5 Tips for Investing in Penny Stocks

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Investing in penny stocks provides traders with the opportunity to dramatically increase their profits, however, it also provides an equal opportunity to lose your trading capital quickly. These 5 tips will help you lower the risk of one of the riskiest investment vehicles.
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1. Penny Stocks are a penny for a reason.
While we all dream about investing in the next Microsoft or the next Home Depot, the truth is, the odds of you finding that once in a decade success story are slim. These companies are either starting out and purchased a shell company because it was cheaper than an IPO, or they simply do not have a business plan compelling enough to justify investment banker's money for an IPO. This doesn't make them a bad investment, but it should make you be realistic about the kind of company that you are investing in.

2. Trading Volumes
Look for a consistent high volume of shares being traded. Looking at the average volume can be misleading. If ABC trades 1 million shares today, and doesn't trade for the rest of the week, the daily average will appear to be 200 000 shares. In order to get in and out at an acceptable rate of return, you need consistent volume. Also look at the number of trades per day. Is it 1 insider selling or buying? Liquidity should be the first thing to look at. If there is no volume, you will end up holding "dead money", where the only way of selling shares is to dump at the bid, which will put more selling pressure, resulting in an even lower sell price.

3. Does the company know how to make a profit?
While its not unusual to see a start up company run at a loss, its important to look at why they are losing money. Is it manageable? Will they have to seek further financing (resulting in dilution of your shares) or will they have to seek a joint partnership that favors the other company?

If your company knows how to make a profit, the company can use that money to grow their business, which increases shareholder value. You have to do some research to find these companies, but when you do, you lower the risk of a loss of your capital, and increase the odds of a much higher return.

4. Have an entry and exit plan - and stick to it.
Penny stocks are volitile. They will quickly move up, and move down just as quickly. Remember, if you buy a stock at $0.10 and sell it at $0.12, that represents a 20% return on your investment. A 2 cent decline leaves you with a 20% loss. Many stocks trade in this range on a daily basis. If your investment capital is $10 000, a 20% loss is a $2000 loss. Do this 5 times and you're out of money. Keep your stops close. If you get stopped out, move on to the next opportunity. The market is telling you something, and whether you want to admit it or not, its usually best to listen.

If your plan was to sell at $0.12 and it jumps to $0.13, either take the 30% gain, or better still, place your stop at $0.12. Lock in your profits while not capping the upside potential.

5. How did you find out about the stock?
Most people find out about penny stocks through a mailing list. There are many excellent penny stock newsletters, however, there are just as many who are pumping and dumping. They, along with insiders, will load up on shares, then begin to pump the company to unsuspecting newsletter subscribers. These subscribers buy while insiders are selling. Guess who wins here.

Not all newsletters are bad. Having worked in the industry for the last 8 years, I have seen my share of unscrupulous companies and promoters. Some are paid in shares, sometimes in restricted shares (an agreement whereby the shares cannot be sold for a predetermined period of time), others in cash.

How to spot the good companies from the bad? Simply subscribe, and track the investments. Was there a legitimate opportunity to make money? Do they have a track record of providing subscribers with great opportunities? You'll start to notice quickly if you have subscribed to a good newsletter or not.

One other tip I would offer to you is not to invest more than 20% of your overall portfolio in penny stocks. You are investing to make money and preserve capital to fight another battle. If you put too much of your capital at risk, you increase the odds of losing your capital. If that 20% grows, you'll have more than enough money to make a healthy rate of return. Penny stocks are risky to begin with, why put your money more at risk?

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