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# Penny Stocks Risks

The first point to remember is that large market cap stocks are likely to be registered on a national stock exchange such as NASDAQ. The reason for this is that when large volumes and amount are involved, which by definition is true for a large market cap stock, it is extremely difficult to get all that trade done outside a stock exchange. Although it is theoretically possible for a large stock to be traded on Pink Sheets and OTCBB, it will be difficult to sustain high volumes on these, because many people, who trade on recognized stock exchanges, may not trade in these stocks, particularly in large volumes.

Registration with a stock exchange involves a number of formalities that have to be complied with. These formalities are aimed at making the whole process more transparent so that the investor has access to relevant information. The availability of information helps you to verify the facts and also to check out on the soundness of the company more thoroughly. When these are missing you are operating under insufficient information and therefore are exposed to higher risk. Thus stock exchange registration by itself reduces the risk involved in investment.

Apart from this, there are other reasons why a penny stock is more risky than large market cap stocks.

Stocks registered with a recognized stock exchange are required to maintain minimum standards. These include requirements such as

Minimum number of publicly traded shares – this should be 1.1 million shares in the case of NASDAQ. The publicly held shares should also be a minimum of 10% of the total shares of the company.

Minimum Shareholder Equity

Minimum Operating income

Availability of market makers

The specified minimum amount should be available in assets, total revenue and listed securities.

There are many such requirements that a company has to meet in order to stay registered with the stock exchange. Basically, these requirements ensure that the stocks are widely held, and the company is running properly. These safeguards make the listed stocks less risky than unlisted ones, which do not have to follow any such requirements.

Penny stocks also generally do not have a history behind them, and suffer from low liquidity position. They have less room to maneuver. Because they are more risky and less preferred they will also have difficulty in raising money for new ventures or expansion. In some cases they may have difficulty in raising money even for operations. Companies generally raise money by borrowing or raising new capital. The amount that can be borrowed is limited for a given equity base. Suppose the company has \$100,000 in capital, lenders may be willing to lend \$200,000 or some such amount. If the company wants to borrow more money, it will have to first increase its capital base. This is more difficult in the case of penny stocks.

Finally, it might not be equally easy to find buyers in the case of penny stocks particularly if you have a large number of them. This will affect your own liquidity in the short term and also make it difficult to offload these stocks if the going is not too good.

These are some of the reasons why a penny stock is considered more risky. However, penny stocks have their brighter side too. They can give you much higher returns. We'll see how this is possible in the next article.

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