Penny Shares Fact Sheet

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What is a 'penny share'? There are many different definitions, but the Financial Conduct Authority (FCA) states: The term `penny shares' usually refers to shares in small companies that are either admitted to public markets in the UK or are unlisted.

One major difference between penny shares and blue-chip shares - large, well-established and financially sound companies - is the level of information available. For larger companies there are a number of analysts covering the shares in great detail. Institutional investors are continually running a rule over such companies and the financial pages track every movement made by directors. Therefore, little news comes as a shock since larger companies are rarely out of the spotlight. In contrast, many penny share companies have little or no research coverage and the main clues as to financial performance are only revealed with results or when major events are announced to the stock exchange. This creates a situation whereby greater volatility should be expected as markets react to fresh information.

In the short term, coverage in investment publications can move prices. For example, if 100 private investors act on a good write-up and each buy £1,000 of shares in a large company, the effects will be negligible. However, trades of that magnitude for a company with a market capitalisation of £5m would have a greater effect on the share price. Often, this can create a situation whereby the share price of smaller companies reflects a shortage of shares in the market rather than any improvement in prospects for the business.

Penny shares are often traded infrequently and one major transaction may swing the share price to the advantage of someone willing to take a contrary view. For instance, if someone sells a large block of shares in a company, this can push the price down to an artificially low level as market makers seek buyers to balance their books. Often there is no change in a company's prospects in this type of situation - the seller may just have lost patience or been forced into a sale through personal circumstances. Those willing to purchase shares and wait for an opportune moment to sell can use the system to their advantage. Equally, a surge in demand through a major buyer can send a price skywards, creating an attractive selling opportunity.

There is a relatively high failure rate amongst smaller companies due to their reliance on a few products, or even one. For example, if a small ice cream producer is hit by two consecutive poor summers then it could spell the end. A diversified industrial company such as Unilever is likely to be able to absorb such eventualities with limited impact. The opposite may also be true such that if trading conditions are favourable, smaller companies may be more likely to see a significant improvement in profitability.

For many, this is where the attraction of penny shares lies - the potential for strong capital growth in a relatively short timeframe. Equally, your entire investment is potentially at risk. The FCA state that penny shares could make up part of a diversified portfolio for people who wish to invest in a high-risk market, especially sophisticated investors.

Investments and income arising from them can fall in value and you may lose some or all of the amount you have invested. There is greater risk of losing money when shares are bought in some smaller companies, including 'penny shares', as there can be a big difference between the buying and selling price.