Oppenheimer Champion Income Fund

by
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Abstract

During the second half of 2008, Oppenheimer's Champion Income Fund lost 80% of its value - more than any other mutual fund in Morningstar's high-yield bond fund category. These extraordinary losses were due to the Fund's investments in credit default swaps ("CDS") and total return swaps ("TRS"). The Fund used CDS and TRS to leverage up the Fund's exposure to corporate debt and asset-backed securities, including Mortgage-Backed Securities and swap contracts linked to Residential and Commercial Mortgage-Backed Securities indices.

I. Introduction

The Champion Income Fund (Ticker: OPCHX) is an open-end mutual fund managed by Oppenheimer Funds, Inc. It describes its primary investment objective as "seek[ing] a high level of current income by investing mainly in a diversified portfolio of high-yield, lower-grade, fixed-income securities that…Oppenheimer Funds, Inc., believes does not involve undue risk."[2] As an open-end mutual fund, the Champion Income Fund was legally prohibited from levering itself by using debt to buy additional securities on margin. The fund worked around the restriction by investing heavily in credit default swaps ("CDS") and total return swaps ("TRS"), both of which are inherently highly levered.

In 2008, investors in the Champion Income Fund (the "Fund") suffered extraordinary losses compared to investors in high-yield bond funds with similar

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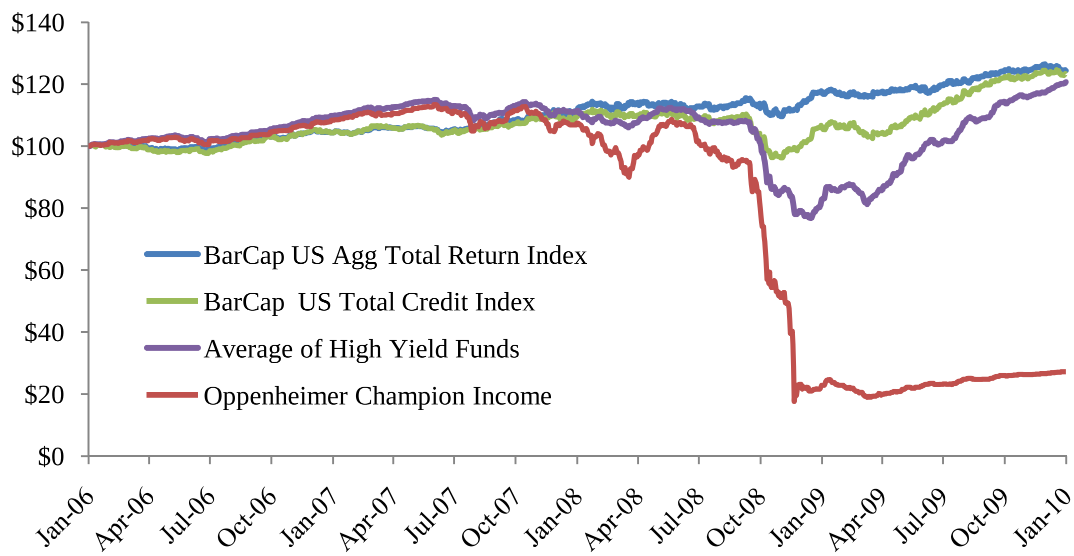
[2] From the January 28, 2010 summary prospectus: https://www.oppenheimerfunds.com/digitalAssets/ChampionIncomesummarypsp012810-8c104cc2-634f-44a4-9406-e85c11d8f0cd.pdf

investment objectives. Figure 1 below compares the Champion Income Fund's total return from January 1, 2006 through December 31, 2009 to other benchmark indices, including the Barclays Capital US Aggregate Total Return index, the Barclays Capital US Total Credit Index,[3] and the average of high-yield bond funds as categorized by Morningstar.[4] Each line represents the value of a $100 investment in the Fund, its benchmark indices, or the peer group on December 31, 2005, with the dividends reinvested in the same fund or index. Figure 1 shows that beginning in late 2007 and continuing through the end of 2008, the Fund experienced enormous losses relative to these benchmarks and peer group. From January 2006-December 2008, Champion Income Fund had a -77% cumulative total return, while the benchmarks had returns between -17% and 17%. In 2009, the benchmarks and peer group rebounded, ending the year with cumulative four-year returns between 21% and 24%. The Champion Income Fund, however, did not rebound, generating a -73% cumulative four-year return.

Figure 1: Total Returns of Oppenheimer Champion Income Fund and Key Benchmarks, 2006-2009.

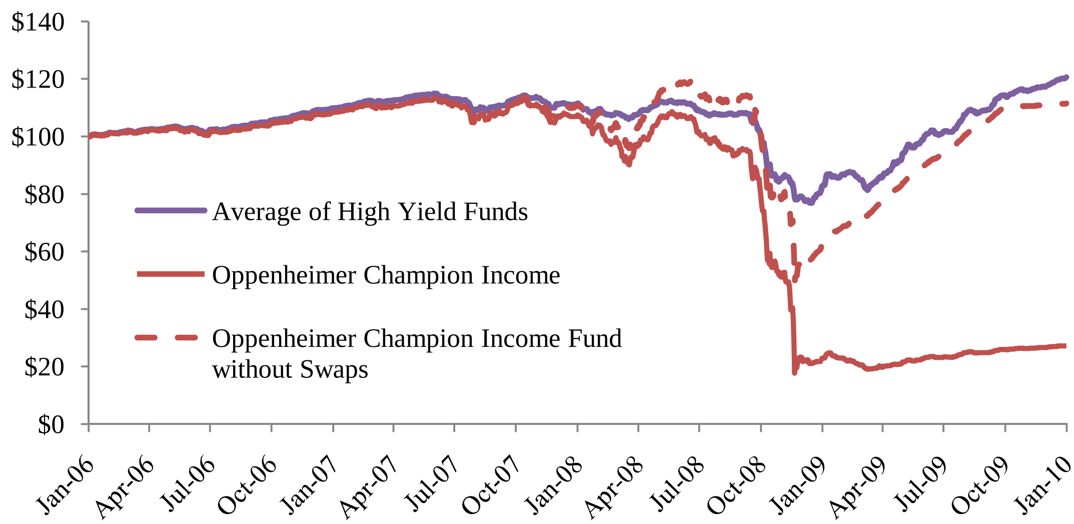


[3] Both these indices were originally issued by Lehman Brothers. The Barclays Capital US Total Credit Index is the default reference index used by the Champion Income Fund.

[4] The average is from 99 Morningstar high-yield funds with return data dating back to December 2005 (excluding the Champion Income Fund). This group of Morningstar high-yield funds is used as a benchmark throughout the paper.

The Champion Income Fund's losses were the result of concentrated investments in a combination of credit derivatives from mid 2007 through 2008. Figure 2 compares the Fund's actual cumulative return to what the Fund's cumulative return would have been if the Fund had not invested in TRS and CDS. The Fund began holding CDS in December 2006 and TRS in September 2007. Beginning in December 2007, CDS and TRS losses caused the Fund's net asset value to drop significantly. By April 2008, losses from swap contracts had caused the Fund's net asset value to decline more than 6%. That percentage skyrocketed to 78.5% by September 2009. The Fund also failed to disclose to investors the increased risk arising from the Fund's swap contracts.

Figure 2: Total Return of Oppenheimer Champion Income Fund, with and without Swap Contracts.



In the remainder of this paper, we analyze the Champion Income Fund's investments and returns, detailing how significantly credit default swap and total return swap holdings contributed to the Fund's losses.

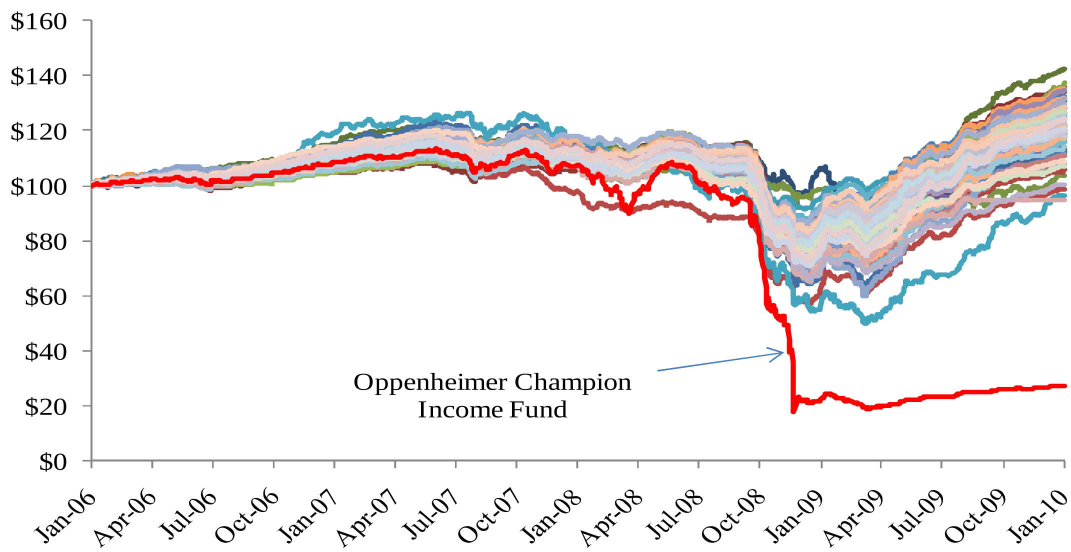
II. Champion Income Fund's Relative Risks and Returns

i. The Champion Income Fund's commonplace returns in 2006 and 2007 were followed by extraordinary losses in 2008.

Figure 3 plots the total return of the Fund along with 99 other funds in the Morningstar high-yield category for which data extends back to December 2005. Each line represents the value of a $100 investment in on December 31, 2005 in the specified fund, with dividends reinvested in the same fund.

In 2006 and 2007, Champion Income Fund's return was not unusual for high-yield funds. However, investors in the Fund experienced extraordinary losses in 2008. In the fourth quarter of 2008, the Fund's losses were more than double the average losses of their Morningstar high-yield peer group. In November 2008 alone, the Fund had a total return of -56%. In the second half of 2008 overall, the Fund lost 80% of its NAV, the largest loss of any single Morningstar high-yield fund during the same time period. The Champion Income Fund's cumulative total return for the four years plotted in Figure 3 is -73% while the mean and standard deviation of the cumulative returns for the other 99 funds are 20.6% and 12.7%, respectively.

Figure 3: Total Return of Champion Income Fund and 99 Other High-yield Funds.



ii. The Champion Income Fund's CDS and TRS holdings increased the Fund's losses and effective leverage.

The Champion Income Fund effectively used CDS and TRS contracts to hold large risky positions in mortgage-backed securities and corporate debt without having to invest any principal or record its $5.56 billion exposure as an asset or a liability.[5] The Fund's TRS contracts, which had a total notional amount of $2.53 billion, were all based on mortgage-backed securities. Five percent ($152.2 million) of the $3.03 billion total CDS notional amount was also based on mortgage-backed securities.[6]

Table 1 and Table 2 identify how each investment type contributed to the Fund's semi-annual returns. Table 1 uses the Statement of Operations to calculate each investment type's semi-annual gain or loss. Table 1 shows that CDS and TRS contracts were collectively responsible for more than $2 billion (56%) of the Fund's $3.5 billion losses during fiscal 2008-2009.[7]

Table 1: Champion Income Fund's Realized and Unrealized Gains and Losses by Investment Type, Fiscal 2008-2009. Losses are calculated using the Statement of Operations. All amounts are in millions. Interest rate swaps contribute insignificant amounts to "Swap Contracts" in some periods. Positive values indicate net gains. Errors are due to rounding.

	Oct 2007 - Mar 2008	Apr 2008 - Sep 2008	Oct 2008 - Mar 2009	Apr 2009 - Sep 2009	Total
Investments	$ (205.0)	$ (467.3)	$ (454.4)	$ (348.9)	$ (1,475.7)
Foreign Currency Translations	1.3	(0.4)	(2.0)	(0.2)	(1.3)
Futures contracts	(25.7)	(33.1)	6.8	6.4	(45.6)
Short positions	(0.0)	(0.0)	(0.0)	(0.0)	(0.2)
Swap contracts	(163.3)	(315.3)	(761.8)	(764.6)	(2,005.1)
Grand Total	$ (392.8)	$ (816.2)	$ (1,211.4)	$ (1,107.4)	$ (3,527.8)

Table 2 uses quarterly holdings data (which do not include intra-quarter transactions) provided in the notes to the Fund's financial statements to estimate CDS

[5] For the period December 2006 through January 2009, the Fund's CDS and TRS contracts had a total notional amount of $5.56 billion.
[6] The remainder of the CDS contracts were based on corporate debt or indices of corporate debt. Twelve percent ($360.1 million) of the Fund's total CDS notional amount was linked to bond indices. The largest CDS positions outside of the bond indices were in General Motors and Ford, each of which had 5.4% (approximately $165 million) of the Fund's total CDS notional amount.
[7] The "Swap Contracts" category includes credit default swaps and total return swaps. In the six-month periods ending in March 2008, September 2008, and March 2009 the category also includes interest rate swaps. During those periods, Champion Income Fund held interest rate swaps with total notional amounts between $20.6 million and $468 million. The interest rate swaps contributed insignificant losses to the total swap contract losses during each of those periods.

and TRS losses separately. The table reports each investment type's quarterly unrealized gains and losses. We estimate that from October 2007 through September 2009, the Fund's CDS holdings generated $292.2 million in unrealized losses. Over the same period, the Fund's TRS holdings generated $44 million in unrealized losses. In the six months from April 1, 2008 to September 31, 2008, credit default swaps and total return swaps were responsible for 21.7% and 24.7% of the Fund's losses, respectively, while corporate bonds contributed 43.7% of the loss.

Table 2: Champion Income Fund's Unrealized Gains and Losses by Investment Type, Fiscal 2008-2009. Losses are calculated using changes in the Statement of Investments and financial statement footnotes. All amounts are in millions. Positive values indicate net gains.

	Oct 2007 - Mar 2008	Apr 2008 - Sep 2008	Oct 2008 - Mar 2009	Apr 2009 - Sep 2009	Total
Cash Investments					
Asset-backed Securities	$ (0.9)	$ 0.3	$ (0.1)	$ (0.1)	$ (0.8)
Common Stocks	(12.4)	3.4	(1.2)	0.0	(10.2)
Corporate Bonds	(157.5)	(154.2)	(119.5)	(116.5)	(547.6)
Mortgage-backed Securities	(1.8)	(21.4)	(31.6)	4.1	(50.7)
Preferred Stock	(3.3)	(16.9)	(0.9)	-	(21.2)
Others	(0.2)	(0.0)	-	(0.0)	(0.2)
Derivative Investments					
Credit Default Swaps	(120.0)	(76.6)	(95.6)	-	(292.2)
Total Return Swaps	42.4	(87.1)	0.7	-	(44.0)
Grand Total	$ (253.7)	$ (352.6)	$ (248.3)	$ (112.4)	$ (966.9)

Together, Table 1 and Table 2 demonstrate that an extraordinarily large portion of the Fund's losses were due to swap contracts, especially credit default swap contracts. The Champion Income Fund used credit default swaps and total return swaps to leverage its exposure to corporate bonds and commercial mortgage-backed securities. These derivative contracts significantly increased the Fund's potential risks and returns.

The swap contracts contributed heavily to the Fund's losses in part because CDS and TRS contracts are inherently levered. At the inception of a TRS or CDS contract, the buyer and seller generally do not exchange the notional amount of the contract. Instead, they exchange cash flows at intermittent periods throughout the life of the contract. The ability of CDS and TRS to effectively increase the investment value of the Fund without requiring any additional equity capital causes the Fund to become levered without ever borrowing capital.

Table 3 shows what the Fund's leverage would have been from December 2006 through September 2009 if the Fund had borrowed capital to invest in the swap contracts' underlying securities rather than entering into the swap contracts. We refer to this unreported leverage as "effective leverage." In December 2006, before the Fund invested heavily in CDS and TRS, the effective leverage was only 0.5%. By September 2008, the Fund's $5.56 billion investment in CDS and TRS had increased its effective leverage to an astounding 130.4%.

Table 3: Effective Leverage of Champion Income Fund, Fiscal 2007-2009. All dollar amounts are in millions. Prior to December 2006, the Fund did not report any CDS or TRS holdings. The Fund did not hold any TRS contracts after December 2008.

Report Date	Fund Net Assets	Net CDS Notional Amount	Net TRS Notional Amount	Effective Leverage
Dec 2006	$2,792.0	($13.7)	$0.0	0.5%
Mar 2007	$2,773.5	($407.8)	$0.0	14.7%
Jun 2007	$2,659.2	($652.5)	$0.0	24.5%
Sep 2007	$2,553.3	($1,208.1)	($79.5)	50.4%
Dec 2007	$2,418.3	($1,357.3)	($442.7)	74.4%
Mar 2008	$2,051.4	($1,456.9)	$1,029.0	121.2%
Jun 2008	$2,113.8	($1,357.0)	$1,028.2	112.8%
Sep 2008	$1,583.3	($1,014.2)	$1,050.3	130.4%
Dec 2008	$638.3	($591.6)	$223.5	127.7%
Mar 2009	$388.5	($36.3)	$0.0	9.3%
Jun 2009	$482.7	$0.0	$0.0	0.0%
Sep 2009	$582.4	$26.3	$0.0	4.5%

The Fund's TRS holdings not only carried hidden leverage; they were also hidden on the Fund's balance sheet. Rather than report the $5.56 billion exposure to mortgage-backed securities and corporate debt on its balance sheet, the Fund recorded the deceptively small market value of all of its swap contracts, including credit default swaps and total return swaps, along with several other items into a single line entitled "Liabilities in Excess of Other Assets" at the very end of the Statement of Investments. Champion Income Fund's Statement of Operations provided more detail, indicating at the bottom of the statement that the Fund was suffering realized and unrealized losses on its swap contracts. However, neither statement indicated the notional amount at risk in CDS and TRS contracts. Only by reading the notes to the financial statements could an investor see the notional amount at risk in each CDS and TRS contract. Even then, the detail provided for each TRS contract was so minimal that investors could not understand the complex payoff structure of the contracts.

III. Champion Income Fund's Credit Default Swap Holdings

i. Credit Default Swaps

Credit default swaps (CDS) are contracts through which the credit risk of a company or debt security, referred to as the "Reference Obligation," is transferred from one party to another in exchange for a series of payments. CDS contracts are essentially insurance contracts in case the Reference Obligation defaults.

One party, the "buyer," makes periodic payments referred to as CDS premiums to another party, the "seller" or "issuer," in exchange for the promise that the seller will pay the buyer if the Reference Obligation defaults. Taking a long position in CDS contracts (i.e., buying a contract) can hedge the risk in a portfolio of corporate bonds; short positions (i.e., selling CDS contracts) increase the credit risk the seller faces.

Like other swap contracts, credit default swaps do not normally require an up-front exchange of the contract's underlying exposure or "notional value." CDS contracts are thus inherently leveraged investments. For example, an investor with $100 in cash could theoretically buy or sell a CDS contract with an arbitrarily large notional amount, e.g., $100,000. Although the investor doesn't need to have the notional value to buy or sell the contract, he does have to deposit sufficient cash to cover any daily declines in the contract's market value.

For example, Champion Income Fund "sold" a CDS contract to Deutsche Bank based on General Motors Corp. The contract was originated during the last three months of 2006 and had a notional amount of $11,510,000. As the seller, the Fund was entitled to receive annual interest payments of 4.68% from Deutsche Bank, similar to the premiums an insurer receives on an insurance policy. If General Motors defaulted before the CDS contract expired on December 20, 2008, Champion Income Fund would have to pay Deutsche Bank $11,510,000.[8] If General Motors did not default before December 20, 2008, Champion Income Fund would keep the premiums and have no further obligations.

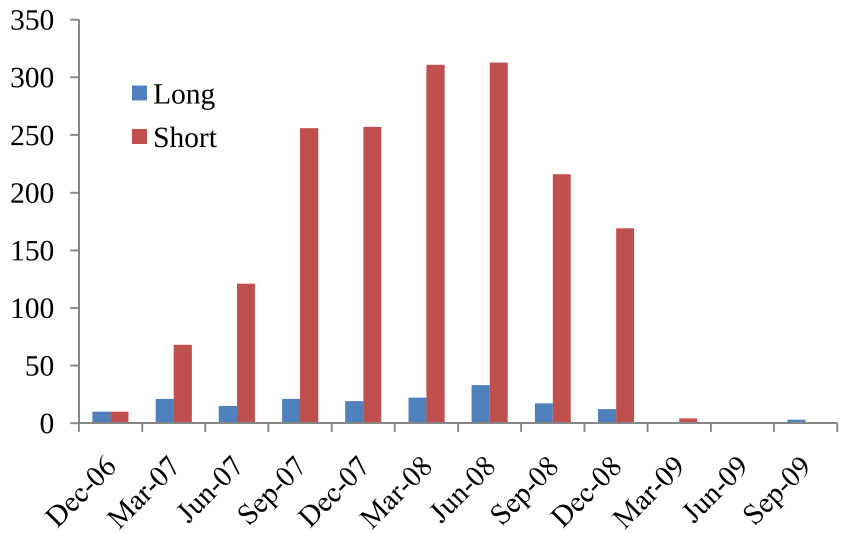
Even if no credit event occurred before December 20, 2008, the market value of the CDS would change on a daily basis during the life of the contract as the credit quality of General Motors changed. If General Motors' credit default swap spread increased by 100 basis points after the CDS contract was entered into (i.e., the credit quality of General Motors deteriorated), Champion Income Fund would record an unrealized loss of $115,100 and Deutsche Bank would record an unrealized gain of the same amount. Conversely, if General Motors credit default swap spread dropped by 100 basis points, Deutsche Bank would recognize the unrealized $115,000 loss and Champion Income Fund would recognize the unrealized gain. At the end of each fiscal period, Champion Income Fund and Deutsche Bank would each report their net realized or unrealized gain or loss on the CDS in their financial statements.

On December 31, 2006, Champion Income Fund began reporting CDS holdings: 10 buy contracts and 10 sell contracts with a net notional amount of $13.7 million (net seller). The Fund subsequently entered into a significant number of CDS contracts in 2007 and 2008 (see Figure 4). The total number of contracts the Fund held peaked in June 2008 at 33 long contracts and 313 short contracts.

On a net basis, the Fund was a large seller of credit protection and so was betting heavily that the credit quality of the reference obligations would not deteriorate further. Because the Fund also had a long position in many of the reference obligations, selling CDS contracts increased the default risk faced by the Fund rather than hedging it.

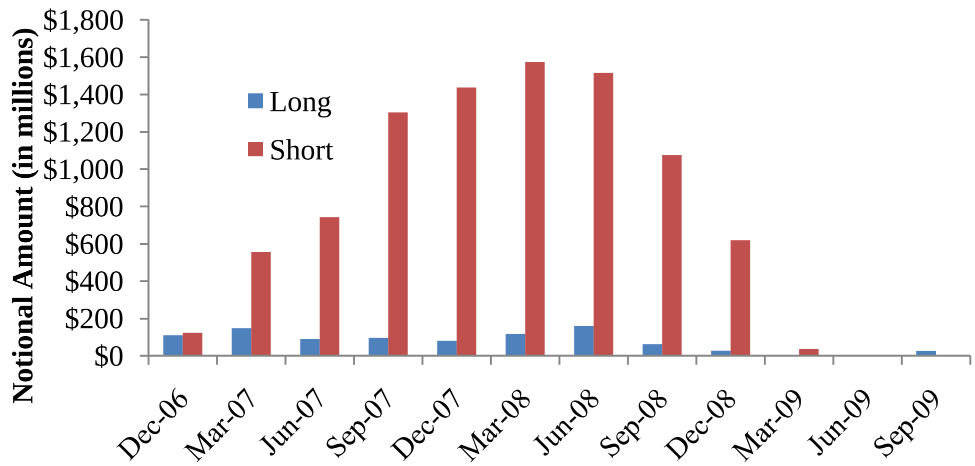
[8] The settlement can be either a physical settlement or a cash settlement. In a physical settlement the seller takes possession of the defaulted debt security. In a cash settlement the payment to the buyer is determined by an auction (see Markit Credit Indices: A Primer, July 2009).

Figure 4: Number of Champion Income Fund's Credit Default Swap Contracts, Fiscal 2007-2009. Prior to December 2006, the Fund did not report any CDS holdings.



The net notional amounts of the Fund's CDS contracts are presented in Figure 5. The net notional amount of the CDS contracts increased from approximately $14 million in December 2006 to $1.46 billion in March 2008. At the same time, the Fund's net assets dropped from $2.8 billion to $2.1 billion. As a result of its CDS holdings in March 2008, the Fund was exposed to the credit risk of $3.56 billion in debt but had only $2.1 billion in net assets.

Figure 5: Notional Value of Champion Income Fund's Credit Default Swap Contracts, Fiscal 2007-2009. Prior to December 2006, the Fund did not report any CDS holdings.



The ratio of the Fund's CDS net notional amount to the Fund's net assets increased steadily from December 2006 through March 2008, reaching a temporary peak of 71% in March 2008 before declining slightly and then spiking up again to 93% in December 2008 (see Table 4). In other words, Champion Income Fund's CDS holdings effectively leveraged the Fund 93% in December 2008. After December 2008, the Fund liquidated almost all of its CDS holdings.

Table 4: Effective Leverage of Champion Income Fund's CDS Holdings, Fiscal 2007-2009. All dollar amounts are in millions. Prior to December 2006, the Fund did not report any CDS holdings.

Report Date	Notional Value of Buy Contracts	Notional Value of Sell Contracts	Net Notional Value	Fund Net Assets	Effective Leverage
Dec 2006	$109.9	$123.6	($13.7)	$2,792.0	0.5%
Mar 2007	$148.2	$556.0	($407.8)	$2,773.5	14.7%
Jun 2007	$88.9	$741.4	($652.5)	$2,659.2	24.5%
Sep 2007	$96.2	$1,304.3	($1,208.1)	$2,553.3	47.3%
Dec 2007	$80.6	$1,438.0	($1,357.3)	$2,418.3	56.1%
Mar 2008	$118.0	$1,574.8	($1,456.9)	$2,051.4	71.0%
Jun 2008	$159.2	$1,516.2	($1,357.0)	$2,113.8	64.2%
Sep 2008	$62.5	$1,076.7	($1,014.2)	$1,583.3	64.1%
Dec 2008	$27.8	$619.4	($591.6)	$638.3	92.7%
Mar 2009	$0.0	$36.3	($36.3)	$388.5	9.3%
Jun 2009	$0.0	$0.0	$0.0	$482.7	0.0%
Sep 2009	$26.3	$0.0	$26.3	$582.4	4.5%

Table 5 shows that the Champion Income Fund had much larger CDS holdings than virtually all other funds in the Morningstar high-yield fund category. Among the 118 high-yield funds we analyzed, 83 funds did not hold any CDS contracts in September 2008. A further 29 funds held CDS contracts whose total notional amount was less than 10% of the Fund's net asset value. Aside from the Champion Income fund, there was only one other fund in September 2008 with CDS holdings whose total notional amount exceeded 50% of the Fund's net asset value.

Table 5: Effective Leverage of 118 High-yield Funds' CDS Holdings, September 2008
Champion Income Fund is one of the two funds in the "50% and above" category.

Effective Leverage	Frequency
0%	83
1% to 9.99%	29
10% to 19.99%	1
20% to 29.99%	1
30% to 39.99%	2
40% to 49.99%	0
50 % and above	2
Total	118

ii. Champion Income Fund's CDS Strategy

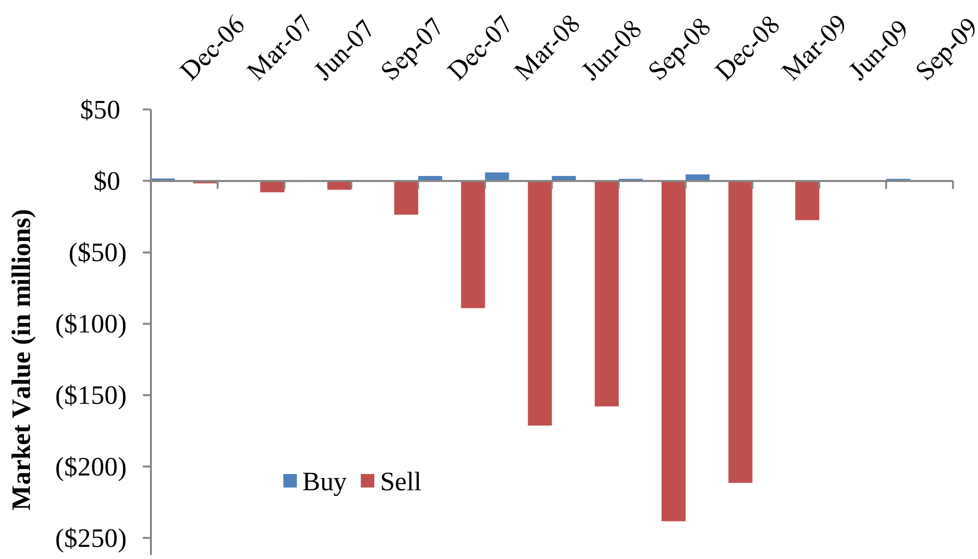
To understand the Champion Income Fund's CDS investment strategy, we start by analyzing the CDS market generally. We use the Markit Group's CDX High-yield (HY) index and the CDX Investment Grade (IG) index, which are standard measures of CDS returns, as our CDS market benchmarks. The CDS spreads for the CDX Investment Grade index and the CDX High Yield index are shown in Figure 7. Each CDX index, including the HY and IG indices, is derived from an equally weighted portfolio of credit default swaps on 100 bonds. The High Yield index is based on high-yield bonds (i.e., "junk bonds") and the Investment Grade index is based on investment-grade bonds.

Prior to June 2007, the High Yield index varied between 200 and 400 basis points and the Investment Grade index varied between 50 and 150 basis points. After June 2007 however, both series of CDS spreads increased significantly. By December of 2008, the index spreads were almost 6 times higher than they were a year earlier.

In addition to the CDX indices issued by Markit, we analyze the Champion Income Fund's CDS portfolio by collecting the quarterly CDS holdings from the Fund's SEC filings. The maturity dates for the CDS contracts vary, ranging from six months to ten years. The average maturity of the Fund's CDS contracts is approximately five years. We download the CDS spread for each CDS contract in the Fund's portfolio from Bloomberg and create weighted-average spreads - effectively creating the CDS index for the Fund portfolio.[9] Because we use quarterly holdings data, we assume that portfolio holdings are fixed during the quarter. Although this methodology is not as precise as using daily holdings, it nevertheless reveals the general patterns that explain why CDS contracts lost so much money. Figure 7, which charts the Fund's weighted-average CDS spread along with the two CDX indices, identifies patterns in the Fund's holdings similar to those seen in the broader CDX indices, but at much higher risk levels than the CDX indices.

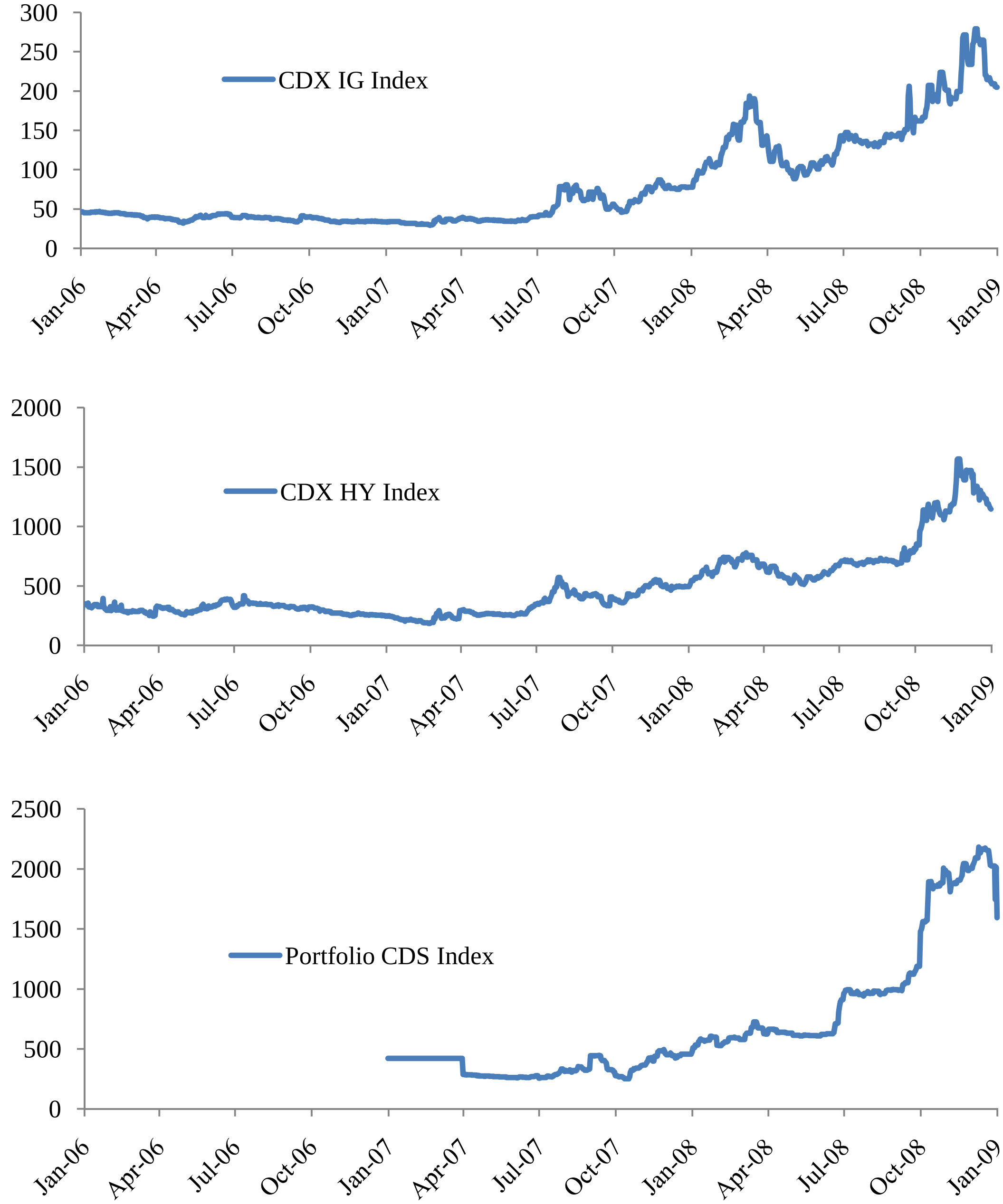
In summer of 2007, as CDS spreads increased, the Champion Income Fund placed bets that the trend would reverse and CDS spreads would decrease. However, in June 2008 the overall credit quality of the Fund's CDS portfolio worsened significantly. In the last two weeks of June 2008 the CDS spread on Champion Income Fund's CDS portfolio jumped from 625 to 960. By December 2008, spreads were astronomically high, causing the Fund to suffer substantial losses (see Figure 6).

Figure 6: Market Value of Champion Income Fund's Credit Default Swap Contracts, Fiscal 2007-2009. Prior to December 2006, the Fund did not report any CDS holdings.



9 Bloomberg does not provide complete information for all of the fund's CDS contracts, particularly for the earliest contracts in the range of dates we consider - of the contracts we reviewed in the fund's portfolio, about 60% have CDS values in Bloomberg.

Figure 7: CDS Spreads on the CDX Investment Grade Index, the CDX High-yield Index, and the Champion Income Fund CDS Portfolio, January 2006-December 2008. The spreads are reported in basis points. The Champion Income Fund did not report any CDS holdings before December 31, 2006.



IV. Champion Income Fund's Total Return Swap Holdings

i. Total Return Swaps

In addition to the $3.03 billion investment value at risk through credit default swaps from 2006-2009, the Champion Income Fund put $2.53 billion investment value at risk through total return swaps. The Champion Income Fund describes a TRS as

> "an agreement under which a set of future cash flows is exchanged between two counterparties. One cash flow stream will typically be based on a reference interest rate or index and the other on the total return of a reference asset such as a security, a basket of securities, or an index. The total return includes appreciation or depreciation on the reference asset, plus any interest or dividend payments."[10]

Essentially, a TRS gives the buyer the exposure it would have if it purchased the underlying security, but does not actually require the buyer to purchase the underlying security. In exchange, the buyer pays the seller an interest rate based on the risk-free rate. Because the market value of high-yield debt and credit default swaps both react negatively to increases in credit risk, TRS returns and CDS returns can be closely related during economic downturns.

Like many CDS contracts, TRS contracts do not require any up-front investment. Theoretically, a person with $100 can buy or sell a $100,000 notional amount TRS contract. However, during the life of the TRS contract the buyer is responsible for making periodic interest payments to the seller, and the seller must pass on the underlying security's dividend or coupon payments to the buyer. TRS contracts are marked-to-market each day and are reported in the buyer's and seller's financial statements at the amount the party would pay or receive if the contract were executed under current market conditions.

For example, during the quarter ended September 30, 2007 Champion Income Fund "sold" a TRS contract to Lehman Brothers based on the Lehman Brothers U.S. CMBS AAA 8.5+ Index. The contract had a notional amount of $41.8 million and expired on February 1, 2008. As the seller, Champion Income Fund agreed to pay

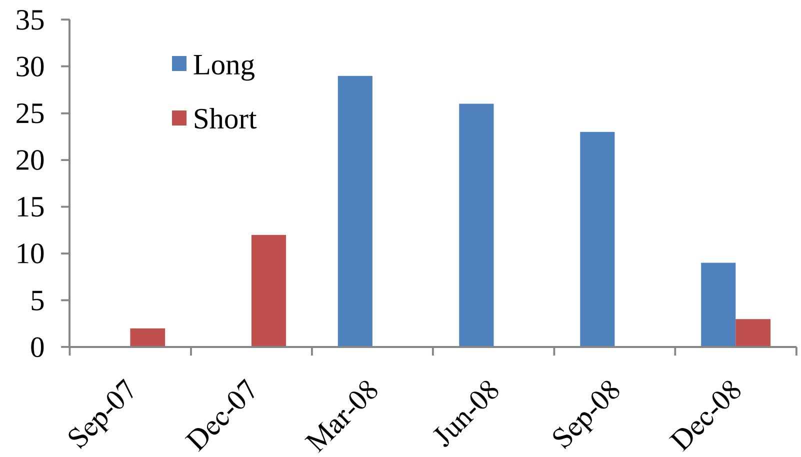
[10] Champion Income Fund, form N-CSR, for period ended September 30, 2007.

Lehman Brothers the index's return, including dividends and interest, if the index increased in value. If the index decreased in value, Lehman Brothers would have to pay the absolute value of the Index's return to Champion Income Fund. In this way, Champion Income Fund provided Lehman Brothers the cash flow Lehman would have had if it had actually taken a $41.8 million position in the index. In return, Lehman Brothers promised to pay Champion Income Fund 37.5 basis points above an undisclosed risk-free rate. During the life of the contract, Champion Income Fund and Lehman Brothers would each record a realized or unrealized gain or loss on the contract in their financial statements.

Champion Income Fund first reported TRS holdings in September 2007, when it reported that it had taken the short position on, or "sold", two TRS contracts. Both contracts were based on the Lehman Brothers U.S. CMBS AAA 8.5+ Index and they had a combined notional value of $79.5 million. The Fund had essentially shorted the index, betting $79.5 million on the margin that the commercial mortgage-backed securities tracked by the Lehman Brothers U.S. CMBS AAA 8.5+ Index would decrease in value.

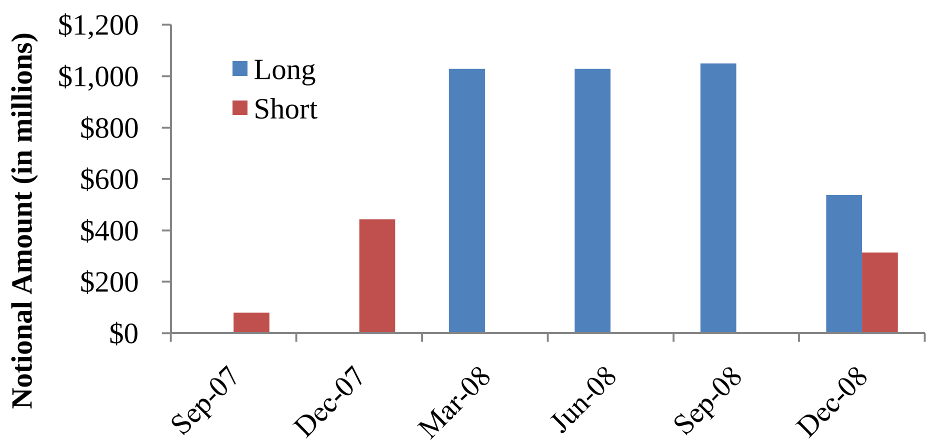
By March 2008 the Fund had increased its number of TRS contracts from 2 to 29 (see Figure 8). The fund had also changed from being sellers of contracts (i.e., betting CMBS would become *less* valuable) to buyers of contracts (i.e., betting CMBS would become *more* valuable). After March 2008 the number of TRS contracts held by the Fund decreased, hitting 23 in September 2008 before dropping to 12 in December 2008. Although the Fund reduced the number of contracts it held, the amount of the Fund's exposure to CMBS remained steady through the end of 2008. In 2009, the Fund completely eliminated its TRS holdings.

Figure 8: Number of Champion Income Fund's Total Return Swap Contracts, Fiscal 2007-2009. The Fund did not report any TRS holdings prior to September 2007 or after December 2008.



The Fund's exposure to TRS contracts—and thus to CMBS—increased from $79.5 million in September 2007 to $1.03 billion in March 2008 (see Figure 9). During the next six months, the Fund reduced the number of contracts but retained approximately $1.0 billion in exposure to commercial mortgage-backed securities. As was true with the $79.5 million in 2007, little if any of the $1 billion TRS notional amount in September 2008 was a hedge; it was all a highly levered wager that commercial mortgage-backed securities would increase in value before the TRS contracts ended.

Figure 9: Notional Value of Champion Income Fund's Total Return Swap Contracts, Fiscal 2007-2009. The Fund did not report any TRS holdings prior to September 2007 or after December 2008.



The TRS contracts substantially increased the Fund's effective leverage. Table 6 shows that between September 2007 and September 2008, the TRS contracts' total notional amount rose from 3% of the Fund's net assets to 66%. As a result of its TRS holdings, the Fund was exposed to $2.63 billion in high-risk corporate debt and commercial mortgage-backed securities but had only $1.58 billion in net assets.

Table 6: Effective Leverage of Champion Income Fund's TRS Holdings, Fiscal 2007-2009. All dollar amounts are in millions. The Fund did not report any TRS holdings prior to September 2007 or after December 2008.

Report Date	Notional Value of Long Contracts	Notional Value of Short Contracts	Net Notional Value	Fund Net Assets	Effective Leverage
Sep 2007	$0.0	$79.5	($79.5)	$2,553.3	3.1%
Dec 2007	$0.0	$442.7	($442.7)	$2,418.3	18.3%
Mar 2008	$1,029.0	$0.0	$1,029.0	$2,051.4	50.2%
Jun 2008	$1,028.2	$0.0	$1,028.2	$2,113.8	48.6%
Sep 2008	$1,050.3	$0.0	$1,050.3	$1,583.3	66.3%
Dec 2008	$537.6	$314.1	$223.5	$638.3	35.0%

The fund also held risky TRS contracts far more extensively than other funds in the Morningstar high-yield category. Table 7 shows that, of the 118 high-yield funds we examined, only three other funds used total return swaps in September 2008. Two of the three funds had an effective leverage of less than 1%, and the third fund had an effective leverage of 12.2%. All three funds used TRS far less than Champion Income Fund, which had an effective leverage of 66% in September 2008. It appears that Champion Income Fund's extensive use of TRS's was an abnormal—and abnormally risky—behavior for high-yield funds.

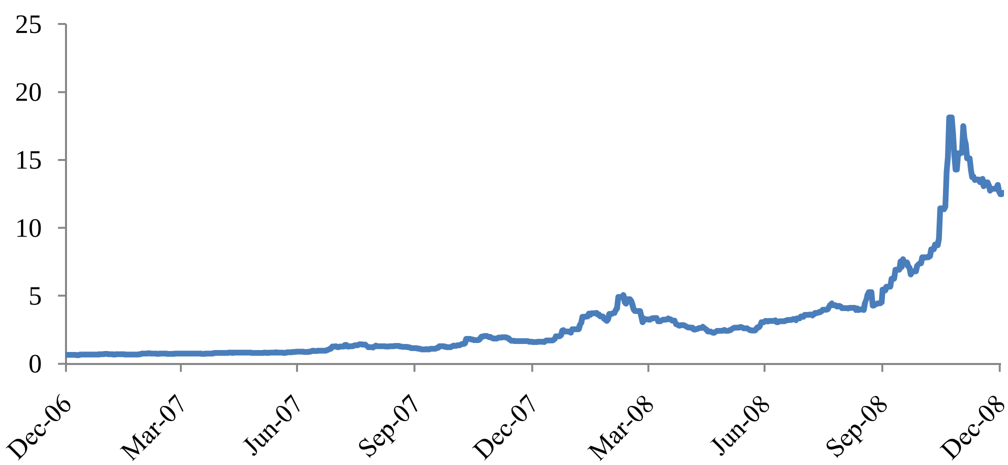
Table 7: Effective Leverage of 118 High-yield Funds' TRS Holdings, September 2008 Champion Income Fund is the fund in the "50% and above" category.

Effective Leverage	Frequency
0%	114
1% to 9.99%	2
10% to 19.99%	1
20% to 29.99%	0
30% to 39.99%	0
40% to 49.99%	0
50 % and above	1
Total	118

ii. Champion Income Fund's TRS Strategy

Almost all of Champion Income Fund's TRS were based on the Lehman Brothers U.S. CMBS AAA 8.5+ Index. Therefore, we first discuss the index's performance to help us understand Champion Income Fund's TRS investment strategy. Figure 10 graphs the option-adjusted spread of the Lehman Brothers U.S. CMBS AAA 8.5+ Index. The option-adjusted spread tracks the risk of the index, which is composed of commercial mortgage-backed securities. When CMBS become more risky, the option-adjusted spread increases and the index decreases. The converse is also true. The index had an average option-adjusted spread of 0.71% over the four years ending in September 2006. Between September 2006 and September 2007, when the Fund began holding TRS contracts, the spread nearly doubled to 1.38% before settling at 1.15%. The increase in the spread reflected the commercial mortgage-backed securities' increased risk.[11] Despite the CMBS index's decline by mid-March 2008 (evidenced by the option-adjusted spread increasing from 1.15 % to 5%), Champion Income Fund invested heavily in total return swaps linked to the Lehman Brothers U.S. CMBS AAA 8.5+ Index. The Fund's investment gamble failed massively in the last three months of 2008 when the CMBS index option-adjusted spread jumped from an already elevated 5% to over 15%.

Figure 10: Option-Adjusted Spread on Barclays Capital CMBS AAA 8.5+ Index, January 2007-December 2008. The spread is reported in basis points.



[11] At the same time, residential mortgage-backed securities indices suffered record losses. The ABX AAA 06-2 Return Index, which tracks the value of the highest-rated subprime residential mortgage-backed securities issued in the last half of 2006, dropped 20% between November 2006 and November 2007. Indices of lower-rated subprime RMBS dropped by up to 80% during the same period.

V. CONCLUSION

From mid-2007 through late 2008, managers of the Oppenheimer Champion Income Fund increased holdings of derivative contracts and mortgage-backed securities, despite clear signs that these financial instruments were becoming increasingly risky. While many other high-yield funds divested themselves of these risky assets, the Champion Income Fund increased its CDS and TRS holdings, resulting in extreme losses for the Fund and its investors.

The losses of the Champion Income Fund can be attributed to a series of investment decisions which failed to diversify the Fund's risk, including 1) the decision to drastically increase the amount of credit insurance the Fund offered via CDS sell contracts during the credit crisis of 2007 and 2008; 2) the decision to gamble billions of dollars in the CMBS market through TRS despite indications that commercial mortgage-backed securities would likely suffer from the residential mortgage-backed security fall-out; and 3) the decision to increase the Fund's direct holdings of CMBS and other mortgage-backed securities while the residential mortgage-backed securities market was plummeting. Furthermore, the Champion Income Fund failed to adequately disclose the magnitude and risk of its gambles to investors. Comparing the returns of the Champion Income Fund to other high-yield bond funds with similar objectives confirms that it would be inaccurate to portray the Fund as a victim of unforeseeable events in the financial markets. Instead, it appears that Fund managers deliberately chose highly risky and irresponsible investment strategies during the rocky financial markets of 2007-2008.