

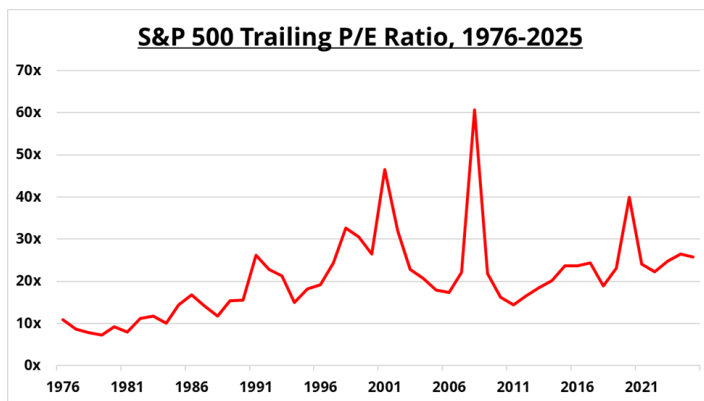


# Newsletter

SMEAD US VALUE — 1ST QUARTER 2026 (3/31/2026)

## Permanently Higher Plateau

Now that the bloom has started coming off the growth/momentum rose, we would like our shareholders to consider the arguments of those who believe the S&P 500 Index is “just in a correction.” Their argument is that today’s S&P 500 Index has the ability to provide a permanently higher price-to-earnings (P/E) ratio to protect forward returns.



Source: Bloomberg

As you can see in this chart, investor confidence drove historically high trailing P/E ratios in 2000 and 2021, while the deep recession and lower earnings during the financial crisis led to an inflated P/E ratio due to a lack of earnings.

We would like to highlight the free cash flow of the dominant stocks in recent years. We think of this the way you’d think of it as a private business owner would. What are the economic earnings after all expenses among the key tech stocks in the Index? We will also do the same exercise for our oil and gas holdings to give our investors an understanding of their merit, and as a contrast to the S&P 500 Index. Remember, we hold partial ownership of publicly traded companies as if we owned them as a private company.

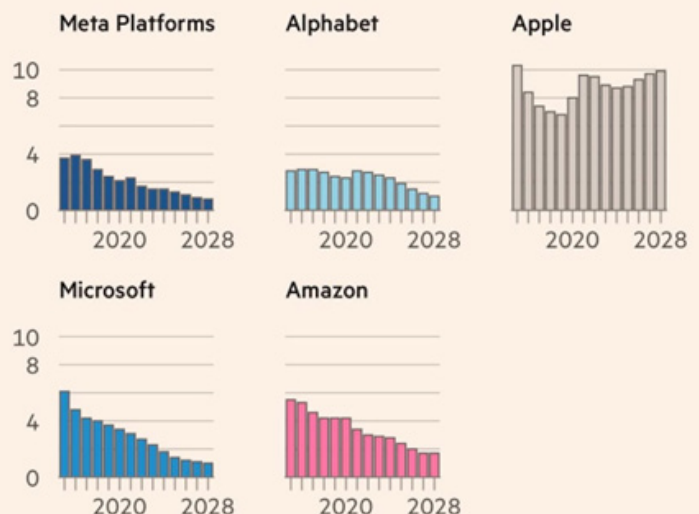
We believe most portfolio managers and asset allocators are comfortable with a P/E ratio for the S&P 500 of 20 because they believe today’s largest companies are much better than those in the past. And they believe that AI and its positive implications will be the next driver.

Certainly, P/E ratios have trended higher over the last 43 years from the depths of the 1982 low point. We would highlight a few reasons that have justified that expansion. First, the 10-Year Treasury bond rate dropped from 14% in 1984 to 1% during the COVID era. Obviously, as the rates declined, the equity risk premium compressed. Second, technology, normally a very cyclical part of the S&P 500, has been carried along by the Microsoft era, then the Dotcom era, then the FANG era, and, as of late, the AI era. Lastly, aside from the 2007–2009 Financial Crisis bear market, corrections haven’t lasted much longer than a year and have been more of the 20% decline variety. The exceptions were in 1987 (-43% in 78 days) and in 2020 (-40% in 60 days). This limited amount of pain has significantly altered investor confidence and does not fit the long-term history.

Therefore, what would justify a historically high P/E ratio for the S&P 500 Index? The heavily concentrated position in the largest dominant companies must have no interruption in their business dominance and free cash flow generation. What we are seeing at Microsoft (MSFT), Alphabet (GOOG), Meta (META) and Amazon (AMZN) is that revenue generated per dollar of fixed assets is declining.

## Many unhappy returns

Revenue generated per dollar of fixed assets (\$)



FINANCIAL TIMES

Sources: Visible Alpha, FT research • Consensus estimates for 2026 onwards

## Permanently Higher Plateau

The key to the magnificent seven companies was their dominant market position, which required very little reinvestment of current cash flows. The race to adapt and win the next phase of technology (AI) is killing the free cash flow goose that used to lay the golden eggs! Now, we will switch gears and look at the long-term ownership implications of the free-cash flow of Apache Corp (APA) as the Iran War disruption has taken the WTI oil price to \$110 per barrel. First, these projections are based on a successful resolution of the current fighting in the near future. Wars have been fairly constant in the Middle East for 3000 years, but we will assume it will end in the next few months.

Second, and most importantly, investors have woken up to the fact that oil and gas are precious commodities that are legal and addictive. And now there is a reestablishment of a geopolitical risk premium that was ignored for a few years in oil prices. You see, low oil prices cause high oil prices and high prices cause low prices. When prices are low, people in the industry save their investable drilling dollars and resist poking holes in the ground looking for oil.

Therefore, as shown in the chart below, APA is likely to enjoy copiously higher free cash flow generation and returns on capital at prices anywhere above \$70 per barrel, even if the threat of war heads into the review mirror. Demand will meet supply at prices that reincorporate a risk premium which has been absent in recent years.

APA Corporation — FCF Oil Price Sensitivity (CF Tab, Row 14)							
Market Cap: \$15,606MM   EV: \$20,831MM   FCF yield on current market cap and enterprise value							
Assumptions		Value					
Market Cap (\$MM)		\$15,606					
Enterprise Value (\$MM)		\$20,831					
Year	NYMEX Oil (\$/bbl)	FCF (\$MM)	FCF / Mkt Cap	FCF / EV	Base FCF (\$MM)	Base NYMEX (\$/bbl)	
2026E	\$70	\$1,900	12.2%	9.1%	\$1,699	\$66.23	
2026E	\$80	\$2,433	15.6%	11.7%	\$1,699	\$66.23	
2026E	\$90	\$2,966	19.0%	14.2%	\$1,699	\$66.23	
2027E	\$70	\$1,218	7.8%	5.8%	\$1,024	\$60.00	
2027E	\$80	\$1,583	10.1%	7.6%	\$1,024	\$60.00	
2027E	\$90	\$1,948	12.5%	9.4%	\$1,024	\$60.00	
2028E	\$70	\$1,448	9.3%	7.0%	\$1,236	\$65.00	
2028E	\$80	\$1,872	12.0%	9.0%	\$1,236	\$65.00	
2028E	\$90	\$2,296	14.7%	11.0%	\$1,236	\$65.00	

Sensitivity methodology: incremental oil revenue  $\times$  (1 - prod tax rate)  $\times$  (1 - current cash tax rate). Deferred taxes and NCI-Egypt net to zero in the DCF bridge. Blue cells = hardcoded inputs. Black cells = formulas.

Apache's 12.2% free cash flow at \$70 per barrel makes us wish we owned the whole company. This is in contrast to what the glam tech behemoths are putting up with. They are commanding lower returns on fixed capital, while Apache is getting higher returns without additions to fixed assets.

In conclusion, our long-time investors are aware that we believe the S&P 500 Index is going to have a hard time producing the kind of returns that match investor expectations. At the same time, we believe investors have underestimated how much value there is in a cyclical but repeat business like oil and gas. It is our belief that we are well positioned to do well relative to other investors in both large-cap and large-cap value, as we have in the past, while we play the long game.

Play The Long Game,



**Bill Smead**  
Lead Portfolio Manager



**Cole Smead, CFA**  
Co-Portfolio Manager



# Invest With Us Today!

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