9.6%	13.7%	1.1%	-45m	GBP	7	/RoE grth/Marg grth/
Airtel Africa	AAF	£3,123m	83p	11	3.5%	27.4%	16.4%	-2.0%	2,233m	USD	7	/RoE grth/Int Cov/
Rotork	ROR	£3,070m	351p	26	2.9%	1.8%	7.8%	-1.6%	-178m	GBP	7	/PEG/RoE grth/
Dunelm Group	DNLM	£2,917m	1,439p	22	0.8%	36.7%	13.5%	0.6%	182m	GBP	7	/RoE grth/Marg grth/
Evrast	EVR	£8,816m	604p	7	5.9%	98.9%	0.1%	-1.1%	2,348m	USD	7	/RoE grth/Marg grth/
PayPoint	PAY	£407m	593p	11	5.4%	135.2%	6.4%	-5.6%	48m	GBP	7	/RoE grth/Marg grth/
Anglo American	AAL	£40,151m	2,946p	7	2.5%	188.9%	-24.0%	-3.5%	4,382m	USD	7	/RoE grth/Fwd EPS grth/
Persimmon	PSN	£9,522m	2,984p	12	7.9%	13.0%	5.8%	-6.0%	-872m	GBP	7	/RoE grth/Marg grth/
Intertek Group	ITRK	£9,148m	5,668p	28	1.9%	12.3%	11.7%	-5.3%	644m	GBP	7	/RoE grth/Marg grth/
Redrow	RDW	£2,245m	637p	8	0.9%	112.9%	17.9%	-4.4%	101m	GBP	7	/RoE grth/Marg grth/
Barratt Developments	BDEV	£7,096m	697p	9	1.1%	75.9%	10.8%	-11.2%	-1,058m	GBP	7	/RoE grth/Marg grth/

Source: FactSet, 14 July 2021

Small-cap quality selection (passing at least 7 of 9 tests)

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
Severfield	SFR	£244m	79p	10	3.7%	15.0%	11.9%	0.8%	7m	GBP	8	/RoE grth/
Norcros	NXR	£256m	317p	10	2.6%	1.9%	6.3%	12.0%	14m	GBP	7	/PEG/RoE grth/
RM	RM	£206m	246p	13	1.9%	15.8%	34.6%	9.8%	31m	GBP	7	/RoE grth/Marg grth/
Porvair	PRV	£269m	582p	23	0.9%	6.9%	12.6%	3.9%	7m	GBP	7	/PEG/RoE grth/
PayPoint	PAY	£407m	593p	11	5.4%	135.2%	6.4%	-5.6%	48m	GBP	7	/RoE grth/Marg grth/
Henry Boot	BOOT	£353m	265p	13	2.1%	78.6%	45.0%	-6.7%	-27m	GBP	7	/RoE grth/Marg grth/

Source: FactSet, 14 July 2021

Aim quality selection (passing at least 7 of 9 tests)

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
Cerillion	CER	£221m	750p	33	0.8%	46.4%	33.0%	46.5%	-3m	GBP	9	na
Science Group	SAG	£173m	420p	19	1.4%	15.4%	2.7%	35.5%	-10m	GBP	9	na
Gamma Communications	GAMA	£1,984m	2,065p	31	0.6%	21.0%	14.5%	16.7%	-35m	GBP	9	na
CareTech Hldgs	CTH	£711m	627p	12	2.1%	19.0%	10.8%	16.1%	378m	GBP	9	na
Water Intelligence	WATR	£145m	935p	42	0.0%	50.0%	21.4%	21.4%	1m	USD	9	na
Renew Hldgs	RNWH	£539m	685p	14	1.9%	12.0%	12.1%	16.1%	33m	GBP	9	na
Eckoh	ECK	£162m	64p	41	1.0%	38.1%	21.1%	-15.2%	-10m	GBP	9	na
RWS Hldgs	RWS	£2,236m	575p	22	1.6%	16.5%	19.5%	-16.4%	37m	GBP	9	na
boohoo group	BOO	£3,685m	291p	25	0.0%	22.6%	25.8%	-18.1%	-258m	GBP	9	na
Steppe Cement	STCM	£115m	52p	9	6.7%	56.8%	-3.8%	34.3%	2m	USD	8	/Fwd EPS grth/
Enwell Energy	ENW	£83m	26p	10	0.0%	149.1%	76.0%	22.3%	-44m	USD	8	/RoE grth/
Learning Technologies	LTG	£1,472m	198p	36	0.4%	17.0%	16.2%	21.3%	-61m	GBP	8	/PEG/
Alpha Financial Mkts Consulting	AFM	£408m	345p	20	2.0%	15.4%	14.3%	19.4%	-32m	GBP	8	/RoE grth/
Keystone Law Group	KEYS	£235m	753p	40	2.3%	13.7%	12.3%	20.5%	-6m	GBP	8	/PEG/
EMIS Group	EMIS	£761m	1,202p	22	2.7%	5.8%	6.4%	2.7%	-46m	GBP	8	/PEG/
Team17 Group	TM17	£1,008m	767p	38	-	5.1%	11.9%	0.9%	-60m	GBP	8	/PEG/
Franchise Brands	FRAN	£144m	151p	26	0.7%	20.1%	23.4%	9.5%	-5m	GBP	8	/RoE grth/
Kape Technologies	KAPE	£677m	303p	14	0.0%	77.2%	21.4%	3.8%	-6m	USD	8	/Marg grth/
Pan African Resources	PAF	£326m	17p	4	4.1%	107.3%	3.6%	-0.9%	62m	USD	8	/Marg grth/
Watkin Jones	WJG	£589m	230p	14	4.3%	5.9%	9.8%	0.4%	100m	GBP	8	/RoE grth/
Solid State	SOLI	£79m	925p	16	1.7%	9.2%	-1.3%	4.5%	-1m	GBP	8	/Fwd EPS grth/
Sureserve Group	SUR	£135m	84p	11	1.2%	65.8%	17.4%	3.7%	1m	GBP	8	/Marg grth/
SDI Group	SDI	£183m	185p	27	0.0%	136.3%	16.5%	-3.9%	3m	GBP	8	/Marg grth/
Sylvania Platinum Ltd.	SLP	£295m	108p	3	1.5%	154.4%	16.4%	-9.1%	-49m	USD	8	/Marg grth/
M.P. Evans Group	MPE	£381m	700p	16	3.1%	54.9%	11.5%	-5.9%	57m	USD	8	/RoE grth/
Atalaya Mining	ATYM	£409m	296p	5	0.0%	199.4%	2.7%	-8.2%	-5m	EUR	8	/RoE grth/
Michelmers Brick Hldgs	MBH	£131m	139p	17	1.8%	59.6%	10.1%	-5.8%	0m	GBP	8	/RoE grth/
Caledonia Mining Corp.	CMCL	£110m	950p	4	3.5%	31.1%	35.9%	-12.4%	-9m	USD	8	/FCF/
ASOS	ASC	£4,620m	4,628p	28	0.0%	24.4%	7.4%	-14.7%	238m	GBP	8	/RoE grth/
IG Design	IGR	£484m	500p	18	1.8%	48.8%	9.5%	-15.5%	27m	USD	8	/RoE grth/
Focusrite	TUNE	£804m	1,370p	37	0.3%	35.2%	-18.0%	26.9%	-19m	GBP	7	/RoE grth/Fwd EPS grth/
Dewhurst	DWHT	£114m	2,450p	-	0.6%	-	-	42.0%	-13m	GBP	7	/PEG/Fwd EPS grth/
RBG Hldgs	RBGP	£151m	158p	18	1.9%	0.0%	25.0%	44.3%	2m	GBP	7	/PEG/Marg grth/
Somero Enterprises, Inc.	SOM	£264m	470p	14	5.5%	38.2%	7.3%	17.5%	-25m	USD	7	/RoE grth/Marg grth/
Alumasc Group	ALU	£99m	274p	12	1.9%	167.3%	7.9%	37.0%	6m	GBP	7	/RoE grth/Marg grth/
Character Group	CCT	£151m	705p	15	1.3%	143.9%	4.2%	51.6%	-33m	GBP	7	/RoE grth/Marg grth/
K3 Capital Group	K3C	£258m	355p	18	1.9%	33.2%	20.1%	13.6%	-8m	GBP	7	/RoE grth/Marg grth/
Eleco	ELCO	£111m	134p	28	0.3%	-5.7%	9.8%	17.5%	-4m	GBP	7	/PEG/Fwd EPS grth/
Cake Box Hldgs	CBX	£118m	295p	22	1.9%	34.9%	13.3%	14.3%	-4m	GBP	7	/RoE grth/Marg grth/
James Latham	LTHM	£235m	1,180p	-	1.8%	-	-	22.3%	-24m	GBP	7	/PEG/Fwd EPS grth/
Anexo Group	ANX	£169m	146p	10	1.0%	23.9%	17.9%	10.6%	40m	GBP	7	/RoE grth/FCF/
Advanced Medical Sol.	AMS	£629m	292p	29	0.6%	70.1%	14.7%	14.3%	-43m	GBP	7	/RoE grth/Marg grth/
Springfield Properties	SPR	£176m	172p	11	1.9%	76.3%	6.0%	18.6%	37m	GBP	7	/RoE grth/Marg grth/
Alliance Pharma	APH	£539m	101p	17	1.6%	8.9%	16.1%	8.6%	113m	GBP	7	/PEG/RoE grth/
Next Fifteen Comm.	NFC	£864m	932p	18	0.8%	19.9%	9.4%	18.0%	29m	GBP	7	/RoE grth/PE/
Breedon Group	BREE	£1,878m	111p	22	0.0%	41.2%	47.8%	19.6%	318m	GBP	7	/RoE grth/Marg grth/
Anpario	ANP	£159m	685p	31	1.3%	3.1%	2.6%	10.5%	-16m	GBP	7	/PEG/RoE grth/
Instem	INS	£166m	760p	30	0.0%	9.3%	34.8%	11.8%	-25m	GBP	7	/PEG/RoE grth/
Oxford Metrics	OMG	£138m	109p	38	1.7%	58.7%	55.0%	10.7%	-14m	GBP	7	/RoE grth/Marg grth/
Trans-Siberian Gold	TSG	£106m	116p	-	6.9%	-	-	0.9%	-5m	USD	7	/PEG/Fwd EPS grth/
Xpediator	XPDI	£101m	72p	16	2.1%	14.6%	5.7%	15.3%	25m	GBP	7	/RoE grth/Int Cov/
SigmaRoc	SRC	£250m	90p	18	0.0%	15.5%	9.4%	8.5%	44m	GBP	7	/RoE grth/Int Cov/
Venture Life	VLG	£115m	92p	24	0.0%	-13.9%	17.7%	5.8%	-31m	GBP	7	/PEG/Fwd EPS grth/
Nichols	NICL	£544m	1,473p	29	2.5%	71.6%	28.4%	6.5%	-44m	GBP	7	/RoE grth/Marg grth/
Titon Hldgs	TON	£15m	139p	15	2.5%	1323.1%	31.1%	13.1%	-4m	GBP	7	/RoE grth/Marg grth/
Wynnstay Group	WYN	£111m	550p	14	2.7%	37.5%	3.3%	11.7%	5m	GBP	7	/RoE grth/Marg grth/
Anglo Asian Mining	AAZ	£156m	136p	-	4.4%	-	-	-2.9%	-27m	USD	7	/PEG/Fwd EPS grth/
Volex	VLX	£587m	374p	20	0.9%	-15.8%	10.6%	3.8%	20m	USD	7	/PEG/Fwd EPS grth/
Central Asia Metals	CAML	£427m	243p	7	5.8%	93.5%	-4.4%	-6.4%	24m	USD	7	/RoE grth/Fwd EPS grth/
GB Group	GBG	£1,734m	883p	44	0.7%	-21.9%	13.4%	-3.3%	-17m	GBP	7	/PEG/Fwd EPS grth/
Nucleus Financial Group	NUC	£145m	189p	18	0.5%	50.3%	44.8%	0.3%	-14m	GBP	7	/RoE grth/Marg grth/
Dewhurst plc Class A	DWHA	£114m	700p	-	1.9%	-	-	-3.4%	-13m	GBP	7	/PEG/Fwd EPS grth/
Crimson Tide	TIDE	£21m	3p	-	0.0%	-	0.0%	-5.8%	-1m	GBP	7	/PEG/Fwd EPS grth/

Continued

Aim quality selection (passing at least 7 of 9 tests) continued

Judges Scientific	JDG	£381m	6,040p	31	0.9%	9.8%	6.4%	-4.4%	11m	GBP	7	/PEG/RoE grth/
EKF Diagnostics	EKF	£339m	75p	24	1.5%	26.2%	-	-9.9%	-20m	GBP	7	/RoE grth/Fwd EPS grth/
Driver Group	DRV	£29m	56p	13	2.7%	17.4%	59.1%	1.4%	-5m	GBP	7	/RoE grth/Marg grth/
Concurrent Tech.	CNC	£63m	87p	17	2.9%	33.3%	-	-9.9%	-11m	GBP	7	/RoE grth/Fwd EPS grth/
Aferian	AFRN	£131m	157p	16	1.2%	26.3%	15.5%	-4.8%	-5m	USD	7	/RoE grth/Marg grth/
iEnergizer Ltd	IBPO	£494m	260p	15	5.4%	-7.0%	10.0%	-15.6%	72m	USD	7	/PEG/Fwd EPS grth/
MTI Wireless Edge	MWE	£65m	74p	2178	1.9%	-98.8%	11.2%	-8.1%	-7m	USD	7	/PEG/Fwd EPS grth/
Keywords Studios	KWS	£1,956m	2,590p	37	0.0%	22.9%	13.9%	-9.7%	-66m	EUR	7	/PEG/RoE grth/
Frontier Devp.	FDEV	£897m	2,280p	32	0.0%	12.3%	57.7%	-23.1%	-12m	GBP	7	/PEG/Marg grth/
Distil	DIS	£13m	3p	-	0.0%	-	-	-13.3%	-1m	GBP	7	/PEG/Fwd EPS grth/
Tandem Group	TND	£29m	555p	-	1.6%	-	-	-21.3%	-4m	GBP	7	/PEG/Fwd EPS grth/
Griffin Mining	GFM	£175m	101p	7	0.0%	303.3%	13.1%	-30.7%	-12m	USD	7	/RoE grth/Marg grth/
Best of the Best	BOTB	£151m	1,600p	11	0.3%	16.9%	15.7%	-45.2%	-	GBP	7	/RoE grth/Int Cov/
Appreciate	APP	£60m	32p	10	3.1%	192.6%	32.7%	-19.0%	-159m	GBP	7	/RoE grth/Marg grth/

Source: FactSet, 14 July 2021

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