Market Guide
In collaboration with SEC

Misfortune of penny stocks

“Confronted with a challenge to distil the secret of sound investment into three words, we venture the motto, Margin of safety”
-Benjamin Graham

As rational investors we would intend to earn profits when investing in the market. Unfortunately some tend to be overly greedy and impatient to earn profits. These incorrect attitudes prompt many investors to enter penny stocks with the expectation of earning quick money. Even though relevant authorities continue to disseminate the misfortune of penny stocks a certain segment of investors disregard the risk involvement.

It was observed that certain illiquid stocks with a small market cap were pushed up during the last few months. It is interesting to note that prices shot up in the absence of price sensitive information. Further on, several retail investors blindly followed other investors.

Hence, it is timely to focus on penny stocks and give our readers an opportunity to reconsider their perception on penny stocks, quick returns and undue risk.

Definition of a penny stock
It is a stock that trades at a relatively low price, market capitalization and generally considered to be highly speculative and more risky because of lack of liquidity, large bid-ask spreads, small capitalization and certain, financial/legal constrains. Above all it is easier to manipulate these types

of stocks. In the Sri Lankan context, illiquid stocks with small market caps that are exposed to his speculations are referred to as penny stocks. As we always say penny stocks entail a large amount of risk.

Why do penny stocks fail?

What makes penny stocks risky? Five major factors make these securities riskier than other stocks.

- Liquidity

When stocks don't have much liquidity, two problems arise: first, there is the possibility that you won't be able to sell the stock. If there is a low level of liquidity, it may be hard to find a buyer for a particular stock, and you may be required to lower your price until it is considered attractive to another buyer. Second, low liquidity levels provide opportunities for some traders to manipulate stock prices, which is done in many different ways - the easiest is to buy large amounts of stocks, hype it up and then sell it after other investors find it attractive (also known as pump and dump).
If you get entangled in pump and dump you might expose your portfolio to undue risk. It is worse as most of these stocks are inflated far above its intrinsic value.

- Penny-baited traps

Penny stocks have been a thorn in the side of the regulator for some time because they are an easy target for fraudsters. There are many scams used to separate investors from their money. The most common include:

- Biased recommendations

Some pay individuals to recommend the company stock in different media, such as newsletters, e-mail, social media, etc.
You may receive spam email trying to persuade you to purchase a particular stock. All postings and recommendations of that kind should be taken with a grain of salt.

- Poor financial performance

One disadvantage of investing in penny stocks is that they are more often than not experiencing serious financial problems. Speculating on the possible fate of a floundering company can be a very risky. If your prediction is good and the company does recover, you stand to make a fortune if the penny stock rises in value and you are able to sell them off fast while their prices are still high. However, in most cases, the company completely shuts down and becomes delisted in the stock exchange. When this happens, the poor investor is left with 'dead stocks'.

There are ample examples of investors entering these stocks even when the authorities openly informed the investors on its irregularities. The rest is history.

- Undue volatility

Market volatility is vital to earn profits. Yet, usually these stocks entail a higher degree of volatility as most of them are manipulated. If you notice it is always the same penny stocks that sky rocket and again tremble down drastically. This process continues in circles as certain stakeholders manipulate the stock by entering and exiting it.

- The ripple effect

As stated earlier penny stocks are usually traded far above its intrinsic value. This would distort the efficient price discovery mechanism in the market. It would be an impediment towards achieving efficient markets. In general bad news spreads faster than positive news. Thus, manipulating penny stocks can hinder investor confidence. A few irregular cases can outperform the lucrative aspect of equity.

Penny stock fallacy

A common fallacy pertaining to penny stocks is the notion that that there is a positive correlation between the number of stocks a person owns and his or her returns. Many investors may be attracted to penny stocks due to the notion that there is more room for appreciation and more opportunity to own more stocks. If a stock is at 10 cents and rises by five cents, you will have made a 50 percent return. This, together with the fact that a Rs.1,000 investment can buy 10,000 shares, convinces investors that these stocks are a rapid, surefire way to increase profits. Unfortunately, people tend to see only the upside of penny stocks, while forgetting about the downside. A 10-cent stock can just as easily go down by five cents and lose half its value. Most often, these stocks do not succeed, and there is a high probability that you will lose your entire investment.

Ways to avoid penny stock scams

Despite tightened disclosure and reporting requirements, penny stock scams continue to trap unwary investors. If you want to avoid losing your hard-earned money to such scams, follow these four rules.

1. Conduct extensive due diligence

In general, investors do not spend enough time researching a stock before buying. While this is a risk when buying a blue-chip stock on the stock exchange, it is downright reckless to do it with penny stocks. The degree of due diligence required to unearth all the facts and separate the truth from the hype is much higher with penny stocks than with blue-chip stocks. Like most investors, you may feel that you need to act quickly to get in on a stock before it starts rising and gets too expensive, but spending a few hours researching a penny stock before buying is time well spent.

Even if the stock price rises during your research, the additional money you spend in buying the stock at a higher price will be offset by (a) the potential losses you avoid by dodging a dodgy stock and (b) the peace of mind acquired in knowing you conducted due diligence.

At a minimum, your due diligence should extend to checking management's past record and accomplishments (or lack thereof), the company's financial statements check if the company is current in its filings and that there are no regulatory actions against it. You should also do a general online search to unearth anything else—positive or negative—on the company. You may be surprised at the number of red flags that crop up around your slam-dunk penny stock. Your odds of being taken in by a scam will be significantly reduced if you conduct extensive due diligence before investing in a penny stock.

2. Beware of penny stock marketing traps

As technology has evolved, unscrupulous penny stock promoters have become more creative in their marketing efforts. You can stay away from these marketing traps by following a few simple precautions. Stay away from bulletin boards and social media (refer Table 1 for examples) sites that focus on penny stocks. Finally, never ever respond to an e-mailed stock marketing pitch (or better still, block or delete such e-mails instantly). Despite these precautions, you still receive a hot tip from another source (such as a friend or acquaintance, or a direct pitch from a promoter) politely decline the opportunity even if it appears tempting.

Verify if the issuers of the recommendations are being paid for their services as this is a giveaway of a bad investment. Also, make sure that press releases aren't given falsely by people looking to influence the price of a stock.

Table 1- Extracts from a Sri Lankan equity blog observed recently

USER : Stock BaCk
Wait for three more days. Buy stock 'R' at Rs.1.
USER: Wolf of Stocks
Today is the last day at this price.
USER:BIG cAP
Stock "l" will go up next week.
USER: Rugby Star
The "family" entered the stock. Buy now

3. Learn to spot hype and misinformation masquerading as news

Do not get fooled by bullish newsletter reports that masquerade as unbiased research. If the newsletter writer is being paid by a promoter to write up a specific company, what are the chances that the ensuing report is going to be objective and highlight the risks of investing in the stock? Similarly, news releases that serve no purpose other than to boost the penny stock should be ignored. In the penny stock world, there's no such thing as being too cynical.

4. Become a better-informed investor
Low-priced penny stocks have an undoubted appeal. But rather than making the mistake of only looking at the stock price, check the stock's market capitalization as well. Studying valuation and portfolio techniques will also help you become a better investor and pay dividends in the long run.

Regulator cannot be silent

Equity is a lucrative investment. It is the misconduct of a few that creates an unpleasant perception about the market. Hence, the regulator will have to take necessary measures to prevent these forms of investment practices. Accordingly, investors are advised to make wise, responsible and ethical investment decisions.

- See more at: http://www.dailymirror.lk/93585/misfortune-of-penny-stocks#sthash.HWeZWpbh.dpuf