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

But that advice has real downsides if you don't apply it properly. Plunging ahead, full of self-assurance based on passing knowledge, 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.

The Power of Common Knowledge

Some investment thinkers like Warren Buffett have encouraged harnessing the "power of common knowledge" by buying stock in companies that produce goods and services that you are personally familiar with.

However, successful professional investors do not generate their impressive returns by simply buying shares in companies whose goods they purchased. They 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 to a company that, after thorough analysis, appears to be a well-managed business with sustainable competitive advantages and favorable valuation, then it could be reasonable to consider the stock in the context of a larger economic analysis.

But buying shares in a company just because you like its beverages is not a good strategy. If that company has sizable profit margins and substantial other competitive advantages and a truly justifiable stock price, etc. etc. that may be something else.

What this adage also tells us is, don't have your head turned by an "urgent hot tip" where you are relying on the judgement or honesty of another party whose credentials and history are not known to you.

Exercise Caution with Your Company's Stock

Also hazardous is when familiarity with the company for which you work 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. The trouble is, this can lead 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.

Remember when Marsh & McLennan, the large insurance brokerage firm, was charged 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.

Think about it like 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.