Buy What You Know?

My Son Likes Video Games. Should He Invest In Them?

READ THE ARTICLE BELOW AND SUMMARIZE THE MAIN POINTS IN <u>10 BULLET POINTS</u>. YOU CAN TYPE YOUR RESPONSES IN AN EMAIL, WORD, OR POWERPOINT.

Question: My teenage son has $3,000 in a savings account that we're thinking of investing in a stock or two. I've read that you should invest in things that you have an interest in, which in his case is video gaming. Any suggestions?

Answer: Yes, my suggestion is that you keep your son's video gaming and investing separate.

The "invest in things you have an interest in" -- or, more accurately, "invest in what you know" -- school of investing was popularized by legendary mutual fund manager Peter Lynch.

In his best-selling book One Up on Wall Street, Lynch wrote about buying Dunkin' Donuts stock because he liked the coffee and investing in Hanes because his wife wore the company's then new L'eggs line of pantyhose.

Investors worldwide have since taken this to mean that if you come across a product or service you really like or intrigues you, others will probably be drawn to it too, so chances are you can make money investing in the stock of the firm that manufactures the product or delivers the service.

Applying that principle to your son, and the idea is that he might want to invest in a company that makes popular video game systems, such as Nintendo (Wii) or a publisher of video games, such as Electronic Arts (Battlefield 2) or Activision Blizzard (Guitar Hero).

But as appealing as this concept may be, I don't think buy-what-you-know really cuts it as an investing strategy, and I don't recommend you and your son invest his three grand on that basis.

Why?

Well, for one thing, people who espouse this theory oversimplify what Peter Lynch actually said. After he talks in the book about Dunkin and Hanes, he goes on to say that "finding the promising company is only the first step. The next step is doing the research."

And knowing how to do that research and actually doing it is what made Peter Lynch a great investor, not his taste in coffee or panty hose (well, his wife's taste in panty hose).

The reason that the research is so important is that even if a company really does make a superior product, it doesn't necessarily mean its stock is a great buy.

The price per share might be blimpish relative to its future earnings prospects, limiting the potential for future gains. It may not have enough new products in the pipeline to stay competitive. Or it could be carrying crushing debt or just poorly run.

Sorting through such issues takes a bit of financial knowledge and expertise. I'm not saying that stock analysis is completely beyond the ken of an intelligent teen. But he would have to be as willing to devote himself to poring over balance sheets, income statements and financial projections as he is to thumbing his way around a video game controller.

And even if your son is OK with doing the necessary homework for investing in individual stocks, where would he be at the end of the process? He'd have all his money invested in a couple of stocks in one industry. He'd be vulnerable to "idiosyncratic" risk, which is a fancy way of saying that if, despite his best efforts, the stocks he chose blew up, he'd take a big hit because he concentrated his money in just a couple of picks.

In fact, even if the companies themselves had no major problems but the industry fell out of favor for some reason -- say, a backlash against the violence in some of these games -- he could suffer losses simply because he put all his eggs in one industry basket rather than spreading them around a variety of industries and sectors.

So unless your son sees himself as a Peter Lynch in the making and considers this basic training -- or you feel there's no other way to get your son's attention when it comes to investing -- I'd say you're better off helping him pick a broadly diversified stock mutual fund, like the total stock market index fund on our MONEY 70 list of recommended funds.

One more thing: If it's any consolation to him, by investing in the total stock market index fund he'll also indirectly own a piece of video game companies like Activision, Electronic Arts and Take Two, not to mention more than 3,000 other companies, which should cover any other interests he might have.