10 Sure Fire Ways to Trade Penny Stocks

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Even with these clear dangers, some people insist on trading the pennies. So, if you find yourself on the receiving end of a telephone call from a penny-stock promoter, or you spot an advertisement that promises dollars from your pennies — and you still decide that maybe penny stocks aren't wooden nickels, just remember these 10 rules:

1. Ignore penny-stock success stories

Timothy Sykes, a penny-stock expert who trades both long and short, says you must not believe the penny-stock stories that are touted in emails and on social media websites.

"You have to say no," Sykes said. "You can't invest in penny stocks as if they were lotto tickets, but unfortunately that's what most people do, and they lose again and again. Think of penny stocks as inmates in a prison that you can't trust."

Instead, Sykes says, focus on the profitable penny stocks with solid earnings growth and which are making 52-week highs.

2. Disregard tips and read the disclaimers

Penny stocks are sold more than bought — mostly via tips that come your way in emails and newsletters.

"The free penny-stock newsletters are not giving you tips out of the goodness of their heart," Sykes said. "If you read the disclaimers at the bottom of the newsletters, they are getting paid to pitch a stock because their investors want exposure for the company. There is nothing wrong with wanting exposure, but almost all penny newsletters make false promises about their crappy companies."

Sykes says there is a difference between stocks making a 52-week high based on an earnings breakout and stocks making a 52-week high because three newsletters picked it. Reading the disclaimers at the bottom of the email or newsletter, which the SEC requires them to do, will usually reveal a conflict of interest.

“Most newsletters don’t tell you the truth,” Sykes said. “They are being compensated to pump up the stock, and they rarely tell you when to sell. Often it’s far too late.”

3. Sell quickly

One allure of penny stocks is you can make 20% or 30% in a few days. If you make that kind of return with a penny stock, sell quickly.

Unfortunately, many traders get greedy, aiming for a 1,000% return. Considering that the penny stock you’re in might be getting pumped up, take any profits and move on.

4. Never listen to company management

In the murky penny-stock world, don’t believe what you hear from companies.

“You can’t trust anyone,” Sykes said. “The companies are trying to get their stock up so they can raise money and stay in business. There is no reliable business model or accurate data, so most penny stocks are scams that are created to enrich insiders.”

Sykes says large rings of the same people run promotions using different press releases and companies, including the reappearance of a notorious stock manipulator who was first convicted for an email pump-and-dump scheme when he was in high school.

5. Don’t sell short

Although shorting pumped-up penny stocks may seem attractive, don’t do it.

Penny stocks are too volatile, and if you’re on the wrong side of the trade, you could easily lose 50% or more on a short squeeze. Another problem is that it’s difficult to find shares of penny stock to short, especially those that made huge moves based on hype and newsletter tips. Leave shorting penny stocks to the pros.

6. Focus only on penny stocks with high volume

Stick with stocks that trade at least 100,000 shares a day. If you trade stocks with low volume, it could be difficult to get out of your position.

“You must be aware of the number of shares traded and the dollar volume,” Sykes said. He also suggests that you trade penny stocks that are priced at more than 50 cents a share. “Stocks that are trading less than 100,000 shares a day and are under 50 cents a share are not liquid enough to be in play,” he added.

7. Use mental stops

Because the bid-ask spreads on many penny stocks can be high, as much as 10%, hard stop-losses can actually cause you to lose money. p>

Although it takes more concentration, use mental stops. “I focus more on risk-reward than stops,” Sykes said. “If I want to make a dollar a share on a three-dollar stock, I will cut my losses at 20 cents so I have a 5:1 risk reward. I aim for 3:1 or 4:1, but not 1:1 or 2:1. If I think a dollar stock has only 50-cents upside (2:1), my mental stop loss will be at 10 cents because the risk-reward is better.”

8. Buy the best of the bunch

Sykes looks to buy penny stocks that have had an earnings breakout.

“I love buying penny stocks when they have good earnings, or when they are breaking out to 52-week highs on volume that is at least a quarter million shares a day,” he said. “They are easy to find if you look.”

The challenge is to find stocks that make 52-week highs that aren’t due to a pump-and-dump scheme. Examples of penny stocks that have fit Syke’s criteria in the past include Tangoe, Magal Security Systems, and Staar Surgical Co.

9. Don’t trade large positions

“You really need to be careful with position sizing,” Sykes said. “I learned the hard way not to trade big. My rule now is not to trade more than 10% of the stock’s daily volume.”

In addition, he said, limit your share size so you can get out of the stock faster.

10. Don’t fall in love with a stock

Every penny stock company wants you think it has an exciting story that will revolutionize the world. If you enter the penny stock arena, be cynical, do your own research, and diversify, even if a friends or family member is touting a stock.

Penny stocks have earned their bad reputation, so beware.