How you can make (or lose) money on penny stocks

As we have seen earlier, penny stocks carry higher risks and also can give greater returns. This actually means that you can either lose a lot of money by investing in penny stocks (because of the higher risk factor) or make a lot of money (because of the higher potential returns). Which of these happens to you will depend a lot (but not only) on how you go about assessing the investment. Before we go further, however, you should be aware that no matter how much care you may take there is a certain amount of risk associated with penny stocks, which is much higher than in the case of large cap, stock exchange registered stocks.

In order to assess whether you can make money out of a penny stock, you should understand how one makes money in the stock market. One of the returns that one gets from a stock investment is in the form of dividends. That however, is usually a very small portion of the returns that one gets from stock investment. The major returns come from appreciation in the price of the stocks. The prices of stocks are assessed using different yardsticks or parameters. The first of these is the return on investment. If the return on a stock is 10% and the price earnings ratio is 10, for example, the stock would be priced at ten time the earnings or 100% of issue price. In other words this stock would be traded at its face value. From this we can see that the price would depend on two things, the absolute return and the price-earnings ratio.

The second important factor that affects the price is the book value of the stock, which is basically computed as a figure that represents the assets available in the company against each stock. For example, if a company has net assets of $100,000 and has issued 10,000 shares, the value of each share under this method would be $10.

The price of a share is also valued on the basis of a few other criteria. However, the most important factor from the market point of view is the returns that the stock generates. The value under this method would depend on the earnings and the price-earnings ratio. The latter is a matter of perception that will depend on the risks associated with the stock. This perception will undergo changes depending on the history of performance of the organization, the available information about the company and its prospects, and the market buzz about impending major events in the company (for example a takeover by a major organization).

Of these, the most important from the long-term point of view is the consistency and quantum of earnings from the long term and the direction of the price-earnings ratio in the short term. As an investor what you need to assess and be aware of are

- Is the company stable enough to sustain its earnings and growth? Who are the promoters? How long has it been in business? Answers to these and other such questions

- How is the market perception of the company? How is it likely to change?

- How are the "fundamentals"? Does the company have a good asset base? Does it enjoy a good business?

Finally, the old adage "don't put all your eggs in one basket" is true to a greater extent in the case of penny stocks. So invest a little at a time and don't put all your money on one or a few such stocks.

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