Warren Buffett, Peter Lynch and Your Company Stock

The "Power of Common Knowledge" is a good place to start, not an end

It's an old investing adage: "Buy what you know."

But that advice has real downsides if you don't apply it properly. Investing icon Warren Buffett and legendary portfolio fund manager Peter Lynch both advocate that investors purchase stock in companies whose businesses they understand. The proviso is that investors take a sophisticated approach. Because plunging ahead, full of self-assurance, often is risky and unprofitable.

What Does It Mean to Understand a Business?

Some businesses are understood more intuitively than others, but familiarity should never be a substitute for due diligence. What often separates professionals from individual investors are attention to detail and focus on valuation. Many investors fail to appreciate the scrutiny that successful professionals require to understand a business.

Consider an investor who purchases General Electric stock because he likes their appliances. He ignores the fact that GE got kicked out of the DJIA last year. And then GE lost about 57% of its value in 2018, on its way to the second worst stock performance for the year.

Or consider the investor who bought Coty, the beauty and makeup supplier because she likes their products. She ignores that Coty spent $12 billion to merge with a bunch of Procter & Gamble's businesses. Well, Coty was the worst performing stock in 2018, dropping 67%.

The Power of Common Knowledge

Peter Lynch, the former Fidelity Magellan manager, compiled one of the most impressive track records for mutual funds. He encourages investors to harness the "power of common knowledge" by buying stock in companies that produce goods and services that you are personally familiar with. Lynch drove a Volvo and bought stock in the company and he was a fan of Dunkin Donuts coffee and also bought that stock.

Lynch, however, did not generate impressive returns by simply buying shares in companies whose goods he purchased. He meticulously analyzed company filings and financial statements to learn as much as possible about its business and its valuation.

Familiarity Is a Starting Point, Not an End Point

While it makes sense to use the "power of common knowledge" as a starting point, investors should resist the temptation to substitute familiarity for due diligence. Familiarity with products, in and of itself, is not a good reason to purchase a stock.

If familiarity leads you to a company that, after thorough analysis, appears to be a well-managed business with sustainable competitive advantages and favorable valuation, then seriously consider buying the stock.

But buying shares in a company like Coca-Cola just because you like their beverages is not a good strategy. Warren Buffett is well-known for investing in Coca-Cola, but he did not invest just because he likes Diet Coke. Buffet bought the beverage giant's stock because the company sells products in nearly every country and has sizable profit margins. Also, Coke can charge a premium for its products because consumers are hesitant to shift to a competing brand.

Exercise Caution with Your Company's Stock

Even more hazardous is when familiarity with the company you work for prompts you to allocate a large portion of your portfolio to its stock. Many people feel that investing in their employer's stock makes sense because they know the company best. Trouble is, this leads to very poor diversification.

Your employer is the source of your income. So, your personal finances are disproportionately dependent on the success of one company. Should your company's business take a turn for the worse, you may get hit with the unpleasant combination of investment losses and job loss.

Not very many investors think their company will go through bad times or deliver investment losses, but it happens a lot.

Remember when New York State's attorney general, Eliot Spitzer, charged Marsh & McLennan, the large insurance brokerage firm, with insurance fraud? Employees held over $1.2 billion in company stock in retirement plans. The fraud charges caused the price of the stock to plunge 48% in four days. More than $500 million in retirement funds was wiped out. Over the next six months, Marsh laid off 5,500 employees. Many remained jobless for an extended period, with a retirement fund cut in half.

Professor Lisa Meulbroek of Claremont McKenna College estimates that a 50% allocation to your employer's stock, over 10 years, is worth less than 60 cents on the dollar after adjusting for risk. And the risk-adjusted value of just a 25% allocation to your employer's stock is only worth 74 cents on the dollar.

Think about other aspects of your personal finances. Your home is not likely to burn down, but it remains prudent to protect yourself with homeowner's insurance.

Your company will probably not be the next Enron, Washington Mutual or Lehman Brothers. Still, you should still insure against the possibility of catastrophic investment losses coupled with job loss by placing a limit on your allocation to company stock.