Penny Stock Investing

There is no set definition of a penny stock. Some say it is a stock priced under one dollar, some under five dollars. Some people include only those securities traded in the "pink sheets", some include the entire OTC market. The Securities Division considers a stock to be a "penny stock" if it trades at or under $5.00 per share and trades in either the "pink sheets" or on NASDAQ. In addition, a true penny stock will have less than $4 million in net tangible assets and does not have a significant operating history.

Manipulation

Penny stocks are susceptible to price manipulation. Usually, a broker-dealer gathers a large holding of a penny stock at a very low price. Using high-pressure sales techniques, the sales force of the broker-dealer hypes up the stock and stirs up demand. The price continues to rise until there are no more investors who will buy, and then the bottom falls out and the price plummets. Sometimes the broker-dealer will buy back the securities at the fallen prices to recapture the stockpile for a future revival of the stock, but more often than not investors are left holding the worthless stock.

This is also called a "pump-and-dump" scam – where a holder of a big block of penny-stock shares orchestrates a big whisper campaign to pump up the price of the shares. Traders rush in, driving the price skyward, enabling the orchestrator to "dump" his shares at a huge profit. The big sales, combined with the end of the hype, usually cause the penny stock to nosedive, causing the greatest losses for those who bought in last.

Thus, if a penny-stock trader lost a ton of money trading in the low-priced shares, there's a very good chance they were among the victims of a pump-and-dump campaign.

How to choose penny stocks

Penny stocks are associated with many problems and millions of dollars of losses. However, there are legitimate companies whose securities trade in the pink sheets at very low prices. Struggling companies that are just starting out are some of such examples. Investment in such a company, held through the company's formative years, can pay off well. Such a good investment usually requires three things: the ability to choose the right company, the capital to invest and hold the investment, and luck.

In order to choose the right company, you must know about the business in which the company engages. You must be able to evaluate the feasibility of the company's business plan and its ability to compete in the particular segment. You must also be able to evaluate the abilities of the company's management. Lastly, you must be able to evaluate the capitalization and cash flow of the company.

Once you find the right company, you must be able to hold the investment for a period of time to allow the company to progress and for the stock to appreciate in value. Investment in "growth" companies is long-term investment. You must have also sufficient capital to be able to withstand total loss of your investment, because investment in emerging companies is always a high-risk investment.

Finally, there is an element of luck in any stock investment. Luck plays an even greater role in a market in which manipulation is so widespread. Some legitimate companies have had their stocks manipulated to such an extent that they were forced out of business. Even without manipulation, the success or failure of a fledgling business is unpredictable.

Technical analysis patterns for penny stocks

1. The Gap Up

The "gap up" is one of the most effective patterns for identifying a stock that's about to move upward. With a gap up, the share's price is significantly higher at opening than the previous night's close price.

For the gap up to really have a potential to gain, there needs to be two things: The company needs some sort of news catalyst to prompt a gap up, and the stock needs to gap up over any overhead resistance levels (prices that could prove to be stumbling blocks for the stock).

An example is shares of Tuesday Morning Corp. (NASDAQ:TUES) below, a stock that gapped up past resistance back in January 2010. The buy signal on this stock took place after the gap up over the blue box.

Brinx Resources (OTC:BNXR) is another gap up play that rallied strongly once it's the pattern was executed. The stock shot up more than 80% in the three days following the gap up.

Gap up plays require a fast response by the investor. Once a stock gaps up, some of the biggest initial gains take place within days. However, this pattern is one of the least subjective and can be easily spotted.

2. Ascending Triangle

The ascending triangle pattern is popular because it often results in fast, dependable gains. Ascending triangles are a combination of a set resistance level coupled with consecutively higher lows for a stock. This means that the price level of a stock keeps bouncing down off a resistance level and up off an up trending support line.

A good example of the ascending triangle pattern is the chart of R.G. Barry Corp. (NASDAQ:DFZ) below. In this case, the stock continually bounced off resistance right above $9 per share as the lows became higher and higher.

In R.G. Barry's case, the ascending triangle gave an advanced warning for the gap up that eventually lead to gains. Like most patterns, however, the ascending triangle is susceptible to failing. As such, you never want to make a trade off of an ascending triangle until the share price actually pushes above resistance.

3. Pennant Continuation Pattern

The pennant pattern is what's known as a continuation pattern - it suggests that a stock's share price is headed in the same direction as it was going before the pennant started. It is often mistaken for an ascending triangle.

You can spot a pennant by looking for an ascending triangle pattern that has a downward-sloping top instead of a flat one. The pattern gets its name because it resembles a triangular pennant flag. For a good example of a pennant pattern in action, take a look above at Gold Reserve Inc. (AMEX:GRZ) back in September and October of 2009.

Generally, continuation patterns like pennants happen when a stock is halfway through its price movement and investors take a rest before they push shares higher. That means that you can look at the price movement before the pennant happened to get an idea of what kind of profit target you can aim for. This also means another important thing — pennant patterns can predict movements in either direction, which means that if share prices were falling before the pennant formed, it's best to stay clear of the stock.

For the pennant continuation pattern, you should wait for shares to break above the upper line before considering buying.

4. Crossover Breakout

The crossover breakout pattern combines a breakout, which happens when a stock moves above resistance, with a bullish moving average crossover. A breakout, which can be thought of as a gap up without the gap, is coupled with a moving average crossover, as it isn't entirely dependable on its own.

A moving average (the thin red and blue lines in the chart below) is a line that maps out a stock's average price over a trailing number of days. A bullish crossover means that a lower-numbered moving average (i.e. 50-day moving average) crosses over a higher-numbered average (i.e. 200-day moving average).

Below is a chart of GeoGlobal Resources (AMEX:GGR)

For a crossover breakout, you'll need confirmation before you decide to put your money on the line, meaning that your technical analysis on a stock is confirmed by some other action. In this case, that means waiting for a second consecutive open above the moving averages before placing your trade.

5. The Aborted Bearish Pattern

The aborted bearish pattern is one of the most tradable. When traders put a stop to a bearish pattern, it presents an opportunity for long-side investors to come in for a profitable play. This kind of trade can be made off of any bearish pattern that never materializes.

That was the case with China Infrastructure Investment Corp. (NASDAQ:CIIC). The company was following a descending triangle until shares hit the horizontal blue support line and bounced off.

As with the pennant continuation pattern, wait for a second open above resistance before making your buy based on an aborted bearish pattern.

Conclusion

Penny stocks can offer investors some of the biggest profits around, but only if they know how to avoid the pump and dumps and stick with the repeatable patterns that make profits.

These five patterns follow the rules of support, resistance, and trend – the three basic principles of technical analysis. These patterns although not exhaustive, can be very useful to investors, especially when they are backed with sound fundamental knowledge.

Nicholas Chen