What's Wrong with Pittsburgh? Delegated Investors and Liquidity Concentration
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Executive Summary

Delegated investors don't find Pittsburgh attractive. While the share of commercial real estate (CRE) purchases by delegated investors averages 24 percent across U.S. cities, it is a mere 14 percent in Pittsburgh. What makes Pittsburgh so much less attractive than other cities? More generally, what makes some assets and not others appropriate for delegated managers?

I argue that one reason delegated managers focus on some assets is the concentration of other institutions in that market. I start from the observation that some types of investors trade frequently while others are more likely to buy and hold. The key intuition is that investors who value liquidity most concentrate their investments in the most-liquid markets. In so doing, they give up an illiquidity premium. Thus, concern for liquidity segments markets by investor type. The market segmentation in turn makes the most-liquid markets even more liquid because the main asset owners are those that trade relatively more frequently. To the extent that delegated managers are more likely to have higher liquidity needs than direct investors, an asset's attractiveness to delegated mangers depends on the existing concentration of delegated managers in a market.

My paper provides evidence on the relationship between investor composition and trade frequency in CRE consistent with this explanation. Consistent with delegated investors having relatively more need for liquidity, they have shorter holding periods than non-delegated investors (i.e., direct investors) on average. Furthermore, a CRE purchase is more likely to be made by a delegated than a direct investor in markets with higher turnover, even after controlling for property-level characteristics and the economic fundamentals of an MSA. Finally, dividend yields are higher in markets with less trade frequency, consistent with assets in such markets commanding illiquidity premia.

The paper then calibrates a directed search model that features investors who are heterogeneous in the frequency with which they receive valuation shocks. The model illustrates how market segmentation by liquidity preference amplifies cross-market differences in liquidity. The model can replicate the large differences in trade frequency across cities and modest difference in cap rates. Quantitatively, the model generates an illiquidity premium for investing in U.S. CRE of about two percentage points per year.

The findings highlight path dependence in what different types of investors consider investable. Many delegated managers express a desire to increase their allocations to alternative asset classes but then assert that such product does not exist. One characteristic of the asset that makes it institutional quality is in fact the concentration of other institutions in that market due to the implications for liquidity of investor composition. As such, the results suggest that it will be difficult for delegated investors to rapidly change their allocations to alternatives including real estate. This difficulty in increasing allocations to alternatives may lead to even further increases in the share of publicly traded equities held by institutional investors.