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Chapter 1

Getting to Know Penny Stocks

Penny stocks are shares of companies that trade at low prices — typically anywhere from one cent to five dollars per share. The low-priced shares are usually associated with very small companies that are just getting started. When the companies grow, the value of their shares increases, making money for anyone who owns the stock.

I just described the upside of trading in penny stocks, and it's this potential for making money that explains the growing popularity of this type of investment vehicle. Of course, not all small companies thrive or even stay in business — which brings me to the downside of penny stocks: Should the company shrink, or run into any number of other problems that I describe later in this chapter, shares will decrease in value, leaving investors with a partial or potentially complete loss of their investment.

Many investors are drawn to penny stocks because they find the upside compelling. They're intrigued by the idea of investing in a tiny company in its early stages and watching that money grow along with the company. After all, many companies that started out as penny stocks have gone on to become household names, making their early investors very wealthy in the process. Few other investment vehicles offer the possibility of turning a small amount of cash into a small fortune without even having to work at the company or break a sweat.

To succeed as a penny stock investor, you need to be able to maximize the upside (making money), while minimizing the downside (losing money). Unfortunately, far too many investors treat penny stock trading more like a get-rich-quick scheme (or a trip to the casino) than a legitimate investment strategy. But as I explain in this book, there is a right way to trade penny stocks and a wrong way. Said more directly, there is a profitable way and a costly way. In this book I give you all the information and tools you need to avoid the downside, while benefiting from owning small shares that have the potential to grow exponentially.

The first step to reaping the rewards of penny stock investing is to understand the basics, and the process of gaining that knowledge begins in this chapter. I begin by separating fact from fiction, exposing the truth about penny stocks and letting you know which rumors and innuendos have some basis in reality. (Spoiler alert: A lot of the negative things that you may have heard about penny stocks are actually true.) I also offer a clear definition of penny stocks and fill you in on the ways they're unique investment vehicles.

A Big, Fat, "Tiny" Penny Stock Summary

Companies usually need to raise money to operate, and the most common way to generate that cash is for them to sell shares of their corporation on the stock market. If they need more money at a later time, they can issue even more shares (see Chapter 3 for details on this process). The company gets money to operate; in exchange, the new shareholders get part of the company.

The shareholders will see the value of their investment in the company change based on what the share price does. If the company does well and grows, the shares typically increase in value. But if the business shrinks or runs into detrimental issues such as weak sales numbers, lawsuits, or new competitors, its shares will likely decrease in value.

Although the aim for most companies is to get bigger and bigger, the majority of them start out very small, with only a handful of employees or a total company value of a couple million dollars or less. Their shares may trade for a few dollars, or even pennies. However, those penny stocks may become worth much more if the companies grow. If everything goes according to plan, the stock won't actually be a "penny" stock for long, and both the value of the shares and your investment in them will be dramatically higher.

A lot of quality companies trade as penny stocks and many of these will perform very well for their investors. Of course, because share price is a reflection of perceived value, many downright awful companies with no prospects, or even on the verge of bankruptcy, trade as penny stocks as well.

Unfortunately, the number of low-quality companies outweighs the good ones. In fact, only 5 percent of penny stocks I review pass my analysis. Combined with the propensity for promoters and shady characters to provide misleading information (more on the shadowy side in a bit), penny stocks have earned a bad name.

Some of the negative connotations surrounding penny stocks suggest that they are

- **Hard to buy and sell.** This is true for lightly traded shares on many of the penny stock markets. You won't have this problem if you stick to shares trading on the better stock exchanges, which I detail in Chapter 3.
- **Subject to scams.** Unfortunately, penny stocks are the focus of many scam artists because of the opportunity to make money by manipulating the prices of the underlying shares. Dishonest promoters try to push up the prices of the penny stocks they own by tricking unsuspecting investors through free newsletters and message boards.
- **Based on low-quality companies.** The majority of penny stock companies are not strong — and that's putting it kindly. The key is to avoid those lackluster stocks and instead find the top 5 percent that will be extremely profitable. This book details how you can do exactly that.
- **Volatile.** Penny stocks are volatile, but that's part of their appeal. Although such volatility isn't appropriate for everyone, low-priced shares can move quickly and significantly, which can generate profit potential that isn't available elsewhere.

REMEMBER

You need to be aware of the risks surrounding penny stocks. That awareness, combined with appropriate knowledge, will enable you to sidestep the dangers, while remaining open to all the opportunities that low-priced shares can provide.

Defining Penny Stocks

No universally accepted definition of the term *penny stock* exists. Instead, folks in the financial sector categorize these low-priced shares in a variety of ways, depending on who is doing the defining and why. What one trader may consider a penny stock may not qualify as such under another person's definition.

In the following sections, I walk you through the three major ways investors typically distinguish penny stocks from their more expensive counterparts.

Price per share

Price per share is the most common (and simplest) criteria for identifying penny stocks. Many people apply the tag to any shares trading at one dollar or less. For others, the price range includes stocks trading as high as three or even five dollars per share.

REMEMBER

The closest definition to actually being "official" is that of the Securities and Exchange Commission (SEC), which identifies shares trading at five dollars or less as a penny stock. Following the SEC's lead, almost all stockbrokers and professional investors have adopted the same criteria, and I have as well. So, for the purposes of this book, I consider penny stocks to be any shares that trade at five dollars or less.

The primary drawback with using this definition is that price fluctuations can move the stock below and above the threshold level. What started out as a penny stock in the morning could trade above the threshold price at noon and then fall back below it an hour later.

Market capitalization

Market capitalization (*market cap,* for short), refers to the total value of a company, which is derived by multiplying the total number of shares available by the price per share. For example, if a company has two million shares valued at two dollars each, the market cap of the company is four million dollars. Some investors like to consider companies with market caps of less than $10 million to be penny stocks, while others use a cutoff point of $25 million, or $100 million, or an even greater number.

Using market capitalization to define penny stocks is more involved than simply looking at the price per share. Also, because the underlying share prices and the total market cap continually change, it can make for more work when identifying penny stocks. Using market cap may also lead to situations in which a company trading at one cent per share isn't considered a penny stock (due to the company having an extraordinarily large number of shares outstanding).

Most investors don't use market capitalization as a method to define penny stocks. However, some prefer to focus their holdings on companies of a certain size for the implied stability that comes with larger businesses, and in such a case they may find the market capitalization approach helpful.

Stock market

Some choose to label all companies trading on lower-quality stock markets (see Chapter 3 for details) with the penny stock moniker. For example, any company listed on the Pink Sheets may be considered a penny stock, even if its shares are trading at $90 each and its market cap is in the billions.

Mix and match

In some cases, investors may combine more than one of the previous criteria when defining a penny stock. For example, they may decide that any company trading on the Pink Sheets *and* with a share price of less than two dollars is a penny stock.

Why does it matter?

You may wonder why the definition of penny stock matters at all. For most people, and in most cases, it doesn't. However, the distinction can have significant implications in certain circumstances:

- **Broker restrictions and fees:** Stockbrokers often have special rules for low-priced shares. Some don't allow their customers to purchase any penny stocks, while others charge much higher commissions for penny stock trades. Because most brokers define penny stocks as shares trading at five dollars or less, these parameters have implications on a significant number of investments.
- **Listing requirements:** The stock exchanges have very specific requirements for any company whose shares are traded on them. Those requirements vary from one exchange to the next and generally get more demanding the more reputable the exchange. Some of the criteria involve share price and market cap, and they typically exclude penny stocks. Penny stocks usually start trading on lower-level exchanges with easier parameters for inclusion. (I discuss the various stock exchanges for penny stocks in Chapter 3.)
- **Option eligibility:** Certain shares are considered "option eligible" by the stock exchanges and stockbrokers. The criteria is usually based on a share price of at least five dollars, and it allows trading on margin (buying the stock with borrowed money), short selling (selling the shares and then buying them back later), and options trading in the particular company. Flip to Chapter 6 to find out more about these concepts.
- **Portfolio balancing:** Individual investors, or professionals such as hedge fund traders or mutual fund managers, may only want a certain portion of their total portfolio to be in more speculative or volatile shares such as penny stocks. If they realize that they have too much or too little of a percentage in one investment size or type, they will rebalance their holdings through the appropriate trades. Of course, they need to have their own view of what constitutes a low-priced share in order to manage their holdings.

A PENNY STOCK IN THEIR PAST

Many people are surprised to find out just how many successful companies have been considered penny stocks at some point in their past.

Penny stocks have included the Ford Motor Company, Sirius Satellite Radio, American Airlines, Nokia, Lucent Alcatel, and many other recognizable names. In other words, these low-priced shares aren't necessarily the junky companies you may have been led to believe!

EDUCATING THE MARKET

Many people have invested in penny stocks at some point. Almost all of them have lost money on those shares, and they've let their negative experiences with low-quality penny stocks scare them away. However, to conclude that penny stocks are foolish investments means that people aren't taking responsibility for the mistakes they've made. They have painted the entire investment class with one brush just because of their singular experience, but that's like assuming all live concerts are bad just because you picked a bad seat at the only show you ever attended.

My first task when speaking about penny stocks is to explain that there is a difference between low- and high-quality penny stocks. After I address the negative connotations surrounding the topic and explain how easy it is to avoid the pitfalls and junk, people always become more interested.

Low-quality penny stocks traded in the wrong ways are foolish investments. High-quality companies trading for pennies at the right time, in my opinion, are far and away the best investment choice available.

The good news is that everything you need to know to trade penny stocks successfully is included in this book. I have no doubt that you will become a phenomenal investor in low-priced shares if you follow the suggestions discussed in these pages.

However, my biggest hope is that you go a step further and help protect your friends and family from getting burned by the wrong kinds of penny stocks. They'll never know that you saved them thousands. They'll never thank you. But isn't that the best kind of reward?

Comparing Penny Stocks to Their Blue-Chip Cousins

Many differences exist between penny stocks and higher-priced shares. By being aware of how smaller companies and their lower-priced shares behave, you can position yourself in the right kinds of investments and make better trading decisions. More important, you'll have an idea of whether these types of investments are for you.

Investors typically organize stocks into the following categories:

- **Large cap companies, also known as blue-chip stocks:** Any company whose shares value the business at $5 billion or more are known as *large capitalization companies,* or *large caps* for short. Some investors use the value of $10 billion as criterion to apply the large cap moniker, while others use different parameters.

  Shares of the very biggest companies, which are valued at billions of dollars, are known as *blue-chip stocks.* Many of these companies are household names, such as IBM, McDonald's, Disney, and Exxon, and trade on the New York Stock Exchange (NYSE) or on other major stock markets (see Chapter 3 for details on the various markets).

- **Mid cap companies:** The term *mid cap* is short for *middle capitalization,* but you'll probably never hear the long version of the name. These companies are typically valued between $500 million and $5 billion, but again this depends on who is providing the definition.

- **Small cap corporations:** These companies have total values of between $50 million and $500 million.

- **Micro caps, also known as penny stocks:** Any company whose total value is less than $50 million is considered a *micro cap.* Because penny stocks typically represent smaller, growing corporations, they're often in the micro cap category. This category of stocks reacts to situations that are unique and material to it, even when the same events would have little impact on much larger companies.

  REMEMBER

  Although micro caps are similar to blue-chip shares, only smaller, they play by their own set of valuation and price behavior rules. To become consistently successful trading penny stocks, you need to understand this concept and the specific ways in which these micro cap shares behave.

Volatility and speed

In terms of percentage of the share price, penny stock shares make greater moves, and more quickly, than their better-capitalized counterparts. Several factors cause faster and larger price changes:

- **Starting from lower prices:** The lower the price of the shares, the greater any moves in them will be, proportionately. If a penny stock increases from 20¢ to 30¢, that's a 50 percent gain. The same ten-cent jump in a stock priced at ten dollars per share only represents an increase of 1 percent.
- **Earlier phase of corporate life cycle:** When a company is new, its potential is wide open. It may end up at point A or point Z, or anywhere in between. Any event or shift in the mind-set of investors can result in major changes in expectations for the company's future. With any early shift in that anticipation comes significant adjustments to what investors are expecting from it, and those adjustments directly impact the share price.
- **Thinly traded:** As penny stocks are generally traded by fewer people, and in smaller amounts, a large buy or sell order can move the price significantly. If there is a limited supply of shares for sale at lower prices, any significant buying demand may push the price up into higher prices.
- **Changes in speculation and potential:** The prices of penny stock shares have a much greater basis in speculation and potential. In other words, what a company theoretically "could" do has a lot more value when it is just getting started or is in the early phase of its life cycle. Unlike quarterly financial reports, or gradually improving client lists, for example, massive shifts in speculation can occur quickly and have a dramatic impact on the potential for the underlying company and its share price.
- **Fewer, more meaningful events:** Newer and smaller companies typically experience fewer major events. When they do have something to report, such as a new client win or a patent approval, that event will have a proportionately greater impact on the company, and its shares.

REMEMBER

To invest in penny stocks well, you need to understand the reasons behind the larger, and more rapid, price moves. Proper knowledge leads to improved anticipation, clarity, and wiser trading choices.

Safety and risk

Most people in the financial world consider larger companies to be safer investments, and for the most part they are correct. Companies tend to grow in size as they become successful (as expressed by a higher share price and larger market cap). And the bigger a company gets, the more financially stable and resilient it is.

In contrast, newer, smaller, or less-successful companies generally see their stock trading for low prices. From this perspective, penny stocks are typically riskier or lower-quality investments than larger companies.

The risk and perceived lack of safety associated with penny stocks are what create the opportunities for penny stock investors to reap substantial rewards. If the underlying companies were not in a financially precarious state, penny stocks wouldn't trade as penny stocks at all, but would instead be priced at much higher levels.

Investors who can identify and accept areas of concern for a company, or anticipate improvements in those risk factors, can find numerous values among low-priced shares.

TIP

Opportunity exists for those penny stock investors who can

- **Accept the risk.** As long as you're aware of the greater perceived risk and are willing to accept it in exchange for the potential of greater returns, you can find opportunities among penny stocks.
- **Find overblown risk perceptions.** When investors are overreacting to a company's risk factors, they may greatly undervalue the shares. Investors who recognize that the concerns are overblown can accumulate shares at very low prices. For example, if a drug development company with 12 products fails to get Food and Drug Administration (FDA) approval for one of them, the shares often collapse in response. But investors who remember that the company has another 11 drugs in development will scoop up the shares for a fraction of what they're actually worth.
- **Identify shrinking degrees of risk.** Often the risk factors keeping the shares of a company down eventually abate or change for the better. Usually there is a delay of weeks or months between when circumstances improve for the company and the resulting share price increases. That delay represents an opportunity for people to invest in a penny stock that's being held down by a perceived risk that's no longer a factor.

Investor following and visibility

Larger companies generally trade on bigger stock exchanges (I tell you all about stock exchanges in Chapter 3). Those companies have more investors, a greater number of people following their shares, and larger amounts invested in them.

When a massive company trading on the New York Stock Exchange needs to raise money, it generally doesn't have a problem getting that cash. Given its high level of visibility among investors and its large following of institutional investors and analysts, it is able to generate the funds it requires.

Penny stock companies, on the other hand, have far fewer involved parties and are usually listed on lower-quality stock exchanges with easier listing requirements and fewer serious investors. When they need to raise money, they often have to sell their concept first. They need to convince individuals, banks, and other creditors that they represent a good investment. Part of the job of a tiny company — and a potential distraction to operations — invariably becomes generating investor interest and expanding its base of shareholders. Insiders and key executives often front a major portion of any money a penny stock company needs; they know the potential the business holds, but the company doesn't have enough of a following or history of operations to generate the money from a bank or outside investors.

Any penny stock has the responsibility to increase the visibility of its shares and its company. As it becomes more successful at this task, whether by listing on a more widely followed stock market or expanding the number of shareholders who are invested in it, the company may find that the price of its shares increases, perhaps even to the point where it no longer qualifies as a penny stock.

Larger stones take more force to move

The bigger something is, the more effort it will require to move or lift. This is not only true in the physical world, but in the stock market as well.

Multibillion-dollar corporations might encounter issues that they barely even notice, while those same events could derail or dramatically impact any micro cap company. While small events don't tend to affect the prospects or direction of a blue-chip stock, everything matters when a company is new, tiny, or more vulnerable.

Larger corporations are also more diversified. They may have several business lines, thousands of customers, offices in dozens of countries, and a legal team capable of intimidating even the fiercest plaintiff. Penny stocks, on the other hand, often have a select few clients and revenue streams, so while any advances can really increase the share price, they're also significantly more vulnerable to any losses or lack of improvement.

In the following sections, I describe some types of events that can dramatically affect penny stocks but that may not be significant to large cap companies.

The bigger a company becomes, such events will have proportionately less of an impact on the shares. Until that point, however, many issues will be of greater importance to penny stocks than mid cap and large cap companies. Although this vulnerability can represent massive downside potential if things go against the smaller business, it also clears the way for dramatic and lasting upside price gains when events play out as hoped.

Lawsuits

Besides being very costly and a distraction for the executives and shareholders alike, the outcome of a lawsuit can have a major impact on a small company.

Suits brought against a penny stock are usually a massive financial drain and, if the company loses, can mean lights out. When the penny stock is the one launching the suit, the action may demonstrate the company's commitment to defending its products or patents through the courts; and if it comes out in the end with a good settlement or a victory, the results may be very beneficial. This assumes that it has the funds to see the litigation to the end.

Larger corporations devote a smaller percentage of their income to pay legal bills and have the financial luxury and insulation to launch or defend numerous court battles as they see fit.

Regulatory approvals or denials

FDA approval, a trademark grant, or a regulatory body award will have a much more significant impact on the share price of smaller companies. With some single-product corporations, a clearance or allowance is everything — without it, they go out of business; with it, they could change the world. On the other hand, a large cap corporation with 55 patents may not see a major impact when it wins its 56th patent.

Employee poaching or brain drain

Losing key employees is a very common problem for penny stock companies, especially among specialized technology companies. Bigger nanotech corporations, for example, often lure employees away from smaller nanotech businesses. The large cap companies can pay more and head-hunt more aggressively, while struggling and new penny stocks have a tough time thwarting these efforts. In some cases, a larger company will buy an entire smaller company for the sole purpose of gaining the employees.

Intellectual property events

The development and subsequent legal defense of trademarks, patents, and other intellectual property is very costly and time consuming, but such protections can help tiny companies level the playing field. As such, intellectual property awards can have proportionately more impact on the shares of a smaller company.

Financial results

Penny stocks are often so new and small that the financial results demonstrate a lot more than just the numbers. Implied within the data is the validity of the product, the demand among customers, the growth trend, and client retention levels. When a micro cap company says that its sales increased by 20 percent, it's also saying that its product or service has value and that more customers are buying or coming back for more. Financial results early in a company's life cycle can reveal a lot more in terms of upside potential for the share price — and early viability of the business concept — than those released after years of operations.

Customer changes

When a company has fewer customers, winning or losing one will have more impact. Customer changes could be really significant (such as a penny stock going from two to three big clients), or very detrimental to the company and its stock price (such as losing one of only two big clients).

Changes in competitors

When a penny stock loses a competitor, it may be able to pick up the market share that has become available as a result, and that benefit may be very significant for a small company. When that same penny stock sees new (and sometimes massive) competition enter its space, its best option is often to get bought out or taken over (see Chapter 3 for details), unless the company has the patents and trademarks it needs to defend itself and its sales channels.