What Are Penny Stocks?

As promised, Understanding Penny Stocks starts from the very beginning. For the purposes of understanding Penny Stocks, I will treat any share that trades under $2.00 as a penny stock. Strangely, there is no official definition for penny stocks. There are three different criteria that various individuals and organizations use to define penny stocks. What is considered a penny stock really depends with whom you are dealing.

Penny stocks can be defined by:

1. **Price Per Share**: Sometimes any shares that trade under a certain price are considered to be penny stocks. For example, the SEC considers all stocks that trade for less than $5.00 per share to be penny stock. Different individuals and organizations have their own cut-off.

2. **Market the Stock Trades Upon**: In some schools of thought, any shares that trade on a certain market (i.e. the OTC-BB, or the OTC, or the 'Pink Sheets,' or the CDNX) are treated as, or considered to be, penny stocks.

3. **Market Capitalization**: Market cap is simply the total trading value of the entire company. The value of each share of a stock, multiplied by the total number of shares outstanding, equals the market cap.

For example, 12,343,000 shares of ABC at $0.29 each gives ABC Corp. a market cap of $3,579,470 (12,343,000 shares times $0.29 per share = $3,579,470). That is kind of like saying that the company's total value is 3.5 million dollars. In some cases, organizations or individuals will treat any company beneath a certain market cap (for example, less than $10 million) as a penny stock.

Interestingly, using option 1 or 3, a company can have its shares change in price moment by moment, and may drop in or out of the definition of 'penny stock' over time. What may be a "penny stock" when the market open in the morning, may not be a penny stock by noon.

In some cases the definition of penny stock is generated by a combination of the above criteria. For example, any stock trading on the OTC-BB with a market cap of less than $20 million is considered a penny stock.
What Are Penny Stocks?

Defined by price per share
I treat any share that trades under $2.00 as a penny stock. The Securities and Exchange Commission (SEC) considers any stock below $5.00 per share to be a penny stock.

Defined by the market the stock trades on
Some markets that trade penny stocks include:
» Over The Counter (OTC)
» NASDAQ Small Cap
» Pink Sheets
» Over the Counter Bulletin Board (OTC-BB)
» Canadian Venture Exchange (CDNX)

Defined by Market Capitalization
Stocks with less than $50 million in total capitalization can be considered penny stocks, but this market cap cut-off varies greatly from one organization's definition to the next.

It is worth repeating: I treat any share that trades under $2.00 as a penny stock.

I have specifically developed my techniques and trading methods to apply to shares less than $2.00 in price. However, keep the other definitions in mind because what is and is not a 'penny stock' will depend on who you ask. The only common characteristic that we feel holds true from one definition to the next, is that penny stocks are high risk, high reward investments.

Penny stocks are high risk, high reward investments. It is easy to lose money on a penny stock investment. However, if your shares do begin to move, they can produce hundreds of percentage points of gains, and they often do this in only a short time frame.

Penny stocks are often very volatile, and just as often unpredictable.

In most cases, penny stocks are considered to have higher risk and higher potential rewards than most other 'more conventional' investments. Their speculative value can be extreme, and their visibility of information and / or accessibility of operational results is usually very poor.

Few financial professionals venture into the field of penny stocks because they are either unwilling or unable to do the work required to accurately predict what these highly explosive shares may do.

Or perhaps some big-wig investment types feel that low-priced shares are 'beneath' them. Hmmm. I could have retired when I was 26. Is that beneath them?
Big Stocks vs. Penny Stocks I

As you review the following differences between "blue-chip" equities and penny stocks, you may be able to see why professional analysts and institutional investors usually shy away from these speculative shares. The kind of money that the big players use could crack the backs of many of these penny stock companies. There would not be enough volume on the other side of their trades to enable the transaction, because some penny stocks often trade only a few thousand dollars worth per day.

The negative connotation towards penny stocks among financial industry insiders needs to be kept in context. Sure, these investments are often low-volume, inexpensive shares of unproven companies. However, that is the beauty of penny stocks, and is partly why you can acquire such potentially rewarding stocks at such bargain prices.

As well, the lack of institutional interest is one of the keys to our methodology of picking winning penny stocks. Getting involved early, then holding on as the company gets discovered and explodes in price, is partly dependent upon the previously unknown company suddenly gaining interest from bigger players.

Speculation

Speculation is based on penny stock companies having lower available information about their operations, minimal revenues, unproven management, and often an unproven product or industry. A big-name company like General Electric or Ford Motors will have very little speculative value. In other words, you will probably not make hundreds of percentage points on your shares, but instead would be happy with returns of 10% to 20% per year.

In some cases, traders even use large-cap stocks to hedge or protect their portfolios, out-perform the market, preserve their capital, or diversify their exposure.

On the other hand, trading penny stocks with hopes of selling when you have realized a 20% gain might be folly. Penny stocks make their gains by the hundreds of percentages, and thousands, not by the tens. There are many bad investments in the penny stock field, so the best way to succeed is by isolating those with superior speculative value. The chance of buying into shares of the company that could multiply 10 or 20 or 50 times in price is the whole idea of speculation.

Value and Predictability

Large-cap companies usually have more predictable revenues and earnings. Many analysts and investors follow the companies, so that day to day events are quickly factored into the share price, and the stock often reflects a pretty accurate 'worth.'
In contrast, it is not possible to calculate the actual worth of most penny stocks. Some do not have inventories, a revenue stream, or even a proven product. The shares rise and fall based on buying and selling demand, and that demand is driven mainly by waves of speculation.

By their nature, it is nearly impossible to know what price a penny stock share should be trading at, and conventional financial ratios and industry comparisons are rarely effective measures for realizing a penny stock's tangible value.

**Compare Penny Stocks to More Conventional Blue-Chip Stocks**

<table>
<thead>
<tr>
<th>Speculation</th>
<th>PENNY STOCKS</th>
<th>BLUE CHIPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>High value, greater perceived potential. Penny stocks are also very unpredictable.</td>
<td>Highly speculative. For some penny stocks, speculation is all they have going. The better penny stock companies often see their shares soar on speculative buying.</td>
<td>Little or no speculative value.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Value and Predictability</th>
<th>PENNY STOCKS</th>
<th>BLUE CHIPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poor visibility levels, lower reporting responsibility. Can be researched properly if the Leeds Analysis method I describe in Chapter Three is applied.</td>
<td>Less actual value, greater perceived potential. Penny stocks are also very unpredictable.</td>
<td>Safer but boring. Very little potential for a price explosion.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fundamental Analysis and Information Availability</th>
<th>PENNY STOCKS</th>
<th>BLUE CHIPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>TA methods cannot be applied to penny stocks, except for the proprietary techniques and indicators I describe in the second half of Leeds Analysis later in this book.</td>
<td>Poor visibility levels, lower reporting responsibility. Can be researched properly if the Leeds Analysis method I describe in Chapter Three is applied.</td>
<td>Well known, heavily followed companies have a wealth of information available.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Technical Analysis</th>
<th>PENNY STOCKS</th>
<th>BLUE CHIPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>TA can be easily applied to high volume shares.</td>
<td>TA methods cannot be applied to penny stocks, except for the proprietary techniques and indicators I describe in the second half of Leeds Analysis later in this book.</td>
<td>TA can be easily applied to high volume shares.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Volatility</th>
<th>PENNY STOCKS</th>
<th>BLUE CHIPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highly volatile, with more frequent profit-taking opportunities, and greater price swings.</td>
<td>Highly volatile, with more frequent profit-taking opportunities, and greater price swings.</td>
<td>More secure and insulated from volatility.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Spread</th>
<th>PENNY STOCKS</th>
<th>BLUE CHIPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sometimes there is a gap between prices of buyers and sellers.</td>
<td>High volume stocks have very little spread between the bid (buying offer) and the ask (selling offer) prices.</td>
<td>High volume stocks have very little spread between the bid (buying offer) and the ask (selling offer) prices.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Risk / Reward Ratio</th>
<th>PENNY STOCKS</th>
<th>BLUE CHIPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>The risks are higher, while the potential rewards are much greater.</td>
<td>The risks are higher, while the potential rewards are much greater.</td>
<td>Less risk, less reward potential.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Ease of Acquisition</th>
<th>PENNY STOCKS</th>
<th>BLUE CHIPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>More complicated to purchase some types of penny stocks, such as those trading Over-The-Counter.</td>
<td>More complicated to purchase some types of penny stocks, such as those trading Over-The-Counter.</td>
<td>Much easier to trade through your broker, no special commission rates.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Revenues and Company Life-Cycle</th>
<th>PENNY STOCKS</th>
<th>BLUE CHIPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower, or no actual revenues. Initial or growth stage companies.</td>
<td>Lower, or no actual revenues. Initial or growth stage companies.</td>
<td>Mature or advanced companies, less growth but greater revenue streams.</td>
</tr>
</tbody>
</table>
### PENNY STOCKS vs. BLUE CHIPS

<table>
<thead>
<tr>
<th>Category</th>
<th>Penny Stocks</th>
<th>Blue Chips</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dividends</strong></td>
<td>Very rarely pay or are in the position to pay dividends.</td>
<td>Many blue-chip stocks pay dividends.</td>
</tr>
<tr>
<td><strong>Takeover or Acquisition Targets</strong></td>
<td>More likely to be taken over by another company, which is usually very beneficial to the price of the shares.</td>
<td>More likely to be the company purchasing or taking over the smaller player, which is usually detrimental to the price of shares.</td>
</tr>
<tr>
<td><strong>Industry and Sector Influences</strong></td>
<td>Highly exposed to sector influences, to the potential benefit or detriment of the shares.</td>
<td>Insulated to the impacts of the sector and industry.</td>
</tr>
<tr>
<td><strong>Economies of Scale and Niche Marketing</strong></td>
<td>Niche marketing is more important, because penny stocks can not compete with the economies of scale of the bigger players in their field.</td>
<td>Benefit from economies of scale, but can not respond, react, or adapt to the smaller companies quickly enough. Often leave niches exposed for penny stock companies to capitalize.</td>
</tr>
<tr>
<td><strong>Driving Factors vs. Fiscal Situation</strong></td>
<td>Share price is not strongly tied to fundamental results and the balance sheet.</td>
<td>Fundamental results and the balance sheet are the most important factor to the share price.</td>
</tr>
<tr>
<td><strong>Irrational Spikes and Profit Opportunities</strong></td>
<td>More frequent and extreme spikes and dips, from less provocation.</td>
<td>More stable, less volatile.</td>
</tr>
<tr>
<td><strong>Broker Policies</strong></td>
<td>For certain types of penny stocks, brokers can charge greater commissions, or be problematic.</td>
<td>Brokers will not be problematic for trades in blue chip stocks.</td>
</tr>
<tr>
<td><strong>Investment Horizon</strong></td>
<td>Gains can be seen in short time frames, from hours or days, to weeks or months.</td>
<td>It often takes larger, slow-moving companies years for their share prices to advance meaningfully.</td>
</tr>
</tbody>
</table>

### Fundamental Analysis and Information Availability

Shares trading on senior exchanges must comply with regimented reporting requirements. To keep their shareholders happy, and to maintain their exchange status, they often must detail the entire inner workings and operational finances of their company to the public. It is simple to get the latest results from IBM, and to take it one step further you can even get estimates of future results.

Depending where the penny stock trades, the disclosure level is usually anywhere from mediocre to nonexistent. There are penny stock companies which bend over backwards to inform the public of their every move, but these are few and far between.

It will take more work to acquire the information you could easily get from a larger company, and even then the data may not be available.
Big Stocks vs. Penny Stocks II

Technical Analysis

Technical analysis is the examination of the trading chart of a stock to look for trends, patterns, and hopefully predict future price direction. For these methods to work accurately, the underlying stock needs to have a high level of trading activity. The high trading volumes in most large-cap, big name investments make technical analysis of the company's trading chart possible and improves the accuracy of those predictions.

Penny stocks lack the critical mass of trading volume to enable standard technical analysis. For the purposes of penny stock investors, I was forced to develop my own proprietary methods that could be applied to thinly traded securities, and these are detailed in Chapter Three of "Understanding Penny Stocks".

Above is an example of some of the Technical Analysis indicators that can be used to attempt to predict stock price direction.

While they have little bearing on the concepts presented in Understanding Penny Stocks, they are presented here as an example. Some of the indicators featured above include smooth moving average, bollinger bands, momentum, relative strength index, and others.

Side Note: I did not need to use all this fancy technical analysis to discover BXG (the stock featured above) just before it made its big move. Rather, I found BXG using Leeds Analysis and revealed it to my subscribers just before it multiplied in price.

Volatility

Penny stocks can often undergo dramatic price swings, and often these moves can be on nothing more than a large buy or sell order. It is not unusual to see your shares drop or spike 20% or 50% or more during a trading day, and even return to their original starting point by the end of that same day.

When a company does come out with a significant press release, for example a biotech gaining FDA approval for its latest drug, expect the shares to make a big move, and even potentially build upon that advance the following few trading days. Price explosions of several hundred percent in a matter of hours or minutes are not uncommon.

Spread

Stock markets try to match up the highest bid price (to buy shares) and the lowest asking price (to sell shares). When these numbers match a trade takes place. For example, when you see a price quoted as $0.25, you know that the last trade was when a buyer and a seller both agreed upon $0.25 for their transaction.
At all times when the bid and ask are not matching, there is a spread. For example, if the highest bid is $0.80 and the lowest ask is $1.00, the spread between the two will be 20 cents.

You will quickly find that penny stocks are subject to much larger spreads (on a percentage basis) than more heavily traded stocks. It is common to see penny stocks with spreads of 15% to 30% when the buyers and sellers are not agreeing upon a price.

**Risk and Reward**

Penny stocks are considered higher risk, because uninformed or unlucky investors have lost money, and quickly.

Sometimes those losses are contained to a fraction of the invested capital, but other times traders lose 100% of their investment (for example, if the company goes bankrupt). Companies ceasing operations, running out of money, and/or closing their doors is much more common among penny stocks than other larger investments.

That is why it is so important to limit your risk, and avoid the common pitfalls that so many investors blindly fall into. Understanding Penny Stocks will help you limit your risk significantly.

It is not unlike driving. Driving will always be dangerous. So, drive a Volvo, the safest car, to protect yourself. Investing will always be dangerous. So, read Understanding Penny Stocks to protect yourself. Rewards are also much higher (potentially) than with other investment vehicles. Many penny stock companies have just started out, and will one day be huge corporations. The returns a trader could make off of one of these could be enough to live off of for years.

**Ease of Acquisition for Individuals**

You can buy thousands of shares of penny stocks with a small investment. In contrast, it is not always within the means of an individual to purchase 100 shares of a $40 stock, which means that buying blue chip and large cap equity investments is not always realistic.

As well, if you do have a few thousand dollars it is easier to diversify among a group of penny stock companies, instead of buying only one or two more-expensive blocks of higher priced shares.

**Revenues and the Company Life Cycle**

Most companies start off with an idea or business model, raise capital, and implement their operational strategy.

If they get this far, and many don't, they enter their growth phase. In this phase, their revenues go from nil to some level that (usually) is still not enough to meet their expenses.
The growth phase, when companies become discovered by the public and the financial industry, is when they usually enjoy the greatest share price movement.

As a company matures, they begin looking for additional complementary products and services to sell. They get their fiscal situation in order, turning those revenues into earnings, and may even pay dividends.

This process from new company to mature corporation takes years. Microsoft was once a two-man operation, and they had an office sign that was scribbled on a piece of cardboard. They enjoyed an explosive and arguably the most dramatic growth phase in the history of the stock market, and now have hit maturity. They do not expect to keep advancing at their explosive rate, and are looking for alliances and ways to consolidate their industry position.

It is important to know that the majority of penny stocks are in the pre-revenue or very early growth stages. Many do not have revenues, and just as many have yet to prove that their concept or operational strategy has any merit.

Many penny stocks in this infancy stage are 'story stocks,' meaning that they have investor interest because of their potential. They have a great sounding 'story' or idea (for example, a new technology or drug that could revolutionize an industry), but have yet to prove it, or to show that they have a method to capture market share or educate society about their concept.

### Dividends

Some larger companies, or those with higher cash flow, pay a portion of their cash to shareholders. Penny stocks, being cash-strapped and in their growth phase by their very nature as described above in 'the company life cycle,' generally do not.

However, it has happened from time to time. I once bought shares in BVR.A on the TSE (Bovar, Toronto Stock Exchange) for $0.14 each. The company decided to unload a large cash position that it had on its books. They paid out a one time dividend of $0.16, which by itself was higher than the original purchase price.

(Note: Part of my personal justification for purchasing BVR.A was that they had more cash on hand per share than the current trading price). I had more money than I had originally put in just from the dividend, and I still held the shares!

### Takeover or Acquisition Targets

Since the market capitalization of a penny stock company is lower, they are excellent takeover targets for bigger players in the same field. As well, smaller penny stock companies often merge with one another as a way to increase sales and revenues in a bid to compete with or survive against the bigger industry players. Generally, if a company is getting taken over their share price will benefit. If they are merging with another company, how the share price performs will depend on the situation, and could be beneficial or detrimental.
Big Stocks vs. Penny Stocks III

Industry and Sector Influences

While Disney (DIS on NYSE) may be impacted by trends in movie go-ers, travellers, and advertising, the day to day and month to month changes in these underlying criteria do not sway the stock too dramatically.

In comparison, most penny stock companies have exposure to one facet of the economy, and are highly leveraged against that driving force. Gold penny mining stocks suffer extreme swings as the price of the precious metal fluctuates, and a biotech company could be crushed if a competitor releases a superior drug. In other words, penny stock companies are usually one-tiered, highly leveraged entities, that suffer and enjoy extreme price fluctuations whenever their underlying industry shifts.

Economies of Scale and Niche Marketing

Larger companies have more resources and capital at their disposal, and usually enjoy stronger strategic alliances with bigger companies, as well as more pervasive name recognition for their product or service. This creates problems for penny stock companies looking to enter a pre-existing market that already has a dominant force. In these scenarios, the penny stock company generally performs best by capturing a niche market, rather than going head to head with a competitor.

For example, take a look at one of my favorite stocks in recent years. Paravant Computers had no hope of surviving a market share war with Dell, Compaq, IBM, and all the other players in their saturated sector.

However, since they were in the niche market of developing rugged laptops and computer peripherals for outdoor and military use, the company thrived and the stock soared. They enjoyed better earnings and lower debt loads than all of their bigger competitors, and developed name recognition and reputation in the niche market that mattered to them.

Several times over the years I had told members of PennyStocks.com all about Paravant, and they made money on it each time. After September 11th, PVAT soared as military spending increased.

Driving Factors vs. Fiscal Situation

Penny stocks often have too much debt, no revenues, or ugly balance sheets. Looking closely at their fiscal results can be frightening. However, investors often ignore the fundamentals of speculative companies, because of the potential the shares could enjoy if the company's product catches on.

For example, Xerox once had a horrible financial situation when they first started out. However, that did not have much impact once their technology became the standard - long before they were actually turning a profit.
Irrational Spikes and Profit Opportunities

Penny stocks can often spike (or drop) based on the slightest provocation, even if that driving factor is of little significance.

Pretend that a change in CEO seems like a great turn of events for an anxious trader, who disliked the old CEO. The investor dives into the market for $10,000 worth of shares, which could result in a 50% leap in share prices because of the buying pressure. However, the new CEO may not be enough to justify a 50% increase in the overall value and market cap of the corporation.

Part of the process is to understand which driving factors are accurately priced into the shares. If you do not share our exuberant investor's faith in the new CEO, you may want to take this opportunity to exit your position and take profits as the stock spikes 50% higher.

Broker Policies

Due to the lack of visibility of penny stocks, the markets they trade upon, their volatility, and their risk factors, some brokerage houses have instituted strict policies for trading these investments.

Shares that they consider 'penny stocks,' which are usually stocks for $5.00 and under, are not option eligible. This means that you cannot sell short, set stop loss orders, or buy on margin. For most traders this would not be an issue anyway, because these are all more exotic trading methods, and ones that I strongly warn against.

As well, depending on the stock exchange that the shares are listed on, you may not be able to use limit orders to buy or sell, and will have to take the best available market price. There is much more on buying and selling coming up later in this chapter.

Investment Horizon

Traders generally tend to hold penny stocks for shorter time frames, and attempt to get their returns from the stock in a matter of months rather than years.

- Want your trading to be exciting;
- Have limited capital;
- Don't have the patience to wait for years;
- Want to use your profits to generate even more profits.
Picking Your Own Explosive Penny Stocks

A little work can go a long way.

In the case of penny stocks, the amount of effort and research you put into finding the perfect investments is directly proportional to success.

Almost all traders who get involved with penny stocks are doing so for the wrong reasons. For example, they hear a hot tip from a friend at work, or see a small news article about a company in the paper. Unfortunately, by the time you hear about the shares, they are already common knowledge.

This is not to say that you will need to research for eight hours a day just to make money. It is quite the opposite actually. A few moments of effort, along with the knowledge and concepts revealed in Leeds Analysis, will help you quickly identify which are the best penny stocks from the pool of thousands.

For those of you who are willing to research extensively, the theories will be incredibly valuable. If you are not inclined to do very much work, or do not have the time to commit, these concepts become even more important. They will show you how to:

- Easily rank stocks
- Avoid the common mistakes

Perhaps you do not want to do any research yourself at all, but instead prefer to use a professional penny stock picking service. This is also an excellent way to proceed, as long as you decide on a service that is reliable and accurate.

I recommend that you do use the services of a professional penny stock analysis company, but besides PennyStocks.com, I would not consider any of the other options out there to be 'professional.' Generally they are individuals who have figured out how to program a web page, and their expertise does not go far beyond that.

A Little Work

As I have mentioned, a little work can go a long way. However, most traders do not put in the required effort, or any effort for that matter. Those of you who are willing to do the extra due diligence or analysis will benefit greatly from what you are about to read.

Understand that 95% of penny stock companies should be considered bad or dangerous investments. However, the proven approach outlined in the next several sections of Understanding Penny Stocks makes it easy to tell which stocks should be ruled out.
A Long Way

As you become more experienced, you will learn that a good penny stock trader can make money on good and bad penny stocks alike, simply by investing at the right time. Since every stock fluctuates, you shall see that money can be made by buying even the worst companies at the right time, and money can be lost by buying the best companies at the wrong time.

Ideally you want to accumulate the best penny stock companies at the most advantageous prices. We suggest using fundamental analysis (detailed in an upcoming section) to discover which are the best penny stock companies, while using technical analysis (also detailed further along in Understanding Penny Stocks) to pick the most opportune buying prices.

Different Research and Analysis Schools of Thought

There are many different strategies for picking winning stocks, and perhaps you have heard of most of them. From 'advanced technical analysis trading programs' to 'computer-assisted undervalued screens,' no one method has consistently proven effective with penny stocks.

You may as well have been throwing darts at the stock page in the newspaper!

For this reason, my company has developed our own proprietary research and analysis technique, which applies specifically to the penny stock markets. Our methodology has been working exceptionally well, and has been fine-tuned over many years to further increase its effectiveness.

You are about to learn this long-secretive approach to picking winning penny stocks, called "Leeds Analysis." This technique has helped me make tremendous amounts of money, both for myself and for my subscribers. However, I first ask that you review the different research and analysis schools of thought. I believe that it is very important to understand the numerous ways that investors have attempted to beat the market over time. The roots of my own secretive penny stock research and analysis technique stems from some of the best pieces of the following methodologies.

I feel that I must make one thing clear! The methodologies presented below were created to apply to higher priced equities, and when applied to penny stocks they often lose their relevance and accuracy. That is why myself and my team were forced to create our own approach to picking penny stocks, which is detailed in the next section of Understanding Penny Stocks.

Why don't conventional research techniques work for penny stocks, you ask?

This is because penny stocks are an animal all of their own, and they play by significantly different rules. When investors try to take a strategy for investing and apply it to penny stocks, they are often surprised by how ineffective it can be. Different Schools of Thought.
Technical Analysis

This uses patterns in the trading chart to try to uncover trends, and then predict the future direction of shares. It is also done in an attempt to uncover the best buying and selling opportunities and prices, as well as to predict the future activity of the underlying stock.

For example, when most stocks demonstrate what TA calls a ‘cup and handle’ pattern, they generally spike higher in the subsequent weeks. Thus, a cup and handle pattern may be a good buying opportunity. What a technical analyst’s desk may look like.

TA is significantly limited when applied to penny stocks, as the trading volumes and low investor interest (compared to most stocks) negates most analysis patterns. TA works best on well-followed, heavy volume shares like IBM or FORD.

"Conventional" TA cannot and should not be applied to penny stocks. Instead, we have developed our own TA methodology for application specifically to penny stocks, and I detail it in upcoming sections of Understanding Penny Stocks.

Fundamental Analysis

This approach uses the company's financial statements. It looks at the financial numbers and ratios, as well as the corporate situation. We feel that fundamental analysis is a great starting point for screening and researching penny stocks, and that it is an effective method of finding the best companies to invest in.

Fundamental analysis looks at things from revenues and debt, to ratios like price/earnings and debt/equity. It then compares these with other stocks in general, and with direct competitors. Using fundamental analysis, you will also look at such criteria as management team effectiveness, press releases, brand recognition, barriers to entry for new competitors to the sector, among a host of other parameters.

Fundamental analysis is an excellent way to research and rank stocks. However, it becomes more difficult when dealing with penny stocks since it is often challenging to get access to all of the required information (and even when you do, you often need to be wary of the reliability of the facts).

Later, in the section on Information Sources, I detail how you can go about finding the information you need. In the next section, I explain to you exactly what fundamental factors drive the share prices of penny stocks based on our research.

Individual Concepts

The pure depth of fundamental analysis can be daunting, and as a result many trading concepts have sprung up from FA roots to take on lives of their own.
For example, some research methods simply take one fundamental concept such as price/earnings ratio, and use that as a way to compare investments. The companies with the lowest P/E ratios would be considered undervalued, while the ones with the highest P/E ratios would be overvalued. (One flaw with the approach in this example is that it assumes that all other factors are equal).

Another may look just at insider trading by itself. When insiders are buying, it must be a good time to load up on shares, and when they are selling, they must be privy to some bad news. (Insiders are just people, though, and often they can sell shares to raise money for their daughter's braces or a new car. Other insiders 'go down with the ship' and never sell their shares while the company sinks. In other examples, there may not be enough clear insider activity to reveal anything at all).

If you are sensing a trend here, it is that these 'Individual Concept' investment approaches are easily flawed. Most are fads that may have worked on certain stocks in certain market environments, but they quickly become exposed as ineffective once they are applied by individual investors. While traders may get lucky in some markets, then swear by the effectiveness of the approach, all of these strategies have proven to be unreliable from one moment to the next.

If any of these methods ever did prove effective (which they never will) it would not be long before every trader in the world was applying them, especially due to their simplicity.

Besides, why look at only one factor of a company, when you can look at all of them? True, you may be able to make some profits some of the time by seeing a small part of the picture, but revealing the entire picture will help you make more money, more of the time.

Themes

You may have heard of some of them: undervalued stocks, bottom-fishing, industry leaders, rolling stocks, momentum investing (the last of which is a spin-off from technical analysis methods). These are sometimes effective if the market cooperates, and painful when the market misbehaves.

Sure, it is great to pick up shares in undervalued stocks when the market has bottomed out and has just begun to rebound. But in that sort of a market, is it not also a great idea to be involved with bottom-fishing, industry leaders, momentum investing, stocks that begin with the letter 'D', and investment horoscopes?

Look at January to March of the year 2000. The three months leading up to the bursting of the dot-com bubble, you could not have lost money in the market if you tried! (If you did, please write to me and tell me all about it. I would LOVE to hear how you pulled that off!)

Perhaps I am being a little harsh. Sometimes these methods listed above can help you uncover some good shares.

Just beware of their gimmicks, and only get involved when the market is just right. As well, know that there is no substitute to getting the entire company picture, as I detail in the next section.
The method I am about to explain to you has consistently outperformed the market.

Think of this weight loss analogy: there are a thousand different gimmick diets you could try, and although you may see some temporary results (which do not last), they do not work. The best way to lose weight is through changing your eating habits and lifestyle. In other words, doing the work required rather than going with a gimmick. Similarly, the best way to make money in penny stocks is to do the work required, rather than going with a gimmick.

I believe penny stock traders (even those that use a professional penny stock picking service) should examine the fundamentals as described in the next section on Leeds Analysis. This will help you to discover the best penny stock companies. Then use our specially developed technical analysis methods (also described in Understanding Penny Stocks) to find the best buying and selling prices of those shares.

### Different Analysis Approaches

<table>
<thead>
<tr>
<th><strong>Technical Analysis</strong></th>
<th>Using trading charts and activity to attempt to predict future trends and prices</th>
<th>TA requires high trading volumes and predictability of stock activity, neither of which are common enough with the majority of penny stocks.</th>
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<tbody>
<tr>
<td><strong>Fundamental Analysis</strong></td>
<td>Using the financial results, assets, and earnings to predict the value of a company's shares.</td>
<td>Fundamental Analysis can be effective for penny stocks, <em>IF</em> it is applied with special considerations in mind. The fundamentals which drive the price of a blue-chip company are very different than those which drive a penny stock company, as detailed in Leeds Analysis.</td>
</tr>
<tr>
<td><strong>Individual Concepts</strong> P/E comparisons, momentum investing, revenue growth comparisons, and dozens of other solo theories.</td>
<td>Comparing companies by one factor (i.e- Price/Earnings Ratio).</td>
<td>This method is too shallow even for large-cap and blue-chip stocks, and is even less effective for penny stocks, which are a much more complicated beast.</td>
</tr>
<tr>
<td><strong>Themes</strong> Rolling Stocks, Bottom-Fishing, Buy Low, Sell High, and other faulty 'quick fixes.'</td>
<td>Like fad-diets that don't work, theme-based stock picking is very marketable, but not very effective.</td>
<td>Like Individual Concepts mentioned above, Theme-Based techniques do not work to begin with, and have little chance of success when applied to the penny stock markets.</td>
</tr>
</tbody>
</table>
Advanced Penny Stock Strategies

Now we are really getting into the good stuff!

Just note that we strongly recommend reading all of the concepts presented in the previous chapter if you haven't already.

Everything revealed in this chapter builds on those methodologies discussed earlier. These concepts do not hold as much relevance without the proper groundwork, which has already been provided.

In other words, make sure to read Chapter Three, Picking Penny Stocks, first.

...OK, you're back. Now that you have read Chapter 3, let's get right to Chapter 4, Advanced Strategies! If you want to read this information in order, you should start with Short-Term Trading Begin Your Journey into Penny Stocks.

Short-Term Trading

Most short-term trading is driven by impatience and greed. However, the impatient and greedy investors never develop winning short-term strategies.

If you want to trade quickly to make a quick buck, forget about it and skip on to the next section. If you want to trade short-term because you believe that there are profitable trading theories that can be applied to stock fluctuations, keep reading.

Pops and Dips

Sometimes shares can spike or dip just due to a large trade order. This is because penny stocks are generally thinly traded, and any significant volume will push the stock around. Take advantage of this by selling into the rise, not after. You want to be unloading your shares into the buying frenzy, because in this situation it is better to be much too early than a little too late.

Before you sell, however, be sure to discover if the move is permanent or temporary based on the following criteria:

**Fundamental Driving Factors:** Tangible impacts like FDA approvals, new mining discoveries, etc, may make the share price jump, and stay higher. Selling into this is not generally a profitable strategy. In other words, if it is a temporary price pop, it may be a profit-taking opportunity. If it is a permanent price increase based on a legitimate driving force, it may be more effective to continue to hold the shares.
Subsequent Trading: You can more readily tell if a pop or dip is temporary, and perhaps a trading opportunity, by closely watching the trading activity. For example, if a price spikes on huge volume, then you notice that the price advance and trading volume are both significantly lower the following day, the spike may be losing steam. If a dip is on very low volume, it usually is erased as soon as a few bargain hunters jump on the shares. If the dip is on major volume, it may be a sign of things to come. High volume dips usually last, while low volume dips usually do not. Thus, high volume dips are usually a warning sign, while low volume dips are often a buying opportunity.

To benefit from the trading opportunities that pops and dips provide, you need to be able to quickly identify them, then react just as swiftly. Take up positions in those stocks that have dipped but will recover. Sell off shares in those stocks that have speculative price-spikes, while holding shares in companies that may be able to sustain their gains.

I provide an examination of short-term trading strategies in this chapter, in the discussions on Volatility Play Investing, Trading Windows, and Day Trading.

Volatility Play Investing I

Based on some of the concepts presented in the previous sections on Technical Analysis, you may be interested in getting involved with Volatility Play investing.

This is a method of trading penny stocks developed by and used by PennyStocks.com and its subscribers. While other services and traders have attempted to copy and/or resell the concept, no one else has had the success that can be gained by following the concepts that PennyStocks.com has perfected.

These concepts, detailed below for the first time for public use, allow penny stock traders to make money off of the same stock again and again, by buying near or at the support levels, and selling near or at the resistance levels. (Support and Resistance Levels are both detailed in Chapter Three).

Others have 'butchered' the concept, thinking that any stock can be used as a Volatility Play. They take a penny stock chart and believe that the buy levels should be somewhere near the year low, or perhaps the month low, and that the sell levels coincide with the upper prices the stock has reached. Such a basic and assuming way of applying these concepts to penny stocks is sure to be disappointing when it comes time to tally your results.

To appropriately identify a penny stock that would be a potential Volatility Play, you need to follow these steps.

1. First, look for a penny stock that has excellent volatility.

A difference from its year high to year low needs to be at least 100%, but some of the best Volatility Plays we have ever uncovered enjoyed a difference of 300% to 500%. This helps ensure a high level of investor speculation and unpredictability in the underlying stock.
2. There also needs to be a pattern of trend reversals.

The penny stock needs to have hit and tested its lower and upper prices several times, preferably two bottom tests and one or two upper tests.

(By testing, we mean that the stock approached its support or resistance level, but was not able to break through and instead reversed. The reversal should take the stock most or all of the way back to the opposite test level. ie - if it tests and bounces off the high, it should then drive directly towards the low over the following trading days.)

3. The penny stock needs a clearly identifiable support level, and excellent strength at that level.

This does not mean that the support needs to be at a round number, like $1.00. Rather, if a company has just recently announced a stock buy back plan, you can be assured that they will have a lower range at which they intend to pick up shares. If you can identify this level through a surge in volume and a rebound from a certain price, you can expect that there would be good support at that level.

While share buy back prices can change over time, most companies will start purchasing at certain prices to keep the shares above a specific level.

In addition, if buyers seem to dip into the market at a certain level, you can usually identify this through increases in volume and a strong rebound off of the support level brought about by sudden buying demand.

A good Volatility Play penny stock always has a strong and easily identifiable support level. This may be $0.45 or it may be $1.00, but you will be able to pick it out easily on the chart through a combination of volume and price analysis.

Volatility Play Investing II

4. A good Volatility Play penny stock will almost always have an obvious price level where traders tend to cash out and take profits.

Unlike a support level, which may or may not be at a threshold number (like $1.00), resistance is almost always at a threshold number for penny stocks.

While a penny stock without a resistance level may just keep rising over time, the difficulty is that you will not know when to take your profits. You will see that a stock without a clear resistance level could reverse on you at any time.
5. A potential Volatility Play also needs good daily trading volume.

Look for stocks that see an average of 50,000 or more shares trade hands per day, rather than averages of 20,000 or 8,000, or 1,000. Volatility Play penny stocks may not hold their pattern for very many cycles, and can break free at any time. You will benefit more by your ability to pick good Volatility Plays than you will by trading well. Identify more Volatility Play penny stocks than you will be investing in, with the theory being that you watch the entire flock. Most Volatility Plays will only be in a buying opportunity about 5% of the time. You buy into the ones that approach their support levels while passing on the others that are not reaching your targets.

Timing

- The best time to buy is right after the penny stock bounces off of the support level you delineated (which also affirms your choice of support price).
- The second best time is to buy right before the stock hits support, but is trading at only a fraction above the support price. The problem with the latter choice is that you will be subject to those situations where the penny stock sees the support level fail, and the price falls right through to lower levels.
- The best price to acquire shares at is just above the support price. For example, if support is at $1.10, you may want to acquire shares at $1.15 or even $1.12.
- The best time to sell is just before the stock reaches the resistance level. Drops from profit takers can be quick, so it is usually more effective to sell too early than too late.
- The best price to sell is just below the resistance level. For example, a $2.00 resistance is best sold into at $1.95. (Or even $1.85 to be safe, especially if the penny stock has a history of collapsing back to former levels very quickly).

When investing in this fashion, make sure to factor in the fact that you will be taking more frequent commission charges from your broker.

Also, make sure that the range of volatility is enough to support profits, because you may be buying and selling in a tight price range of only 15% to 40%. If you are making 15% profits on a few hundred dollars, you may only be breaking even after paying trading commissions and taking the occasional loss.

Make sure that the changes in price direction and the degree of price activity are not based on fundamental factors like news releases, changes in financial performance, or other factors mentioned in the discussion on Fundamental Analysis detailed in Chapter Three of Understanding Penny Stocks. A company may have been a great Volatility Play, but if it gets a huge FDA approval, the trading ranges can get thrown out the window.

Also remember that you do not necessarily have to sell all of your shares each cycle. This applies even more so if you are not positive about the upper resistance threshold, or you are not even sure if the stock will follow your volatility expectations. You could sell half or a portion of your position, and leave the rest to ride. As well, you may benefit by gradually increasing the amount you invest in each cycle. If you have made some profits and have a good feel for the stock, and the support and resistance levels have proven out near the prices you expected, you may want to put more cash onto the table.
A Note About Jumping Ship

If you have pegged a stock's support level at $1.00, and the price breaks through that level, you can know that perhaps:

• Your choice of support level was wrong
• The stock is not a Volatility Play after all, and the concepts presented in this section do not apply
• Some fundamental or technical factor has arisen which has forced a failure of the support level

In any of these cases, it is best to liquidate your position as quickly as possible, trying to take only a 5% to 15% loss. If you hold every Volatility Play that sinks past your support levels, you will eventually wind up with a portfolio of sinking ships.

The beauty of Volatility Play investing is that you should be taking frequent profits, so the strategy allows for some losses in the interest of the overall picture.

Advanced Fundamental Analysis

Beyond the fundamental analysis discussion I have provided you with earlier in Understanding Penny Stocks, there are further ratios and methods that you may wish to learn and apply.

I generally feel that these techniques are over-rated, and that they fail to apply to some penny stocks that are driven on speculation, but we will describe them here for you because they may be of value in certain scenarios. It is also a good idea to have a well-rounded knowledge of research techniques as you learn to apply them.

A Quick Secret

One of the most effective yet under-used research techniques is quite a simple one - contact the investor relations person of the company you are interested in, and ask them some questions you have already prepared. Let them talk and don't interrupt. Often they will lead you to the important information that you need to know, without your having to ask, even if it is off topic from your original question.

Make sure to express your main concerns with the company, and see how they address your tough questions. If they are losing money year over year, ask them how they intend to raise the necessary funds, and when they are going to start bringing in some earnings. If a new competitor has risen up in their sector, ask them for details of their plan to adapt to this new situation.

Listen especially hard for the underlying message that they are providing you with. Are they coming across like a pushy salesperson, or are they confident and excited about the company's prospects? Go a step further, and contact the investor relations department of the company's competitors. Make sure not to confuse which individual contact-person you liked best with which company has the best prospects. Remove emotion from the equation.
YOU are the Key

Do not ignore any specialized or insider knowledge you have in a particular industry. If you are working at an oil refinery, you should know whether your company is expanding or contracting.

If you or a reliable friend/family member is working in the technology sector, you may be able to have advanced warning before they release their next product launch announcement. You may also be able to get an idea of whether or not the new technology has any merit, and if it will be so expensive to bring to market that it breaks the back of the company in the process.

If you are a doctor, perhaps you have the advantage of understanding the technical reports that your favorite biotech company is putting out, and perhaps even whether or not their concept has any appeal or practical use. Do not ignore your own intuition or that voice in your head! If you have a trading advantage, leverage it. If you do not have a trading advantage, admit it to yourself and act accordingly.

Note: None of this is insider trading. You will never get in trouble for it. The misconception that society has about insider trading is far off the mark.

This, among advanced fundamental and technical analysis, is what PennyStocks.com does professionally. We provide our subscribers with the insights that other traders do not have, and thus enable you to profit significantly. I strongly encourage you to get a subscription to the site, or at least go to PennyStocks.com and take a look around. I believe you will be both enlightened and pleasantly surprised.

Advanced Technical Analysis

I do not agree with advanced TA as it applies to penny stocks.

I have described our proprietary TA techniques in Chapter three of Understanding Penny Stocks, and suggest that you use these, and only these, if you are attempting to analyze a penny stock.

Below is an example of the types of technical analysis techniques that are discussed in Understanding Penny Stocks. For a full explanation of all of them, review the section on Leeds Analysis, and specifically Leeds Analysis Technical Indicators.

More advanced TA is unproven even for larger, more heavily traded stocks, and when applied to thinly traded issues like penny stocks, the methodologies are useless and misleading.
Introduction

Prices in the financial markets move in trends, reflecting buyers that are more enthusiastic than sellers and creating uptrends or bull markets; sellers that are more enthusiastic than buyers create downtrends or bear markets, a temporary period in which the enthusiasm between buyers and sellers is roughly in balance - often setting the stage for a reversal in trend. A reversal in trend does not necessarily mean that an uptrend will turn into a downtrend or vice-versa, it simply means that a trending market may be transitioning into a consolidating market, or that a consolidating market may be transitioning into a trending market.

If a trader can recognize some of the several common price patterns, he will be better positioned for a profitable move. However, it is critical to be able to discern the difference between a trend reversal that results in a continuing or consolidation pattern and one that actually results in a reversal of prices. This manual will help the trader identify and differentiate between continuation patterns and reversal patterns.

Continuation Patterns

Continuation patterns are price formations that imply a pause or consolidation in the prevailing trend. The most common types are triangles, flags and pennants.

There are three types of triangle patterns: ascending, descending and broadening. While perhaps the most common of all price patterns, triangles are unfortunately the least reliable. The ascending triangle is a sideways price pattern between two converging trend lines, in which the lower line is rising while the upper line is flat. This is generally a bullish pattern (see diagram).
The **descending triangle** is a sideways price pattern between two converging trend lines, in which the upper line is declining while the lower line is flat. This is generally a bearish pattern (see diagram).

The final type of triangle is known as a **broadening formation**. Broadening formations occur when a series of three or more price fluctuations widen out in size so that peaks and troughs can be connected with two diverging trend lines (see diagram).
**Flags** are a continuation price pattern generally lasting less than three weeks, resembling a parallelogram that slopes against the prevailing trend. As the name implies, this pattern looks like a flag on the chart. It represents a quiet pause accompanied by a trend of declining volume that interrupts a sharp, almost vertical rise or decline. In the case of a rising market, the flag is usually formed with a slight downward trend, but in a falling market, it has a slight upward bias. Flags may also be perfectly horizontal. As the flag is completed, prices breakout in the same direction that they were moving in prior to its formation.

In a rising market, this type of pattern usually separates two halves of an almost vertical rise. Volume is normally extremely heavy just before the point at which the flag formation begins. As it develops, volume gradually dries to almost nothing, only to explode as the price works its way out of the completed formation. Flags can form in a period as short as five days, or as long as three to five weeks. Essentially, they represent a period of controlled profit taking in a rising market (see diagram).

Pennants, on the other hand, are flags with converging, rather than parallel, boundary lines. They develop under exactly the same circumstances as a flag and have similar characteristics. The difference is that this type of consolidation formation is constructed from two converging trend lines. In a sense, the flag corresponds to a rectangle, and the pennant to a triangle, because a pennant is, in effect, a very small triangle (see diagram).
**Wedges** are chart formations in which the price fluctuations are confined within converging straight (or practically straight) lines. A wedge is very similar to a triangle in that two converging lines can be constructed from a series of peaks and troughs. However, whereas a triangle consists of one rising and one falling line, or one horizontal line, the converging lines in a wedge both move in the same direction. A falling wedge represents a temporary interruption of a rising trend, and a rising wedge is a temporary interruption of a falling trend. It is normal for volume to contract during the formation of both wedges. Since wedges can take anywhere from two to nine weeks to complete, they sometimes occur on weekly charts but are too brief to appear on monthly charts. Rising wedges are fairly common as bear market rallies. Following their completion, prices usually break very sharply, especially if volume picks up noticeably on the downside (see diagram).
A **Runaway Gap** is a relatively wide gap in prices which occurs in an advance or decline gathering momentum. It is also called a "measuring gap" since it frequently occurs at just about the halfway point between the breakout, which started the move and the reversal day, which calls an end to it. The runaway gap occurs during a straight-line advance or decline when price quotations are moving rapidly and emotions are running high. Either it is closed very quickly, such as within a day or so, or tends to remain open for much longer periods and is not generally closed until the market makes a major or intermediate swing in the opposite direction to the price movement that was responsible for the gap. This type of gap often occurs halfway between a previous breakout and the ultimate duration of the move (see diagram).

**Reversal Patterns**

**Double Bottoms** occur when a bottom is formed on relatively high volume which is followed by a rally (of at least 15%), and then a second bottom at the same level (plus or minus 3%) as the first bottom on lower volume. A rally back through the apex of the intervening rally confirms the reversal. More than a month should separate the two bottoms (see diagram).
Double Tops occur when a high-volume top is formed, followed by a reaction (of at least 15%) on diminishing activity. Another rally back to the previous high (plus or minus 3%) is made, but on lower volume than the first high. A decline through the low of the reaction confirms the reversal. The two highs should be more than a month apart (see diagram).

![Double Top Chart](chart.png)

V-Bottoms are sudden reversals that take place with little or no warning. A sudden price drop on heavy volume is the only telltale sign. Unfortunately, these sudden turns are hard to spot in advance (see diagram).

Saucer Bottoms are constructed by drawing a circular line under the lows, which roughly approximates an elongated or saucer-shaped letter “U.” As the price drifts toward the low point of the saucer and investors lose interest, downward momentum dissipates. This lack of interest is also characterized by the volume level, which almost dries up at the time the price is reaching its low point. Gradually, both price and volume pick up until eventually each explode into an almost exponential pattern (see diagram).

![Saucer Bottom Chart](chart.png)
Head and Shoulders are the best known of the reversal patterns. At a market top, three prominent peaks are formed with the middle peak (or head) slightly higher than the two other peaks (shoulders). When the trend line (neckline) connecting the two intervening troughs is broken, the pattern is complete. A bottom pattern is a mirror image of a top and is called an inverse head and shoulders (see diagram).
Breakaway and Exhaustive Gaps are spaces on the chart where no trading has taken place. An up gap is formed when the lowest price on a trading day is higher than the highest high of the previous day. A down gap is formed when the highest price on a day is lower than the lowest price of the prior day. An up gap is usually a sign of market strength, while a down gap is a sign of market weakness.

A Breakaway Gap forms on the completion of an important price pattern and usually signals the beginning of an important price move (see diagram).

Conversely, an Exhaustion Gap occurs at the end of an important trend, and signals that the trend is ending. The price gaps are relatively wide and are quickly closed, most often within two to five days, which helps to distinguish them from runaway gaps, which are not usually covered for a considerable length of time (see diagram).
A **Key Reversal Day** in an uptrend is a one-day pattern that occurs when prices open in new highs, and then close below the previous day’s closing price. In a downtrend, prices open lower and then close higher. The wider the price range on the key reversal day and the heavier the volume, the greater the odds that a reversal is taking place (see diagram).

![Key Reversal Diagram]

The signal day must make a new High (after an up-trend) or new Low (after a down-trend).