Here’s how and why investors can put their money in penny stocks…

Penny-stock traders are like the Rodney Dangerfields of the investment world – they get no respect from their bigger brethren.

If a penny-stock trader made a killing on a few penny-stock trades, there’s a good chance he or she orchestrated 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 his shares. Traders rush in, driving the price skyward, enabling the perpetrator to “dump” his shares at a big profit.

The big sales, combined with the end of the hype, usually cause the penny stock to nosedive, inflicting the greatest damage on 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.

The Stock Market’s Wild West?

Naturally, these aren’t the only ways that penny-stock trades work out, but they are the two most prevalent plotlines that play out daily on the largely unregulated OTC Bulletin Board and the Pink Sheets Electronic Quotation Service, the finance-sector’s Wild West where investors must make due with little information on the companies themselves and even less explanation for the wild price shifts that can ensue.

Despite the risks, there’s an allure to penny stocks that makes them impossible for some investors to resist. So-called “pennies” get their name from their low price – they typically trade for less than $5 a share (though many trade for true pennies, which share prices well under a dollar). Most are also “thinly traded,” although some boast volumes in the hundreds of millions per day.

So, if you’ve ever actually notched a profit from a penny stock play, you are one of the lucky ones.

“If you make money on a penny stock, my advice is immediately sell half. Make a profit because few people walk off with a profit,” Frick said. “That’s the smart way, if there is a smart
Over the course of his career, Frick has chronicled the penny stock culture, and won several awards for his journalistic investigations of the scams and scammers. He’s also penned a handful of books, one being Barron’s “Keys to Risks and Rewards of Penny Stocks.”

But before getting too deep into the seamy underbelly of the penny stock world, let’s take a broader look at the topic at large.

**Why They’re So Cheap**

The SEC generally defines penny stocks as speculative securities from small companies, most of which trade on the OTC bulletin board and Pink Sheets, which have both have minimal listing requirements.

Penny stocks have much fewer shareholders than a typical SEC-regulated stock, and their lack of liquidity makes it much easier for the share price to spike, or plunge, with a major shift in trading.

For example, a gain of just six cents for a 30-cent stock means a 20% jump in valuation, whereas a 6-cent gain for any stock trading on the New York Stock Exchange wouldn’t turn many heads.

Investors are lured to penny stocks because of their low entry prices – which makes it easier to amass a major “position” – and the perception of a much greater upside potential.

But what many typically ignore is that the odds of a real killing are slim indeed.

Investors fixate on the hope that their $2,000 investment will blossom into $200,000 in a few weeks.

**Policing Penny Stocks**

The SEC estimates that 100 million stock spam e-mails are sent every day.

In addition to the volume, spammers are creating more efficient ways to target potential victims, such as creating an e-mail format that sneaks under the radar of spam-preventive software.

“There’s a lot the SEC should be doing, but they have a limited budget and [tend to focus on] the big guys,” Frick said. “They don’t have time to deal with all the cockroaches in the room.”

Of the 4,800 stocks that trade on the Pink Sheets, about 10% of them are spam targets because of their lack of submitted financial information.

And the United States isn’t the only place where regulators face this problem.

The Bombay Stock Exchange recently clamped down on hundreds of brokers accused of manipulating the stock prices of KGN Industries and Sylph Technologies. Sylph’s stock surged ahead 100,000% intra-day on May 22.

After being a haven for “pump-and-dump” schemers, Canada overhauled its regulations to require
executives and promoters of small-company stocks to undergo background checks and register their promotional efforts.

**How to Invest in Pennies Safely**

Frick’s first piece of advice concerning penny stocks is straightforward: “Don’t do it. Absolutely, don’t it.”

But he knows he can’t convince everybody, so he also gave some concessionary tips.

First, remove the dollar signs in front of your eyes and replace them with company research. Start by looking for companies with financial track records, an important screen that eliminates 95% of the companies out there.

Second, apportion only a small amount of money for penny-stock investing. That means that you can’t clutter your mind with a lot of “what if” long-shots – such as, “what if this stock soars…I’d be able to buy a vacation home or retire rich by 49.”

That kind of financial sobriety sounds boring, but sobriety today means there’s no hangover tomorrow – especially since penny-stock scammers prey on investors’ long-shot dreams.

Third, if you’re lucky enough to pocket a double-digit gain, don’t waste time celebrating or hoping for more. Sell at least half your holdings – if not all of them – and get out before you give everything back. And by “everything,” we’re also including your original investment.

Cautions Frick: “You have to ask yourself: Why are you in this area? Are you looking to make a killing? If so, there are predators dangling outrageous offers that don’t exist.”

[Editor's note: A former head of research for Merrill Lynch released a “tell all” document today… detailing how to buy oil for just 25 cents a barrel... and cash it in for an outrageous short-term gain.]