

High Volatility Investments

By James A. Andrews

Penny stocks and options are high volatility investments that attract both the trader and the long term investor because of the small amount of capital required to make substantial gains as compared with less volatile higher priced stocks. The long term investor buys a stock believing that a company's value will increase over time and the stock price along with it. When he buys an option it is usually to reduce the risk in owning the underlying stock. The short term trader looks at things a little differently. Typically a trader looks for large percentage price movement over a short period of time. Large percentage, short term price movements can be found both in options and certain penny stocks.

Penny Stocks are often defined as stocks priced below \$5. It is often implied, but not necessarily the case, that penny stocks are also micro caps with capitalizations of less than about \$250 million. Penny stocks can be found across the full range of capitalizations from micro caps to large cap stocks. For example, Sun Microsystems (NASDAQ: SUNW) met the definition of a penny stock for much of 2004, trading between \$4 and \$5. In late 2004, trading between \$5 and \$6 per share, its capitalization was over \$18 billion. The price of a large cap \$18 billion stock would rarely be expected to move by a large amount over a short period of time. The largest percentage daily price gainers, of say 50% or more are typically stocks that started from \$5 or less. But they are typically micro caps.

As a group, micro cap penny stocks are avoided by large funds because prices are too easily affected by sizeable buy and sell orders and capitalizations are too small to affect a large fund's bottom line. Buying more than 10% of a publicly held company carries with it certain insider responsibilities. Large funds must wait until stock prices rise typically above about \$20 before they can become seriously involved without moving the price and still have price movement impact their financial results. The small investor has a distinct advantage over large fund managers when he takes an early position in a good micro cap penny stock.

Short term options are best suited when the underlying stock has a higher price, say above \$50. While it is more likely that a micro cap penny stock will gain 50% in a single day than it is for a higher priced stock, the typical 5 or 10 to one leverage that options provide makes it only necessary for a higher priced stock to move 5% to see a 50% gain in the corresponding option price. There are several additional considerations involved in choosing an option. Not the least of these is the market environment. When chosen properly, options for higher priced stocks provide the same large daily price movements of penny stocks. Lower priced stocks need to move by a larger percentage in order to see a similar percentage move in the corresponding option. They are only likely to do so if they are micro cap penny stocks.

James Andrews publishes the Wiser Trader Stocks and Options Newsletter. One can read more about choosing penny stocks and options at <http://www.wisertrader.com> © 2004 Permission is granted to reproduce this article, as long as, this paragraph is included intact.