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Investors have long been counseled to diversify investments among several asset types. Over the past two years, however, any diversification away from common stocks has diminished portfolio returns. Thanks to the Federal Reserve's zero interest rate policy, risk-free cash equivalents provide effectively no return, as has been the case for nearly six years. This has severely penalized retirees or others with little appetite for equity risk.

The traditional refuge for risk-averse investors has been ownership of U.S. Treasury bonds and notes. Unfortunately, that strategy has produced losses since yields bottomed in mid-2012. Despite rising rates over the ensuing two-year period, fixed income yields remain near historic lows. There remains little defense against potentially rising rates and inflation in the years ahead.

Those who have built substantial anti-inflation positions in gold have similarly realized losses over the past two years. While inflation risk in the years ahead is very real, it has not yet materialized in the world's major economies.

Notwithstanding a relatively stagnant world economy, historic central bank money creation has successfully boosted stock prices worldwide. When stocks have threatened to decline in the past few years, central bankers have quickly stepped in to promise continued stimulus. That promise has overcome concerns about valuations, banking system vulnerability, the threat of sovereign bankruptcies, military conflict and anything else worried investors could imagine.

Not surprisingly, when equity prices have risen for more than five years, especially when other asset categories have been non-productive, there is a clamor for more money to be deployed into equities. A growing number of investors have been increasing allocations to equities from bonds and cash. History inconveniently reminds us, however, that performance of any asset class is inversely related to its popularity at extremes.

In recent months, the U.S. stock market has demonstrated many parallels to conditions that prevailed around the historic price peaks of 2000 and 2007. Because all pleas for caution over the past few years have been sternly rebuked by ever rising prices, any such comparisons today are dismissed by many as "crying wolf." Nonetheless, common sense demands that investors respect conditions that have historically proved dangerous, even if markets have sidestepped such dangers so far in this cycle.

The greatest contributing factors to the market collapses that began in 2000 and 2007 were excessive valuations and extreme levels of debt. A composite of the most commonly employed valuation measures puts today's figures at or above those of the most important stock market peaks in U.S. history--exceeded only by the extremes reached in the dot.com mania. Warren Buffett's favorite measure of value (stock market capitalization as a percentage of GDP) shows the current market to be more overvalued than any in history but the peak in 2000.

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Debt figures paint an even more ominous picture. While debt was extreme in 2000 and 2007, it is more extreme today. Nearly every major Western country has taken on substantially more debt since 2007, with debt levels now excessive in all corners of the globe. This month, the chief investment officer of Europe's largest insurer, Allianz, stated that the euro crisis is not over, that European countries are still building up their debt piles, raising the probability of trouble. The Bank for International Settlements (BIS), the central bank's central banker, recently declared that debt levels in many emerging markets, as well as (supposedly conservative) Switzerland, "are above the threshold that indicates potential trouble."

Former chief economist at the BIS, William White, gave an extended interview with a prestigious Swiss business newspaper earlier this year under the headline, "I see speculative bubbles like in 2007." Several of his contentions deserve serious consideration.

1. Not even during the Great Depression in the Thirties has monetary policy been this loose. And if you look at the details of what these central banks are doing, it's all very experimental. They are making it up as they go along.

2. The fundamental problem we are still facing is excessive debt. Not excessive public debt, but excessive debt in the private and public sectors. To resolve that, you need restructurings and write-offs. (In other words, defaults.)

3. It's worse than 2007, because then it was a problem of the developed economies. But in the past five years, all the emerging economies have imported our ultra-low policy rates and have seen their debt levels rise.

4. We are back in a world where the banks get all the profits, while the government socializes all the losses.

5. The strengthening growth might be a mirage. And if it does not materialize, all those elevated prices will be way out of line of fundamentals.

Most investors are apparently unconcerned, or they believe that they will be able to exit their equity positions before serious damage may be done. Such complacency was last seen prior to the 2000 and 2007 peaks. The exits during the ensuing price declines proved far too narrow to allow timely escapes.

Other parallels to the conditions surrounding the 2000 and 2007 peaks include the desire to speculate and the willingness to assume great risk. Earlier this year, margin debt exceeded the prior peaks reached near the 2000 and 2007 market highs. And investors are willing to use those margin loans for increasingly speculative securities. Also earlier this year, investors achieved the dubious distinction of supporting initial public offerings (IPOs), 79% of which had "negative earnings" – i.e., losses. That figure matched the percentage of money losers brought to market in February 2000, a month before 2000's price peak.

Wall Street has proved nothing but resourceful, bringing to market far more junk bonds than ever before at increasingly suspect levels of quality. Today's bond buyers either don't know the sad history of such low quality debt, or they're banking upon the belief that this time will be different. Such financial recklessness, even at far lesser degrees, has attended all prior important U.S. stock market peaks.

While the dangers are certainly real, and have been a legitimate concern for quite some time already, stock prices have continued to climb a wall of worry. That trend is testimony to the power of copious quantities of free money. And while the latest iteration of quantitative easing is scheduled to end in October, Fed Chair Yellen has pledged to maintain a highly accommodative monetary policy for a considerable period beyond that. With ominous parallels to 2000 and 2007, yet a still generous Federal Reserve, it is an open question whether stock prices can continue to power ahead. Much depends on investors' degree of confidence that central bankers can maintain control of dangerous underlying fundamental conditions.

In dealing with a market that could still provide more profits if confidence prevails but could suffer dramatic and lasting losses should that confidence disappear, Mission employs a strategic equity allocation process that has outperformed the S&P 500 over the past 33 years with fewer and smaller losses than that index has experienced. It is designed to participate in (not beat) equity markets in strong periods and to protect assets in questionable or dangerous environments. After back-testing the strategy for nearly a third of a century, Mission introduced it to clients in late-2012. In just over a year and a half, the process has produced a return of approximately 13% while being exposed to equity risk about 32% of the time. We believe it to be ideally suited for the equity portions of portfolios in a highly uncertain environment.

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