Real Estate Feature
America's Most Overpriced Real Estate Markets
Matt Woolsey, 05.04.07, 12:01 AM ET

No matter the locale, its denizens almost always gripe about the stiff cost of living, housing and doing business. But in some places the financial pain is clearly more acute than others.

Take San Diego. A slumping housing market, where only 5% of residents can afford the median home, and a high price-to-earnings ratio made the oceanfront city our most overpriced real estate market. Had weather been included as a statistical measurement, there's no doubt San Diego would have avoided our list of top 10 most overpriced cities--but we didn't factor in sunshine.

Arriving at the relative value of a given market isn't as simple as calculating median home prices, income rates and cost of living. Instead, our list of most overpriced real estate markets incorporates a more meaningful methodology.

In Pictures: 10 Most Overpriced Real Estate Markets

In Pictures: 10 Least Overpriced Real Estate Markets

Behind The Numbers
Using the 40 largest metro areas, we started by estimating a "price-to-earnings" ratio for each market. (Like the P/E of a stock, this value attempts to measure the price a homeowner would pay for one dollar of return.) Using data from the National Association of Realtors (NAR), the U.S. Census Bureau and the Office of Federal Housing Enterprise Oversight, we took each market's median home price and divided it by annual rents minus taxes and insurance for those properties. (We assumed for this exercise that other costs don't vary drastically from city to city.)

The average P/E for the 40 markets is 28. Note: Unlike, say, the S&P 500 index of stocks, ours is not a weighted-average P/E. If it were, certain cities with greater overall sheer market value would carry more weight.

We incorporated a second metric: an affordability index. Calculated from National Home Builder Association and Wells Fargo data, the affordability score is the percent of the population who can afford to buy the median-priced home, assuming a 6% mortgage rate. In a city like Los Angeles, No. 4 on the list, a wee 2% of homes are affordable for residents pulling down a median income.

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Consider Detroit. Almost 88% of its homes are available to those with a median income, and its 17.5 P/E ratio appears relatively low, but that doesn't make real estate in the Motor City a good investment. Already stagnant home prices have decreased at a rate of 1% over the last year and, of the major metros, Detroit is the only one on our list to have lost jobs since 2005 (other than New Orleans, which we left off; in the wake of Hurricane Katrina the city's statistical figures were such anomalies that it wasn't comparable to the rest of the cities).

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So which markets are in bubble territory? Look for a high P/E ratio, low affordability, low income growth and a high cost of living.

San Francisco, ranked fourth, fits that bill. Despite home prices growing at a 2% clip over last year, according to the NAR, the city by the bay ranks third to last in expected income growth, reports Moody's. Not good news in a market where only 7.5% of housing is affordable for the median-income earner. Combine that with a housing P/E ratio over 50, and it isn't difficult to imagine some softening on the horizon.

The usual suspects littered our list: Miami came in second, followed in order by: Sacramento, Calif.; San Francisco; Washington, D.C.; Honolulu; New York; Los Angeles; and Boston. San Jose, Calif., rounded out the top 10.

Courtesy of JB Goodwin