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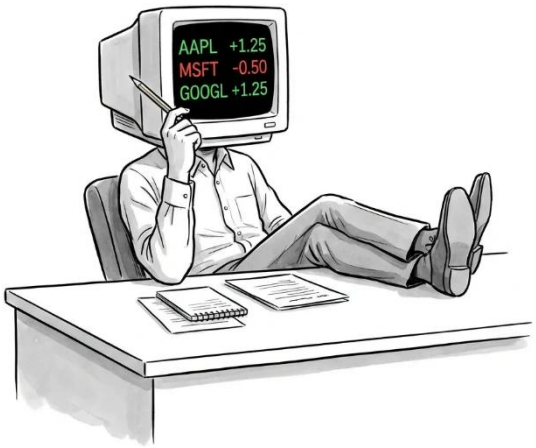
The Machine That Outsmarts Itself: AI Trading and the Old Law it Can't Repeal

By Peter Hunt, Chief Investment Officer



"One man's data is another man's AI"

There is a quiet shift happening in how money moves. A growing number of investors - professionals and amateurs alike - are handing their thinking over to artificial intelligence. Ask a chatbot which stocks to buy. Let an algorithm pick the entry point. Subscribe to a service that promises AI-selected portfolios. For now, a lot of this works well enough to feel like magic. The uncomfortable question is what happens when everyone is holding the same wand.

The case for the machines

It would be a mistake to open with cynicism, because the appeal of AI-driven trading is real and, in many respects, earned.

Markets are oceans of data, and humans are poor swimmers in them. We tire, we panic, we fall in love with losing positions, we sell winners too early to lock in the feeling of being right. Machines don't. An AI system can absorb earnings reports, price histories, supply-chain signals, satellite images of parking lots, and the tone of a central banker's speech - all before a human analyst has finished their coffee. It can act on that information without flinching.

For the ordinary investor, the democratizing effect is genuine. Tools that were once the private preserve of hedge funds with nine-figure technology budgets are now available through a monthly subscription. A retiree in a small town can access pattern-recognition that would have been science fiction a generation ago. That is not nothing.

And in the near term, the results can be impressive. When a strategy is new and few people are running it, it captures a real edge. Early adopters win. This is the phase we are largely in now, and it explains a great deal of the enthusiasm.

The oldest law in markets

But there is a law in finance older than any algorithm, and AI does not repeal it. It states, roughly: any edge that becomes widely known stops being an edge (Eugene Fama's 1970 Efficient Market Hypothesis).

This is not a quirk. It is the fundamental mechanism by which markets work. When a profitable pattern is discovered - say, that certain stocks with rising momentum tend to keep rising - early traders exploit it. Their buying pushes prices up until the opportunity is priced away. The signal that made money becomes the consensus that everyone already acts on, and the profit evaporates. Every strategy ever invented has walked this path, from value investing to index funds to high-frequency arbitrage.

AI does not exempt itself from this cycle. If anything, it may accelerate it. When thousands of investors lean on similar models, trained on similar data, optimized toward similar goals, they begin to think alike - and to trade alike. The very efficiency that makes AI attractive is what dissolves its advantage once enough people adopt it.

When everyone reaches for the same exit

Here is where the article's central concern becomes concrete, and where the risk is more than theoretical.

When many market participants run correlated strategies, they create a hidden fragility. On a calm day, nobody notices. But when conditions turn, everyone tries to sell the same positions at the same moment - everyone reaches for the same exit through the same narrow door. Prices don't drift; they gap. Volatility spikes not because anything fundamental changed about the underlying companies, but because the structure of who owns what, and why, suddenly unwinds all at once.

This is not a hypothetical scenario dreamed up to make a point. In August 2007, a group of quantitative funds running statistically similar equity strategies unwound almost simultaneously over a few days, producing violent price swings that had no external news to explain them. The strategies were individually sensible and collectively catastrophic. Momentum strategies in particular have a long, documented history of working steadily and then crashing hard—precisely because they attract crowds, and crowds turn.

Now layer AI on top of that dynamic. If a wave of models is trained to react to the same signals, a move in one direction can cascade: the selling itself becomes the signal that triggers more selling. Stocks lurch for reasons that have nothing to do with the businesses they represent and everything to do with machines responding to other machines.

The most recent example of this is the is the fund Situational Awareness which was a high-flying hedge fund launched in 2024 by a former OpenAI researcher. The fund recently peaked at $45 billion in assets but collapsed in July 2026 when its core AI infrastructure holdings plunged by 30-50%. The sharp asset decline wiped out the fund's equity cushion relative to its debt triggering margin calls that forced an emergency liquidation. The assets were picked up by Citadel. The valuation of the portfolio was roughly $16 billion.

A word of honesty about attribution

To keep this analysis fair, one caveat deserves emphasis, because it is where breathless commentary usually overreaches.

It is genuinely difficult to prove that "AI" is the culprit behind any specific bout of unexplained volatility. Algorithmic and automated trading have dominated market volume for well over a decade - long before the current AI boom. When a stock moves sharply on no news, the cause could be automated strategies, but it could equally be passive-fund flows, options dealers hedging their exposure, or plain old human fear. Automation and artificial intelligence are not the same thing and conflating them weakens an otherwise sound argument. The honest framing is not "AI is secretly crashing stocks" but "the growing homogenization of strategy, of which AI is now a powerful driver, increases the odds of these episodes."

The short-term temptation

There is a further wrinkle worth naming: the incentives baked into many AI trading systems tilt toward the short term.

Models are typically judged on how well they predict near-term price movement, because that is what is measurable and rewardable on a fast timescale. Patience - the willingness to hold a good business for years - is hard to optimize and easy to neglect. As AI shapes more decisions, the market's collective attention may compress toward the next hour rather than the next decade. A machine that can trade a thousand times a day has little temperamental reason to wait.

This matters for ordinary investors because short-term thinking, dressed in the authority of sophisticated technology, can quietly crowd out the patient, boring approach that has actually built most long-term wealth.

Where this leads - and the counter-argument

So does all this mean AI trading is a bubble destined to pop, after which humans return, chastened, to old-fashioned common sense? That is the tempting conclusion, and it is partly right - but it deserves a fair challenge.

The real answer is more fundamental than any technology: the antidote to a crowded, homogenized market is diversity of strategy itself. Whenever most participants converge on the same trade, the neglected position - the one nobody is crowding into - becomes valuable precisely because it is uncorrelated with the herd. What matters is the diversity, not the source of it. That diversity can come from many places. It can come from a human who reads the market differently, trusts an unfashionable thesis, or simply has the temperament to sit still while others stampede. It can come from a firm deliberately designing strategies to be *un*like the consensus. And yes, it can come from a more adaptive machine that learns to profit from the crowd's predictability - but that is only one possible source among several, not the destined winner. To assume the cure for too much AI is simply better AI is to mistake the symptom for the solution. The pendulum does not have to swing from crowded machine to clever machine; it can swing back toward independent human judgment, toward contrarian discipline, toward any approach willing to be different. Homogenization is the disease. Difference - wherever it originates - is the remedy.

And there is a second counter-current. Some of the best-resourced quantitative efforts already hunt for longer-horizon, harder-to-copy signals because the short-term space has become so crowded. Crowding, in other words, contains the seed of its own correction. The pressure that makes everyone chase the same short-term trade is exactly what makes the neglected long-term trade valuable again.

The takeaway

Strip away the technology and a timeless principle remains. Edges erode when they are shared. Crowds are dangerous precisely when they feel safest. And the investor's real advantage has never been raw processing power - it has been independent judgment, applied where others aren't looking.

AI is a genuinely powerful tool and dismissing it would be foolish. But treating it as an oracle to be obeyed rather than an instrument to be questioned is how the crowd forms in the first place. The likeliest future is not the triumph of the machines, nor a nostalgic return to gut instinct, but something more demanding: a market where the old virtues of skepticism, patience, and independent thought matter more as the tools get better - because when everyone can access the same answer, the only remaining edge is asking a different question.

The machine, in the end, may be smart enough to outsmart itself. It is the investor who declines to think for themselves who has the most to lose.

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