Making Everything Easier!™

2nd Edition

Penny Stocks

FOR

DUMMIES®

A Wiley Brand

Learn to:

- Identify and purchase lucrative penny stocks
- Identify growth trends and market sectors positioned for growth
- Grasp the basics of penny stocks and make sound investments

Peter Leeds

Penny Stocks

for dummies®

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Contents at a Glance

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Introduction

Some of the greatest companies started out very small, with their stocks valued at less than five dollars per share. In other words, they started out as what the investment world calls "penny stocks." As those businesses grew in size, many of their shareholders grew in wealth along with the companies.

Few paths to significant and rapid wealth creation are as effective as investing in the right kinds of low-priced penny stocks. Excellent companies, regardless of their size, will always be able to provide their shareholders with impressive investment gains.

With increased opportunity, though, you have increased risks. Many people have been stung by those risks, and subsequently penny stocks have gotten a bad name in some investment circles. In almost all situations in which investors lost money, however, they could have easily avoided the downside if they had only followed the tips and suggestions in this book.

By showing you how to sidestep the risks, I clear the way for investors like you to profit from high-quality penny stocks. I help you find companies that have low debt loads, strong management teams, expanding market share, growing revenues, and game-changing intellectual property.

I wrote *Penny Stocks For Dummies* for two reasons. First, I want to help you — and investors like you — steer clear of the common (and easily avoidable) mistakes in penny stock trading. Second, I can show you how wonderful it will feel to get in on a great company early and build significant wealth from a small investment as the shares multiply in value many times over.

About This Book

In this book, you get the straight goods, free of any boring theories, complicated strategies, or inane details. In short, I tell you what you need to know to become a successful penny stock trader. Among the topics I cover are:

- Why penny stocks have a bad reputation among many traders
- Why avoiding the pitfalls is the first step to major profits

- How to trade risk-free with no money
- What the best penny stock investments look like and where you can find them
- Why proper trading strategies can turn into money in the bank
- How effective due diligence removes the guesswork
- Why fundamental analysis is the most important step to truly investing well — and in solid companies
- How technical analysis helps you develop your buying opportunities
- How financial ratios make for better comparisons and, by extension, better opportunities
- Why an abstract review gives you a major trading advantage

You can zip straight to the sections that interest you. I promise you will find what you want to know very quickly, and I won't subject you to financial mumbo jumbo or unnecessary details along the way.

Whether you benefit from sidestepping all the junky investments out there or you profit big by finding really excellent (yet still undiscovered) stocks, this book has something for you. And the beauty is that the information you need is just a few page-flips away!

Feel free to skip the sidebars that appear throughout the book; these shaded gray boxes contain interesting info that isn't essential to your understanding of penny stocks. The same goes for any text I mark with the Technical Stuff icon.

Within this book, you may note that some web addresses break across two lines of text. If you're reading this book in print and want to visit one of these web pages, simply key in the web address exactly as it's noted in the text, pretending as though the line break doesn't exist. If you're reading this as an e-book, you've got it easy — just click the web address to be taken directly to the web page.

Foolish Assumptions

We haven't met, but I bet you've made some assumptions about me. For instance, you probably think that I'm a nerdy financial type and that, because I'm involved in the stock market, I've always been a good investor. Believe me, I really wish that were true. (The part about being a good investor, not the nerdy part.)

Well, I've made a few assumptions about you, too. Here they are:

- You're logical and make decisions quickly.
- You're willing to take the steps needed to better your situation, and you don't shy away from excitement.
- Someone you know (possibly you) has invested in penny stocks before — and almost certainly lost money!
- You're new to investing or have limited experience in trading penny stocks.
- You have limited funds available to invest and you want to make the most of them.
- You're willing to accept a little risk in exchange for the potential to have greater returns.
- You know that many of the best companies started small, and you realize that the shareholders in those companies reaped massive financial rewards.

Icons Used in This Book

To make this book even easier to read, I include a few icons to highlight certain types of information.

TIP

Abide by these quick points to save yourself time and hassle.

REMEMBER

This icon identifies fundamental points that focus on basic rules and concepts of trading low-priced shares.

WARNING

Heed these warnings to protect yourself from some of the pitfalls surrounding penny stocks.

TECHNICAL STUFF

You can easily skip over the content flagged by these icons without missing out on any benefits the book provides. However, for those who really want to know everything, give these a look.

Beyond the Book

In addition to the material in the print or e-book you're reading right now, this product also comes with some access-anywhere goodies on the web. Check out the free Cheat Sheet for tips on protecting yourself from penny stock pitfalls, crucial criteria found in great penny stocks, and the no-cost method to becoming an excellent penny stock investor. To get this Cheat Sheet, simply go to `www.dummies.com` and type **Penny Stocks For Dummies Cheat Sheet** in the Search box.

Where to Go from Here

This book is set up so you can get right to the information you want. By all means, start at the very beginning if you feel like it, but if you're like most people and have only so much time to devote to investing, flip right to the sections that interest you.

Decide what approach works best for you, and use this as a reference for anything you could possibly want to know about penny stocks. The table of contents and the index will help with that, or just visit the specific parts that will provide you with the most benefit.

1 Getting Started with Penny Stocks

IN THIS PART . . .

Find out what characteristics distinguish penny stocks from other types of shares.

Uncover the truth about common assumptions — both positive and negative — about low-priced shares.

Get the scoop on which stock markets are the best for penny stock investors.

Examine the differences between investments of various sizes.

Become acquainted with events that can impact a company and its shares.

Learn how to protect yourself from scams and low-quality companies.

IN THIS CHAPTER

- Getting to know penny stocks
- Separating fact from fiction: The truth about low-priced shares

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, stockholder 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 that 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.
- **Very 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 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 that 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.
- **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:** An individual investor, or a professional such as a hedge fund trader or mutual fund manager, may only want a certain portion of her total portfolio to be in more speculative or volatile shares such as penny stocks. If she realizes that she has too much or too little of a percentage in one investment size or type, she will rebalance her holdings through the appropriate trades. Of course, she needs to have a criterion for what constitutes a low-priced share in order to manage her holdings.

» **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.)

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

TECHNICAL STUFF

Imagine standing before a huge group of people who don't like live music. They've had bad experiences at concerts before, whether because the speakers were too loud, the venue had poor acoustics, or they just picked the wrong band.

But you know that some live music can be great. You know that these people will love concerts if they just attend the right ones. Now imagine that it's your job to convince them to give concerts another try. Substitute the word *concert* with *penny stocks,* and you get a sense of what I face when trying to persuade people that trading in penny stocks can be a positive investment experience.

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 this type of investment is 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