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People who don't understand value investing often say that in order to make a higher return, you must take on more risk. No risk; no reward. We know that those people are wrong, of course. The challenge is finding and investing in the opportunities where risk is low and the possibility of gains is high.

Let's break this down into two parts: One, where are the opportunities where risk of permanent capital loss is low? And, two, what are some characteristics that may lead to exponential gains?

We can reduce the chance of permanent capital loss by looking for companies that have strong balance sheets, low debt, a large amount of cash relative to their market cap, predictable operations, and competitive advantages, to name a few characteristics. This part is actually not that difficult. The difficult part is finding companies with those characteristics trading at great prices. We want to look for companies whose other investors are involved in the company because of its balance sheet. We want the investor base to be conservative and the price to be reasonable. We want investors to view the company for its safety, not its potential.

What characteristics do we look for that may lead to exponential gains? These companies typically have significant reinvestment opportunities. Their managers have strong capital allocation skills. Returns on equity and returns on invested capital are high. They often are owner-operated, where the directors and managers own a significant number of shares. There are also often incentives in place that reward growth, whether it is a bonus structure, tax loss carryforwards, or engaged directors or large shareholders focused on performance.

The opportunity for us is to find a company from the first category that also has the characteristics from the second category. We are then able to buy in along with all of the other investors who are focused on the balance sheet, but at prices that do not reflect the growth opportunity and earnings potential. The good news is that there are not that many companies like this out there. That's the bad news too. When we find these opportunities, we need to recognize them for what they are and be willing to allocate a significant amount to them.

The way to get exponential gains is for operational results to improve and for public market multiples to increase. Gains can be even greater if the company's current investors are paying a multiple of book value, but future investors are willing to pay a multiple of earnings, or cash flow, or EBITDA. This is what I call balance sheet to income statement investing.

The company I [presented] at Best Ideas 2017 is a great example of balance sheet to income statement investing. It has several characteristics mentioned above, is one of my largest holdings and favorite ideas, and offers both safety and potential for significant gains.

On the safety side, this company trades for a significant discount to its book value. Even better, it has several off balance sheet items that cause its true book value to be even higher that its GAAP book value. The company is a cannibal. It has bought back a huge chunk of its outstanding shares over the past several years and will buy back another 9% of its shares next year. Shares trade for only 80% of the company's stated book value, so all repurchase are accretive, even more so when taking into account its unstated assets.

This company also has significant earnings potential. They have entered several ventures where the chances of success are high. While these ventures are relatively new, returns on invested capital are high. Managers are actively buying shares and their incentives are aligned with shareholders. The company also has tax assets that are just beginning to be applied to its earnings.

Current investors are involved because of the safety of this company's balance sheet. Future investors will buy into the company on multiples of its earnings. In this case, you don't need to take on a high amount of risk to have the potential for significant gains.