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David Bendig, Malte Brettel, Benedikt Downar

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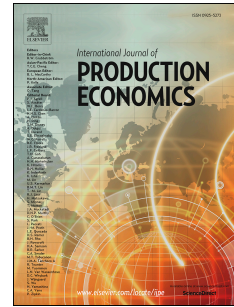
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Inventory Component Volatility and Its Relation to Stock Returns

ABSTRACT

Members of manufacturing supply chains have to take many risks. Prior academic work emphasizes that inventory management is one of the pivotal sources for operational risks, particularly in terms of inventory volatility and excess inventory. Recent research shows that total inventory volatility not only poses a threat to a firm's operational performance, but also increases a firm's abnormal stock returns. However, the volatility impact of the three underlying inventory components—raw materials, work-in-process, and finished goods—is still unresolved. We argue that the relationship between inventory volatility and stock returns differs between the three inventory components since they each relate to different stages of the supply chain. Using a sample of U.S. manufacturing firms over the period 2005 to 2013, we empirically examine the relationship between inventory component volatility and stock returns. We find a significant positive association between work-in-process inventory volatility and stock returns, a significant negative association between finished goods inventory volatility and stock returns, and no significant association between raw material inventory volatility and stock returns. In additional analyses, we find that types of industry dynamism influence these relationships. The results of this study provide a more detailed picture regarding the investor perception of inventory dynamics.

Keywords: Operational risk; inventory management; stock returns; raw material; work-in-process; finished goods

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