

CLIENT QUESTION OF THE MONTH: Can AI be used to identify mispriced securities?

Active investors have long attempted to get an informational edge on markets by using artificial intelligence (AI) processes to retrieve and process data. For example, tools that gauge sentiment from social media or scrape text from company financial reports predate ChatGPT by many years.

Material information gleaned from running AI processes is very likely a subset of the vast information set known by the market in aggregate and reflected in market prices. If new information is obtained, the process of acting on that information incorporates it into market prices.

Another reason to question AI's role in helping with market timing is limitations with its predictions. AI's forecasting ability fares well when assessing patterns that are relatively stable. The market is fantastically complex. So much so that no one knows exactly how much a particular piece of information impacts a price, because there are so many other simultaneous inputs. AI trying to predict market prices is like self-piloting cars trying to read stop signs with words, shapes, and colors that differ every day.

As an example, consider the AI-Powered Equity ETF, launched in 2017. It employs IBM Watson's AI to analyze publicly available information to pick US stocks that will outperform the US market (**Exhibit 1**).

Exhibit 1: AI Powered Equity ETF vs. Russell 3000 Index and S&P Technology Select Sector Index

Cumulative returns, November 1, 2017–May 26, 2023



Source: FactSet. Sample period begins with the first full month of returns for AI Powered Equity ETF. Past performance is not a guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. S&P data © 2023 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved.

While Watson can outwit an individual, its intelligence pales in comparison to the aggregate wisdom of the millions of individuals trading in stock markets each day. It is perhaps unsurprising then that the Watson-powered ETF has lagged the broad US market and, by a wide margin, the US technology sector since its inception.

Sure, AI can help the execution of trades. But the market is powerful and ensures a price is the most accurate current representation of the value of a stock or bond. There's no reason to think that AI should fundamentally influence the way people think about stock prices anytime soon.

[WATCH: Gerard O'Reilly discusses the Difference between AI and Markets](#)

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