Does The Hedonic Editing Hypothesis hold in Pakistani Stock Exchange?

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Abstract: Hedonic editing which is based on prospect theory narrates that investors integrate or segregate multiple outcomes in such a way that their perceived value should be maximum. As per this hypothesis Value is maximized in four ways (i) Gain is segregated from other gain (ii) Loss is integrated with other loss (iii) Small loss is integrated with large gain, called mixed gains (iv) Small gain is segregated from large loss. In this way investors' integrate or segregate outcomes to achieve highest value. This study tests this hypothesis in real decision making scenario to divulge the timing of sales of investors when realizing gains or losses. If the investors behavior is in line with principles postulated by hedonic editing , it would be observed that investors integrate losses more often than gains and integrate smaller losses with larger gains instead of its opposite.

Key words: Hedonic editing, Behavioral finance, Prospect theory

Introduction

Prospect theory presented by Kahenman and Tversky (1979) has revolutionized the behavioral studies in the specter of finance. As per loss aversion bias, the investors' weight losses more than gains and thus value curve is steeper on loss end. Hedonic editing which is based on prospect theory narrates that investors integrate or segregate multiple outcomes in such a way that their perceived value should be maximum. As per this hypothesis Value is maximized in four ways (i) Gain is segregated from other gain (ii) Loss is integrated with other loss (iii) Small loss is integrated with large gain, called mixed gains (iv) Small gain is segregated from large loss. In this way investors' integrate or segregate outcomes to achieve highest value.

The hedonic editing is revolutionary among the principles of editing presented so far but there are some grounds on which one can challenge this hypothesis. First is that hedonic editing hypothesis presumes that investors are very active in making edition of prospected outcomes, so they have to spare extra effort beyond their capacity which is not feasible in real world as individuals have limited energy and mental capacity. Secondly, hedonic editing presumes that same coding is followed irrespective of the presentation format but in reality presentation formats do matters in coding. Finally hedonic editing is maximizing process not a rational process, so the real editing outcomes can be less that the ideal editing.

Despite of such reservations the hypothesis is worth investigating as it is powerful in its essence. If the hedonic hypothesis gets hold, it can serve a good model for legitimate prediction of prospected outcomes and much easier. Besides this discovery of its pitfall and alternative remedies may result into a more pragmatic and sophisticated hypothesis.

This study tests this hypothesis in real decision making scenario to divulge the timing of sales of investors when realizing gains or losses. If the investors behavior is in line with principles postulated by hedonic editing , it would be observed that investors integrate losses more often than gains and integrate smaller losses with larger gains instead of its opposite.

Literature Review

The way people follow to frame multiple outcomes Thaler (1985) introduced the concept of hedonic editing which is derived from the prospect theory proposed by Kahenman and Tversky (1979) and main theory of hedonic editing is that people structure multiple outcomes in such a way that they have maximum perceive value. The hedonic editing hypothesis narrates that in few circumstances integration of two or more outcomes into single mental account maximizes the perceived value, on contrary maximum value perceptually is achieved by segregating outcomes in mental account. In some specific scenarios the value is maximized by segregating small gains from large losses while in other situations small losses are integrated with large gains.

Although the appeal and glamour of hedonic editing is very sophisticated, very few studies have tried to divulge this hypothesis. The few studies which have investigated it, they too suggest mixed findings and even people segregate losses instead of integrating them (Lehenkari, 2009). Linville and Fischer (1991) reported partial confirmation of hedonic editing hypothesis. Lim (2006) studies hedonic editing empirically and her results supports the presumptions of hedonic editing. Lehenkari (2009) studied empirically hedonic editing hypothesis in Finish stock exchange and his results support a little evidence for hedonic editing. His study reported neither losses are integrated nor gains are segregated consistently. In many times gains are integrated higher than losses and this finding is at high intensity when important factors like selling behavior which constitutes trading month, historical returns, size of portfolio and investor activity etc. are controlled (Lehenkari, 2009) and also small gains are integrated with high losses rather the other way. So Lehenkari (2009) findings are somewhat counter to hedonic editing hypothesis.

Prospect theory has been also used to explain other investors' behaviors besides integrating and segregating losses and gains especially disposition effect: A tendency of investors to sell winning stocks too soon while retaining the losing too long. Disposition was proposed by Shefrin and Statman(1985) and afterwards studies like Odean(1998), Chui,(2001), Jordan and Diltz (2004), Garvey and Murphy(2004) are few of many studies which confirmed this phenomena.

This study tests hedonic editing hypothesis in real decision making scenario to divulge the timing of sales of investors when realizing gains or losses. If the investors behavior is in line with principles postulated by hedonic editing , it would be observed that investors integrate losses more often than gains and integrate smaller losses with larger gains instead of its opposite.

Methodology

For studying hedonic editing the framework of study proposed by Thaler, (1985) was followed. Thaler (1985) proposed a four item questionnaire with three possible answers. 200 questionnaires were distributed among people who are engaged in some trading activity is Karachi Stock Exchange or Islamabad Stock Exchange. 146 questionnaires were retrieved with response rate of 73%.

Results and Discussion

As this study follows a questionnaire proposed by Thaler (1985), here below table shows the questionnaire items with number of responses for each option of question.

Item	A	B	No difference
1. Mr. A was given a ticket to lotteries involving the World Series. He won $50 in one lottery and $25 in the other. Mr. B was given a ticket to a single, larger World Series Lottery. He won $75. Who was Happier?	71	55	20
2. Mr. A received a letter from the IRS saying that he made a minor arithmetical mistake on his tax return and owed $ 100. He received a similar letter the same day from his state income tax authority saying he owed $50. There were no other repercussions from either mistake. Mr. B received a letter from IRS saying that he made a minor arithmetical mistake on his tax return and owed $150. There were no other repercussions from his mistake. Who was more upset?	107	31	8
3. Mr. A bought his first New York state lottery ticket and won $100. Also, in a freak accident, he damaged the rug in his apartment and had to pay the landlord $80. Mr. B bought his first New York state lottery ticket and won $20. Who was happier?	28	113	5
4. Mr. A's car was damaged in a parking lot. He had to spend $200 to repair the damage. The same day the car was damaged, he won $25 in office football pool. Mr. B car was damaged in a parking lot. He had to spend $175 to repair the damage. Who was more upset?	19	124	3

The results of this study can be categorized into four caters as per the theory of hedonic editing hypothesis.

First cater of hedonic editing hypothesis which states that people segregate gain from other gain get support from our current study but support is a little bit weak as response against segregation are 38% which after taking into account no difference responses are quite huge. Anyhow Generally speaking people segregate gains got support in this research. Second presumption of hedonic editing hypothesis which states people integrate losses did supported in current study and more over support is stronger for integration of losses is stronger than segregation of gains. Thirdly the subject of this study presumes that small loss with large gains is integrated got strong support and finally the last premise of hedonic editing hypothesis that small gains are segregated from large losses also get support. So overall this study support the hedonic editing hypothesis and its findings are in line with Thaler(1985), Lim (2006) and Lehenkari (2009)

Conclusion

This study was conducted to test the hedonic editing hypothesis, either it holds in. The questionnaire approach was used to study this phenomenon. The findings of this study suggest that integration and segregation of losses and gains is at greater extent in line with the theory of this hypothesis.

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