

File Created by [Blogging Rebirth](#) WP Plugin

# Penny Stock Returns

Why do people invest in penny stocks if they are so risky? The answer lies in a few facts as well as a few misconceptions about penny stocks. First let us look at the positive side of how penny stocks can be more profitable.

It is a well-known fact in finance that risk and return have a positive correlation. This means that an investment that carries greater risk will also give higher returns. The reason for this is very easy to understand and is almost intuitive. Suppose you had \$10,000 to invest and two options A and B. Option A is a secure government bond that gives you 5% return, while option B is a higher risk investment in a company that will pay you only if it makes profits. Assume that this company has a history of making 5% Profits over several years and is likely to continue on the same lines.

That is, you can expect to get a return of 5% in future years, but that is subject to the company making the same level of profits. Where would you invest your money? If the returns are likely to be the same and if you are a sane person, you would obviously invest in the risk free option. Now suppose, option B were to pay you not 5% but 15% consistently, you might be tempted to put your money in it. In other words, a higher return can make you to invest in a riskier venture.

Since penny stocks are higher risk alternatives compared to regular stocks, the only way they can attract investment is by holding out a promise of higher return. How would a penny stock offer a higher return? This will be done not directly by the stock or the company, but by market forces. The market price of a stock is fixed on the basis of a few factors such as its intrinsic value and the return yielded by it. The market price of a stock divided by the return it gives is known as the price-earnings ratio.

For example, if \$10 stocks were to be traded in the market at \$20, and the company earns a net income per share of \$1, the price-earnings ratio is 20. The price-earnings ratio will be higher for solid stocks that are known to be backed up by good management, have a history of consistent and good performance, and are perceived to be stable. The price-earnings ratio for stocks that are riskier, unknown and do not enjoy a positive perception will be much lower. This means that as against the example of price-earnings ratio of 20 that we assumed for a stable and well-known stock, a penny stock may have a much lower price-earnings ratio, say 3 or 4. Actual figures will depend on a number of other factors also.

Because of this, a penny stock will be priced lower for the same level of net income, and will therefore yield a higher return on the investment.

You can also find this article published on [Penny Stock Returns](#)