

Five Secrets to Finding Big Profits with Cheap Stocks

**A Special Report from
StockProphets.com**

Five Secrets to Consistent Penny Stock Profits of 350% or More

By Bill Mathews



Bill Mathews is editor of the free newsletter, *Cheap Stocks & Tips*, published by StockProphets.com, as well as the premium subscription newsletter, *The Cheap Investor*. Founded in 1981, *The Cheap Investor* is one of the country's oldest and most respected investment newsletters.

The League of American Investors names *The Cheap Investor* one of the four best small stock advisories in America, and David Roeder of the Chicago Sun-Times says, "Finally, I found a successful stock picker who speaks to the core of my being. My flinty-eyed, frugal core."

Bill Mathews is an often-quoted expert whose market outlook has been featured on many financial broadcast programs, including those on CNBC, major newspapers and magazines including the Wall Street Journal, Business Week, Barron's and the Chicago Tribune.

Bill also taught securities analysis for the MBA program at the Keller Graduate School of Management, and spent 15 years teaching business and investing at Triton College before retiring to invest and write *The Cheap Investor* full-time.

Since 1981 The Cheap Investor has helped tens of thousands of investors make profitable investment decisions.

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Introduction

America is unique in that an amazingly large amount of wealth has been accumulated in a relatively short period of time. Our free enterprise system allows clever, industrious individuals to make a fortune. The basic freedoms and opportunities that many Americans take for granted are the enticement for most immigrants to leave everything they know to come to a new country.

Anyone can participate in our free enterprise system by starting a company and becoming a direct owner. But because most people don't have the necessary capital or entrepreneurial skills, they can indirectly share in the growth and prosperity of a company by investing in its common stock. An investor with a small amount of money can become a partial owner of a growing corporation and enjoy some of the same benefits as the entrepreneur.

Nowhere is that more true than in microcap, or "penny" stocks. This is where you can indulge in and realize your dreams of riches. You can share the visions and excitement of small companies that are on a path to conquer the marketplace.

For me, that is one of the most exciting benefits of penny stocks. Of course, as a bottom-line guy, profits are king. But there are few things in life so satisfying as believing in an idea that you can watch grow into wildly profitable reality.

Amazingly, I have watched a dozen or more of these success stories since 2008. I have specialized in microcap analysis since 1979, but the last several years have been particularly rich. Despite all you hear about the death of technological innovation in America, the OTCBB is a thriving nursery that is regularly producing successful companies.

I wrote this special report to help you discover the same excitement and high profits that I have found in the world of penny stocks.

1. Believe It: Stocks Under \$5.00 are Your Best Chance for Profits of 350% or More.

When it comes to small stocks, think big – as in big profits. In fact, the smaller the stock, the more likely you'll see profits of 1,000% or more. This holds true whether you're talking about one year or ten.

- Of the 212 common stocks that topped 100% gains for the nine months through September 2010, all but 18 started the year trading under \$5.00. Visteon Corp started the year at \$0.03 and is now up 1,842%. Kingold Jewelry went from \$1.20 to \$7.96, up 575%. Electronics maker LGL Group is up 447%, and electronics supplier Surge Components Inc is up 700%. One of my favorite stories of the past 12 months, though, is Vermillion Corp. When the FDA approved the tiny company's ovarian cancer detector, shares shot up nearly 1,200%.
- In the decade ending January 1, 2010, all but one of the 40 best-performing stocks in the Russell 3,000 started the decade trading under \$5.00. The lone exception traded at \$6.56. Here is the list, compiled by Bespoke Investment Group:

Best Performing Russell 3,000 Stocks of the Decade					
Stock	Company	Sector	12/31/99	12/31/09	% Change
MED	Medifast Inc	Cons. Staples	0.19	30.58	16,209.33
GMCR	Green Mountain Coffee Roasters	Cons. Staples	0.88	81.47	9,210.86
HANS	Hansen Natural Corp	Cons. Staples	0.54	38.40	7,022.98
BYI	Bally Technologies Inc	Cons. Discret.	0.68	41.29	5,974.74
SWN	Southwestern Energy Co	Energy	0.82	48.20	5,775.90
CLH	Clean Harbors Inc	Industrials	1.25	59.61	4,668.80
AMED	Amedisys Inc	Health Care	1.03	48.56	4,608.62
DECK	Deckers Outdoor Corp	Cons. Discret.	2.63	101.72	3,775.05
QSII	Quality Systems Inc	Health Care	1.78	62.79	3,435.67
AFAM	Almost Family Inc	Health Care	1.13	39.53	3,413.78
BOOM	Dynamic Materials Corp	Industrials	0.59	20.05	3,276.56
XTO	XTO Energy Inc	Energy	1.39	46.53	3,237.64
JOSB	JOS A Bank Clothiers Inc	Cons. Discret.	1.28	42.19	3,196.09
SIRO	Sirona Dental Systems Inc	Health Care	1.18	31.74	2,599.90
CETV	Central European Media Enterp.	Cons. Discret.	0.88	23.61	2,598.29
TRA	Terra Industries Inc	Materials	1.29	32.19	2,396.70
CKXE	CKX Inc	Cons. Discret.	0.21	5.27	2,354.59
RRC	Range Resources Corp	Energy	2.13	49.85	2,245.88
FCN	FTI Consulting Inc	Industrials	2.22	47.16	2,022.22
KMX	CarMax Inc	Cons. Discret.	1.16	24.25	1,997.21
KWK	Quicksilver Resources Inc	Energy	0.73	15.01	1,958.42
TISI	Team Inc	Industrials	0.97	18.81	1,841.58
CEDC	Central European Distribution	Cons. Staples	1.48	28.41	1,817.65
CALM	Cal-Maine Foods Inc	Cons. Staples	1.78	34.08	1,813.21
ISRL	Isramco Inc	Energy	3.88	71.50	1,745.16
MIDD	Middleby Corp	Industrials	2.73	49.02	1,698.37
PNRA	Panera Bread Co	Cons. Discret.	3.88	66.97	1,628.26
MD	Mednax Inc	Health Care	3.50	60.11	1,617.43
PCP	Precision Castparts Corp	Industrials	6.56	110.35	1,581.52
GROW	US Global Investors Inc	Financials	0.75	12.31	1,552.35
BJRI	BJ's Restaurants Inc	Cons. Discret.	1.16	18.82	1,527.61
FLIR	FLIR Systems Inc	Technology	2.03	32.72	1,510.79
PSYS	Psychiatric Solutions Inc	Health Care	1.32	21.14	1,506.26
ANSS	ANSYS Inc	Technology	2.75	43.46	1,480.36
GHM	Graham Corp	Industrials	1.33	20.70	1,462.26
HOC	Holly Corp	Energy	1.66	25.63	1,440.17

Investors often forget that companies like Microsoft, Home Depot, and Intel started life with market caps and share prices that qualified them as penny stocks. They had zero earnings and close to zero revenue. But their ability to sell shares allowed them to grow into the giants they are today.

Other companies started with higher share prices but fell to penny stock range because of some problem. Concur Technologies flew to nearly \$50 in the tech run-up of 1999, but had fallen to \$0.30 by 2001. Since then it has blasted 5,863%, once again trading near \$50.

When Ford Motors fell to below \$2.00 in February 2009, I recommended the stock to readers of my premium newsletter, *The Cheap Investor*. It topped \$14 in April 2010 for gains of 820%. That same month I recommended LJ International, Bank of America, Callon Petroleum, and Lightwave Logic, which returned 503%, 289%, 304% and 408%, respectively.

More than 3,000 companies trade as OTCBB or pink sheet stocks. But you may be surprised to know that about 19% of all stocks on major U.S. exchanges qualify as penny stocks as well. The percentage rises and falls depending on markets and the economy, and since the market crash in 2007 and 2010's "flash crash," plenty of solid companies have found themselves trading under \$5.00, the very definition of "penny stocks."

You can find penny stocks in nearly every industry and sector, from alternative energy to biotech, and even U.S.-traded stocks of foreign banks and utilities. Including plenty of familiar names that few investors think of as penny stocks, like these below:

Castle Brands	Ford Motor Co	Allis Chalmers
Citigroup	Levi Strauss Japan	Cincinnati Bell
Wendy's	Alcatel-Lucent	Office Depot
Adidas	Air France	Norsk Hydro ASA
Elan Corp	Lloyds Bank Group	Gulfstream
Smith & Wesson	Emerson Radio	Yucheng Technologies
Lucas Energy	Thomas Cook Group	JVC Kenwood
Gentium	Pacific Sunwear	DryShips Inc
Allianz SE	BNP Paribas	Roche Holding Ltd
Sprint Nextel	Cleveland Biolabs	Keryx Biopharm.
Hecla Mining	Syntroleum Corp	Conexant Systems
Mattson Technology	Eastman Kodak	Antigenics Inc

George Forman Enterprises is an OTCBB penny stock, as are Vonage Holdings and Immunosyn. George Forman gave investors 1,100% in the 12 months ending August 2010. Vonage gained 366% in that time, and Immunosyn gained 1,421%.

Why are such large profits possible?

The historic returns of microcaps tower over their nearest competitor. And an analysis of the most complete repository of fundamental and technical stock data in the world – the Standard & Poor's database, proves it. That database was locked to the world until investment fund manager James O'Shaughnessy was granted access for his book, *What Works on Wall Street*, published several years ago.

The book concludes that, based on data from 1952 to 1994, "Almost all of the superior returns offered by small stocks come from micro-cap stocks with market capitalizations below \$25 million."

In fact, there was a difference of +20.4% versus +12.8% compound annual return from 1952 to 1994. That means \$10,000 invested in micro-cap stocks would have turned into \$29 million with your gains reinvested! While the same \$10,000 invested in the S&P 500 would have only increased to \$1,000,000!

A 2007 study by Qianqiu Liu and Liang Zhang of the Department of Financial Economics and Institutions at the University of Hawaii concluded that **penny stocks are more likely to be under-valued, and therefore to hide more investment opportunities**. They also conclude that **equally weighted average portfolio return of all penny stocks is significantly higher than that of non-penny stocks**.

In order to establish benchmark returns for under-\$5.00 and over-\$5.00 stocks, the researchers analyzed all U.S.-traded common stocks from July 1963 to December 2005. Of the many thousands of stocks in their study, 16.5% were classified as penny stocks.

Their findings were unequivocal. For the 42 years of the study, across all industries and all market conditions, the penny stock portfolio returned an average of 2.09% per month, compared to 0.93% per month for the non-penny stocks. In other words, penny stocks returned more than double – 124% -- the returns of non-penny stocks.

The results are significant. Keep in mind that the researchers included every penny stock trading over those 42 years – the good, the bad, and the ugly. And despite penny stocks' reputation for enormous risk, the **aggregate microcap stock returns were 2.09% per month, or 25.08% per year**.

2. Choose Carefully: Not *Every* Penny Stock is a Good Buy.

A separate study published in July 2010 and conducted by John Nofsinger of Washington State University and Abhishek Varma of Illinois State University concludes from an examination of 65,591 brokerage accounts from 1991 to 1996 that the majority of penny stock trades lose money.

Let that sink in a moment. The previously mentioned study found that stocks under \$5.00 outperform stocks over \$5.00 by 124%. Yet most penny stock trades produce losses.

That is not an indictment of penny stocks. It is an indictment of penny stock investors. Stocks under \$5.00 are performing. But investors aren't.

There are a number of reasons for this. In particular:

- Stocks under \$5.00 seldom enjoy analyst coverage, making it hard to find professional-grade details and recommendations on microcaps.
- Most stocks under \$5.00 are thinly traded, which means one or several traders can cause violent price swings. Plenty of penny stock traders bet on these swings, looking for a super-quick payday. But that's gambling, not investing, and you're as likely to lose as to win in those trades. Remember that you're an investor looking for big profits, not a trader looking for a quick win.
- Low trading volume can also result in a wide buy-ask spread. If you do not check the bid-ask before buying you could end up paying too much. Likewise, when you want to sell, you may find that no one is willing to buy your shares at a price you consider reasonable.

In the example below, you see that the bid price for this stock, Bohai Pharmaceuticals, is \$1.27 and the ask price is \$1.45. Thus the spread is .18. While 18 cents may not sound like a lot, it means you would have to pay the market maker a 15% premium to get your hands on the stock.

If you needed to turn around and sell your stock, the market maker would only give you \$1.27 for the stock you just paid \$1.45 to get!

Real-Time Inside Quote				Real-Time Level 2 Montage			
Best Bid	Best Ask	Time of Last Inside Change		Last Sale	1.50	Prev Close	1.26
1.27 (500 shares)	1.45 (500 shares)	10:00:55 AM		Change	+0.24	% Change	+19.05
				Daily High	1.50	Daily Low	1.45
				Volume	3,000	Last Trade	10:00 AM
MMID	Bid Price	Shares	Date/Time	MMID	Ask Price	Shares	Date/Time
NITE	1.27	500	10:00:55 AM	NITE	1.45	500	10:29:06 AM
CHDN	1.00	5,000	Aug 18, 2010	MERQ	1.50	500	10:00:55 AM
DOMS	0.51	2,500	Aug 18, 2010	CHDN	1.80	500	Aug 18, 2010

If you spent \$1,000 to get 690 shares at \$1.45, then sold them back at \$1.27, you would lose about \$125, or 12.4% of your money!

Active penny stocks will have much lower spreads, but it's common to also see spreads of 30-50%. Of course, that doesn't mean you need to stay away from stocks with wide spreads. But consider whether you might need your money in a hurry, or if you're sure enough in the stock's prospects that you can afford to hold on till investors are willing to buy your shares at a large premium!

3. Look for Beaten Down Companies on the Comeback Trail

One university study found that investing in distressed stocks resulted in a 28% increased return over market within a 30-day period.

The bad news for investors is that markets have lashed out a beating over the last decade. The good news is that great companies can be bought for a song. Citigroup fell to \$1.03 in 2009. Ford hit \$1.43 in late 2008. Bank of America bottomed at \$3.79. Lloyds TSB Group, with a market cap of nearly \$73 billion, plunged to \$2.44.

If you've seen my track record you know that these are some of my favorite kinds of stocks. Ford, Motorola, Bank of America, Tyson Foods, US Energy, and Citigroup have all been recommendations over the past 18 months (through September 2010).

And there are plenty more where they came from. From automotive and financials to telecom and construction, the markets are littered with stocks that washed ashore after the financial tsunami of 2007.

Of course, some were beat up for good reason, and they may never make it back. Others are already recovering. Do your homework and you'll find some brilliant buys! (Or, subscribe to *The Cheap Investor* and let me do the work for you!)

4. Future Leaders: Trust Your Instincts and Hold on Tight!

From early 2008 to September 2010 the tiny development stage biotech, BioTime Inc, returned 1,559% to investors. Even though the company's net losses for the six months ending June 30, 2010 were three times revenues and return on equity is negative 42.33. Furthermore, their cellular aging research is still very early-stage.

So why are investors so interested? Because the research is promising, the management seems sound, the company has received several large research grants, and if all falls into place, investors could be looking at a huge payday a year or more down the road.

Back in 1997 BioTime's stock hit a high of \$24.65. Investors who get in now could see profits of nearly 500% if they get in now. But think of the profits for investors who bought in 2008: They could be looking at a 7,587% payday!

Compare that to the meager profits of penny stock traders who go for the quick hits on stocks they find being talked up on message boards or momentum lists. That's nothing more than a pyramid scam with each trader hoping he can grab profits before other traders start taking theirs. And once those stocks start to fall, look out below!

Plus every microcap has a chance at being bought out. In fact, even the most immature companies often get bought out, rewarding investors with huge premiums. Astute investors can catch big gains by choosing the right stocks and watching carefully:

- Angiosyn, a microcap biotech with two employees and one experimental drug that had only been tested in mice. In 2005 Pfizer bought the company for half a billion dollars. Or Esperion Therapeutics, a biotech with no approved drugs yet that Pfizer bought for \$1.3 billion.
- On August 22, 2005 PPCO announced positive clinical results for their new drug in development. The stock shot up 29% in one day. By October 3 PPCO was up a staggering 62% since their press release only six weeks earlier. During that same six weeks the Dow lost 1%.
- In the first week of January 2006, shares of Nuvelo surged 60% after the small biotech announced a partnership with Bayer for its lead drug candidate, alfimeprase. The same week, Alkermes shares jumped 20% on heavy trading volume in reaction to a positive letter from the U.S. Food and Drug Administration on their alcoholism treatment, Vivitrol.
- Angiosyn operates on a modest budget by outsourcing its experimental treatment for blindness to outside contract companies. With just two employees, Angiosyn's "virtual" business advanced sufficiently enough to be bought in January 2005 by Pfizer for over \$500 million.
- Pfizer also purchased Esperion Therapeutics, a startup working on treatments for high cholesterol, for \$1.2 billion.
- BioDisplay Laboratories, founded in 1998, was sold to Abbot Labs only three years later for \$7 million. Not bad for three years work by a University of Illinois professor and his grad students!

Biotech, alternative energy, and natural resources stocks are some of the best places to look for future leaders. When success comes, it tends to do so in huge multiples. A breakthrough drug, an innovative technology, or a rich mining discovery have made millionaires of plenty of investors before you – and they'll be making plenty more millionaires in the months and years to come.

5. Never Discount the Power of News and Attention

It is well documented that trading activity increases on days when a company is in the news. Most interestingly, it doesn't seem to matter if news is positive or negative: Stock price jumps. Attention of any sort attracts investors.

Human nature is complex and sometimes hard to understand. Some celebrities, for instance, prove over and over to be untrustworthy and morally bankrupt individuals. Yet fans continue to adore them, and even exhibit hysteria in their presence.

Companies know this human quirk, and they seek to exploit it. "Spin doctors" are hired to twist public opinion back to positive after damaging events like the BP or Exxon Valdez oil spills.

Does that mean an honorable investor ignores profit opportunities created by “spin”? No! Of course, you don’t want to invest in a company you can’t morally support, but other than that, let your profit-seeking skills be your guide.

Penny stocks are famously short on news distribution. Unless they’re being touted by a promoter. After 30+ years of penny stock investing, I’ve learned that there are three reasons a stock may be promoted:

1. An “interested shareholder” pays for promotion, maybe even without a company’s management knowing anything about it. That shareholder may have a large position he can’t unload because the stock is so thinly traded. His goal, then, is to increase volume enough to divest his holdings. Occasionally, the “interested shareholder” is scrupulous and so sells small quantities into rising price and volume so that no investor gets hurt. Unfortunately, it is more often the case that they don’t give a darn what happens to other investors.
2. “Pump and dump” artists find a cheap, thinly traded stock in a hot sector, then plan a promotional campaign. Just before the “pump” starts, these unscrupulous individuals begin buying the stock. You’ll see that in the one or two weeks prior to the pump, trading volume and price both rise gradually, but significantly. Then, once the pump is on, when the stock price gets high enough, they dump their shares and the price plummets lower even than before they started their evil work.
3. Company management determines that the only way they can get the attention of investors is to go directly to each of them, individually. They use traditional investor relations and article-writing techniques to tell their story in the most interesting way possible, knowing the difficulty of holding anyone’s attention amid the “noise” of media coming from all directions.

Also as a result of my 30+ years of investing in penny stocks, I’ve learned to tell which stock promotions are legitimate and which are not. Ultra Petroleum was a penny stock when it started promoting its strengths and accomplishments in the last decade. In 2008 the stock hit \$99.69. Right now there are several other stocks with terrific technologies and properties that are striving for attention, and getting some through news releases and email campaigns to investors.

Many of these companies want to bypass the financial press because the media invariably believes that penny stock companies are guilty until proven innocent. By some counts there are over 20,000 penny stocks. A handful of those are tainted by corrupt pump and dumpers. Yet parties ranging from the SEC to the financial press try to paint all penny stocks with the same brush.

It’s a tough task for these small companies to get noticed. And while I try not to ever fall victim to a pump and dump scam, I occasionally recommend promoted companies if I believe they are sound, and merely trying to reach investors with their stories rather than profit from investors.

I suggest you do the same. Learn the difference between pump and dumpers and legitimate investor relations efforts. Stay far, far away from the former, because you will lose your money sure as Sunday.

The Final Word

Penny stocks give you the best chance to do what all the experts say to do: buy low and sell high. They're different than other stocks, though. They may have no earnings. They may not even have any products on the market – yet. They may be beaten down and given up for dead. Some of them are. But others are ready to get up, brush themselves off, and get back in the game.

Penny stocks give you the chance to share the biggest American Dream of all; the dream of building something of lasting value and getting rich in the process. You don't have to be an entrepreneur or a CEO. You just have to be a wise penny stock investor.

Here's to your successful investing!

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