PENNY STOCK MILLIONAIRE

How to turn $5,874 into $298,291 in 12 months

MATT BRYANT
# Table of Contents

Copyright and Disclaimer............................................................................................................. 1

Introduction.................................................................................................................................. 2

Introduction to Penny Stocks........................................................................................................ 3
What Are Penny Stocks?
Penny Stock Basics
Why Trade Penny Stocks
Differences between Large Stocks and Penny Stocks
Trading v Investing

Market Terminology..................................................................................................................... 8

Rules and Trading Psychology – The Most Important Lessons................................. 15
9 Important Rules Every Trader Must Abide By
Give Your Ego the Day Off
Hard Work
Losses are NOT Good
Do Not Panic
Revenge is a Dish Best Served Cold

Technical Analysis....................................................................................................................... 25
Candlestick Charts
Moving Averages
Price Action

Advanced Strategies for Massive Profits.................................................................................... 33
Breakouts
Playing the Gaps
Playing what is Hot
Chat Rooms and Trade Alert Websites
Trading the News
Bounce Plays

Epilogue........................................................................................................................................ 79
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Introduction

Welcome to the complete manual on penny stock trading. Many of my trading colleagues have asked me why I am giving this book away for free. They tell me that I could command good money for the content contained in this book. However I have published this book to provide the education and resources that will help people learn to trade profitably, for free, while others continue to charge a lot of money for a rehash of crap. Why? I hear you ask, well... read on.

The goal of this book is to supply both the novice and experienced trader with all the information he or she will need to become a successful penny stock trader. This book details simple, yet powerful strategies that will make you bigger and more consistent profits than you ever imagined. While this book is written specifically for trading Penny Stocks, many of the principles contained in this book apply to all stocks and other forms of trading.

While this book is intended for all traders, and covers some of the basic concepts of trading, it will not cover all of the basics that one must become familiar with before embarking on their trading career. It will cover some basic and important terminology; however a trader just starting out is encouraged to further educate themselves on the absolute basics of trading. Some great reference websites for this purpose are contained at the end of this book.

In this book you will be presented with information on Penny Stocks that you have probably never heard or thought about. You will learn the trading techniques that have worked successfully for me for many years and I hope for you to continue learning my strategies and following me through my website.

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Introduction to Penny Stocks

What Are Penny Stocks?

While there is no official definition of a penny stock, they are generally thought of as stocks priced under $5. Many people have their own definition of a penny stock, such as those stocks that trade on the Over-the-Counter Bulletin Board (OTCBB), stocks with a share price of under $5, or some even define penny stocks by their market capitalization.

Using my own personal definition and trading preferences, penny stocks roughly include all stocks under $10, on all exchanges, of all sizes by market capitalization, but importantly, this is not a hard and fast rule. Many of the principles contained in this book also apply to larger stocks.

There are two different types of penny stocks. Those established companies that have mature business operations, and are listed on a large exchange (usually NYSE or NASDAQ).

The second type of penny stock is a company that is listed on the AMEX, OTCBB or Pink Sheets, usually a growth oriented company in its start-up or early growth stage. Many of these companies first list on a smaller exchange because of the lower barriers to entry and costs involved, however many ultimately graduate to a more senior exchange.

Trading the two different kinds of companies is similar from a technical perspective, although how you interpret things such as press releases, earnings and the analysis of financial statements may be quite different and can sometimes be difficult.

In the following sections you will gain valuable insight into:

- The basics of penny stocks
- Volatility of penny stocks – are they really that unpredictable?
- Why trading penny stocks can be infinitely more profitable than investing in large cap stocks
- What influences the price movements in penny stocks
- How to avoid wealth destruction
- How to profit from “undiscovered” penny stocks
- The difference between penny stocks and large stocks that the professionals trade
**Penny Stock Basics**

I want you to forget everything you have ever read about penny stocks. I will debunk the myths about penny stocks and expose them for what they really are. Read on.

Penny Stocks can be volatile and generally thought of as highly unpredictable and risky. After reading this book, you will see that **penny stocks are actually highly predictable and less risky** than larger stocks and other instruments traded by the big guys on Wall Street.

Because of the more speculative nature of penny stocks, their lower price, and more relaxed reporting requirements of the exchanges they are listed on, **big Wall Street players such as Banks and Institutions do not generally trade or invest in them.**

My timeframe for trading penny stocks is usually 1-3 days, but can vary from a few minutes to a few weeks, depending on the circumstances.

**Why Trade Penny Stocks?**

Penny stocks can be volatile in terms of their price movement, they can go (up or down) double or triple digit percentages in a day or less, but contrary to most people’s beliefs, **these movements are often very predictable.**

You see, large stocks are traded mainly by big players on Wall Street such as Banks and Institutions. These players have significant resources at their disposal, use algorithmic trading methods, employ advanced trading techniques and often have access to news and information well before the small retail trader. Therefore, in reality, **large stocks are often manipulated as much as, if not more than, penny stocks.**

**Now pay attention.** The traditional rules of trading contained in many other educational resources no longer apply. **Penny stocks have their own sets of rules.** With penny stocks we are no longer competing with big Wall Street players that can and do use manipulative techniques to profit. **With penny stocks we are competing against much less sophisticated and intelligent players with fewer resources, giving us a significantly better opportunity to compete and profit.**
## Differences between Large Stocks and Penny Stocks

There are many differences between penny stocks and larger stocks, which are traditionally thought of as safer investments, such as Apple, IBM and Google (usually listed on the NYSE and NASDAQ). Some of these differences are summarized below:

<table>
<thead>
<tr>
<th></th>
<th>Penny Stocks</th>
<th>Large Stocks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Share price</strong></td>
<td>Supply and demand influenced mainly by news, PR and speculation.</td>
<td>Influenced by supply and demand relating to corporate events, company fundamentals and technical analysis.</td>
</tr>
<tr>
<td><strong>Speculation</strong></td>
<td>Highly speculative. Most penny stocks cannot be valued by traditional fundamental analysis because their business is in start-up or growth stage.</td>
<td>Little or no speculative value. Information is readily available to the public and is usually priced into the stock.</td>
</tr>
<tr>
<td><strong>Value and Predictability</strong></td>
<td>Hard to measure current value, but future value is perceived. Penny stocks are often thought of as unpredictable.</td>
<td>Value is usually easily calculated and built in to the share price. Price movements are generally much less volatile and therefore more predictable.</td>
</tr>
<tr>
<td><strong>Information Availability</strong></td>
<td>Less onerous reporting requirements. No analysts.</td>
<td>Strict reporting requirements. All currently known information available to the public. Many Wall Street analysts covering these stocks.</td>
</tr>
<tr>
<td><strong>Technical Analysis</strong></td>
<td>More emphasis placed on technical analysis than fundamental analysis.</td>
<td>Technical analysis is used by major players such as Banks and Institutions.</td>
</tr>
<tr>
<td><strong>Volatility</strong></td>
<td>Often more volatile because of knowing the true value of the company is not readily known.</td>
<td>Less volatile. Company value can easily be calculated.</td>
</tr>
<tr>
<td><strong>Spread</strong></td>
<td>Usually greater because of the greater risk market makers assume as well as less traders buying and selling.</td>
<td>Very little spread between the bid (best buy price) and ask (best sell price) due to greater number of traders and less risk for market makers.</td>
</tr>
<tr>
<td>Risk / Reward Ratio</td>
<td>Generally thought of as riskier, with much greater reward potential.</td>
<td>Generally thought of as less risk with less reward.</td>
</tr>
<tr>
<td>---------------------</td>
<td>--------------------------------------------------------------------</td>
<td>-----------------------------------------------------</td>
</tr>
<tr>
<td>Fundamentals</td>
<td>Little or no revenue. Company in start-up or growth stage. Less financial disclosure.</td>
<td>Usually have stable revenue streams with well-known business operations. Audited financial information that is easily accessible to the public.</td>
</tr>
</tbody>
</table>

**Exchanges and Regulation**

Given our definition in our introduction, penny stocks can be listed on all exchanges. However the majority of the penny stocks we discuss in this book are traded on the OTCBB, Pink Sheets, AMEX, and NASDAQ small cap market. Very few, if any, trade on the NYSE.

The reason why many penny stocks trade on the OTCBB and Pink Sheets is because there are less regulatory requirements to comply with. This is an important consideration for a small company as it is too costly to comply with the requirements of the larger, more reputable exchanges such as the NYSE.

Another important point to note is that the Securities and Exchange Commission (SEC), the governing body of the financial industry, tends to focus much less on companies listed on the OTCBB and Pink Sheets. The main reason is because of the relative low number of investors in OTCBB and Pink Sheet companies and the SEC’s lack of resources to pay attention to everything.

**Brokerages**

The majority of online discount brokerages allow trading of penny stocks, although some do not allow trading of stocks on the OTCBB and Pink Sheets. Some brokers do not allow the short selling of stocks trading under a certain dollar amount. For my strategies to work most effectively, it is important that you find a broker that allows trading stocks on all exchanges. I personally use and recommend [Interactive Brokers](https://www.interactivestockbroker.com), which allows all of the above; however you need to deposit a minimum of $10,000. Other brokers I recommend are [Think or Swim](https://www.thinkorswim.com), [TD Ameritrade](https://www.tdameritrade.com), and [e-trade](https://www.etrade.com). However there are many others you may wish to research.
Trading v Investing

As previously touched upon, this book is more geared to trading, not so much investing. The scope of this book is to educate people on effective strategies to profit in the short and medium term by buying penny stocks, however many of the principles taught may apply to all stocks and as well as other investments.

There are variations to the kinds of trading that people participate in, such as scalping, day trading and swing trading. I will not distinguish between them, however suffice to say that my definition of trading is the “buying and selling of a stock with the intention to profit from predictable price movements”. The time frame does not really matter to me. I will enter and exit a position in a stock within minutes or days, even weeks, depending on how the stock is acting. My strategy usually dictates that I hold my trades for 1-3 days, or up to several weeks, in order to capture the biggest price movements.

Investing on the other hand usually involves buying a stock and holding it with the hope that the stock will rise over the long term, and/or pay regular dividends. It usually involves some fundamental analysis of the company, its industry etc. Buy and hold investing is by far the most popular form of investing. Investing usually ignores temporary price fluctuations because the belief is that the stock price will increase over the long run.

Trading using my strategies does not involve a crystal ball or require you to predict the top and bottom of a stock’s price. It requires you to react to a stock’s price movement, rather than try to predict a stock’s price movement. Nobody can or ever has been able to accurately and consistently predict stock prices over the long run.

I will never let a trade turn into an investment. People often do this when a trade goes the wrong way on them, and they decide to hold it for the long term thinking the stock price will recover. For someone using 20% of their capital for each trade, it will only take five trades for them to tie up all of their trading capital and no longer be able to trade without using leverage.
Market Terminology

I will not touch upon the terminology used in trading and the stock market in general. However I will explain a few commonly used terms that are relevant to penny stock trading and to my strategies.

Stock (or Share)

A stock, or share as it is often called, is a piece of paper (or digital record) that signifies ownership in a company and represents a claim on part of the corporation’s assets and earnings.

Stock is originally offered to investors by the company at a certain price. This is usually called an Initial Public Offering (IPO). Once the IPO has been completed, the Stock price is purely a function of supply and demand of traders and investors participating in the market. Therefore the stock price fluctuates depending on the price buyers are willing to pay and sellers are willing to sell at.

These price expectations change depending on company / industry news, earnings etc. This means that prices move up and down based on people’s changing expectations. For a stock that is listed on an exchange and is available to be traded by the public, its price is always a function of supply and demand.

Fundamental Analysis

This is the analysis of a company’s business. This includes everything from the company’s personnel, financial statements, revenue streams, business plans, marketing plans, capital structure, industry and macro-economic factors etc. From this analysis an individual makes a conclusion as to an appropriate valuation of the company. There are many formulas and ratios available to make comparisons between companies and industries.

From this valuation, an investor will make a determination as to whether the company is undervalued or overvalued, and will make an investment decision accordingly.

Fundamental analysis is rarely used in short term trading, except for where there such information is likely to affect the share price during the period the trade is held. An example would be that a trader is unlikely to trade XYZ stock if it is known that their earnings are about to be released to the public and little is known about whether the earnings are likely to be strong or weak. Similarly, a trader would look at the company fundamentals to determine whether a new contract announced by a company will have a material impact on that company, and therefore assess the relationship between the current share price and the company fundamentals going forward with the new contract in place.
1. Capitalization

Capitalization, or market cap, is the total dollar value of all of a company’s outstanding shares. It is calculated by multiplying all of the company’s outstanding shares by the current market price of one share.

For example, a company with 25,000,000 shares outstanding and a share price of $1.50 per share has a market capitalization of $37,500,000.

i. Nano Cap
   A company with a market capitalization of under $50m

ii. Micro Cap
    Generally known as a company with a market cap of between $50m and $200m.

iii. Small Cap
     Generally referred to as companies with a market cap of between $200m and $2b.

iv. Mid Cap
    Generally referred to as companies with a market cap of between $2b and $10b.

v. Large Cap
    Generally referred to as companies with a market cap greater than $10b.

Penny stocks are usually in the nano or micro-cap categories, but can include some small cap companies.

2. Earnings per Share

Earnings per Share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability and is calculated using the following formula:

\[
\frac{\text{Net Income} - \text{Dividends on Preferred Stock}}{\text{Average Outstanding Shares}}
\]

Largely irrelevant for most penny stocks because most of these companies are in start-up or growth stages.
3. **Price-Earnings Ratio**

The price-earnings ratio (P/E ratio) is a valuation ratio of a company's current share price compared to its per-share earnings, and is calculated using the following formula:

\[
\frac{\text{Market Value per Share}}{\text{Earnings per Share (EPS)}}
\]

In general, a high P/E ratio suggests investors are expecting higher earnings growth in the future compared to companies with a low P/E ratio. The P/E ratio can be used to compare companies within the same industry to determine the company’s value, or how cheap or expensive one company is compared to another. Again this metric is largely irrelevant for penny stocks for the same reason listed above.

4. **Revenue**

The amount of money that a company actually receives during a specific period, including discounts and deductions for returned merchandise. It is the "top line" or "gross income" figure from which costs are subtracted to determine net income.

5. **Income Statement**

A financial statement that measures a company's financial performance over a specific accounting period. Financial performance is assessed by giving a summary of how the business incurs its revenues and expenses through both operating and non-operating activities. It also shows the net profit or loss incurred over a specific accounting period, typically over a fiscal quarter or year.

6. **Balance Sheet**

A financial statement that summarizes a company's assets, liabilities and shareholders' equity at a specific point in time. These three balance sheet segments give investors an idea as to what the company owns and owes, as well as the amount invested by the shareholders. The balance sheet must follow the following formula;

\[
\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}
\]
7. **Cash Flow Statement**

The document provides aggregate data regarding all cash inflows a company receives from both its ongoing operations and external investment sources, as well as all cash outflows that pay for business activities and investments during a given period. It shows us how they received cash in, and how they used their cash.

**Technical Analysis**

The evaluation of a company’s stock by analyzing information generated by market activity such as price action and volume. Technical analysis does not contemplate a company’s fundamentals and ignores a company’s value; instead it uses charts and other tools to identify patterns that can suggest future activity. Technical analysis is predominantly used by traders and rarely used by investors because investing assumes a longer time horizon, and short and medium term price movements are not as relevant.

Important technical analysis terms that I will use in this book include, but not limited to;

1. **Moving Averages**
   The average price of a stock over various time periods. Technical analysts use both short and longer term time periods, such as 13 day, 50 day and 200 day moving averages. Also, moving averages can be simple or exponential. Short term averages respond quickly to changes in price, where longer term averages respond slower.

2. **Resistance**
   The price of a stock at which sellers are more prominent than buyers and therefore the stock does not rise past this point. Resistance can be at any level for a given stock, and there can be resistance through multiple time frames, from intraday to 5 years.

3. **Support**
   The opposite of resistance. The support is the price at which buyers are more prominent that sellers and therefore the stock does not drop below this point. Support can be at any level for a given stock, and there can be support through multiple time frames, from intraday to 5 years.
4. **Breakout**

A breakout is where a stock rises above an identified area of resistance. Once resistance level has broken, as it has when there is a breakout, it is regarded as a new level of support (the opposite of resistance), when the stock experiences a pull back after breaking out. Remember the phrase **former resistance becomes the new support.**

5. **Breakdown**

The opposite of a breakout. The stock falls through an identified area of support. Once support has been broken, it is regarded as the new level of resistance. Remember the phrase **former support becomes the new resistance.**

6. **Price Action**

Price action is encompassed in technical and chart pattern analysis, which attempt to find order in the sometimes seemingly random movement of price. Swings (high and low), tests of resistance and consolidation are some examples of price action.

Price action is discussed further in Part Six – Technical Analysis. It is a very important concept that is the cornerstone of trading.

7. **Volume**

The number of shares or contracts traded in a security or an entire market during a given period of time. It is simply the amount of shares that trade hands from sellers to buyers as a measure of activity. If a buyer of a stock purchases 100 shares from a seller, then the volume for that period increases by 100 shares based on that transaction.

Volume is an important indicator in technical analysis as it is used to measure the worth of the movement in a stock. If a stock has made a strong price move either up or down, the perceived strength of that move depends on the volume for that period.

There are many other technical analysis tools available such as Fibonacci, Bollinger Bands, Elliot Wave Theory, Relative Strength Index etc, however none of them are especially useful for penny stocks, and they are particularly dangerous for those that do not understand them and misuse them. While I have an understanding of many of these advanced technical analysis tools, my strategies only use the most basic of technical analysis such as those described above.
Charts

There are many types of charts available to a trader such as line charts, bar charts, area charts and candlestick charts. By far and away the most popular of these is the candlestick chart. My strategies require the use of candlestick charts. If you do not understand how to interpret candlestick charts, there are many free resources available on the internet. I will provide some basic information on these charts however.

General Trading Terms

1. Short Selling (or Shorting)

   The selling of a security that the seller does not own. Short sellers assume that they will be able to buy the stock at a lower amount than the price at which they sold short.

   Short sellers therefore make money if the share price goes down. It is the opposite of “going long”, where you buy shares with the intent of selling it at a higher price.

2. Buy to Cover (or Short Covering)

   A buy order made on a stock that closes out an existing short position. A short sale involves selling shares of a company that one does not own, as the shares are borrowed and need to be repaid at some point. This order, by buying an equal number of shares as were borrowed, "covers" the sale and the shares can be returned to the original lender of them. The lender will typically be the investor’s own broker/dealer but their broker may have had to borrow the shares from a third party.

   For the investor who has bet on a stock price going down, the hope is to be able to buy the shares back at a lower price than the original short was executed at. There is no timetable for the short investor to follow, so they can wait as long as they wish to repurchase the shares. However, if the stock begins to rise above the price the shares were shorted at, the investor’s broker may require them to execute a buy to cover order as part of a margin call.

3. Level 2 / Level II

   Level II is essentially the order book for stocks. When orders are placed, they are placed through many different market makers and other market participants. Level II will show you a ranked list of the best bid and ask prices from each of these participants, giving you detailed insight into the price action. It can therefore essentially tell you who is buying or selling and at what price.
4. **Time & Sales**

Time and sales (also known as the tape) is information that is used by traders to watch the current price movements at its most detailed level. Time and sales shows each individual trade as it occurs, and is usually displayed as a scrolling list.

The time and sales shows the exact price that each trade occurs at, and also whether the trade occurred at the bid (market selling price) or ask (market buying price). The time and sales also shows the amount of volume that each trade includes (the number of shares that were traded).

5. **Market Maker**

A broker-dealer firm that accepts the risk of holding a certain number of shares of a particular security in order to facilitate trading in that security. Each market maker competes for customer order flow by displaying buy and sell quotations for a guaranteed number of shares. Once an order is received, the market maker immediately sells from its own inventory or seeks an offsetting order. This process takes place in mere seconds.

Market makers are essential in providing liquidity to the market, even though their primary objective is to profit just like an individual trader.

6. **Order Types**

   a. **Market Order**
   
   An order placed with a broker to buy or sell a set number of shares at the best available bid or ask price at the time. Market makers are required to accurately display what the best bid and ask price is at any given time. However because you are competing with others who may also want to pay market price, the price you are filled at may be much higher (or lower) than the price which is displayed.

   b. **Limit Order**
   
   An order placed with a brokerage to buy or sell a set number of shares at a specified price or better, unlike the market order, there is no guarantee that your order will be filled.

   c. **Stop Loss Order (or Stop)**
   
   An order placed with a broker to sell a security when it reaches a certain price. A stop-loss order is designed to limit an investor's loss on a security position. I do not use stops. I mentally calculate the stop price, and enter my order as a limit order.
Rules and Trading Psychology – THE Most Important Lessons You Will Ever Learn

I absolutely mean it. The lessons you will learn here are an absolute MUST.

Trading psychology encompasses various aspects, but it is the number one thing you need to master in order to trade successfully. Trading without a set of well defined rules and control of one’s self is stupid, irresponsible and simply dangerous, and is a sure fire way to destroy wealth. On the other hand, some well defined and understood rules, and mental control, can yield more profits than you ever imagine.

The only difference between a successful trader and a failed trader is not their technical knowledge or skills, but is their ability to master their emotions and strictly adhere to a good set of trading rules.

Please read and reread this entire section until you grasp these simple, yet powerful concepts.

9 Important Rules Every Trader Must Abide By

Having a set of rules and abide by them may seem obvious, and it is. But the simple truth is that most people force trades that do agree to their rules. In fact, most traders do not even have rules!

A few years ago Mark Crisp conducted a survey of 1,000 traders and found the following:

1) Over 84% of traders have never read a book on the stock market.
2) 76% do not have a set of rules (a system).
3) Over 80% do, or have, relied on their broker for advice.
4) Over 84% have, or do, trade on news stories.
5) 84% rely on technical analysis.
6) 89% have never shorted a stock.
7) 93% have, or do, use an advisory service.
8) 72% consider themselves short-term traders.
9) 68% consider themselves "good" traders.
10) 94% have never practiced money management simulations.
11) Over 73% admitted they were losing money trading their own accounts.

So then, what are the trading rules that one must learn in order to be a successful trader. Well, the answer will vary depending on the style of trading employed, your personality, availability to trade etc. All of the lessons in the book should be considered rules. Indeed, my personal trading rules are compiled from all of the lessons in this book. I have however outlined a few absolute fundamental rules below that I live by, and believe are the cornerstone to every successful trader.
**Rule #1 - Know thyself**

Every trader is different. Different personalities, trade in different environments, have different levels of education and have different goals. Therefore any one style or system of trading will not suit everyone. It is essential that you know your strengths and weaknesses, first of all, with your personality, and then as you gain more experience in trading, your technical strengths and weaknesses.

Therefore, every **successful trader must identify their strengths and weaknesses** and trade using a system that suits them, all the while constantly trying to improve themselves.

Finally, you probably will not know your strengths and weakness, or will not find a trading system that suits you, until you begin trading. That is why trading with a paper account, and then graduating to employing only small amounts of capital your trades, is paramount to success. You will quickly become accustomed to your idiosyncrasies.

**Rule #2 – Follow a system**

Every trader needs a system to follow. Whether it is trading penny stocks or scalping highly liquid large caps, a system allows you to automate the trading process. You see, trading is a mechanical process. A good system avoids the need to employ human emotion. The better the system you have, and the more closely you follow it, the better your chances in identifying and executing high probability trades.

I am not aware of any credible study that has proven one trading system to be more effective than another over the long term. Find a system that works for you and stick to it.

I and many others have profited handsomely by following the systems outlined in this book. If you are reading this book, I have to assume that you have not yet been able to find a system that suits you. But importantly, remember that it is the discipline to develop and stick to your trading rules that will dictate whether you succeed as a trader.

**Rule #3 – Embrace Boredom, Don’t Fight It**

Boredom leads to forced trades that do not adhere to any strategy or fit within any rules. Forcing a trade because of boredom, or a lack of ideal setups, is a psychological issue you MUST overcome. **Random trades are the surest way to destroy your account.**

I have been trading for over a decade, through many different trading environments. Believe me, there is ALWAYS another opportunity around the corner. I once did not make a trade for a whole week because of a lack of ideal setups and an overall choppy market that did not give me confidence to make
a trade. The wonderful thing was that I did not lose one penny, and coming out of this slump there were an abundance of opportunities. Too many to take advantage of in fact.

The market has and always will be an attraction to those with stars in their eyes. People will always be drawn to the market, which means that there is literally a revolving door in the world of trading. There always has been and there ALWAYS will be opportunities to profit so long as fear and greed remain part of our psyche.

**Rule #4 – Plan Your Entries and Exits Before Entering a Trade**

It is essential that you have a plan, albeit sometimes a rough one, of when you are going to enter a trade and exit a trade. Entry points are the easiest to plan for, because if you follow your strategy, price action will dictate your entry. For example, a swing trader might enter a trade when a stock has retraced and consolidated for several days after breaking out past its previous high, and is sitting just above its 50 day moving average. Here, the entry may be at a price at the higher end of the consolidation range in anticipation of it breaking out further.

The exit is a little more difficult to plan for, however it could be based on a dollar amount, percentage amount, or at a point within technical indicators on a six month chart, of course always taking into account the actual price action of the stock.

Conversely, but as important, is planning an exit should the stock not perform to your expectations. I call this a “contingency” exit, or “plan B”. In the above example, a good trader might plan to exit the trade should the stock fall below the 50 day moving average, fall below its previous high (which is now the stock’s level of support), or fall below a key price level, such as a round dollar amount (where many stop losses may be placed). Because the stock has already retraced and consolidated, this downwards movement could signify a pattern reversal, or breakdown.

Many traders use a risk/reward calculation, whereby the potential for reward may be four to five times their risk. Again using the above example, if you entered a trade at 5.35, above its moving average of 5.05 and its previous high of 5.15, you may plan to exit your trade when the stock hits 6.15, a 15% return, while limiting downside risk to $0.20, or 4% (at $5.15, the level at which the stock has a new level of support). Of course this is only guidance that is not set in stone. Price action of the stock trumps all, and is essential to follow.

Finally, if you ever find yourself loosening your stop loss in order to accommodate a trade that is not acting as expected, exit immediately. It means that your entry may have been a poor one, or the stock is not acting as expected. Learn from this to ensure your entry is more precise.
Rule #5 – Patience, Patience, Patience
Patience is always a virtue, particularly for a trader. This rule ties in to rule #3 above – embracing boredom.

It is important that you have the patience to wait for ideal setups. When you enter a trade that is setup ideally, be patient with it – give it time to insulate itself from random noise and to play out as anticipated. Give it time for others to see the merit of what you saw earlier; but be enormously impatient with losing trades. Small losses are the best losses, and anything more has the potential to cripple our mental as well as financial capital. It is quite possible to make money trading if we are only "right" half of the time, as long as our losses are small and our profits are large.

If you missed a trade, wait for a pullback, and then a reformation of an ideal setup. Chasing a stock means you are not adhering to any rules or systems. Wait for the pullback and an equally ideal setup to the one you just missed. It is an entirely new trade now.

And remember, not having a position, is a position – usually a financial and mental capital protecting position.

Rule #6 – Do Not Diversify
Not only does it make it harder to make money when funds are employed across a number of trades, it also makes it riskier because you cannot pay attention, and respect, to that stock in which you have a position.

I only trade two or three stocks maximum at any given time. I prefer only one trade at a time. I watch the price action of most stocks I trade like a hawk, with my hand on the mouse ready to sell or cover at any moment throughout the trading day. Price movement can change or even reverse on a dime for any number of reasons; therefore it is important that you truly focus on each and every trade. You cannot intimately follow a stock when you have a half a dozen positions or more.

Furthermore, it is unlikely that there are any more than a few stocks that have an ideal setup at any given time. Therefore, if you are sticking to your rules, and only entering a trade that has an ideal setup, overtrading should not be an issue.

Rule #7 – KISS
Keep it Simple Stupid; A beautiful old adage that I apply to many aspects of my life. In trading, it is especially important to keep everything simple, from your technical analysis, to the information you use, even your trading setup at home. All too often I see novice traders with three or more trading screens, subscribing to a variety of trading services and charting packages, using algorithmic filters they do not fully understand. This is counter-productive, and distracts you from what you really need to focus on.
While many people attempt to use all kinds of sophisticated technical analysis, such as Elliot Wave, Bollinger Bands and MACD, I stick to the basics (as previously mentioned). This has worked for me successfully for many years. In my opinion, the majority of the people who use advanced technical analysis do not fully understand it, nor do they understand how other people use it, thereby limiting its effectiveness – remembering that technical analysis is a self fulfilling prophecy. The more people believe and act on something in the same manner, the more it is likely to happen. Thereby if we stick to simple analysis that the majority understand and use, the more effective it is likely to be.

Do not unnecessarily complicate your physical trading environment, your stock screeners, charting software, or use of multiple trading systems and internet forums. Find something and stick to it. Everything else just creates noise and distracts you.

**Rule #8 – Markets (and Stocks) are irrational**

Forget what the academics say about the markets being efficient. In the short term at least (which is a traders timeframe), they are not. The market can be completely irrational, as it was in 1999 during the “Tech Bubble” or in March 2009 during the global financial crises, and at many times in between.

Individual stocks can behave even more irrationally. Stocks can go parabolic on some “fluff” news. Or they can drop 80%-90% in a day on bad, but not existence threatening, news.

My point here is that where there is a strong movement either way. Don’t try to be a hero and jump in front of it. Many people say “the trend is your friend”. I disagree to an extent, however you certainly do not want to fight the trend because “you think that the stock has to go lower (or higher)”. Again, the market is always right, you are not. If you try to fight the trend, because “you know better”, you are destined for failure.

In essence, it makes no difference to me whether the stock is going higher or lower in an irrational manner. I profit on buying and short selling at key inflection points from watching closely the price action. If the stock breaks out and breaks down irrationally, I will be there to profit, using the strategies and rules outlined in this book.

Because of how I trade, stocks are never too high to buy, or never too low to sell. Every time I think to myself, “surely that can’t go any lower” (which can prevent me from executing a short sell with a great set up), it indeed goes lower. The same happens on the upside.

Knowing the market and individual stocks act irrationally, and training yourself mentally to work within this parameter, will make you an infinitely better, and less risky, trader.
Rule #9 – Money Management

Without trading capital, there is no trading. Protection of your money is the most important aspect to trading. By learning how to trade, how much funds to employ, how and when to take losses (and gains), you will protect yourself from horrendous losses that will take you out of the game, permanently.

There are several money management rules here that I adhere:

1. Limit the use of leverage – I do not trade Futures or Forex, so I have little need to use leverage in my trading. I sometimes trade an option straight up, which is essentially using a form of leverage, but I rarely borrow money or use funds that are not my own. And I have never had my broker make a margin call on me.

2. Take Small Losses – I never let my losses exceed my predetermined limit going into the trade. This limit changes depending on the size of the trade and the particular stock etc. Having the discipline to admit you are wrong and to move on to another ideal setup is vitally important.

3. Have a maximum dollar position on any one trade – I usually enter a trade with 10-20% of my total capital, depending on the liquidity of the stock. Sometimes the stock is not liquid enough for me to do this. However I never use more than 30-40% of my capital for any one trade, no matter how perfect of a setup it may be. Remember, stocks act irrationally, and any piece of news that comes out, or message board chatter, could have dramatic effects on the stock price.

4. If you are a trader, never Invest for the long term – I do not have any side investments that I hold for the longer term. Because I am a successful trader, my returns far outweigh what I could achieve if I was a longer term investor. Having side investments only ties up capital and distracts you from your trading goals. All of my unemployed trading capital is held in interest bearing money market accounts with my broker.

5. Be sufficiently capitalized – Many of the students I have taught only have very small accounts, which is fine. They trade part time so they can build their account while earnings a salary or wage. After all, buy and hold investing has not served them well in the past. However if you wish to trade full-time, it really is important to have enough trading capital so that you are not burdened by the Pattern Day Trader rule, and so that you have enough “margin” to take advantage of the many short selling opportunities that you will be presented with. Of course the appropriate amount of capital will be different for everyone, as people have different expectations, living standards, commitments etc.
Give your Ego the Day Off

First of all, I have an ego, albeit a small one. I think you need to have an ego in order to be successful in life. I mean, it is only those with some arrogance (and ego) that have the confidence to take risks in order to better themselves, their business, or whatever they are involved in.

When it comes to trading, this ego should be tucked up in bed and given sleeping pills so it stays asleep well after you are up and begin trading. Ideally, it should stay in bed until 5pm, when it is safe for it to reunite with you. You see, the market is a massive sphere with which individuals participate all with the same goal, to make money. Stocks don’t move because somebody wants them to move. Stock’s movements are a function of supply and demand. The factors that affect supply and demand are many. Hope, pray and wish are not any of them.

Never, ever, think that you are right when a position is turning against you. Most traders rationalize their losses by telling themselves it was not their fault, while every gain was a result of their intelligence or superior abilities. Thinking that a position will turn around because you think it should is downright stupid. Unless you are a successful trader and your timing was off on your entry into the trade, and have the experience behind you to reassure yourself of this, then chances are you are wrong about your trade and it will continue to go against you.

Of course, the more experienced you are, and have built a track record of good trading performance, your confidence will grow. Once you have confidence, and stick to your trading rules, giving a trade some extra time to play out can be quite appropriate.

The easiest remedy to handle a trade that is going against you is to exit this trade immediately. Exiting a trade should be planned before you enter a trade, and by sticking to the rules detailed below, this should not be too much of a problem. Your overriding goal is always to stay in the game. You cannot take advantage of the opportunities that will always come your way if you have no trading capital.

And remember this. The market is the sum total of the wisdom, and the ignorance, of all of those who deal in it; and we dare not argue with the market's wisdom. If we learn nothing more than this we've learned much indeed.

Hard work

This seems like a rather basic concept, understood by most. Believe me, you are wrong. Most people listen to the BS about trading being fun, easy, portable etc and get sucked in, only to realize it is the EXACT opposite. I mean, it is fun when you’re making money, don’t get me wrong, but when you’re not, there isn’t anything less fun than trading.

The hard work comes mainly from the preparation and hours of concentration you need to commit. I spend around 2-3 hours preparing each night for the next trading day, and then start my trading at
around 6:30am, reading and often trading the news, in the pre-market. I then stay glued to my screen if I have a position, and end the day at around 6pm, after I have finished monitoring and trading the after-market session.

As I will discuss later in this book, preparation is easily the most important part of your day. Without identifying stocks that have high probability setups, and then anticipating entry and exits, you will simply be fishing when the market opens. Even worse, you will search for something that is not there, or perhaps open your ears to a chat room or message board for inspiration. Failure at this point is almost guaranteed.

**Losses are NOT good**

All of us from time to time have heard that you must lose before you can start to win, and that you learn a lot from your losses. It is inspirational when a successful athlete or businessman tells his or her story about their failures before their successes. It is true that you can learn from your losses, because it is only after a loss, usually a big loss that we stop, take deep breaths, analyze the cause and take steps to rectify.

The problem is that people inherently revert to what made them lose to begin with, repeatedly making the same mistakes time and time again. In fact, most people never knew the right way to begin with and therefore have nothing to look to for guidance or to benchmark against.

Even worse is that most people make the same mistakes over and over again, only deciding to change their ways or seek help once they have hit rock bottom. In trading, rock bottom means losing your trading capital, thereby putting you out of the game.

Further, losing in trading adversely affects your mindset. Your mental capital is eroded. Trading is all about confidence. You need to know that each trade you make has been carefully thought out, adheres to your rules and strategies, and will be successful. When you lose, you begin to question yourself, make poor decisions, and force trades. The last straw is when you begin revenge trading. Just like at a casino, you double down on the same stock with the same position, not recognizing you are making the same mistake, but with even more at risk.

If you learn to trade properly, using well defined rules and a proven successful strategy as outlined in this book, there is no need to lose. Of course you will lose some trades. Even the best traders in the world make losing trades. However, losing will be an exception to the rule. Your winners will be far and away exceed your losers, and it is only at this point where you can accurately reflect and analyze a loss.

Until then, you should avoid losses with real money. This may mean you paper trade, or trade with small amounts of money, until you have enough wins under your belt to convince yourself that your rules are worth following and that the trading strategy you have employed is successful, so that you gain confidence.
On the same token, a winning trade that is made by not following your rules is not really a win at all. It is luck. I recall a time that I chased a couple of trades on spiking Biotechnology companies and profited handsomely, completely ignoring my own rules and strategies. My ego got the better of me and I continued to ride my luck in this vein for on several trades over the course of a few weeks, and with my final trade I lost over $30,000. The net loss from these trades was around $6,000.

**Do not Panic**

Panic, I would suspect, is the leading cause of the major losses suffered by an inexperienced or undisciplined trader. It usually comes about when a position is turning against you.

I see many people taking unacceptable losses on positions they held too long, and then to compound the problem, exit the trade at the worst possible moment. This is particularly true of inexperienced short sellers. They enter a trade, its trades sideways (or at best, up and down in a choppy fashion). Convinced the stock is destined to fall, the trader holds their position. Suddenly, because of the price movement, experienced traders jumped in pushing the price higher. Momentum takes over and suddenly the stock is up double digits percentage points. Even worse, unexpected news hits the wires, putting further upward pressure on price. The trader, seeing substantial unrealized losses on his or her screen, finally folds and covers their position, through buying the stock back. Usually when the stock is in amidst a temporary spike.

**Good traders sell into such spikes; novices buy.**

Alternatively, those inexperienced traders who are long a position will see a stock capitulate. The trader, believing the stock will rebound, holds their position. After no such rebound, the trader then justifies their trade by calling it a longer term “investment”. That is, they think the stock cannot go much lower, and if they just hold on for a while, the stock will increase. The stock never returns to its previous price. The trader, frustrated and impatient, sells their position for a large realized loss.

So how do you overcome such situations? Well, the first thing is to make sure you stick to your trading rules (see above). Second, remember that the market is right, and you are wrong. If a stock is not performing exactly how you planned it, exit your position immediately (also see above).

And finally, but equally importantly, if you do find yourself in such a position, DO NOT PANIC. Always watch the price action carefully, intra-day, inter-day, or whatever your trading timeframe might be. All spikes (or plunges) have a moment of pause and retracement. They have to, because profitable traders are taking profits, thereby selling (or buying back) and putting downwards (or upwards) pressure on the stock. If the stock is like the majority of penny stocks, smart short sellers are then entering the trade as the momentum fades and price action is weakening (on a price spike), or buying back on a plunge. Wait for these moments to exit your losing trade.

If the spike in the stock is a result of news, always remember that almost all penny stocks are worthless dogs. Remember that almost all news is released in order to push up the price of the stock in order for
the company to meet listing requirements, for management to sell their shares, or to raise funds through a dilutive financing. Do your homework on all news that is released. Many times such news is old and is simply a re-release, and therefore any actual value to the company that the news event creates has already been priced into the stock.

Of course, spikes (plunges) can continue for longer than anyone thinks they can. This is where experience comes in. And this is why it is essential that anyone new to trading must trade with a paper account, and/or, trade conservatively and with small dollar amounts to begin with.

Ultimately, panic is your enemy. Avoid it at all cost. Have the confidence to avoid following the crowd. Remember, more than 90% of the crowd is wrong.

**Revenge is a Dish Best Served Cold**

Every trader I know, have taught, and have worked with, has experienced a sizeable loss. Believing they were right (and that the stock turned on them), they seek revenge by making the exact same trade on the same stock soon after they take their loss. This is a classic mistake made by almost all inexperienced traders, and another primary reason they end up failing.

If you remember that golden rule that the market is always right, and you stick to your well defined trading rules, you will avoid this situation. Once a stock no longer meets your criteria for a reliable setup (which it would not because you have already lost money on the trade), forget about it. Move on to the next stock.

Never seek to enact revenge for a loss. Only a trader with an oversized (and unjustified) ego will do so.
Technical Analysis

One of the main ways that traders approach the market is through technical analysis. A technical analyst doesn't look at income statements, balance sheets, company policies, or anything fundamental about the company. The technician looks at the actual history of trading and price of a security or index.

Technical analysts believe that securities move in trends and these trends continue until something happens to change that trend. With trends, patterns and levels are detectable.

The tools of the technical analyst are indicators, patterns and systems. These tools are applied to charts. Moving averages, support and resistance lines, envelopes, Bollinger bands and momentum, which is a product of mass (a large number of traders) x velocity (buying at a rapid pace), are all examples of indicators.

As I have previously mentioned, the technical analysis I use is simple, straightforward and easy to understand. Support and Resistance, and to a lesser extent moving averages, is all I really use. Many people mistakenly believe that technical analysis you employ must be sophisticated to be successful. I disagree because Technical analysis is a self fulfilling prophecy. The more people that believe in and use a particular method, the more profound its effect, and it becomes true.

Penny stocks, my bread and butter, are the domain of amateur or part time traders. These people generally have substantially less resources and are generally not as well educated. Banks and institutions do not trade penny stocks for various reasons. Therefore sophisticated technical methodologies, technology, algorithmic and automated trading have are not factors in penny stock trading.

If you wish to learn about envelopes, Bollinger bands, Elliot Wave, MACD, Linear regression lines, Stochastic Oscillators, RSI and the myriad of other technical indicators, be my guest, but if you want to profit like I have through trading penny stocks, I believe you will be wasting your time.

Now that is out of the way, let us focus on what has worked for me for many years, and continues to work in today’s market. In this section I will give an overview of the important elements of technical analysis and charting, explain the various technical indicators I use and how to approach different chart patterns.

Candlestick Charts

A Candlestick chart is a combination of a line-chart and a bar-chart, in that each bar represents the range of price movement over a given time interval. It is perhaps better explained in a graphical formation.
Candlesticks are formed using the open, high, low and close. 

- If the close is above the open, then a hollow candlestick (usually displayed as white or green) is drawn. 
- If the close is below the open, then a filled candlestick (usually displayed as black or red) is drawn. 
- The hollow or filled section of the candlestick is called the “real body” or body. 
- The thin lines poking above and below the body display the high/low range and are called shadows. 
- The top of the upper shadow is the “high”. 
- The bottom of the lower shadow is the “low”.

Individual candles can represent different time frames. For example, looking at a six month chart, each candle usually represents one day. Looking at a one day chart, candles can represent one minute, two minutes, five minutes or thirty minutes.

Candles by themselves, or in a sequence, can sometimes represent a pattern or trend. While I rarely pay too much attention to the patterns formed by candlesticks, I believe a basic understanding is required. Individual candles, and the trends formed by individual candles, represent price action. For example, a candle with long tails represents buying and selling through in a wide range, meaning that there is substantial differences of opinion as to what the stock is worth at that given moment.
Doji, spinning tops and hammers are examples of popular individual candle formations while engulfing patterns and shooting stars are examples of popular candle trend formations.

http://www.fxwords.com/ and http://stockcharts.com/ are also excellent resources to further learn about candlesticks. There are also many good YouTube videos that go over candlestick formations in detail, such as this one.
Moving Averages

Moving averages smooth the price data to form a trend following indicator. They do not predict price direction, but rather define the current direction with a lag. Moving averages are based on past prices which mean they will lag behind current prices. Price leads and the moving average follows. Moving averages form the building blocks for many technical indicators and overlays.

The two most popular types of moving average are the Simple Moving Average and the Exponential Moving Average (EMA). These moving averages can be used to identify the direction of the trend as well as support and resistance levels. They will not identify tops or bottoms, but will turn or break after the top or bottom has occurred.

The longer the moving average, the more the lag. A 10-day moving average will hug prices quite closely, whereas a 100-day moving average is considerably slower to change. Therefore, it takes a sustained price movement in order for the 100-day moving average to change course.

The length of the moving average depends on the analytical objectives. Short moving averages (5-20 periods) are best suited for short-term trends and day trading. Swing traders interested in medium-term trends would opt for 13-100 period moving averages. Long-term investors will prefer moving averages with 100 or more periods. Some moving average lengths are more popular than others. The 200-day moving average is perhaps the most popular. Because of its length, this is clearly a long-term moving average.
Next, the 50-day moving average is quite popular for the medium-term trend. Many traders use the 13-day and 50-day, or 50-day and 200-day moving averages together. I personally pay the most attention to the 13-day and 50-day moving averages.

Much literature will focus on moving average crossovers as a prediction for buy or sell signals. They produce wonderful looking charts such as the one shown below.

The below chart shows clear green arrows as a signal to buy, where the price is touching the 50-day moving average. Of course it is easy to plot these points on a chart after the fact. I have seen so many people use moving averages as their holy grail for buy and sell signals, only for an event or a trend reversal to occur, rendering the moving average temporarily useless. Using moving averages, you will tend to always buy and sell late. If the trend does not last for a significant period of time, you will lose.

I prefer to use moving averages to indicate support and resistance (as shown in the chart below), in conjunction with support and resistance levels based on previous highs and lows. I do this because I know many other penny stock traders are doing the same. They will set their buy, sell and stops around these areas, thus these support and resistance levels are real.
Price Action

Price action is encompassed in technical and chart pattern analysis, which attempt to find order in the sometimes seemingly random movement of price. Swings (high and low), tests of resistance and consolidation are some examples of price action.

As mention above, the candlestick is an important tool for analyzing price action, since they help traders visualize price movement. Candlestick patterns such as the Harami, engulfing pattern and cross are sometimes used to visually interpreted price action.

No two people will analyze every bit of price action the same way, and that is why a lot of traders find the concept of price action so elusive. Quite literally, price action is everything that a security's price does, and just like every other facet of analysis, it is purely subjective.

I emphasize price action as the most important physical element in trading. All of my buy and sell (or short sell) decisions are based on current price action, in relation to historic price action, in an attempt to determine future price action. Chart patterns such as consolidations, gradual up or down trends, and reversals are examples of price action.

I typically use a 1-min or 2-min candlestick chart (5-min or 30-min on a multi day chart, or 1-day on a multi month chart), alongside price & sales data, and level 2, when I am attempting to interpret the price action of a stock.

The success of my strategies really come down to knowing, with a high degree of certainty, how prices behave in certain stocks, around certain news events, around support and resistance and other popular technical chart patterns (such as double and multiple tops) and during certain times of the day.
There is no magic in this. It is simply through many years of experience that I have been able to learn how stocks behave, and more importantly, how the people trading these stocks, think.

I have included a couple of examples of stocks that have good price action. Again, we must look for things such as a stock gradual overall uptrend, which is making higher highs and higher lows (on the retracement) and has consistent volume that increases as the stock is breaking out of intraday range. The opposite is true for good price action on down trending stock for a short selling opportunity. The stock does not necessarily have to be up or down a lot in order to have strong price action.

We also want to look for periods of consolidation after a significant spike in price. Particularly, we are looking for candles that are in a fairly tight range. These candles should predominantly be relatively small, and with little tail. This means that supply and demand at that consolidated price range is balanced, and that there is no overwhelming difference in opinion of what the share price should be. Long tails on candles in a consolidation phase indicates differences in opinion on price and uncertainty.

It is the consolidation base or slight uptrend (for buyers) or slight downtrend (for short sellers) that tells traders that there is sufficient buying pressure (or selling pressure if you are short selling) to make the stock go further in that direction.
Here is an example of strong price action. Stock trades in a tight range during the first six days breaking out to the upside on the seventh day. Stock continues to make higher highs with increasing volume. Stock is holding support at each level. There is some profit taking on the tenth day.

Here is an example of bad price action. Stock is choppy over the course of 5 days with no determinable overall trend. Volume is low and inconsistent including many periods with no trades.
Advanced Strategies for Massive Profits

Like the heading suggests, I will outline the chart patterns and strategies to trade them that I have identified and employed so successfully over the past ten years. While no one chart pattern is ever exactly the same, the chart patterns I illustrate are eerily similar, making the price movement of these stocks is often highly predictable.

While other trading literature is geared towards trading large cap stocks such as Google and Apple, or other instruments such as foreign exchange, the aim of this book was to break away from the repeat of information on trading that is available everywhere, and give you real-life information on how to trade penny stocks successfully, all the while keeping things simple.

Breakouts

This chart pattern is one of the most reliable patterns for buying a penny stock, particularly in an up trending or bullish market. A breakout, as the name suggests, is when a stock breaks out from a range or consolidation, or when it breaks out past a previous significant high. While the breakout can be easy to predict, the velocity and range of the breakout cannot be. Many factors will influence whether the stock will rise 20% or 150%, in one day or one week.

Fundamental factors such as company or industry news, earnings releases, changes in capital structure, insider transactions, and the company’s share float can all influence the velocity and extent of the breakout.

Breaking out on News

Generally, any positive industry or company specific news is good for a stock. Such news, particularly when it is unexpected, will generally draw the attention of traders. This is true for all stocks, but especially true for penny stocks because other than company management, those who trade penny stocks generally have no inside information or sources that will allow them to know this news before it is released.
Company share buy backs, insider transactions (such as management buying shares at current market prices) and other fundamental news can also impact stocks, but typically to a much less degree.

**Breaking out on Earnings**

Earnings have the same effect on stocks. Because analysts do not cover penny stocks, earnings surprises for “real” companies can really create a lot of interest. Below is an example of a Pink Sheets listed company in bankruptcy. Their earnings were announced and were a complete surprise to the market.

Visteon Corp (VSTNQ) is a company that previously traded on the NASDAQ until it could no longer meet NASDAQ listing requirements, ultimately entered bankruptcy, and then began trading on the Pink Sheets while still operating.
Earnings released here, pre-market

Guidance increased here, pre-market

Clean break out here at $6
Another example of an earnings play is shown above. Integrate Silicon Solution, Inc (ISSI) raised its second quarter 2010 guidance. This announcement was unexpected. The result was a substantial initial move upwards, and then a clean break out from its previous high of around $6 in early January. Subsequently, ISSI went on to hit a 52-week high of $13.93 in late April, shown in the second chart below. This particular breakout is my favorite type, as it had many strong variables in play, both fundamental and technical; a “real” company, strong guidance (and/or earnings), previous resistance at a round number ($6), 52-week high, substantial volume, and is now trading at a price where it could potentially meet hedge and mutual fund investment criteria.

Of course, you should not try to automatically buy once seemingly positive news or earnings are announced. Your interpretation of earnings can be quite different to the consensus. Every buy and sell decision must be based on price action. If you buy ahead of earnings, or without waiting for the price action to dictate your entry, you are simply speculating. Below is an example of a stock, La-Z-Boy Inc (LZB) with somewhat positive earnings, but with cautious guidance for the future. Anyone who bought immediately on the headline earnings, in order to get a better buy price, was doomed. Remember too that earnings relate to the past, guidance relates to the future.
Breaking out on Technical's

Technical factors such as price, volume, previous resistance and support, 52 week highs, and moving averages also influence a breakout. Generally, stocks tend to break out with more velocity when there is greater volume. Stocks break out even faster around round numbers.

Often stocks breakout harder and faster when more technical factors are present. For example, a stock that has hit resistance several times in the past few months might finally break out. This breakout may also make new 52-week highs. One would assume that this stock would breakout faster than a stock that has no real pattern of resistance. The reason is because traders are all looking for the same things – well defined resistance levels, 52 week highs etc. In addition, the overwhelming supply of the stock, at the point of the multi month resistance, is gone. So now we have a greater imbalance of demand versus supply.

Another example of a technical breakout, combined with positive guidance, KLIC, is shown below.

The 6 month KLIC chart shows each surge results from strong guidance, breaking out through resistance and making new 52-week highs, along with strong relative volume.

To reiterate, typically, the stronger the prior resistance and longer the consolidation or sideways movement, the faster the stock will breakout. Many stocks can trade sideways for months, and when there is a catalyst for it to move higher, it can do so in an aggressive fashion.
Previous high, now serves as resistance

Guidance raised here

New resistance at 7.50ish

More positive guidance issued here
In the above examples, I have shown you what a breakout looks like on a multi-day / multi-month chart. However, the same principles apply to an intraday breakout.

Above is a 2-day chart of Luna Innovations Corp (LUNA). The stock has an initial morning spike, a small retracement and then consolidates for most of the day. In the afternoon, when many people are looking to enter into to play the gap up the following day, the stock starts approaching its morning high of around $3.40ish. Once it finally breaks this price, it continues to move substantially higher.

This particular breakout is not necessarily typical of an intraday breakout. There are a few other factors helping this stock move. First, it was in the midst of strong market conditions. Second, it was breaking through previous highs and making new 52-week highs. Third, the stock had a relatively high short interest, which means that a high number of the shares available for trading (the share float), was sold short going into the day; and with a substantial morning spike, many amateur short sellers would have sold short in the morning anticipating the stock dropping in the afternoon. This created a short squeeze in the afternoon (this is where short sellers are in a losing position, panic, and buy back to cover their positions). Short squeezes can be more pronounced on a Friday afternoon than at any other time. If identified correctly as such, this can be a very profitable time to buy.
LUNA jumped around 70% on the day. If you had bought before or around the point of the breakout, you could have easily held for a 30% gain.

A more typical intraday breakout is seen below for MESAQ. This stock, a company listed on the Pink Sheets and is currently in bankruptcy, had a morning spike, followed by consolidation and some accumulation, and then broke through the morning high at around 2pm. Again, if you had bought in or around the point of breakout, $0.07, and sold at around $0.08, you would have made a 14% gain.

Below, LEHMQ is another example of an intraday breakout. This company also trades on the Pink Sheets and is in bankruptcy.

You can see that this stock has been accumulated throughout the morning, with above average volume (based on the previous day). It spikes to its high of around $0.11 at 1pm, retraces and then consolidates until around 3pm. It ultimately breaks through the early afternoon high ending up at around $0.135, after hitting its high of $0.145. If you bought this stock at or around its resistance level (early afternoon high) of $0.11, and held into the close, you would have made a 23% gain.
I have illustrated some breakouts on multi month charts, and some intraday breakouts. Below is an example of a stock, Somaxon Pharmaceuticals, Inc. (SOMX) that breaks out multiple times over multiple days. Notice that each time the stock breaks out past its point of resistance, it fails to go below this former point of resistance (except for temporarily on Tuesday morning). This is because previous resistance acts as new support and there is enough buying interest at these levels. This signifies that price action is strong.

You can see that the stock traded sideways for several days prior to the first breakout. When it breaks out past $2.85 on Friday morning, volume increases substantially. Each subsequent breakout has equal or greater volume. If you had purchased this stock at or around its point of breakout of $2.85 on Friday morning, and held to the close, you would have had gains of around 16%.

If you use the point of former resistance as the point the stock is unlikely to fall below, you could have bought this stock at any time after the stock broke out on Friday afternoon until Tuesday afternoon.
As you can see, the stock fails several times to break below its new support level of around $3.10. You could have bought anywhere above this level, and used this support level as guidance for your mental stop loss, should the stock have broken down. Ultimately, it hit its multiday high of $3.70ish on Wednesday morning. This could have represented a realistic gain of around 15% within 2 or 3 days, without having to pick an exact top or bottom.

Note that I try not to use hard stop losses (i.e., stop losses set to execute at a predefined price). I am always watching the price action, and always execute my orders manually. Market makers and more sophisticated traders are easily able to identify where your programmed stop losses are, and do take them out routinely.

Below is another multi day breakout. In fact it is the same stock, SOMX, several months later than the chart above. You can see on Monday morning, the stock broke past Friday’s morning high. It then continued to climb higher, ultimately closing lower than the high of the day, but higher than the previous day high. On Tuesday the stock drop a little, but did not break back down lower than the point of break out (i.e. it held multi day support). On Wednesday, the stock broke through resistance in the morning, on massive volume, and moved higher throughout the day. Finally, on Friday the stock again broke through resistance and moved higher on even more volume.
What happens if the stock fails to break out?

Failed breakouts represent a risk to a trader. A failed breakout occurs when the stock breaks out of a range, or past a previous significant high, but then quickly retraces and does not continue its breakout. Because the stock started to breakout, many traders would have bought at this level. Once the stock retraced, and came back down, the same trader’s stop losses would have been filled, thereby exiting the position with a small loss.

So why does the stock fail to breakout if so many traders are buying at the point of breakout? Large players such as institutional banks have the financial resources to move a stock for while. Basically, these traders will buy near a top or breakout point, pushing the price upwards. Momentum traders will jump on board when they see the stock advancing and nearing breakout, and then even more traders will buy at or just past the point of breakout.

The large traders who initially caused the increase in price will then happily sell their positions to unwitting traders just after the stock has broken out. This massive selling at around the point of breakout, causes downwards pressure on the stock and it fails to continue its breakout path. Large players may only make a small percentage on these trades, but with the large amount of capital employed on each trade, several times per day, the earn great money employing these tactics.
Thankfully, in penny stock land, there are not many, if any, players that have the ability to move individual stocks like this. Below I explain how to profit on stocks breaking out, and avoid losses on stocks that fail to breakout.

I will show you a couple of examples of multi month charts with stocks that have failed to break out. In the first chart below, you will see the stock hitting a high of around $1.75 at the end of March. The stock drops hard after hitting this high, and trades in a choppy fashion from April to June, where it approaches its previous high. Once it hits this high (or close to it), it drops yet again. This is known as a double top.

This chart is not the setup that I like to trade. However once it breaks its minor resistance level of $1.20 (also its previous minor support), there could be an opportunity to enter the trade, in expectation that the stock will continue the up-trend on the way to its major resistance level, and 52-week high of $1.75ish. The new minor support of $1.20 will act as a good reference for setting your mental stop loss. In other words, the upside potential at $1.75, is around $0.50, whereas the risk is around $0.10 –$0.15 (just below its support level). This is a risk reward ratio of 4-5 to 1.

You should not have bought this stock at or around the $1.75 level in anticipation of a breakout, because the chances of a failed breakout are high, especially considering relative low volume, and no real catalyst driving the stock. Also, and more importantly, there is no real support until $1.20, which as the chart shows is weak support anyway; meaning that you are risk reward ratio is very poor.
Here is another example of a failed breakout attempt, although the second spike does not quite reach its previous high. Here you see a much less choppy pattern, which provides for a much better setup.

As with the first example, you would not want to buy this stock in June as it is approaching its former high because of the risk of a failed break out. There is no support until around $0.35. The best time to buy this stock would be when it breaks out of its sideways range. Then you will have a solid reference point of between $0.30 - $0.35 for your mental stop loss, should the breakout fail. Doing this would give you upside potential of at least 50%, while your downside risk is limited to 12.5%, assuming you bought at $0.40 and your support is at $0.35. Of course, you should also check the company’s fundamentals to identify any catalysts that will help propel this stock. If there was not any, you probably would not enter this trade.

The final example is of a chart that has semi broken out, but the story has not yet been played out. At this point, the stock could truly break out, or it could fall back below its previous highs, and fail.

Again, pay particular attention to the volume of the potential breakout occurring in July. The volume is very light, especially compared to the first spike in April. This indicates a lack of real interest from traders, and probably has little or no catalyst to take it further.
The best time to buy this stock is after solid support has been established. As with the examples above, this establishes are solid base for you to determine a contingency exit point. The risk reward ratio is much more favorable if you bought at around the $3.00 mark. The reward would be at least around $0.75, or 25%, while the downside risk would be around $0.10 - $0.15, being just below the level of support. This gives you a risk reward ratio of around five to one.

If you are wondering when you would have played this stock after the initial breakout in April, the answer is you probably wouldn’t have. That is why it is important to have patience, and let the chart patterns develop. Remember, there are thousands of stocks with which to trade, and that’s why it is important to prepare stock watch lists before the market opens.

You want to wait until a definite pattern develops, preferably with well defined support and/or resistance levels. Stocks that consolidate, or trade sideways after initial spikes or breakouts typically give you these characteristics. The sideways movement usually signifies accumulation within a range. There is no dominating buy or sell sentiment.

In the above example, a breakdown (which I will detail later) could possibly occur if the stock broke through $3.00 on the downside. The same rules as a breakout would apply, except the exact opposite.

Finally, keep in mind that not all chart patterns are the same, and the above charts are quite clean patterns. Good trading set ups can be found in many slightly differing patterns, however it is very important that you have the patience to wait until ideal patterns develop. It is equally important, as I have indicated with the above examples, not only to have a buy and sell price in mind, but also know...
exactly where your contingent mental stop will be in case the stock turns in the opposite direction. The chart patterns shown above give very guidance on such stops.

**Playing the Gaps**

We have discussed the mot basic chart pattern to play. There is another setup that is also very effective and reliable, gap up and gap down.

Just like the breakout, the gap up and gap down are both the same patterns, with the same influencing catalysts, except in reverse.

A gap up is when the opening price is greater than the closing price for the previous day. Our aim is to buy a stock that has momentum going into the close with the expectation that this momentum will continue over into the next day, ultimately selling into a next day spike, or gap up. The gap up is caused by buyers and sellers trading in the pre-market (between 6am EST and 9:30am EST), thereby pushing up the stock price from the preceding day’s close.

This particular strategy can be very effective for stocks that have significant trader interest. It is not uncommon for stocks to gap up 10%, 20% or even 50%. Of course there are risks involved that are beyond your control. Any adverse company or industry news event can hit the wires. Such unexpected news can have sellers from the previous day, as well as longer term shareholders, sell in the premarket, causing the stock to actually gap down. Other news, such as earnings related news generally does not apply to my strategy, because I never trade a stock going into an earnings announcement. I always wait for earnings to be announced before entering the trade.

Such news events are generally the exception rather than the rule. This being the case, we should not preclude this strategy as an important profit making strategy in our trading arsenal.

**Which Stocks Are Going to Gap Up?**

If it were that easy, there would be more than 5% of traders who actually make money. You can never know which stocks are going to gap up. It depends on many factors such as trader interest, market conditions, potential news events, position in its chart pattern and message board hype.

However in my ten year trading career, I have trained myself to identify, with good accuracy, which stocks are going to gap up. Because we need to have a long position in these stocks on the day before the gap up, a pre or post market stock screen is not effective. We must identify potential stocks the day before we expect it to gap up.

Below is a six month chart of Voyager Oil & Gas, Inc. (VYOG). The stock begins gapping up in mid April. This coincides with a massive increase in volume due to company news and stock promotion. Notice that the stock is consistently closing at or near its daily highs (shown by the little or no shadow on the
daily candles). This means that people are buying into the close in anticipation of the stock gapping up the next day.

The stock also gaps up significantly in late June. Notice the increase in relative volume. Also, and very importantly, the gaps up over its multi month resistance level of $3.75. Playing the gap, in combination with the playing the breakout (or breakdown on the short side), makes this play even more effective. The chart also shows the stock bounces of the major support level of $3.00 on several occasions over a two month period.

You could have bought this stock into the close in late June on the day the relative volume increased, for around $3.70. The next day it opened at $3.95 and hit a 52-week high of $4.28 in the morning trading session. Even if you sold right at the close, notwithstanding you could have held this stock longer after breaking its resistance of $3.75, you would have made a 7% gain. Should you had held till mid morning and sold around $4.15, where it traded for several hours, you would have made a 12% gain. In the absence of any adverse news, the downside risk here is limited.

Importantly, as with any gap play, if the stock fails to gap up, you should immediately exit your position. All of the other amateur traders, recognizing that the stock is not gapping up (or not spiking at the market open), will also look to exit their positions, however because they make up part of the 90% of traders who fail, they will wait too long to sell. You need to beat them to it, as a failed gap up or spike has the potential to collapse.
Here is another six month chart, Dearborn Bancorp, (DEAR). The stock gaps up large in late April. Notice again that the stock closes right on its high of the day before the gap up, which is also much higher than the previous day highs. The volume on the day before the gap up is not larger than the previous two days, however, it considerably higher than the average daily volume. Ignore the massive gap up a few days prior, as this was a news event the morning of the gap up, and could not have been anticipated the day before.

If you had bought this stock at or near its high of 3.95 the day before the gap up, and sold at the open at around $4.35, you would have had a return of around 10%. However this stock spiked right at the open, ultimately reaching its 52 week high of $5.47 mid morning. If you sold at around $5.30, where it traded for around an hour, your return would have been 34%. Again, absent of any adverse news, the risk of a gap down was limited.

You can see there was no gap up in mid Jan where the volume and stock price increased substantially. In fact, the stock gapped down. This was not the ideal setup because the stock did not close near its high, and therefore momentum into the close was not strong.

Below is the six month and five day chart for STEC, Inc. (STEC). The five day chart shows the intraday movements for the gap up in early July on the six month chart.
The six month chart shows the stock gapping up through multi week resistance in early July. There is a corresponding increase in volume relative to prior days. A strong overall market over these couple of days has also contributed.

Looking at the five day chart for STEC below, you can see the stock breaks out from the day’s resistance level of $13.2, and closes at its high of the day on Wednesday, with substantial relative volume into the close. The five day chart also shows a nice up trend.

If you had bought this stock into the close, at around $13.25, just above its resistance, and sold right at the open for around $13.55, your return would have been around 2%. If you held this stock for longer, as it is an ideal setup for a swing trade after breaking multi weak resistance in a strong overall market, you could have easily sold for around $14.00, a 6% return.
Notice that the stock does not gap up in mid April after a big positive day and large relative volume. This is not a predictable gap up because the stock does not close near its high, and closes right on its resistance level. There was not the momentum into the close required for the stock to gap up. Also, because the stock is up 12.5% on the day, which looking at the longer term chart is a considerable movement for this stock, there would have be many traders who wanted to lock in profits.

Finally, below is the five day chart for Affymax, Inc. (AFFY). This chart shows a trend reversal beginning on Tuesday. The stock closes strong on Wednesday breaking minor multi day resistance, very near its high of the day with strong closing volume. The stock eventually gaps up around $0.17 and continues its trend upwards. If you bought this stock near the close at around $5.65, and sold at the open at around $5.82, your return would have been 3%. Of course the chart shows a very nice setup to hold for longer than this. If you held into the close on Thursday, your return would have been around 8%.

I hear you saying, “But if I bought this earlier than just before the close, my return would be even greater”. Well, yes it would be, however there is risk that to stock reverses in the final moments near the close. Many times traders will sell into the close to lock in profits on a stock that is already up on the day. There could be many reasons for this such as nervousness about adverse news being released, earnings announcements, or expectations of a weak overall market the next day.
Regardless, unless the stock is showing extremely strong price action, it is advisable to wait until the final moments of the trading day to buy a stock in anticipation of the gap. Remember, it is the gap up and following day spike that you will sell into to lock in profits. It isn’t so much about the current day as it is about the expectations of the following day.

If there is a reversal in momentum in the following minutes of the trading day, this could be a very strong indication that there is no expectation of a move up the following day. The stock could actually gap down where there is a reversal in momentum into the close, as shown on the DEAR and STEC charts above.

So to recap, the main indicators of a predictable gap up include the following:

- Strong relative volume into the close.
- Stock closing near or at its high of the day (the closer to the high of the day the better).
- The stock has a history of gapping up.
- A strong overall market, with positive pointing futures.
- No adverse news expectations. Do not play the gap into earnings announcements.
- A stock that has, or could, break resistance levels.
- Positive hype and message board chatter.
Finally, this pattern is fairly predictable and profitable. But always remember that should the stock not gap up, sell immediately just before, or at the open. You can always get into the trade at a later time. If all of the above factors are in play, it is highly unlikely that the stock will gap down; it just might not necessarily gap up. A gap up followed by a morning spike gives an excellent opportunity to sell into this strength.

**How Do I Find Stocks that could Gap Up?**

As stated in the introduction to this section, we cannot use overnight scans to spot gap ups, because we already need to have a position in the stock going into the following day. A good way to spot stocks that have the potential to gap up are by using the same scans that you use to spot breakouts, and monitoring its intraday price action.

Also, a scan that shows stocks with a substantial volume increase on the day relative to prior days will give you stocks with higher than normal interest. Any scan that shows % and volume leaders is also good to monitor. But remember, you need all of the elements listed above for the stock to be considered as a reliable gap up candidate.
Playing what is Hot

Every now and again a stock will surge on company or industry related news. This can trigger a ripple amongst its peers, and cause other stocks in the same industry to also spike. Many times, company PR spinsters will see the effect the news had on the first stock to spike, and issue their own press release, and given the right market conditions, this stock may also surge. Sooner or later, several stocks within the same industry are being heavily traded for no reason at all as traders begin speculating. Momentum then takes over and these stocks can spike to unrealistic levels.

The best example of this phenomenon was tech stocks in 1999.

More recently, between 2009 to today we saw a few mini bubbles. First there was the pharmaceutical / biotechnology industry, followed by the “Q’s” (bankrupt companies), and then the poisoned Bancorp’s, medical marijuana, rare earth metals and so on.

These situations gave a trader plenty of opportunities to profit from both buying and short selling. By identifying the overall trend early, you have the ability to monitor similar companies within these industries and when one of these stocks starts moving, you can get in early buying at a low price. If you miss the opportunity to buy these stocks, you can always wait until the pattern plays out and jump on them and profit by short selling.

Below are some examples of industries that have been hot as of late. Of course these lists are time sensitive and will probably not be hot at the time you read this book, however it will give you an idea of how stocks within an industry can move together.

Example #1 - Pharmaceuticals

Below are the charts of several pharmaceutical companies that went parabolic during this crazy period. Companies, one after another, relentlessly issued press releases on drug trial updates and FDA announcements. The substance of the news did not necessarily matter. It was an opportunity for traders to jump on the bandwagon.

After the first couple of stocks to spike, you could have easily predicted a trend and built a watch list full of pharmaceutical stocks under $5 with small market capitalization, had alerts set so that you would be notified when a stock’s volume or price is moving (easily done with Interactive Brokers), and scanned the news filtering for these particular stocks. Such an approach would have given you an early advantage in picking up these stocks before they made their large move upwards.
An increase of almost 500% from $0.50 to its high of $2.43, in 3 days.

An increase of over 300% from $4.00 to its high of $12.50, in 5 days.
An increase of over 600% from $1.00 to its high of $6.40, in 3 days.

An increase of over 400% from $1.00 to its high of $4.08, in 3 days.
The above charts are only a sample of the stocks that moved during that period. There were many other stocks that moved equally impressively. It is great if you can buy these stocks before or at the start of their run.

**Example #2 - Companies in Bankruptcy**

In the same vein as the pharmaceutical companies above, there was frenzy with companies in bankruptcy (as denoted by the Q at the end of their ticker symbol). Again, many of these stocks moved one after another. Below are the charts for some of these companies showing their parabolic move. As with the pharmaceutical companies, news usually triggered the trading activity, as well as speculation that may come out of bankruptcy.
This chart shows a spike during the “Q craze” combined with a perfect breakout through resistance of $0.25.

Major resistance at $0.25

Another chart breaking out through resistance during the “Q craze”

Multi-month resistance at $0.06
An increase of over 1000% from $0.02 to its high of $0.22, in one day.

An increase of over 900% from $0.005 to its high of $0.05, in 2 days.
As you can see, these companies all had their runs at slightly different times, but were all driven by news events, including speculation of the companies exiting bankruptcy, positive earnings growth or forecasts and favorable court rulings.

Example #3 - Bancorp’s

There was somewhat of a Bancorp bubble in recent years, spurred by positive news for a couple of debt ridden, beaten down banks. Speculation then takes over with more and more banks being bought up in anticipation. Below are the charts of some of these banks. Again, if we spotted this trend early we could have been prepared by having alerts set on similar stocks within the industry, scanned the news for these companies and closely watched them. Invariably, like the patterns above, these parabolic moves were made on hype and speculation, and ultimately these gains could not be sustained, giving us easy opportunities to profit from short selling, using the previously defined rules.
An increase of over 400% from $0.65 to its high of $3.40, in 3 days.

An increase of over 650% from $0.50 to its high of $3.75, in 3 days.
An increase of around 100% from $1.10 to 2.15, in 3 days, fueled by nothing more than speculation. Notice this is a down trending stock, and was ultimately halted by the SEC and delisted from the NASDAQ exchange.

An increase of 267% from $1.50 to its high of $5.50, in 4 days.
An increase of around 180% from around $1.25 to its high of $3.50, in 4 days.

An increase of over 200% from around $0.43 to its high of $1.34, in 3 days.
Example #4 - NASDAQ De-listings

Companies that list on the NASDAQ are required to meet certain criteria. There are various requirements however some of the more well known ones include the requirement to maintain a minimum bid price and to maintain a minimum market value for publicly held shares (market capitalization).

**Minimum Bid Price**
If a company trades for 30 consecutive business days below the $1.00 minimum closing bid price requirement, NASDAQ will send a deficiency notice to the company, advising that it has been afforded a "compliance period" of 180 calendar days to regain compliance with the applicable requirements.

In order to achieve this requirement, the company must maintain a minimum closing $1.00 bid price for ten consecutive business days within the 180 day period. If the company fails to meet this requirement, they will generally be required to delist from the NASDAQ exchange. The stock will then delist and move on to the OTCBB.
Minimum Market Value of Publicly Held Shares

Companies listed on the NASDAQ capital market (which include the majority of penny stocks not listed on the AMEX, OTCBB or Pink Sheets) must maintain a $1 million market value of publicly held shares.

If the company trades below this requirement for 30 consecutive business days, it will be notified of the deficiency and afforded a 180 calendar day compliance period to regain compliance with the applicable standard.

In order to achieve compliance with the market value of publicly held shares requirement, a company must demonstrate compliance with the applicable standard for a minimum of 10 consecutive business days. If the company fails to meet this requirement, they will be issued with a delisting notification, in which case they will delist from the NASDAQ, and usually move to the OTCBB.

How we profit from these situations

Companies generally want to stay listed on the NASDAQ. Doing so allows their securities to be traded by bigger institutions, banks and more hedge funds. It also enables them to obtain finance easier, as the NASDAQ is more reputable than the OTCBB or Pink Sheets because it has much stricter reporting requirements.

Because companies want to remain listed on the NASDAQ, they will take action in order to be able to meet the requirements. Often this action involves issuing press releases in order to generate hype and buzz in order in an attempt for their share price to increase. Whether or not the news contained in these press releases is legitimate or not, or is timely, is a matter for debate; however the result can be very favorable; a surging stock price brought about by eager investors, speculators and momentum traders. The news is generally in the nature of new product developments, new “contracts”, or an unofficial increase in earnings guidance.

Usually these companies will issue their press releases near the end of their allotted 180 business days. This is because manipulating their share price by issuing press releases is a last resort. Obviously management would prefer to have their share price increased based on improving company fundamentals and/or actual positive news.

The alternative for these companies is to implement a reverse stock split in order to increase the minimum bid price. We have also seen some companies sell assets or raise additional capital in order to meet requirements, depending on their circumstances.

Because these companies are required to notify the public of notices they receive from the NASDAQ, and because this information is freely available on the NASDAQ website, we can know well ahead of time which companies are likely, at some point in the future, to issue press releases that have the potential to move their share price.
Obviously not all of these stocks will conduct their affairs in the manner I outline above. In fact, probably only a small proportion will. Being prepared and monitoring these stocks and news relating to these companies will enable you to jump quickly when the stock begins to move.

Below are the charts of some of the companies that have had non-compliance letters issued to them, and have subsequently issued press releases and had their share price soar.

**HAUP – 6 Month Chart**
HAUP issued with a non-compliance notification.

As 180 days approaches, the stock price starts to increase with little volume, and then news of a new product based on Apple’s iPad is released.

**HMNA – 6 Month Chart**
HMNA receives non-compliance letter from NASDAQ. Share price soars the next day for unknown reason. No news or earnings were released at this time.
PTEK receives non-compliance letter from NASDAQ. Before the 180 period is over, the share price almost doubles on news of business expansion.

ZANE receives non-compliance letter from NASDAQ. Before the 180 period is over, the share spikes on news.
Chat Rooms & Trade Alert Websites

Chat rooms and trade alert websites (those websites are either free or you pay a monthly subscription to receive the real time trade alerts) are becoming more and more popular.

Chat Rooms
Chat rooms can be useful in helping you identify stocks that are moving. Because there are many people in a chat room, there are more pairs of eyes helping you identify stocks that are on the move. This can be a handy addition to your daily watch list and real time stock screener / filter. Be careful, and chose a chat room with a good moderator, who limits the general conversation and allows stock alerts only.

Trade Alert Websites
Like chat rooms, these can be useful to your trading. At the very least, the owner of a good trade alert website will give you their buy alerts in real time. They may also give guidance on exit prices, commentary on price action, and provide free or paid educational material.

Trade alert websites, like Small Cap Momo, can provide profitable trade alerts as well as help you learn the entries and exits of a successful trader.

Below are a few examples of the effects that trade alerts can have on stock prices. Note that these charts also show the stocks breaking out or breaking down, which has a greater influence on the move.
Potential 22% gain in 3 hours

Potential 55% gain

Buy alert here

Buy alert here
Trading the News

I often hear people say things like “it is dangerous to trade the news” or “trading the news is unpredictable”. This is true to an extent, however in my experience, the vast majority of the stocks that move big do so because of a news event that has peaked investor and trader interest. Momentum is generally caused by news.

Generally, when there is an expectation of news, traders will buy in anticipation. When the news is not anticipated, such as shown in the example below, the share price is generally positive. The share price increased around 170% in a few days on unexpected FDA Advisory Committee recommendations.

Again, usually with most news types such as FDA approvals, changes in capital structure, earnings or guidance, new contracts, new products etc, the share price reacts positively when the news is not expected.
Different news types cause different reactions. I will outline what some of these news types are and how they are often interpreted:

**Mergers and Acquisitions**
It is often difficult to evaluate who will benefit from the merger or acquisition. The terms of the deal are often complicated, and the potential benefits to be derived are often interpreted differently. Generally, I have no interest in trading these.

**FDA Approval**
As described above, it depends on whether there was an expectation of FDA approval. If the approval is not expected, and the share price has not seen a recent run up, the share price for a company granted FDA approval can spike big. If the news has been expected, we wait to see what the price action shows us, and possibly enter a trade depending on the chart pattern.

**Drug Trial Results**
Generally the results of drug trials, such as phase I, II and III trials, are not necessarily expected at any one point in time. Companies release this information when it comes to hand. When the news is released, traders react differently depending on the type of news. For example, a phase I trial is a very early stage trial that generally does not have much bearing on whether a drug will be successful in its ultimate objectives. A successful phase III trial however is much more meaningful, as it indicates the drug is effective, and it is after this stage the company will look to make an application to the FDA for approval to market the drug.
Unless there is momentum in the pharmaceutical and bio-tech sectors, phase I trials will not typically generate much interest. Phase II trials trigger more interest, but less than phase III trial news. A successful phase III trial can see a company's share price skyrocket. Other news such as FDA fast tracks, patents and positive efficacy data can also propel a stock. Likewise, any negative data can see the share price fall rapidly.

Along with the stage of the trial, you also need to consider other factors such as the disease the treatment is targeted at (a cancer treatment will generate much more interest than an acne treatment), how marketable the drug is, and the company’s financial situation (for example, are they likely to seek finance by way of a shelf offering and dilute the existing shareholdings).

The FDA process is beyond the scope of this book; however it is certainly worth learning more about it. There are many medical and trading websites to be found on a Google search that will help you get educated on this subject. A few of these sites include the FDA website, Clinical Trials website, FDA Calendar.

**Earnings**

Earnings are backwards looking, guidance is forward looking. Because earnings look backwards, the current share price is already reflective of past earnings (assuming earnings actually meet expectations and those earnings were previously known or expected). The share price is often not reflective of forward looking guidance however.

Earnings announcements are generally a roll of the dice and they can be interpreted differently. For this reason, I do not buy or short sell into earnings. I wait until a pattern is established and I can clearly understand the stock’s reaction to the news. Again, many times people buy in anticipation of earnings and sell into the actual news. You also need to pay attention to the earnings relative to previously forecasted earnings. If the earnings misses up or down by only a couple of cents per share, the reaction is likely to be less severe than if earnings miss by 25 cents per share.

Positive guidance can be very positive for the stock price, particularly when guidance is revised upwards. As this is usually an unexpected, the revision is generally not already reflected in the share price. This can create a wonderful opportunity to buy a stock immediately, if you can get in early, or look for stocks breaking out on positive guidance.

**Contracts and/or New Products**

Announcements about new contracts entered into or new products on the market are generally unexpected, and therefore can create a lot of hype and buzz and movement in a company’s share price.

Obviously the reaction to the news is in direct proportion to the scale of the new contract or product. For example, I included the chart for Jones Soda Co. (JSDA) below. The company announced that Wal-Mart would begin stocking the company’s product. This was seen as significant
news that would materially impact the company’s fundamentals. The share price surged accordingly.

News of new products can also create substantial hype and buzz. Many times companies will release news of a new product that piggybacks off the tails of a larger more established company. Apple is a prime target for many penny stocks. For example, when Apple revealed its iPad, many company sought to profit off of their success by releasing news of products that are used with the iPad, such as accessories and applications. I have previously shown you the example of Hauppauge Digital, Inc. (HAUP), where they released news of an iPad related application. Its share price soared on the news.

The larger the contract, or expected revenues from a new product, the more likely the share price will move. Obviously, the revenue generated from a new contract or product is relative to the size of the company. A contract worth $20 million for a company with annual revenue of $50 million is far more important than for a company with annual revenue of $500 million. Trade accordingly.

**Changes in Capital Structure**

Changes in a company’s capital structure are usually brought about by either an issuance of shares or buy a share buyback. When a company issues shares, in addition to those already outstanding, the company is in effect diluting the holding of existing shareholders. For example, if you own one million shares of a company that has 10 million shares outstanding, you own 10 percent of the
company. Let’s say the company issues an additional 10 million shares. They now have 20 million shares outstanding. If you do not buy additional shares, in direct proportion to your existing shareholding, your 10 percent now becomes 5 percent (1 million divided by 20 million).

The share price generally decreases when new financing is announced because of this dilutive effect.

Conversely, when a company buys back shares, it is usually seen as positive news. A share buyback generally means that the company will use their cash (or assume more debt) in order to purchase shares back from shareholders. This reduces the number of shares outstanding. Often times, the market price for the shares is less than what the company values them at, meaning that the company will often pay more than the current market price to buy back your shares. This news would generally allow for an increase in share price.

Share prices often react more when new equity is being raised. This can create a large sell off and a substantial fall in the share price. The share price usually does not react as much for a share buyback, except for where the buyback price is announced and is higher than market price. Sometimes, depending on the specifics of the buyback, the share price reacts immediately, trading around the buyback price, and there is practically no opportunity to profit.

In summary, it is not always easy to predict the price movement of a stock when news is released. In general, the greater the potential impact on the company’s fundamentals, the greater the demand to buy shares. In addition, when news is expected, often the share price already reflects the news that has yet been released. When it is not expected, the share price usually has not yet reacted.

I pay particular attention to the following keywords contained in news headlines:

- Record Earnings
- Guidance raised
- FDA approval
- Positive phase X (I,II or III) results
- Patent approval
- New contract
- Product launch

Of course these headlines do not always make a stock move, however it is a good way to filter out the myriad of news released each day.

Yahoo! Finance is the preferred news source for many traders, and is free. I personally use Equity Feed as my real-time news service. The speed of delivery as well as the ability to filter by type of news, exchange, stock symbol, price, volume, number of trades etc makes this service second to none in my opinion. There are other free alternatives, such as RSS feeds for news services like Dow Jones News Wire, Marketwire, Google Finance etc.
Bounce Plays

A bounce play is when a company’s stock price is hammered on adverse news (or another reason) followed by a subsequent spike in the share price as short sellers cover, and people realize that there was an overreaction to the news and the stock has been oversold.

These plays can be particularly profitable; however they are not without some risk.

The size of the bounce (or indeed whether there is even a bounce at all) is dependent on the how adverse the news is (and how it affects the company’s fundamentals) as well as the size of the drop in share price. Generally, the greater the drop in share price, the greater potential for a bounce.

Below are some examples of a bounce play. These plays can often take place from a large drop in the share price after hours, followed by a rebound the next day or over multiple days, or it can take place intraday.

Company announces dividend, in line with expectations. Share price drops 25% after hours.

Share price rebounds 19% from the after-hours low of $7.70

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Share price drops 35% after hours on news of earnings adjustment and revised guidance.

Share price rebounds 21% from its after-hours low of $5.80 to the next day high of $7.00.

Share price drops 37% on Thursday morning as an “independent” report into its operations is released.

Share price rebounds 18% from its intraday low of $4.00, and then continues to rise the following day.
Share price drops 76% on Wednesday morning after being ordered to pay $671 million in a lawsuit.

Share price rebounds 83% from its Wednesday low of $1.50 to the following day high of $2.75.

Share price drops 87% in afterhours trading on bad drug trial results.

Share price opens at $0.15 and spikes as high as $0.80, an increase of 433%. It closes at $0.47, a 213% increase from the open.
Looking at the above charts, it is evident that the more severe the news, the greater the fall. You can also see that the share price can take longer to rebound. In some cases, the stock can bounce the morning after the after-hours drop, or it can take one or multiple days for the stock to rebound.

When playing these bounces, it is important to remember that your entry price will dictate your profits. It is essential that you closely watch the price action of the stock.

Below is an example of a stock, which tanked big, day after day, with an opportunity to profit on a bounce play.

And I always advise to be impatient with bounce plays and take profits early.

They are not breakouts, which can rally for extended periods of time. Most of the time these stocks cannot sustain these “dead cat” bounces for very long.
Epilogue

In this book, I have outlined the rules and strategies that I have developed for over ten years that have enabled me to become a successful trader of penny stocks. I have explained why I choose to trade penny stocks as opposed to large cap stocks, options, forex or futures.

I have outlined the real nature and mechanics of penny stocks, cutting through the crap and hype and downright lies that are widespread through the industry, and shown you when to buy and when to sell.

I have outlined the psychology needed in order to become a successful trader as well as the rules that I follow, which have helped me become financially wealthy and independent.

And finally I have given you many examples of charts in order to show you how and when to apply my various strategies.

Of course there is no book in the world that will contain EVERYTHING you need to know when trading. Some things are more important to others, depending on our individual personalities and trading styles. The more you trade, the more you will learn. The internet is full of many useful trading and financial websites in which to educate yourself. Most importantly, learn to trade correctly and with discipline, following my rules or develop your own set of rules, before you throw yourself into the deep end.

You will now be well on your way to joining me as one of the very small percentage of traders who survive this game. If you have troubles along the way, refer back to this book or contact me at any time.

The website, Small Cap Momo, contains a wealth of resources, educational material, and trade alerts on some of the most profitable penny stocks. I welcome you part of the team and look forward to delivering profitable stock alerts in the future.