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How to Lose Money on the World’s Most Popular Investment Theme

Pity the investors in the three artificial-intelligence-themed ETFs that managed to lose money this year

By *James Mackintosh* Follow

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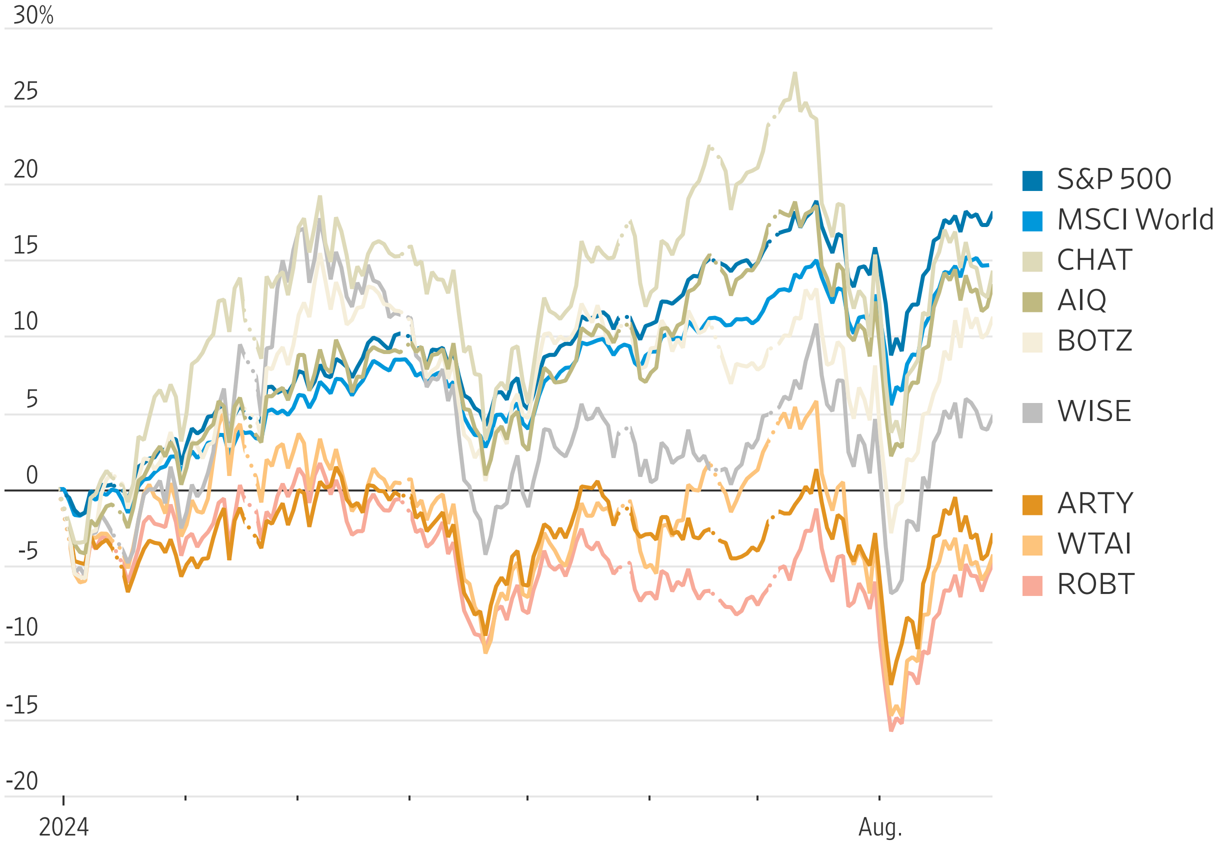
Ironically enough, Nvidia’s success has made it harder for some of the AI funds to beat the wider market. PHOTO: CFOTO/NURPHOTO/ZUMA PRESS

There are lots of embarrassing ways to lose money, but it is particularly galling to lose when you correctly identify the theme that will dominate the market and manage to buy into it at a good moment.

Pity the investors in the three artificial-intelligence-themed exchange-traded funds that managed to lose money this year. Every other AI-flavored ETF I can find has trailed both the S&P 500 and MSCI World. That is before the AI theme itself was seriously questioned last week, when investor doubts about the price of leading AI stocks Nvidia NVDA **1.51%** ▲ and Super Micro Computer SMCI **-2.48%** ▼ became obvious.

The AI fund disaster should be a cautionary tale for buyers of thematic ETFs, which now cover virtually anything you can think of, including Californian carbon permits (down 15% this year), Chinese cloud computing (down 21%) and pet care (up 10%). Put simply: You probably won't get what you want, you'll likely buy at the wrong time and it will be hard to hold for the long term.

Price change of selected AI ETFs this year



Note: Only ETF tickers shown
Source: FactSet

Ironically enough, Nvidia's success has made it harder for some of the AI funds to beat the wider market. Part of the point of using a fund is to diversify, so many funds weight their holdings equally or cap the maximum size of any one stock. With Nvidia making up more than 6% of the S&P 500, that led some AI funds to have less exposure to the biggest AI stock than you would get in a broad index fund.

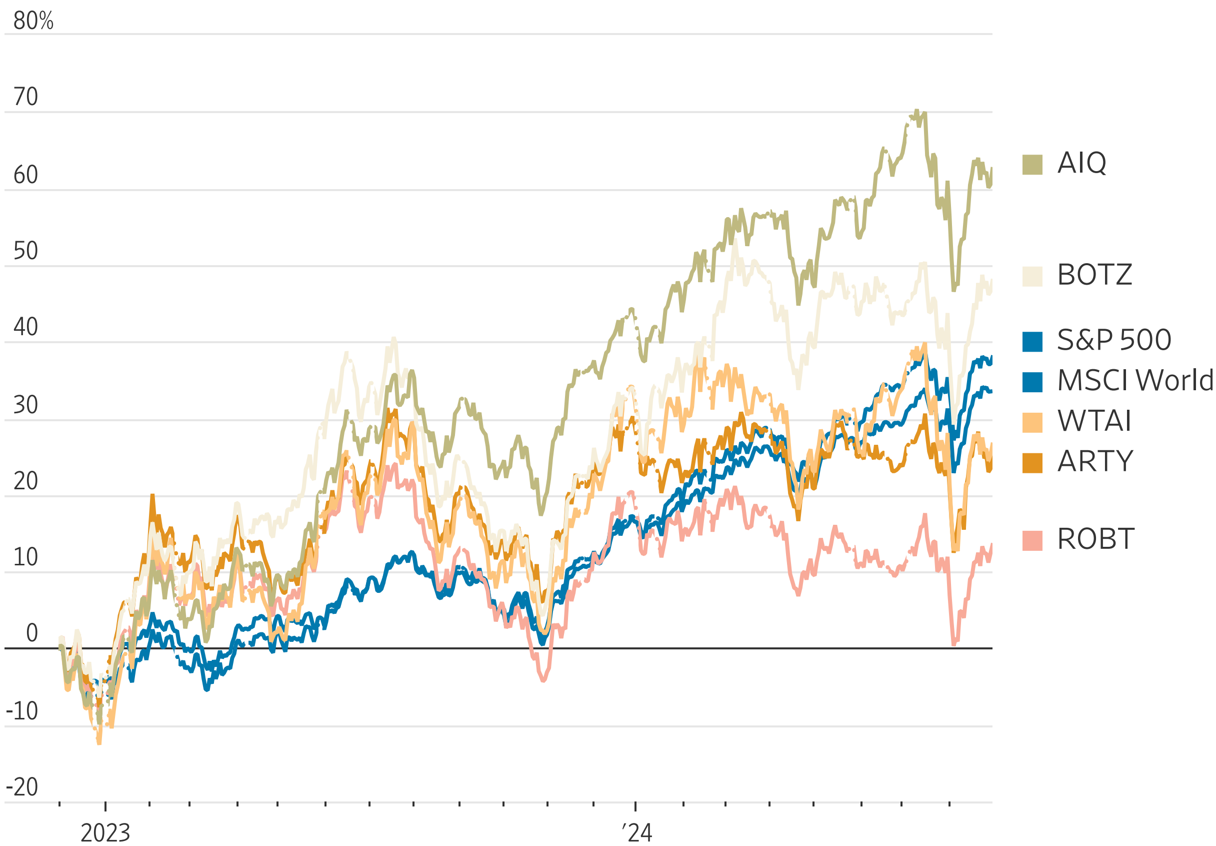
This problem hit the three losers of the year. First Trust's $457 million AI-and-robotics fund has only 0.8% in Nvidia, a bit over half what it holds in cybersecurity firm BlackBerry.

WisdomTree's $213 million AI-and-innovation fund holds the same amount of each stock, giving it only 3% in Nvidia.

BlackRock's $610 million iShares Future AI & Tech fund was also equal weighted until three weeks ago, when it altered its purpose from being a robotics-and-AI fund, changed ticker and switched to a market-value-based index that gives it a larger exposure to Nvidia.

The result has been a 20-percentage-point gap between the best and worst AI ETFs this year. There is a more than 60-point gap since the launch of ChatGPT in November 2022 lit a rocket under AI stocks—although the ETFs are at least all up since then.

Price change of selected AI ETFs since ChatGPT launched in Nov. 2022



Note: Only ETF tickers shown; WISE and CHAT ETFs excluded as launched later.
Source: FactSet

The market has penalized being equal weighted recently, instead rewarding big holdings in the largest stocks.

Jay Jacobs, U.S. head of thematic and active ETFs at BlackRock, says it is best to be market-value weighted when a theme has winner-takes-all characteristics, which he says generative AI has. When the firm's AI fund included robotics it was spread across a lot more stocks that didn't compete with each other, so equal weighted made more sense.

For investors, it isn't so simple. Global X takes the opposite approach with its two $2 billion-plus AI funds, AIQ and BOTZ. BOTZ only buys stocks that focus on AI and robotics, but takes larger positions. AIQ spreads its bets on AI and tech more widely, and its 3% cap on its biggest holdings each time it rebalances means it has far less in Nvidia than BOTZ, with a cap of 8%. AIQ still managed to beat BOTZ this year, though.

So far, so confusing. The basic lesson: Picking among funds within a theme is hard, and depends on luck as well as close reading of the fund's documents. A more advanced lesson is that it is hard to pick a theme in the first place, or to stick with it. The three problems:

1. Defining the theme is hard. Nvidia features in the anti-woke YALL ETF, which pitches itself as for "God-fearing, flag-waving conservatives." The chip maker is also held by vegan, gender-diverse and climate-action ETFs. Its shares are clearly driven by the prospects for AI, but it is still big in computer-game and bitcoin ETFs, where its chips were originally used.

2. Timing the theme is even harder. Get in too early, and there aren't any companies to buy. Get in when the funds are being launched, and the chances are the theme is already widely known and overpriced, as there are typically large numbers of launches during bubbles and late-stage bull markets.

"They are trendy by design," says Kenneth Lamont, a senior researcher at Morningstar. "They play to our worst instincts, because we're narrative-driven creatures."

A recent example was the race to launch clean-energy and early-stage-tech ETFs during the bubble of late 2020 and early 2021. Performance since then has been miserable as prices corrected, with many of the ETFs halving or worse.

Dire timing is common across themes: According to a paper last year by Prof. Itzhak Ben-David of Ohio State University and three fellow academics, what they call "specialized" ETFs lose 6% a year on average over their first five years due to poor launch timing.

3. **Long-term investing** is pitched by fund managers as the goal for thematic investing, to hang on until the theme bears fruit. But even investors who really want to commit to a theme for the long run often find it hard, as so many funds are wound up, merged or change strategy when they go out of fashion.

The boom in internet funds of the late 1990s vanished after the dot-com bubble burst, with few surviving to see the internet theme blossom a decade later, while six of the 50 “metaverse” funds launched after Facebook switched to Meta Platforms in 2021 have already shut, according to Lamont.

The oldest thematic fund, the DWS Science and Technology mutual fund, started as the Television Fund in 1948 before adding electronics, and has gone through at least four other names. I only have data back to 1973, but it has lagged far behind the wider market since then, despite golden ages for television, electronics, science and now tech. (Yes, it has a lot of Nvidia.)

So what to do? At a very minimum, don’t buy based on the name of a fund. Look at the holdings, look at the index it follows and how it is structured, and consider whether it does what it says. Then think about just how expensive the idea has already become. Watch for the theme coming into fashion and getting overpriced, as that is a good time to sell (or to launch a fund).

But mostly, look at the fees: They will be many times higher than a broad market index fund, and the dismal history of poor timing suggests that for most people they aren’t worth paying.

Write to James Mackintosh at james.mackintosh@wsj.com

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