USAA Real Estate Company

ARE THE SIX MAJOR MARKETS OVERPRICED?

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As capital continues to flow into the top 6 major markets & cap rates continue to decline, many investors have become concerned that the major markets have become overpriced. As a result, investors have been moving to the non-major or secondary markets looking for better returns. While this behavior is understandable, it may not produce a better total return.

Past research has shown that many higher yielding markets have not provided initial yield premiums large enough to compensate for the level of supply & demand along with the low liquidity (small size) offered by many secondary markets. In addition, if fears about rising interest rates & cap rates come true, a move to higher-risk markets may prove to be bad timing. Research shows that low cap rate markets with higher barriers-to-entry have outperformed higher cap rate markets with low barriers-to-entry on a total return basis due at least in part to strong NOI growth & capital expenditures. Strong NOI growth is particularly important in a rising cap rate environment because it is one of the factors that can provide some protection against rising interest rates.

If the objective of investors is higher total returns, the move to higher-yielding markets may not be successful. While the pursuit of higher-yielding markets is interesting, results show a strong bias toward low cap rate market portfolios over the long-term.

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