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Diversification Benefits of Treasury Inflation Protected Securities: An Empirical Puzzle

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Abstract

This paper empirically tests the benefits of Treasury inflation protected securities (TIPS) for investors. This study examines whether TIPS enhance the risk return characteristics of an investor's portfolio. The results of conditional spanning tests show that adding TIPS to any combined portfolio of stocks, Treasury bonds, Treasury bills, corporate bonds, and real estate provides investors with diversification benefits. This paper also shows that United Kingdom (UK) inflation-linked gilts (ILGs) enhance the risk return characteristics of an investor's portfolio. These findings hold in different economic and inflationary environments, and they confirm the prediction of economic theory that indexed bonds are important for investors who are vulnerable to inflation.

Keywords: Treasury inflation protected securities (TIPS), portfolio diversification

JEL Classification: G11, G12

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