Rules to Live By in Protecting Your Penny Stock Investments

As the market continues to try and rebound in 2010, it's penny stocks and other small-cap investments leading the way. And if you've taken a look at your portfolio recently, you've noticed this lead. But investing in penny stocks isn't something to be done blindly (nor any investment, for that matter).

Aside from the technicals, one of the big reasons savvy investors are making more from small-caps right now is because they're using some guidelines and protecting themselves well from potential losses. Investing in penny stocks means doing your research about the particular investment and seeing if it's worth your time and money.

In researching penny stocks, one must be aware of market timing. Knowing what the market is doing - when it's doing it - will go a long way in determining your success (or failure) as an investorâ€¦

Improve Your Market Timing with These 3 Simple Rules

Market timing is one aspect of trading that investors will squabble about until the end of time. There are those who will emphatically deny any chance at timing the market - or an individual stock's movements. On the flip side there are the traders who swear buy market timing, claiming there's no other proven method for buying and selling stocks.

While both of these methods can be effective, it's important to remember this cardinal rule: No matter what your investment style might be, you should always be sure to buy shares at the best possible day and time to maximize gains.

For some solid advice on the best time to buy stocks, we turn to a true expert: legendary financial writer and market forecaster Justin Mamis. Mamis literally wrote the book on trading strategies. Many of the practices outlined in his book How to Buy are still valid nearly thirty years after it was first published.
Here are three things to look for before you make your next trade:

1. The day of the week. Early gains on a Monday tend to fade; they are usually temporary reactions to weekend news, Mamis says. On Fridays, a strong close can indicate a healthy market. Our most important take-away would be to vigilant when planning to purchase shares at the beginning or end of the week: these days can give you a good indication as to what direction the market as a whole is headed.

2. The time of the day. As a rule, I will avoid the first half hour to 45 minutes after the market opens when looking to buy a stock. Unless you're acting on a fast-moving issue, it's best to let the market sort itself out. It's easy to be fooled by a stock's strong early performance, only to see those gains evaporate by the afternoon. Adding to this, Mamis suggests that investors should avoid lunchtime rallies as well, since they tend to be isolated.

3. Anticipate the weak and the strong. Mamis advises to never buy weakness in the late afternoon. His reasoning is simple: you could most certainly get just as good of a price early the next day as investors' sentiment carries over into the next trading session. The opposite holds true for strong stocks. Buying a strong stock at the end of the day is a great bet - you're anticipating a gap-up the next day.

As you've probably already guessed, market timing techniques like these are important when you're trading penny stocks - especially when you're searching for short-term gains. That's why I tell my readers to never rush into a position. Decide what price you're willing to pay, use a limit order and hone your timing skills. That way, you'll always get the shares you want - without succumbing to the emotional pulls of the marketsâ€¦

And when the market does pull, you'll be better equipped to protect your investments against losses with another rule of thumb I encourage you to try. It will make all the difference in the world between successfully cutting your losses and preserving your gainsâ€¦and just losing all you've worked hard for. It's a techniques known as the â€œstop lossâ€•â€¦

How to Use a Stop Loss to Limit Your Downside Risk

If you're trading penny stocks, it's important to understand the benefits of setting stop losses to limit the downside on your trades. When you learn how to set up a proper stop loss, you can avoid holding onto a failing position due to purely emotional reasons. And by cutting your losses at the correct time, you can drastically improve your portfolio. Today, I'm going to show you exactly how to do just thatâ€¦
Take a look at the chart below (the name of the stock has been redacted - it's not important for our discussion):

In this example, let's say you entered a position in the stock at $1.09. You're hoping the stock is able to break through resistance at $1.15. But you

also want to protect yourself should the stock break its trend and move lower.

That's where the stop-loss order comes in. A stop loss is an order with your broker to sell your shares in a particular stock automatically when its price hits a specific level. That means if your shares of Stock A are up 30%, you can set a stop loss to trigger when the stock drops to 25%, guaranteeing your minimum profit. And when you're entering into a new position, like the one above, placing a stop loss guarantees that you won't be bleeding red ink if the trade goes awry.

Here's how it works: I drew the horizontal blue line through recent areas of support and resistance. If you look toward the earlier dates on the chart (October, November, December), you will see similar points of support at 60 cents, 75 cents and 90 cents, respectively. Resistance is at 70 cents, 85 cents and $1.05. It's not perfect, but rather a general area where a stock encounters a bit of a speed bump in its movement in either direction.

Now let's apply support and resistance to stop losses. We don't want the stock to break its uptrend. The stock has been bumping its head on $1.15 since December, and we want it to break and hold this mark. And we don't want the stock to break support of $1.05.

If you prefer a tight stop loss, set it at $1.05. That is, if the stock closes below the $1.05 mark, not if it merely breaks the $1.05 mark in intraday trading. If you want to give your trade a little more breathing room, you might want to consider the all-important $1 mark as your stop.

Of course, you can revisit your stop loss if and when your stock moves up. That's why you need to continue to monitor the position, updating your stop loss as the trade progresses. When the stock finds a new point of support, reset the stop loss directly below the new support. If it breaks the mark, sell and take your gains off the table.

As I mentioned above, the stop loss helps protect investors against their own emotions. Wanting a stock to go up - and the stock actually moving in the right direction - are two very different things. All to often, investors will hold onto their losing trades much longer than they should. These losses will eat away at all of your profitable trades, potentially causing you to make increasingly risky bets to make up the lost ground.

Simply put, it can be a recipe for disaster.

But, of course, stop losses only work if you set them and stick by your decision, selling if and when the time comes. Constantly second-guessing the market is another big mistake that can spell doom for your portfolio.

Hopefully, this will give you a better understanding of stop losses - and will help you set your own exit points for all of your trading activities.

About the Author

Guenthner Greg is a contributor to The Penny Sleuth, which offers unbiased commentary from expert analysts and authors about **penny stock investing**.

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