The Maverick Investor

LESSON SEVEN

by

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How to Make Lesser Known Investment Opportunities Work to Build Your Personal Nest Egg!

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The Maverick Investor's Home Study Course

PART SEVEN

PROFITING FROM PENNY SHARES

CONTENTS

Page:

3. Profiting From Penny Shares

3. The Lowdown on Shares

6. Doing Your Preliminary Research

9. Knowing What to Buy

12. The Signs of Success

13. How to Trade

15. Knowing When to Sell

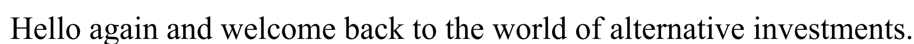
17. The Signs of Failure

18. What to do Next

19. Summary

22. Further Reading

22. Check Your Understanding



Hello again and welcome back to the world of alternative investments.

For many mainstream investors, shares are a major part of their investment portfolio. Alternative investors should consider these too, but may also wish to look more closely at what are known as ‘penny shares’. These are low-cost shares, usually in new companies developing products and services in innovative areas.

This lesson I will walk you through this interesting area. I will cover:

- **The Lowdown on Shares**
- **Doing Your Preliminary Research**
- **Knowing What to Buy**
- **The Signs of Success**
- **How to Trade**
- **Knowing When to Sell**
- **The Signs of Failure**
- **What to do Next**
- **Summary**
- **Further Reading**
- **Check Your Understanding**

Successful alternative investors recognise that penny shares tend to be highly speculative in nature. Thus, they tend to invest only a small-ish proportion of their investment funds into penny shares, and an amount that they can afford to lose in a worst-case scenario. For many alternative investors, these are fun investments similar to putting a tenner on a long-shot outsider at a race meeting. Nine times out of 10, you’ll not win but, when you do, you get a terrific return!

The Lowdown on Shares

Before looking at ‘penny shares’ in more detail, it is wise to have some background know-how about companies, shares and what owning shares really means in practice.

A company is a legal entity that trades in its own right. It is owned by **shareholders** and run by **directors** appointed by those shareholders. In smaller companies, shareholders and directors are sometimes one and the same. Buying a share or shares in a company means you become a shareholder – or part-owner – of it (although in practice this isn’t as grand as

it sounds as there may be thousands of shares or even millions).

Shareholders elect a **board of directors** to run the company on their behalf. They also have the opportunity to re-elect board members at regular intervals, if they don't like what the existing lot are doing. Shareholders often receive a share of the profits when business is good – these are paid for in the form of **dividends**, issued perhaps once or twice a year. Shareholders are sometimes entitled to other perks. In an air travel company, for example, they might receive discounts when flying.

How to Profit From Shares

The share price of a particular company reflects what the market thinks the business is worth. If a company has a million shares valued at £1 each, the market reckons the business is worth a million quid – give or take. If disaster strikes and the market reckons the company is now only worth half a million, then since there are still a million shares out there, each one must fall in value to just 50p. The opposite applies if the market reckons the business is worth two million (e.g. it acquires a super contract overseas) – the shares would now be worth £2 each.

Of course, 'the market' is just thousands of punters (you and me?) putting their money where their mouths are and either buying or selling these shares.

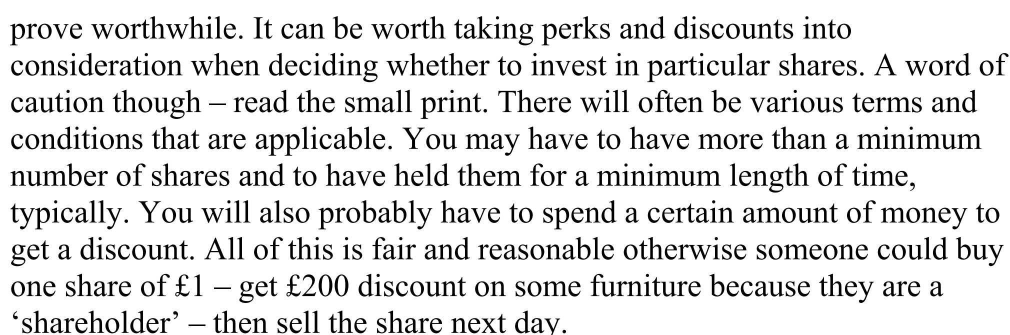
Shareholders profit most from shares by buying at a low price and selling at a higher price – just as investors do from any other type of investments. And, as with other investments, shares can rise and fall in value and for all sorts of reasons. **There are many influences upon share prices.**

Clearly, if the company is doing well, making money, and becoming successful, its shares will usually become more in-demand and prices will rise. Conversely, if it is doing badly (or just being perceived to be doing badly or about to do badly), shares will fall in demand, pulling down prices too. The company itself – and its success and failure – is obviously a key influence!

The price is not just to do with how well or badly the company is doing though – if the sector or economy *on the whole* is in a downturn, this will often have an impact. With some companies, and this is especially true of those newer, smaller ones, rumour and gossip can affect the price – anticipated good or bad news can send share prices rising or falling!

Often ignored, you can also profit from shares in other ways (and these should be taken into account). Companies that are doing well will often pay dividends to shareholders, typically upon publication of financial results. Dividends are not guaranteed though. New companies, those that are diversifying, developing new products and services or simply not doing very well, will not pay a dividend automatically. You can also often 'profit' from various shareholders' perks.

If, for example, you are a home-owner, shares in a company with furniture stores may offer shareholder discounts for shopping in those stores. These can



prove worthwhile. It can be worth taking perks and discounts into consideration when deciding whether to invest in particular shares. A word of caution though – read the small print. There will often be various terms and conditions that are applicable. You may have to have more than a minimum number of shares and to have held them for a minimum length of time, typically. You will also probably have to spend a certain amount of money to get a discount. All of this is fair and reasonable otherwise someone could buy one share of £1 – get £200 discount on some furniture because they are a 'shareholder' – then sell the share next day.

It's sensible to know the reward-risk relationship involved with shares – just as you should for every other type of investment, alternative or otherwise. The word 'shares' really covers a broad range of possible investments, from the biggest, most successful companies trading in well-established markets such as retail to the smallest, newest start-ups trading in speculative markets such as gold mining. **Clearly, some shares are going to be riskier than others!**

Risk and Reward

Remember that reward and risk tend to go hand in hand. The greater the potential rewards, the greater the potential risks. That gold mining company may see its shares rocket in price if it strikes gold. But the longer it fails to do so, the lower the share price is likely to fall.

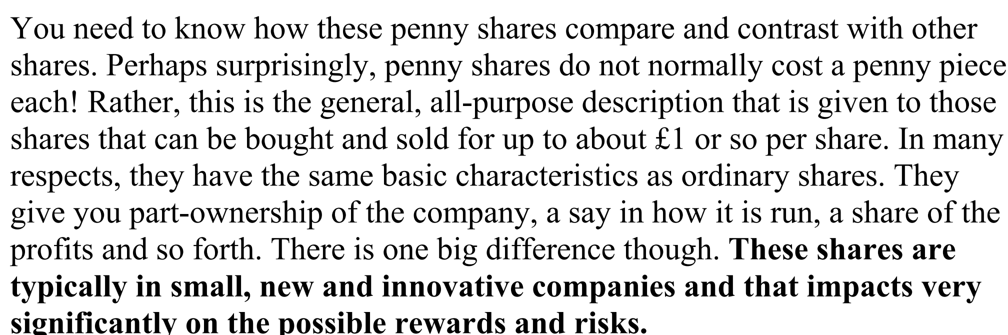
Generally, most shares offer medium rewards and medium risks. Prices do rise and fall according to how companies and sectors are perceived, how the economy is doing and, not least, how the companies themselves are doing. That automatically brings both potential rewards and risks.

Stock markets do rise and fall in value. Sometimes these movements can be sudden and dramatic – the most memorable in recent years was 'Black Monday' in 1987, when the stock market plunged by 30%. Sectors can be hit hard too, on occasions. The best example here would be the tragic 11th September attacks that led to airline shares falling in value (and, indeed, had a wider impact than that, hitting all sorts of travel-related companies).

Buy at the wrong time and through no fault of your own or the company, prices could fall. Of course, there is an upside to this - markets and sectors do bounce back at some stage and it is often a matter of patience, waiting for them to do so.

Those investors who buy in when the market is at the bottom of a trough will also profit more when it starts to recover – it's often the perfect buy low, add value, sell high success story. You buy when prices are near the bottom, let time add that all-important value – and then sell up when prices are close to the top.

As indicated, there are all sorts of shares in all types of companies. Many alternative investors favour **penny shares** as part of their alternative investment strategy – it's their way of putting a tenner on the outsider at a horse race.



You need to know how these penny shares compare and contrast with other shares. Perhaps surprisingly, penny shares do not normally cost a penny piece each! Rather, this is the general, all-purpose description that is given to those shares that can be bought and sold for up to about £1 or so per share. In many respects, they have the same basic characteristics as ordinary shares. They give you part-ownership of the company, a say in how it is run, a share of the profits and so forth. There is one big difference though. **These shares are typically in small, new and innovative companies and that impacts very significantly on the possible rewards and risks.**

One benefit of investing in penny shares is that you can buy a lot of shares for relatively little money – they're that much cheaper in one sense than many of the more popular, better-known shares. But £1,000 invested is £1,000 invested – whether it's 200 shares in Boots or 20,000 shares in ACME Mining. Please do not equate 'cheap' with 'getting more value for your money'. That's very important.

They can also add a little diversity and spice to an otherwise mainstream investment portfolio. If the company is successful in discovering gold, the cure for illness and disease or whatever, the rewards can be very significant – it's not unknown (albeit relatively rare and unusual) to see returns of 500% on these shares! At the same time, the risks involved with penny shares are much higher than for ordinary shares, not least because these are usually of such a speculative nature.

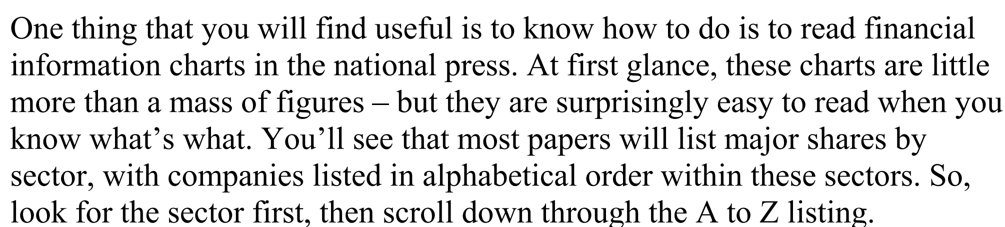
If you can make 500%, you can just as easily (and, to be frank, are much more likely to) lose the whole lot. So, these can be high-risk and unpredictable investments in volatile activities and sectors – but, for some alternative investors, that's all part of the attraction, excitement and glamour!

Doing Your Preliminary Research

Before investing in penny shares – or, indeed, any shares at all – it is a good idea to start familiarising yourself with what's currently happening in the stock markets and in various sectors and companies. You really need to soak up some know-how. Fortunately, there are lots of sources of news and information out there waiting for you. DO NOT BUY THESE SHARES ON A 'TIP'!!!

Begin by reading the financial pages of the national press, both tabloids and broadsheets. The tabloids are, surprisingly, a good place to begin as they tend to explain everything in a straightforward manner. The Daily Mail and the Daily Express have mid-week money sections that are clear and informative. Of the broadsheets, the Guardian has an impressive money supplement on Saturdays. Have a look at the Financial Times as well, which is not as daunting as it might first appear to first-timers.

Of the magazines available, Investors' Chronicle, Shares and Small Company Investor can be sourced from your local newsagents. These give a more detailed picture of what's happening. Start reading all of these on a regular basis.



One thing that you will find useful is to know how to do is to read financial information charts in the national press. At first glance, these charts are little more than a mass of figures – but they are surprisingly easy to read when you know what's what. You'll see that most papers will list major shares by sector, with companies listed in alphabetical order within these sectors. So, look for the sector first, then scroll down through the A to Z listing.

Once you've found a company of interest, you should see a row of figures. These can vary from one publication to the next, but you'll often find that the first figure is the 'price'. This is what's known as the mid-price figure at the close of the stock market on the previous day. The mid-price figure is midway between the selling and buying prices. As you would expect, you will buy at a higher price and will sell at a lower price. The buying price is called the **offer price**. The selling price is called the **bid price**. The difference between the two is the **spread**.

By this first figure, you will see a plus (+) or minus (-) figure. This shows how much the price has gone up or down from the day before. +20 shows it has gone up 20 pence. Along from this, you might see 'high/low' figures. These reveal the highest and lowest price of the share over a particular period of time. They may show the highs and lows over the past year, or from 1 January of this current year – the notes that are normally given at the bottom of the chart should clarify this.

Do check the notes – they can vary. A 'Mkt Cpt' (or 'market Capitalisation') figure may be next and this gives you the price of all the company's shares added together (e.g. 200,000 shares at 50p would value the company at £100,000 market cap.). It is a good way to compare the sizes of different companies. P/E may be next – the price/earnings ratio. This shows the current share price divided by the earning per share – earnings per share are the company's net profits divided by the number of shares that have been issued. **A high P/E rating suggests a fast-growing company.** 'YLD' (or 'yield') shows the dividends being paid out per £100 of shares. So, 2.5 shows that £2.50 is being paid out for every £100 of shares held.

The Internet offers access to lots of good information too, as long as you focus on well-established and respected sites. As with other aspects of the net, there is an awful lot of worthless and misleading information out there. It's worth trawling for web sites linked to the financial press, such as www.ft.com from the Financial Times. Other respected sites include Hemscott at www.hemscott.net and, for share tips, UK Analyst at www.UK-Analyst.com and T1ps at www.t1ps.com.

As with all web sites, stick to the better-known names, and do check how old the information is that you are reading. It is not unknown for new investors to read some financial advice and 'hot tips' only to find that these were uploaded when the site was set up three years ago. It's quite easy to do!

It is also wise to check that you are reading UK-related information – it is often easy to find yourself studying material that's relevant only to the US,

New Zealand or elsewhere!

Beware The Fixers!

You should be wary of message boards and chat rooms for share investors (particularly penny shares) even those linked to the most reputable sites. These are often used by new investors looking for 'hot tips', 'insider gossip' and the like. For many experienced investors, these are the last places on Earth that they would go for this sort of information. Most of the users are looking for tips, many are inexperienced and don't know what they are tipping and an alarming number are motivated by less than honest motives. **This is especially true when it comes to penny shares.**

Remember, these are in new, small companies, mostly – their shares can be influenced more easily than those from larger companies. If several disgruntled investors get together and start tipping the company left, right and centre, this can have an impact on demand and the price will rise – and these disgruntled investors can then offload their unwanted shares. Message boards and chat rooms are where they can start this manipulation ("Guys, my cousin just got back from Outer Bakuland and he overheard in a bar that ABC Mining have just struck the motherload – they're keeping it totally hush-hush at the moment as the directors are trying to buy as many shares as possible...". Beware!

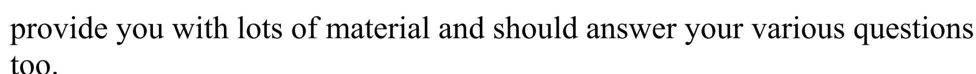
You can check share prices via the Internet more quickly and accurately than via the press and those charts full of financial information. Some of the share-tipping sites will give you instant access to real-time share prices as they happen (or will at least be more up-to-date than yesterday's close of business prices). Some will even give you a regular commentary on what is happening, and how they interpret it. If, or when, you start trading, you will want to know what the prices are now, of course – not what they were as of yesterday!

As you progress, and perhaps sign up to a reputable share-tipping service via a tipster or broker, you will also often have access to phone and other services that will provide the latest news and information regarding shares.

You will find it helpful, when you're building up your background know-how, to focus on, say, half-a-dozen companies that catch your eye. You'll find it is both informative and fun to spot companies that you think might do well and then follow their progress for a month, three months or six months - see how good your instincts are! What is also useful is to send for information on those companies.

Most will have web sites these days – you can uncover these easily enough by searching on Google. Study the web sites – you can often download lots of information from these including sales literature, company accounts and other documentation. You can also write to the 'Company Registrar' at the company claiming that you are a would-be investor.

The company registrar keeps a list of shareholders, issues share certificates and generally handles all the documentation and paperwork. They will



provide you with lots of material and should answer your various questions too.

Knowing What To Buy

So, we come to the crunch question asked by every alternative investor interested in penny shares – how do we pick a winner? With what might be described as mainstream shares – big shares in well-known companies – investors will look at the market, the sector, and then analyse companies of potential interest, by studying their accounts, applying ratios and so on.

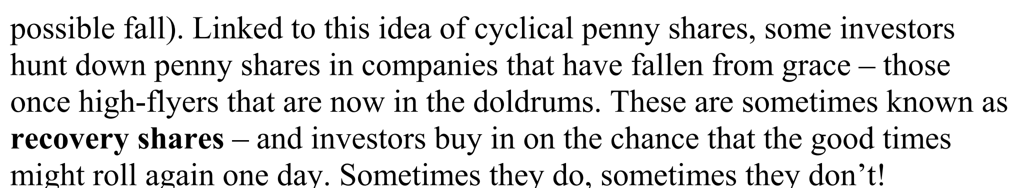
Penny shares are different. They are almost always in small companies, so they have a relatively low profile in comparison with larger companies. They are often new – so they have little or even no track record and accounts to study. They may well operate in what could best be described as speculative sectors so they are, by implication, high-risk in nature. So the 'rules' for assessing and choosing shares are not always appropriate at all for penny shares. Many successful penny share investors succeed through a mix of a brief assessment (so far as information is available), guesswork and, to a great degree, their instincts!

So far as penny shares are concerned, many successful investors look to spot what might be called the next 'big thing' – either in terms of a sector or a particular company that perhaps is developing a specific product. Remember Internet companies a few years ago? They could do no wrong, and many penny share investors did well by buying anything with .com in its name when prices where low and selling up when prices rose – but before the sudden slump. Other investors, of course, held on too long – and lost the lot, which really highlights both the upside and downside of penny share investing.

You would do well to study the press, monitor web sites and the like to see if you can sense which sectors are on the up, and to get a sniff of those companies that may be at the forefront. Biotechnology companies that are developing products are a favourite target of many successful penny share investors. They can produce stunning returns on your investment if they develop something that reaches the market – but note, only 10% of products in development ever go beyond that stage, and only about 10% of those reach the market!

There are sectors and companies that could be described as being cyclical in nature – they tend to ebb and flow, often in line with the economic cycle. These often hold some considerable appeal for successful alternative investors. Penny shares in these companies that are bought during a 'bust' time can offer profit potential if they are then sold on when the 'boom' time comes around.

House building is one such sector that tends to have a cyclical nature, mirroring the ebbing and flowing of the property market. It is often more profitable to buy in when these stocks are out-of-fashion (when relatively few are investing) than when they are 'hot' and prices are close to a peak (and a



possible fall). Linked to this idea of cyclical penny shares, some investors hunt down penny shares in companies that have fallen from grace – those once high-flyers that are now in the doldrums. These are sometimes known as **recovery shares** – and investors buy in on the chance that the good times might roll again one day. Sometimes they do, sometimes they don't!

With a company offering penny shares, there are some criteria to consider even if it is a small, new company with little or no track record of its own to assess. **Check how long the company has actually been trading for.** This is rarely considered by anyone investing in shares – but is a key concern for anyone buying into a penny share investment. Many of these companies are new, and the majority of start-ups fail within the first three years, and many of these within the first year.

Any company that has been trading beyond that time-scale – or looks as though it is going to do so - must be doing something right! Any company that has been trading for less than that period of time is likely to be a higher-risk investment for you – so invest accordingly.

You need to check the company's accounts if you can. The key here is to see if the company can keep going for long enough to succeed, uncovering gold, finding the cure for the common cold, or whatever. Check its income. Ideally, you should be looking for rising sales. Look at its expenditure, and see if this is under control. Consider its profits.

Many new companies will not go into profit for some time so you need to think how it will continue to trade until it does. Think about its cashflow. This is often overlooked by many investors. It is crucial for all businesses, and especially smaller ones that have limited borrowing capabilities.

A company that is joining or is already listed on the London Stock Exchange rating is considered a promising bet as it is on the rise. Study the directors and managers who are running the company you're considering. You are looking for a team which brings both breadth and depth of experience to the company – ideally, a good track record to date in whatever the company is setting out to do. Clearly, you will have more confidence in someone who has achieved success in this field than someone who has not.

One thing that many successful penny share investors look and listen out for is news, gossip and those little snippets of information that suggest the company will succeed. **You are really looking out for some sort of trigger that will send share prices rising.** Penny share prices tend to over-react to rumour and expectation.

If it's whispered that a company is about to release positive news about a new drug, the share price will rise. You need to buy in fast. Likewise, if bad news is predicted, the share price will fall and you will want to get out soon. Although many of the more successful investors won't admit it in public, they often invest in penny shares on little more than a hunch, instinct, and a little bit of good news – a new manager has just joined from a rival firm, a new

order is in the pipeline; anything that suggests the company is on the up.

Once you start researching penny shares, you'll find that the world is packed-full of tipsters offering advice in everything from the national press through share-tipping newsletters to web sites. Go to a web site such as Google, type 'Share Tips' in the search facility and you'll find more than a million leads! Wherever you turn, someone is tipping something! The upside of all this is that (if you find a good tipster), your work is cut down – you can (once you feel confident in them) simply buy and sell whatever they are tipping as and when they tip it. The downside is that the vast majority of tipsters simply aren't any good at all. There have, over the years, been various tongue-in-cheek surveys comparing the tipping performances of share tipsters, pre-school children and even parrots and monkeys. **The share tipsters invariably trail in last.**

Which Tipsters to Use

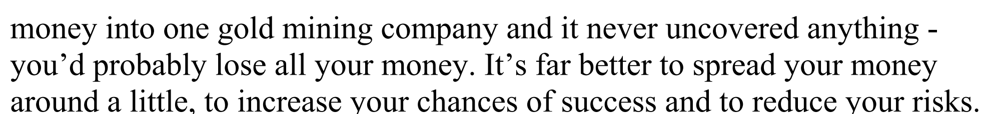
What you need to do is to source tipsters (via newspapers, magazines, newsletters, the Internet etc) and then shortlist them. You should be looking for a tipster who tips specific companies rather than those who talk vaguely about hot and cold sectors. Ideally, a tipster should not necessarily tip regularly – they should tip when they have a hot buy or sell, not because they have to make a tip a day; they'll be less selective the more often they tip. **You want to hear the reasons behind the tip, and you want to know what they are thinking and why.**

You can then do a little research to see if you agree with them or not. Those tipsters who refer to their failures are worth considering, as long as they explain their reasons. What a lot of less successful tipsters do (just like racing tipsters) is to tip lots and lots of outcomes and then – when they get lucky once or twice (as even the most useless will do) – use these in their publicity material. You're looking really for an overall success rate. Even the best tipsters will have the odd failure – and the great ones will admit to them. **Make sure you can access their previous tips.**

You then need to 'papertrade', simply following their tips (buying prices, trading costs, selling prices etc) to see how well you'd have done. It is sensible to do this for at least three months, and preferably longer. This is the most effective way of spotting a tipster that's worth following.

A word of caution here though. When you have faith in your tipster and decide to invest in what they say, you should invest when they say you should, and sell up when they advise you to do so. What some new investors do is to wait to see what happens to the share price immediately after the 'buy now' tip. They then watch the share price go up and up, and congratulate themselves for having picked a great tipster. When the price has risen, they buy then – and the price then levels off or even falls. These new investors then blame the tipster!

A final word of advice for buying into penny shares. It is always advisable to diversify, putting your money into different products. Say you put all your



money into one gold mining company and it never uncovered anything - you'd probably lose all your money. It's far better to spread your money around a little, to increase your chances of success and to reduce your risks.

Diversification doesn't mean putting your money into three gold mining companies instead of one though! You should put some money into the best-looking gold mining company, other money into, say a bio-tech company and a little more into, say, a company building sheltered housing; and the rest in two or three other, different companies. And, as always, don't invest more than you can afford to lose!

The Signs of Success

Companies offering penny shares do not, by the nature of their size, longevity, and innovative products and services, tend to mirror their larger counterparts when it comes to being evaluated. A new company, for example, has fewer accounts (if any) and less of a track record than a more established one.

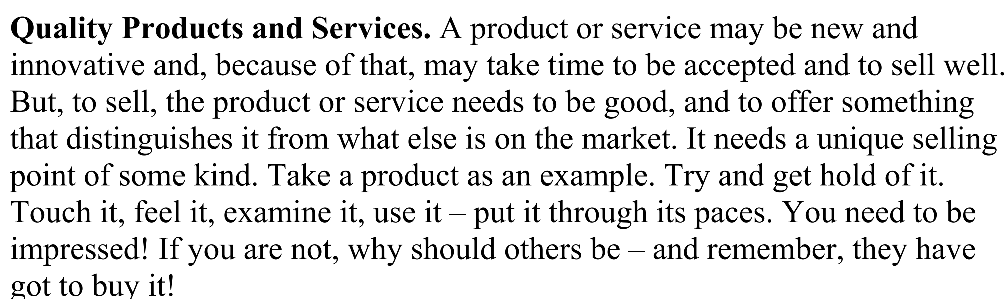
Studying its accounts is rarely an option! Those that are available will often show heavy borrowings. However, there are certain 'signs of success' that are worth watching for – spot these and you may have identified a company that just might be a winner. You're looking for a company with...

A well-established management team. Companies that have 'names', a management team that stays in place and that attracts other 'names' to it usually have a better chance of success. It's worth asking whether these managers have a stake in the company – putting their money where their mouth is can be a promising sign. If they don't, why not? It's also useful to know if and when these key players are buying or selling shares – when they do, they may well know something you don't yet.

Clear and well-defined plans. It is important that the company knows where it is going, what it wants to achieve and when. Ask! This way, you can, to a certain degree, measure how it is doing at any given time. It is helpful if these plans are specified in financial terms and backed-up with some facts and figures rather than being vague ones. You need hard facts not PR puff!

An open attitude. Those companies that keep their shareholders informed tend to inspire more confidence than those who do not. Do you have to go to them to ask questions? Or do they give you information you need to know quite readily? Do they seem secretive? You should be looking for accounts that are prepared on time, are explained and so on. The more open a company is, the more re-assured you will feel.

Happy staff. Often overlooked, it is wise to consider the workforce employed by the company. Are they happy or do they seem demoralised? Are the employees looked after well? Do they seem enthusiastic, keen to work, and so on? Some would-be investors try to get in amongst the staff, to talk to them and get a view of the company from the bottom up. You should do the same, where possible.



Quality Products and Services. A product or service may be new and innovative and, because of that, may take time to be accepted and to sell well. But, to sell, the product or service needs to be good, and to offer something that distinguishes it from what else is on the market. It needs a unique selling point of some kind. Take a product as an example. Try and get hold of it. Touch it, feel it, examine it, use it – put it through its paces. You need to be impressed! If you are not, why should others be – and remember, they have got to buy it!

Improving finances. You should be looking for a company that is steadily improving its sales and its margins. A new company will often see its share price go up on talk of a new deal, a new order and so on. But at some stage (sooner than later), the company has to actually deliver success rather than never-never – it has to make money! You also want to see costs under control, debts going down and profits going up. A new company can only live on hopes and dreams for so long – when is it going to deliver on its promises?

New and developing plans. Those companies that lead the way tend to make the most money – not always universally true, but a good guideline to follow as a general rule. You should therefore be looking for a company that is constantly achieving its goals, and then setting and striving for new ones. Those companies with no purpose tend to make no profit either!

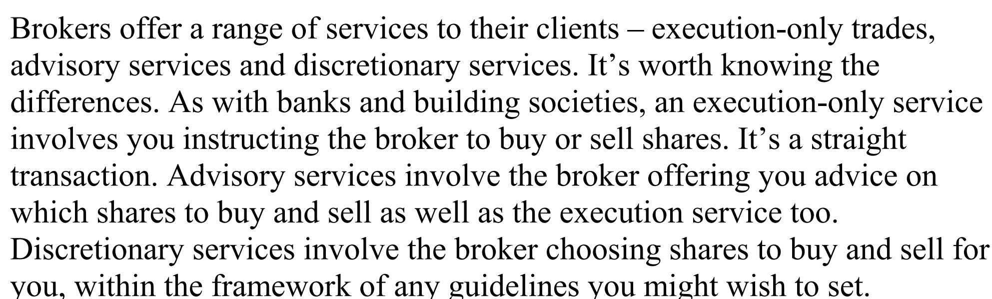
How To Trade

Buying and selling shares is – contrary to popular belief – very easy to do. It is really no different to any other financial transaction. If you are buying, you pay your money and get shares in return.

If you are selling, you exchange your shares for money. That's really all there is to it. Many banks and building societies offer what's known as an execution-only service. You simply decide what you want to buy or sell, go in, say what you want to do and hand over your money and/or paperwork. The clerk then does everything for you on their computer screen. You will pay commission on the sale or purchase, typically 1% of the value (although there may be a minimum charge on smaller transactions so check and take account of this). You'll then walk out five or 10 minutes later. These days you can do all this over the Internet as well.

Often, this is the easiest way to trade shares. All you have to do is to contact your local banks and building societies to see which ones offer these services, which are the cheapest, most efficient and most convenient for you. Some offer telephone and/or on-line services too which may prove helpful.

If you are going to buy and sell shares only occasionally, an execution-only service via a local bank or building society is probably the simplest way of doing it. If you intend to trade regularly, and especially in smaller, lesser-known penny shares and/or in overseas' investments, you may choose to do it in a different way. You might set up a deposit account with a broker, putting in an initial sum of, say, £3,000 to finance your trading activities.



Brokers offer a range of services to their clients – execution-only trades, advisory services and discretionary services. It's worth knowing the differences. As with banks and building societies, an execution-only service involves you instructing the broker to buy or sell shares. It's a straight transaction. Advisory services involve the broker offering you advice on which shares to buy and sell as well as the execution service too. Discretionary services involve the broker choosing shares to buy and sell for you, within the framework of any guidelines you might wish to set.

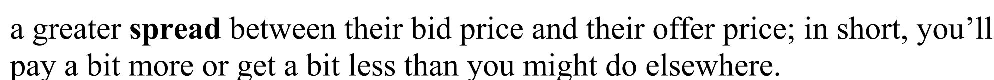
For execution-only services, you would normally expect to invest about £3000 in a deposit account with a broker. For advisory services, you should be looking at having about £10,000 and for discretionary services, you should expect to put around £50,000 into the account. You can source brokers via the Association of Private Client Investment Managers and Stockbrokers (020 7247 7080).

Clearly, the route you go down depends on your personal circumstances. If you are happy to make your own choices (or are following a tipster's recommendations) and are making only small and occasional trades, using a bank's execution-only service may be the best option. If – now or later – you want to progress and invest more significantly and often, a broker offering advisory and discretionary services may be more suitable for you.

Do take account of the costs involved. It is easy to know what your buying or selling prices are – the bank, building society or broker will give you the price from their screen. But, too often, first-time investors overlook the costs involved – ask in advance. Check the minimum trading charge. It will often be £10, although it can be higher, sometimes double that. This doesn't sound very much – but will soon eat into your profits if you make lots of little trades. Say you buy at £100, sell at £140 (that's a thumping 40% gain) – but have to pay two lots of minimum trading fees of £20 a time!

Consider the commission too. This is usually levied on a sliding scale based on a percentage of the value of the transaction. For an execution-only service, you might expect to pay 1% (subject to that minimum fee). If you sold £300 worth of shares, for example, you would pay that minimum fee of, say, £20 as 1% would only be £3.00. If you sold £5,000, you would pay £50.00; being 1% of the transaction's value. Sometimes, the commission will be less if you trade more often, or in larger amounts. If you are paying for advisory or discretionary services, you will pay more accordingly – perhaps 1.5%, so shop around to see what is on offer. Double-check any other charges that will be levied too – you may, for example, have to pay more if you invest in shares where the company is based overseas.

Once you start investigating this investment opportunity, you'll spot various 'no commission' offers for buying and selling shares. Do bear in mind that, as with everything else in life, you rarely get something for nothing. 'No commission' deals are a good example – clearly, no intermediary is going to buy and sell shares for you without making anything on the exchange. They are running a business, not a charity. They make their profit by simply having



a greater **spread** between their bid price and their offer price; in short, you'll pay a bit more or get a bit less than you might do elsewhere.

Overall, you'll probably find you'll end up about the same as you would by paying commission – but do shop around and compare your prices. All deals are not the same – you need to find the best one available at the time.

It's worth noting at this point that you do not normally need to buy (or sell) a minimum or maximum number of shares. You could, in theory, often buy a single share, and some people have been known to do this. Why? Because it gains them entry to the Annual General Meeting which enables them to put questions to the Board of Directors! A football fan may want to do this, for example. In investment terms though, you'll probably be buying perhaps £500's worth of shares at a time, as an average. Bear in mind the charges for buying and selling shares which eat up your profits – **lots of little trades will mean you are throwing away much of your profits in those charges.**

There are no limits to the number and/or value of shares you can own. However, you would be well advised to remember to diversify your money between different investments, neither putting too much of your money into penny shares nor in other investments for that matter.

Generally, for penny shares, you will be happy to go with an execution-style service only – after all, you will find that there is plenty of investment advice available from fairly reliable sources (newsletters, web sites etc), without having to pay extra for it.

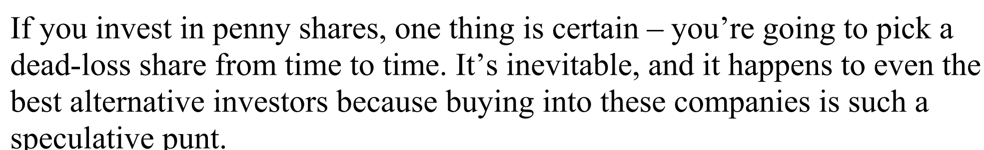
One thing you will find if you use execution-only style services from a broker is that some will occasionally give you a nod and a wink regarding their opinions. The trick is to be friendly with whoever you're speaking to by phone or e-mail – when you find someone who is friendly, ask for them in future. See if you can build up some sort of relationship with them.

They are then more likely to give you a little advice now and then. Say your share rises by 50 pence and you can't see why - your friendly broker may know something you don't. Ask and they may reveal all!

Knowing When to Sell

First things first – remember that penny shares are high-reward, high-risk, unpredictable and volatile investments! **These are not investments that will increase slowly and steadily in value over the years.**

Penny shares in one company might do incredibly well, and then fade away almost immediately afterwards. Another company's shares might crawl along not doing anything year-on-year; and then either fizz furiously or die all of a sudden. Just as likely, they might simply continue crawling along indefinitely never doing anything. One company's shares might simply plummet overnight! Another's might rocket! It's worth thinking about your selling strategy in advance so that you know what to do as and when whatever it is happens.



If you invest in penny shares, one thing is certain – you're going to pick a dead-loss share from time to time. It's inevitable, and it happens to even the best alternative investors because buying into these companies is such a speculative punt.

The secret is to only put in a little, don't invest more than you can afford to lose and to set what is generally known as a stop-loss figure. A stop-loss figure is the price at which you will accept your losses and sell up. In short, you made a mistake and you admit defeat – it happens to everyone from time to time, even the most experienced and savvy investors!

What the most successful investors do is to set a stop-loss figure of, say, 20% on each of their investments. If or when the share price falls to 20% below what they paid for it, they sell automatically, walk off and don't look back. It can be tempting to hang on, and hope that the price will recover. Maybe it will. Maybe it won't. It could fall further. **Setting a stop-loss figure takes the uncertainty out of the deal. Making it automatic takes away the stress of a tough decision.**

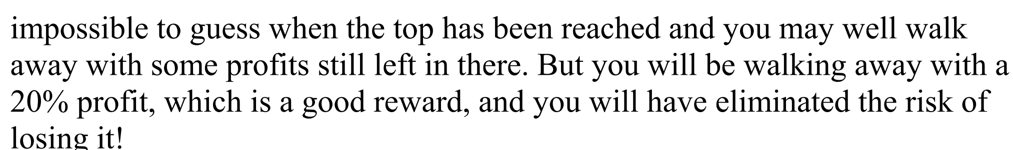
Of course, some of your investments will do well, perhaps even brilliantly well. Strangely, one of the hardest things about investing in penny shares is taking profits when your shares have risen substantially in value –hard to believe, but true! If a share goes up, say, 50% or even 100% in relation to what you paid, it's incredibly tempting to congratulate yourself for a wise choice and to then just hold on a little longer. Maybe it will go to 150%, 200% or even more! So, as you'll soon be convincing yourself, if you sell now, you could actually be *losing* money, and possibly even quite a lot of it! Of course, what often happens is that you hold on for a bit more...and on for a little bit more ...and...kick yourself silly when the price suddenly plummets to less than you paid.

If you see the share price rise, it is wise (at the very least) to think *why* it has risen, whether the criteria for picking this share are still sound, and what might happen next. If you think it would be wise to buy in even at this price, then it may be worth holding on to...possibly.

The golden investment rule is easy to state, but so, so hard to do. It is this: "Cut Your Losses Quickly. Take Your Profits."

What a lot of the canniest successful investors do is to set what might be called a stop-profit figure on each of their buys. If a share rises to, say, 50% *more* than what they paid for it, they sell, take the profits, and walk away and don't look back. This removes the emotion from share investing – and puts in purely on to business-like lines.

This may seem odd to a first-time investor – the fact that someone can simply walk away from a share that's going up. All those profits going to waste! But it is sensible though. After all, the share price is unlikely to go up and up and up indefinitely. All sorts of factors can intervene – a market or sector slump, bad news, a rumour that all is not well; just about anything. It is hard to



impossible to guess when the top has been reached and you may well walk away with some profits still left in there. But you will be walking away with a 20% profit, which is a good reward, and you will have eliminated the risk of losing it!

Stop-loss and stop-profit figures cover you if the shares you have bought go down or go up – but you need to think what to do with those shares that just go along and don't seem to do anything. Generally, for share investing (and, indeed, all types of investing), it is wise to have a spread of shares across different sectors and to hold on to them for some time.

The more you chop and change, the more you will spend on trading costs. Every tenner spent on a minimum trade is a tenner less left in your profit pot! It is also a good idea to **give the shares time to do something**.

The key really is to keep monitoring them, talking to the company registrar, attending annual general meetings, reading any materials they produce and listening for mentions in the press, on-line, and so on. If you (or your tipsters) have picked wisely, it is sensible to keep to the same basic mix and spread of shares, and wait for them to do something.

The Signs of Failure

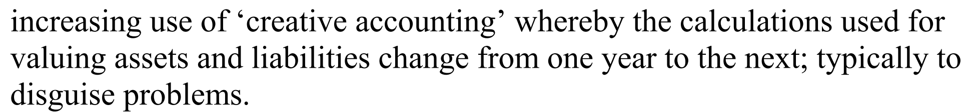
Any company that is doing badly – penny share or otherwise – will tend to develop various characteristics that an observant investor will be able to spot soon enough.

Of course, the odd sign may not on its own be significant nor necessarily a signal that the end of the company is nigh. But the more negative characteristics you can spot, the more likely it is that this company may be in trouble. It may be wiser to sell up now whilst you can still get a relatively good price for your investment. Here are the signs of failure...

Loss of directors and/or managers. A company that is losing key players is a cause for concern. In particular, you should watch for directors and managers who leave without being replaced, several key players leaving at the same time, a rapid turnover of key players and shares being sold by directors and managers. Successful companies generally keep their key players – failing companies lose them fast, and often in rapid succession.

Many new and innovative companies grow by borrowing funds to finance that expansion. That is to be expected. But, at some stage, that expansion will actually have to take place, be completed, and debts should then start to fall. Those companies that never seem to reduce borrowings and – worse, seem to keep increasing them may be heading for a fall. Watch the figures. At some stage, the company needs to stand on its own two feet and pay its way.

Late Accounts. An obvious sign of problems is when accounts are not produced on time. Publication will reveal the true state of the company which will hit share prices etc. You need to make sure that accounts are produced on time – if not, it may be time to move out fast. Linked with this sign is the



increasing use of ‘creative accounting’ whereby the calculations used for valuing assets and liabilities change from one year to the next; typically to disguise problems.

Unhappy staff. Linked with the loss of directors and/or managers, you should consider the employees right the way down to the ground floor level. Often, they are the first to see the signs of failure; hours are cut, replacements are not brought in as employees move on, perks are cut back, the staff room is not redecorated as expected, new machinery isn’t brought in as planned etc. Talk to these employees!

Poor accounts. The obvious give-away! The first sign can be reduced profit margins which are propped up by the use of previously untouchable financial reserves. Losses may be reported...yet again (and perhaps also greater than expected). Do watch for those companies that are always going to ‘make it big’ next year or the year after, and that always have ‘the big project’ coming soon. No company can survive indefinitely like this. They have to produce results sometime soon!

Loss of suppliers. An early sign of upcoming difficulties is where a company changes its suppliers. The company will typically put a good spin on this, but it needs investigating. Talk to others in the industry, and to the suppliers themselves where possible. It is quite possible that suppliers have had to be changed because the company has been struggling to pay its existing suppliers.

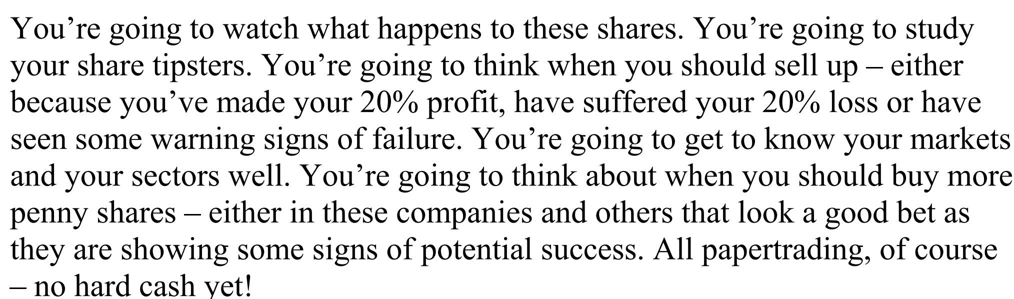
Lack of hard and accurate planning. Those companies that are not doing so well tend to produce financial facts and figures less readily than they used to do. This tends to be followed by a period of rhetoric when they, for want of a better expression, ‘talk big’. Sadly, they usually fail to back this up with specific plans and forecasts. The ship is no longer being steered on a steady course!

What to do Next

If penny shares interest you, the first thing you should do is to start building that know-how. Trawl the newspapers, magazines and Internet and find a tipster who is recommending various penny shares. Pick, say, half a dozen of these shares that they are recommending – one from each of a range of sectors so you have a good mix. **Diversification is important!**

Now check out what you would pay for them if you bought them today – you’ll find ads for various execution-style services in the financial press, on web sites etc. Phone around and check those prices, and see how many shares you’d get for investing, say, £500 in each – a total portfolio of £3,000 in penny shares. Get yourself a little black book, note down the companies, the number of shares in each and the total investment, including costs.

Don’t spend any actual money at this stage though! You’re going to papertrade for three months or, if you are patient enough, preferably six months! Over that period of time, you’re going to read, read, and read.



You're going to watch what happens to these shares. You're going to study your share tipsters. You're going to think when you should sell up – either because you've made your 20% profit, have suffered your 20% loss or have seen some warning signs of failure. You're going to get to know your markets and your sectors well. You're going to think about when you should buy more penny shares – either in these companies and others that look a good bet as they are showing some signs of potential success. All papertrading, of course – no hard cash yet!

At the end of the three or hopefully six-month period, you can sit down with your little black book and see what you own. Have you made a profit or a loss? Don't forget to include all dealing costs. You may have one or two shares that really haven't done that well – and, from your research in the three to six months since buying, you will probably know why. Maybe you started off with a duff tipster!

You should have some that will have done rather well – ideally, ones that you have picked and added to your portfolio as you went along. There may be one or two that really haven't done much at all – you may think it's time to offload these, or you might want to hold on to them for a little longer. You can then check what you would get if you sold every share now and can see if you are in profit or not. Whatever the outcome, you should now have enough knowledge and experience to start investing successfully in penny shares with real money!

Summary

1. A company is a separate legal entity in its own right. It is owned by shareholders and run by directors.

2. Shareholders can profit from shares in three ways - by an increase in share prices, by receiving dividends, and by receiving perks such as discounts on the company's goods and services. Nothing is guaranteed though!

3. The reward-risk relationship for shares is generally medium reward and medium risk – but there are many types of companies and varying rewards and risks.

4. Share prices can go up and down as a result of many influences – everything from how well (or how badly) the company is doing through to the overall performance of the stock market. An event such as 11th September 2001 can hit share prices significantly.

5. Penny shares tend to be available in new, small and innovative companies. They have many of the same characteristics of ordinary shares, but the main difference tends to be their unpredictability. You could make a lot of money – or you could lose everything! For many alternative investors, that is part of their appeal.

6. There are many good sources of know-how for the first-time investor, including newspapers and magazines. The Daily Mail, Daily Express,

Guardian and Financial Times offer useful introductory information.

7. It is useful to know how to read the share charts in the financial pages of the press. These show the most popular shares in leading companies, provide basic data about them, and reveal how they are currently doing.

8. The Internet is another good source of knowledge if used carefully. It is sensible to access the better-known and well-established sites such as the FT's www.ft.com. When trawling sites, it is advisable to check that they and the information that they provide are relevant to this country. It is also wise to check how old the information is before taking it into consideration.

9. Message boards and chat rooms are used rarely (if at all) by experienced investors. Most of the users are as inexperienced as each other. Some have been known to tip shares that they want to sell. With companies that have penny shares, this can have quite an impact on price on occasions.

10. One of the best sources of information about a company is the company itself. Many companies have web sites where information can be downloaded. You can also write to the Company Registrar who will provide paperwork etc to would-be shareholders.

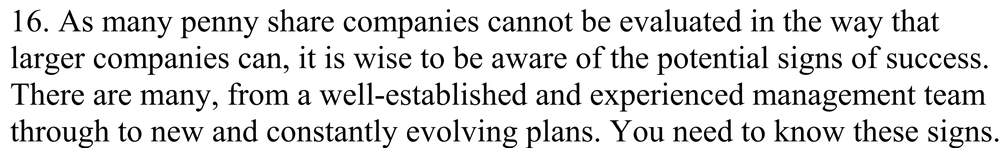
11. The 'rules' for assessing shares – reading accounts, applying financial ratios etc – cannot be applied easily to penny shares which tend to be in companies that are new, small, innovative and out of the limelight. Successful alternative investors work largely on instinct!

12. Some investors look for the next 'big thing'. It was Internet companies a few years ago. Bio-tech companies offer some potential success in the future. Other investors look at cyclical sectors and companies that ebb and flow such as housing-related companies. Those companies that have fallen from favour sometimes come back and may be worth considering too.

13. When penny shares are being considered in a particular company, it is advisable to check how long it has been trading, have a look at the accounts, check the management team and to listen out for news and gossip. With small, new companies, news and gossip can be influential.

14. Using a tipster can save a lot of time, effort and research. But many of them tip worse than pre-school children and parrots! You should look for one that makes specific tips, not necessarily regularly. You are looking for the best overall success rate, and an explanation (rather than an overlooking) of failures.

15. Before investing money into penny shares, it is sensible to 'papertrade' – pretending to trade in those shares that you or your tipster thinks are profitable investments. It is also a good idea to diversify, putting your money (whether pretend or, in due course, real) into penny shares in different sectors. This reduces risks.



16. As many penny share companies cannot be evaluated in the way that larger companies can, it is wise to be aware of the potential signs of success. There are many, from a well-established and experienced management team through to new and constantly evolving plans. You need to know these signs.

17. Trading shares can be done most easily via an execution-only style service at a local bank or building society. A broker can offer this service too, and may be worth using if you trade regularly, trade in penny shares and/or invest internationally. Brokers also offer advisory and discretionary services – advice and management of your investments in essence.

18. When trading shares, it is important that you take account of the commission levied on each transaction; typically 1%. There may be a minimum fee that is levied, which may make lots of little trades prohibitively expensive. Be wary of ‘no commission’ deals – the drawback is that you will usually pay slightly more or get slightly less on each trade.

19. Even the most experienced investors buy the occasional share that loses money for them. What they usually do is to set up a stop-loss figure to minimise their losses. Once a share drops by, say 20% of what they paid for it, they will sell up and forget about it.

20. It can be harder to sell a money-making share than a loss-making one! Everyone wants to squeeze out every last drop of profit – although this is incredibly hard to do in practice. Experienced investors do not try to do it. Many of these investors set a stop-profit figure instead. Once a penny share rises to, say, 50% more than they paid for it, they sell up and bank those profits.

21. Given their new, small and innovative nature, penny share companies cannot be monitored as easily as larger companies. You need to know and watch for the signs of failure. These are many and varied. Key personnel moving on is rarely a good sign. Changing suppliers may indicate problems too. Make sure you know what to look for.

22. As many penny share companies cannot be evaluated in the way that larger companies can, it is wise to be aware of the potential signs of success. There are many, from a well-established and experienced management team through to new and constantly evolving plans. You need to know these signs.

23. Before investing, papertrade for three to six months. Take a mix of shares that you or a tipster like the look of. See what you would pay for them. Monitor and amend your portfolio over time, using your stop-loss and stop-profit figures and your increasing experience too, of course. At the end of the three or six months, you should be ready to invest hard cash!

Further Reading

Winning With Shares: Investing Wisely and Profitably in the Stock Market by Alvin Hall (0340793384, Hodder & Stoughton)

Shares Without Tears: The Private Investor's Guide to Share Trading by Jennie Hawthorn (1903994004, Take That)

How To Make A Killing in Penny Shares by Michael Walters (094803520X, Rushmere Wynn)

Penny Shares Made Simple by John Campbell (1899964304, Fleet Street Publications)

The Guide for Penny Stock Investing by Donny Lowy (0738834808, Xlibris Corporation)

A Fortune in Penny Shares by Jeremy Curtis (1871379350, Orcom available over the Internet from several dealers.)

Check Your Understanding

The Lowdown on Shares

1. What is a company?

2. What are shares, and what does ownership of them entitle you to?

3. How can you profit from shares?

4. What are dividends?

5. How would you describe the reward-risk relationship with regard to shares?

6. What can impact on share prices, for good and for bad?

7. What are penny shares?

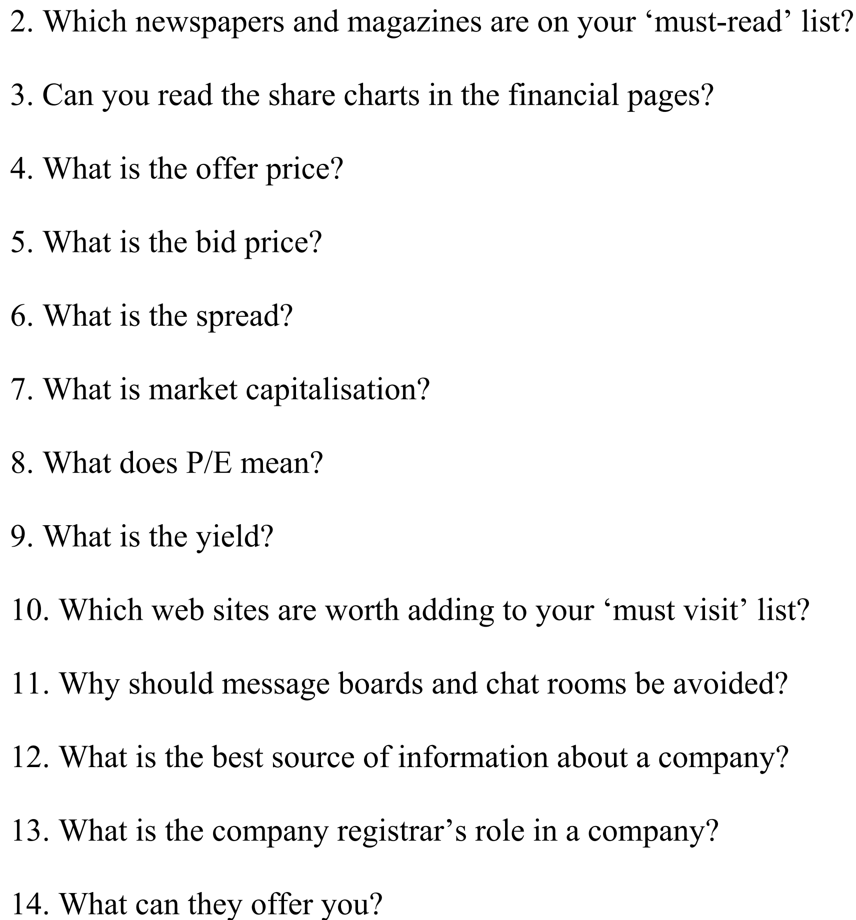
8. What is the main difference between ordinary shares and penny shares?

9. How would you define the reward-risk relationship with regard to penny shares?

10. What is the attraction of penny shares?

Doing Your Preliminary Research

1. Where can you obtain some preliminary know-how about shares?



2. Which newspapers and magazines are on your ‘must-read’ list?

3. Can you read the share charts in the financial pages?

4. What is the offer price?

5. What is the bid price?

6. What is the spread?

7. What is market capitalisation?

8. What does P/E mean?

9. What is the yield?

10. Which web sites are worth adding to your ‘must visit’ list?

11. Why should message boards and chat rooms be avoided?

12. What is the best source of information about a company?

13. What is the company registrar’s role in a company?

14. What can they offer you?

Knowing What to Buy

1. Why are the usual rules of assessing shares hard to impossible to apply to penny shares?

2. How can penny shares be assessed?

3. What is the next big thing – or where should you be looking for it?

4. What is a cyclical sector or company – and which ones should be considering?

5. Why should you be alert to news and gossip about the company?

6. What sort of ‘trigger’ are you looking out for?

7. How can you identify a tipster to follow?

8. What is papertrading, and why is it so important?

9. Why should you diversify your investments?

The Signs of Success

1. Can you list, say, six signs that suggest a company is going to be successful?

2. Are there any other signs of success?

3. Why do you want to know if members of the management team invest in the company?

4. Why should you get in amongst the staff and talk to them?

5. Why should you handle the goods or use the services on offer?

How To Trade

1. What are execution-only, advisory and discretionary services?

2. Where can you buy and sell shares?

3. When is it usually best to use a broker?

4. What is the typical commission on a trade?

5. What is a typical minimum fee?

6. Why are ‘no commission’ deals often to be avoided?

7. What are the minimum and maximum number of shares you can buy?

Knowing When to Sell

1. What should you do if you have bought a dud share (and remember, it happens to the best investors too)?

2. What is your stop-loss figure?

3. What should you do when a share is going up and up?

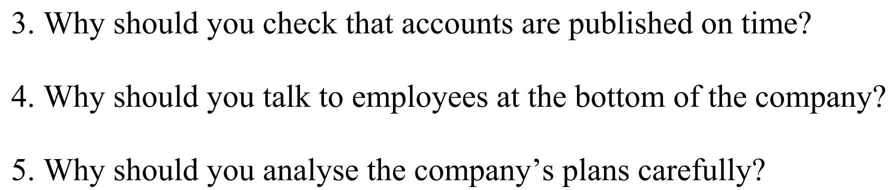
4. What is your stop-profit figure?

5. What should you do with shares that don’t seem to be doing anything?

The Signs of Failure

1. Can you list, say, six signs that indicate a company is not doing as well as you might have hoped?

2. Are there any other signs of failure?



3. Why should you check that accounts are published on time?

4. Why should you talk to employees at the bottom of the company?

5. Why should you analyse the company's plans carefully?

<u>What to do Next</u>

1. Why should you papertrade before investing properly?

2. How many shares should you 'invest' in?

3. And for how long?

Have you answered all of these questions to your satisfaction?

You're now ready to move on to Part 8 of your course!