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HOW PENNY STOCK AFFECT STOCK MARKET INVESTMENT DECISION

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Abstract:

Penny stocks, generally characterized as shares trading below INR100, are recognized for their significant volatility, limited liquidity, and vulnerability to market manipulation. In India, nearly 90% of stocks fall under the classification of penny stocks according to this definition. Given their significant presence in the stock market, it is essential to investigate whether these stocks present an untapped investment opportunity or if they are justifiably overlooked. While equity market analysts may highlight specific stocks they consider promising, a comprehensive analysis of this asset class is notably lacking. While they offer the potential for substantial returns, they also present considerable risks for investors. This study investigates how the distinctive features of penny stocks affect investor behavior, market dynamics, and the overall stability of financial markets. Through the analysis of historical data and surveys conducted with market participants, the research aims to shed light on the risks and rewards associated with penny stock trading and its wider implications for financial markets.

Key Words: penny stocks, comprehensive analysis, financial markets, stock market, trading

Introduction

Equity markets serve as a crucial financial intermediary within any economy, facilitating the flow of capital from savers to those in need of funds. Their performance significantly influences the sentiments of economic agents, including individuals who may not be directly involved in trading activities. This importance has led to extensive exploration within the fields of economics and finance. However, much of the existing literature focuses on large, liquid, and frequently traded stocks. This emphasis is understandable, as large-cap stocks represent a disproportionately high share of market capitalization and trading volume. For instance, as of November 2014, the BSE 500, which includes the largest 500 of over 5,000 companies listed on the BSE, accounted for 94% of the total market capitalization of the BSE. Consequently, a considerable number of listed stocks receive insufficient attention from the academic community, likely due to the heightened uncertainty associated with them stemming from infrequent trading and minimal compliance with disclosure requirements.

Literature Review:

Weld, Thaler et al. (2009)[1] observed that the average nominal share price in the United States remained around $35 from 1935 to 2007. They contended that trading norms played a significant role in maintaining this price level, as firms adhered to established market traditions when determining their nominal prices, often through stock splits.

Baker, Greenwood et al. (2009)[2] introduced and empirically validated a Catering Theory of Nominal Share Prices, positing that finance managers tend to issue more low-priced securities through stock splits when these securities are trading at a premium compared to their high-priced counterparts. This phenomenon is termed "catering," as such corporate actions do not alter the intrinsic value of the security but rather appear to align with certain characteristics for which investors are currently willing to pay a premium.

Lakonishok, Shleifer, and Vishny (1992)[3] demonstrated that individual investors tend to hold low-priced stocks more frequently than institutional investors, indicating a market segmentation based on investor type and the nominal price of the stock. Evidence suggesting that stock splits enhance the appeal of a stock to small investors.

Regarding minimum listing requirements, these typically mandated positive earnings prior to the establishment of market-based criteria dictated by capitalization **(Klein and Mohanram 2006)**[4]. The necessity for revenue reporting prior to listing is inherently included in the earnings requirements, and stock exchanges generally do not entertain listing firms that are at a pre-revenue stage. There are several arguments against the listing of such emerging companies. Firstly, the failure rate for pre-revenue companies is notably high, and individual investors often lack the tools and expertise to accurately assess these investments, which share many traits with private equity. Secondly, pre-revenue firms are usually financed by specialized intermediaries capable of addressing information asymmetries through screening, contracting, and monitoring processes.

Increased Activity In Penny Stocks

The key factors contributing to the increased activity in penny stocks:

Factor	Description
Global Economic Recovery	Positive influence on market sentiment and optimism towards small-cap stocks.
Rise in Retail Participation	Increased participation, particularly among millennial and Gen Z, driven by new Demat accounts.
Emergence of User-friendly Online Trading	Growth in online trading platforms, making it easier for retail investors to engage in speculative trading.
Influence of Social Media	Social media platforms fueled speculative trading, contributing to extreme price fluctuations.

Factor	Description
Volatility	Some penny stocks saw gains exceeding 300%, but the volatility also introduced risks like market manipulation and a lack of transparency.

Several significant factors led to the heightened activity in penny stocks following 2021. The resurgence of the global economy, coupled with enhanced market sentiment, fostered a sense of optimism among retail investors regarding small-cap stocks[5]. A notable increase in retail participation, particularly among millennial and Generation Z, was largely attributed to the surge in newly established Demat accounts during the pandemic. Furthermore, the rise of user-friendly online trading platforms and the pervasive influence of social media catalyzed speculative trading, resulting in dramatic price volatility for numerous penny stocks. While certain stocks saw gains surpassing 300%, this volatility also introduced risks, such as market manipulation and insufficient transparency.

The Negative Relationship Between Size At IPO And The Failure Risk

The inverse correlation between IPO size and failure risk has been substantiated by research conducted by Rutherford, and Springer (1997). Consequently, we anticipate a negative correlation between the size of the IPO and the delisting rate. LOGSIZE represents the natural logarithm of the shareholders' equity post-issue. Numerous IPOs are launched during periods of heightened market activity, characterized by excessive demand for new issues, which often attracts lower-quality issuers. Therefore, we predict a diminished survival rate for issues that arise during these active market periods. We define Hot and Cold Issue market periods in accordance with Helwege and Liang (2004)[11], by calculating the three-month centered moving average of the number of IPOs. DHOT (DCOLD) is assigned a value of 1 if the corresponding month falls within the upper (lower) third of the moving average distribution.

Factors Influencing Penny Stock Activity

Economic Recovery and Positive Market Sentiment

The post-COVID-19 economic recovery and subsequent GDP growth in India have significantly bolstered investor sentiment. Retail investors have exhibited increased optimism towards small-cap and micro-cap stocks, benefiting from the overall economic rebound.

High Retail Participation

The Covid-19 pandemic led to a significant increase in the number of new Demat accounts opened in the Indian stock market, likely due to the reduced cost of entry resulting from the market crash during this period. According to the Securities and Exchange Board of India (SEBI) report of 2023[6], the number of active retail investors surged by over 50% from 2020 to 2023. Data from the National Stock Exchange (NSE) corroborates this trend.

Large Price Surge

Following the Covid-19 pandemic, penny stocks experienced dramatic price fluctuations, with several stocks witnessing gains exceeding 300% within brief periods. This surge in prices was primarily driven by speculative trading. Investments in penny stocks offered substantial returns, attracting numerous investors to this segment. For instance, stocks such as

Brightcom Group and TTML experienced significant rallies in 2021 and 2022, largely due to a frenzy of retail buying and the influence of online trading communities[7].

Influence of Social Media and Online Forums

The global rise in the use of social media and online forums during the Covid-19 pandemic significantly contributed to the popularity of penny stocks. Retail investors increasingly relied on "stock tips" and speculative posts, which led to excessive buying and inflated stock prices. A sentiment analysis of online discussions during this time revealed a predominantly optimistic view of penny stocks, with frequent references to "multibagger potential" and "low risk, high reward."

Speculative Trading Behavior

The prices of penny stocks are heavily influenced by speculative trading behavior, where investors pursue quick profits based on short-term price fluctuations rather than fundamental analysis. This behavior was intensified by the "fear of missing out" (FOMO)[8] during the market rally that followed the pandemic.

Drawbacks Of Investing In Penny Stocks

Limited Transparency

Penny stocks often suffer from a lack of financial transparency, making it challenging for investors to accurately assess their true value. Consequently, the actual financial position of penny stocks remains obscured[12].

Market Manipulation Potential

Penny stocks, characterized by their low share prices, are particularly vulnerable to market manipulation. It is not uncommon for promoters to artificially inflate the stock price prior to liquidating their holdings.

High Price Volatility

The prices of penny stocks can experience significant volatility, even within a single trading day, which can result in considerable losses for investors. Furthermore, institutional involvement in penny stocks is minimal. This lack of institutional engagement often leads to small buy or sell orders exerting a substantial influence on the stock price[9].

Conclusion:

Nominal share prices, which are not adequately explained by traditional financial theories, present a compelling issue in finance. This paper investigates this phenomenon by categorizing stocks based on their nominal prices. We establish specific breakpoints to classify stocks, defining penny stocks as those within the lowest price category[13]. Our findings indicate that penny stocks, despite representing a minor portion of market capitalization and trading volume, continue to persist. They demonstrate lower average returns when adjusted for the tails of the returns distribution, yet exhibit significantly higher returns otherwise. Additionally, they trade less frequently than even low-priced non-penny stocks. When controlled and corporate governance factors, they yield excess returns. However, in the context of Indian markets, higher denomination stocks consistently produce positive abnormal returns in comparison to those with lower nominal prices. These results remain robust across various breakpoints used to define penny stocks.

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