

Western Asset Mortgage Defined Opportunity Fund Inc.
Form N-CSRS
August 28, 2018
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM N-CSR

CERTIFIED SHAREHOLDER REPORT OF REGISTERED
MANAGEMENT INVESTMENT COMPANIES
Investment Company Act file number 811-22369

Western Asset Mortgage Defined Opportunity Fund Inc.
(Exact name of registrant as specified in charter)

620 Eighth Avenue, 49th Floor, New York, NY 10018
(Address of principal executive offices) (Zip code)

Robert I. Frenkel, Esq.

Legg Mason & Co., LLC

100 First Stamford Place

Stamford, CT 06902

(Name and address of agent for service)

Registrant's telephone number, including area code: (888) 777-0102

Date of fiscal year end: December 31

Date of reporting period: June 30, 2018

Table of Contents

ITEM 1. REPORT TO STOCKHOLDERS.

The **Semi-Annual** Report to Stockholders is filed herewith.

Table of Contents

Semi-Annual Report

June 30, 2018

WESTERN ASSET

MORTGAGE DEFINED OPPORTUNITY FUND
INC. (DMO)

INVESTMENT PRODUCTS: NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE

Table of Contents

What's inside	
<u>Letter from the chairman</u>	II
<u>Investment commentary</u>	III
<u>Fund at a glance</u>	1
<u>Spread duration</u>	2
<u>Effective duration</u>	3
<u>Schedule of investments</u>	4
<u>Statement of assets and liabilities</u>	18
<u>Statement of operations</u>	19
<u>Statements of changes in net assets</u>	20
<u>Statement of cash flows</u>	21
<u>Financial highlights</u>	23
<u>Notes to financial statements</u>	25
<u>Additional shareholder information</u>	41
<u>Dividend reinvestment plan</u>	42

Fund objectives

The Fund's primary investment objective is to provide current income. As a secondary investment objective, the Fund will seek capital appreciation.

The Fund seeks to achieve its investment objectives by investing primarily in a diverse portfolio of mortgage-backed securities, consisting primarily of non-agency residential mortgage-backed securities and commercial mortgage-backed securities.

The Fund intends to liquidate and distribute substantially all of the Fund's net assets to shareholders on or about March 1, 2022.

Letter from the chairman

Dear Shareholder,

We are pleased to provide the semi-annual report of Western Asset Mortgage Defined Opportunity Fund Inc. for the six-month reporting period ended June 30, 2018. Please read on for Fund performance information and a detailed look at prevailing economic and market conditions during the Fund's reporting period.

As always, we remain committed to providing you with excellent service and a full spectrum of investment choices. We also remain committed to supplementing the support you receive from your financial advisor. One way we accomplish this is through our website, www.lmcef.com. Here you can gain immediate access to market and investment information, including:

Fund prices and performance,

Market insights and commentaries from our portfolio managers, and

A host of educational resources.

Edgar Filing: Western Asset Mortgage Defined Opportunity Fund Inc. - Form N-CSRS

We look forward to helping you meet your financial goals.

Sincerely,

Jane Trust, CFA

Chairman, President and Chief Executive Officer

July 27, 2018

II Western Asset Mortgage Defined Opportunity Fund Inc.

Table of Contents

Investment commentary

Economic review

Economic activity in the U.S. was mixed during the six months ended June 30, 2018 (the reporting period). Looking back, the U.S. Department of Commerce reported that revised fourth quarter 2017 U.S. gross domestic product (GDP) growth was 2.3%. GDP growth then moderated to a revised 2.2% during the first quarter of 2018. Finally, the U.S. Department of Commerce's initial reading for second quarter 2018 GDP growth released after the reporting period ended was 4.1%. The acceleration in GDP growth in the second quarter reflected positive contributions from personal consumption expenditures (PCE), exports, nonresidential fixed investment, federal government spending and state and local government spending. These were partly offset by negative contributions from private inventory investment and residential fixed investment. Imports, which are a subtraction in the calculation of GDP, increased.

Job growth in the U.S. was solid overall and supported the economy during the reporting period. When the reporting period ended on June 30, 2018, the unemployment rate was 4.0%, as reported by the U.S. Department of Labor. While the unemployment rate ticked up from 3.8% to 4.0% in June, the increase was largely attributed to an increase in the workforce participation rate. The percentage of longer-term unemployed moved higher during the reporting period. In June 2018, 23.0% of Americans looking for a job had been out of work for more than six months, versus 21.5% when the period began.

Table of Contents

Investment commentary (cont d)

Market review

Q. How did the Federal Reserve Board (the Fed) respond to the economic environment?

A. The Fed increased the federal funds rateⁱⁱⁱ twice during the reporting period. Looking back, at its meeting that concluded on September 20, 2017 before the reporting period began the Fed kept rates on hold, but reiterated its intention to begin reducing its balance sheet. At its meeting that ended on December 13, 2017, the Fed raised rates to a range between 1.25% and 1.50%. As expected, the Fed kept rates on hold at its meeting that concluded on January 31, 2018. However, at its meeting that ended on March 21, 2018, the Fed again raised the federal funds rate, moving it to a range between 1.50% and 1.75%. Finally, at its meeting that concluded on June 13, 2018, the Fed raised the federal funds rate to a range between 1.75% and 2.00%.

Q. Did Treasury yields trend higher or lower during the reporting period?

A. Both short-term and longer-term Treasury yields moved higher during the six-month reporting period ended June 30, 2018. The yield for the two-year Treasury note began the reporting period at 1.89% the low for the period and ended the period at 2.52%. The peak for the period of 2.59% occurred on several occasions in May and June 2018. The yield for the ten-year Treasury began the reporting period at 2.40% the low for the period and ended the period at 2.85%. The high for the period of 3.11% took place on May 17, 2018.

Q. What factors impacted the spread sectors (non-Treasuries) during the reporting period?

A. Most spread sectors generally posted weak results during the reporting period. Performance fluctuated given changing expectations for global growth, uncertainties regarding future central bank monetary policy and concerns over a global trade war. All told, the broad U.S. bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index^{iv}, returned -1.62% during the six-month reporting period ended June 30, 2018.

Q. How did the commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS) perform during the reporting period?

A. Both CMBS and RMBS generated weak results during the six months ended June 30, 2018. Demand was solid overall as investors looked to generate incremental yield in the low interest rate environment. Over the six-month reporting period, CMBS, as measured by the Bloomberg Barclays U.S. CMBS Investment Grade Index^v, returned -1.38%. RMBS, as measured by the Bloomberg Barclays U.S. Mortgage-Backed Securities Index^{vi}, returned -0.95% over the same period.

Performance review

For the six months ended June 30, 2018, Western Asset Mortgage Defined Opportunity Fund Inc. returned 5.58% based on its net asset value (NAV^{vii}) and -1.44% based on its New York Stock Exchange (NYSE) market price per share. The Fund's unmanaged benchmark, the ICE BofAML U.S. Floating Rate Home Equity Loan Asset Backed Securities Index^{viii}, returned 1.41% for the same period. The Lipper U.S.

IV Western Asset Mortgage Defined Opportunity Fund Inc.

Table of Contents

Mortgage Closed-End Funds Category Average^{ix} returned 1.13% over the same time frame. Please note that Lipper performance returns are based on each fund's NAV.

During this six-month period, the Fund made distributions to shareholders totaling \$1.26 per share. As of June 30, 2018, the Fund estimates that all of the distributions were sourced from net investment income.* The performance table shows the Fund's six-month total return based on its NAV and market price as of June 30, 2018. **Past performance is no guarantee of future results.**

Performance Snapshot as of June 30, 2018
(unaudited)

Price Per Share	6-Month Total Return**
\$21.17 (NAV)	5.58%
\$23.04 (Market Price)	-1.44%

All figures represent past performance and are not a guarantee of future results. Performance figures for periods shorter than one year represent cumulative figures and are not annualized.

**** Total returns are based on changes in NAV or market price, respectively. Returns reflect the deduction of all Fund expenses, including management fees, operating expenses, and other Fund expenses. Returns do not reflect the deduction of brokerage commissions or taxes that investors may pay on distributions or the sale of shares.**

Total return assumes the reinvestment of all distributions, including returns of capital, if any, at NAV.

Total return assumes the reinvestment of all distributions, including returns of capital, if any, in additional shares in accordance with the Fund's Dividend Reinvestment Plan.

Looking for additional information?

The Fund is traded under the symbol **DMO** and its closing market price is available in most newspapers under the NYSE listings. The daily NAV is available on-line under the symbol **XDMOX** on most financial websites. *Barron's* and the *Wall Street Journal's* Monday edition both carry closed-end fund tables that provide additional information. In addition, the Fund issues a quarterly press release that can be found on most major financial websites as well as www.lmcef.com (click on the name of the Fund).

In a continuing effort to provide information concerning the Fund, shareholders may call 1-888-777-0102 (toll free), Monday through Friday from 8:00 a.m. to 5:30 p.m. Eastern Time, for the Fund's current NAV, market price and other information.

*This estimate is not for tax purposes. The Fund will issue a Form 1099 with final composition of the distributions for tax purposes after year-end. A return of capital is not taxable and results in a reduction in the tax basis of a shareholder's investment. For more information about a distribution's composition, please refer to the Fund's distribution press release or, if applicable, the Section 19 notice located in the press release section of our website, www.lmcef.com (click on the name of the Fund).

Table of Contents

Investment commentary (cont'd)

Thank you for your investment in Western Asset Mortgage Defined Opportunity Fund Inc. As always, we appreciate that you have chosen us to manage your assets and we remain focused on achieving the Fund's investment goals.

Sincerely,

Jane Trust, CFA

Chairman, President and Chief Executive Officer

July 27, 2018

***RISKS:** The Fund is a non-diversified, limited-term closed-end management investment company designed primarily as a long-term investment and not as a trading vehicle. The Fund is not intended to be a complete investment program and, due to the uncertainty inherent in all investments, there can be no assurance that the Fund will achieve its investment objective. The Fund's common stock is traded on the New York Stock Exchange. Similar to stocks, the Fund's share price will fluctuate with market conditions and, at the time of sale, may be worth more or less than the original investment. Shares of closed-end funds often trade at a discount to their net asset value. Because the Fund is non-diversified, it may be more susceptible to economic, political or regulatory events than a diversified fund. The Fund's investments are subject to a number of risks, including credit risk, inflation risk and interest rate risk. As interest rates rise, bond prices fall, reducing the value of the Fund's fixed-income holdings. The Fund may invest in lower-rated high-yield bonds (commonly known as "junk bonds"), which are subject to greater liquidity risk and credit risk (risk of default) than higher-rated obligations. Mortgage-backed securities are subject to additional risks, including prepayment risk, which can limit the potential gains in a declining interest rate environment. The Fund may invest in securities backed by subprime or distressed mortgages which involve a higher degree of risk and chance of loss. Leverage may result in greater volatility of NAV and the market price of common shares and increases a shareholder's risk of loss. The Fund may make significant investments in derivative instruments. Derivative instruments can be illiquid, may disproportionately increase losses, and have a potentially large impact on Fund performance. The Fund is not guaranteed by the U.S. government, the U.S. Treasury or any government agency.*

All investments are subject to risk including the possible loss of principal. Past performance is no guarantee of future results. All index performance reflects no deduction for fees, expenses or taxes. Please note that an investor cannot invest directly in an index.

The information provided is not intended to be a forecast of future events, a guarantee of future results or investment advice. Views expressed may differ from those of the firm as a whole.

VI Western Asset Mortgage Defined Opportunity Fund Inc.

Table of Contents

- i Gross domestic product (GDP) is the market value of all final goods and services produced within a country in a given period of time.
- ii The Federal Reserve Board (the Fed) is responsible for the formulation of U.S. policies designed to promote economic growth, full employment, stable prices and a sustainable pattern of international trade and payments.
- iii The federal funds rate is the rate charged by one depository institution on an overnight sale of immediately available funds (balances at the Federal Reserve) to another depository institution; the rate may vary from depository institution to depository institution and from day to day.
- iv The Bloomberg Barclays U.S. Aggregate Index is a broad-based bond index comprised of government, corporate, mortgage- and asset-backed issues, rated investment grade or higher, and having at least one year to maturity.
- v The Bloomberg Barclays U.S. CMBS Investment Grade Index measures the market of U.S. agency and U.S. non-agency conduit and fusion commercial mortgage-backed security deals with a current deal size of \$300 million.
- vi The Bloomberg Barclays U.S. Mortgage-Backed Securities Index is an unmanaged index composed of agency mortgage-backed pass-through securities, both fixed-rate and hybrid adjustable rate mortgages, issued by the Government National Mortgage Association, Federal National Mortgage Association and Federal Home Loan Mortgage Corporation.
- vii Net asset value (NAV) is calculated by subtracting total liabilities, including liabilities associated with financial leverage (if any) from the closing value of all securities held by the Fund (plus all other assets) and dividing the result (total net assets) by the total number of the common shares outstanding. The NAV fluctuates with changes in the market prices of securities in which the Fund has invested. However, the price at which an investor may buy or sell shares of the Fund is the Fund's market price as determined by supply of and demand for the Fund's shares.
- viii The ICE BofAML U.S. Floating Rate Home Equity Loan Asset Backed Securities Index tracks the performance of U.S. dollar-denominated investment grade floating-rate asset-backed securities collateralized by home equity loans publicly issued in the U.S. domestic market. Qualifying securities must have an investment grade rating, at least one year remaining to final stated maturity, a floating-rate coupon, and an original deal size for the collateral group of at least \$250 million.
- ix Lipper, Inc., a wholly-owned subsidiary of Reuters, provides independent insight on global collective investments. Returns are based on the six-month period ended June 30, 2018, including the reinvestment of all distributions, including returns of capital, if any, calculated among the 7 funds in the Fund's Lipper category.

Table of Contents

Fund at a glance (unaudited)

Investment breakdown (%) as a percent of total investments

The bar graph above represents the composition of the Fund's investments as of June 30, 2018 and December 31, 2017 and does not include derivatives, such as futures contracts, swap contracts and forward foreign currency contracts. The Fund is actively managed. As a result, the composition of the Fund's investments is subject to change at any time.

Table of Contents

Spread duration (unaudited)

Economic exposure June 30, 2018

Total Spread Duration

DMO 7.09 years

Benchmark 2.85 years

Spread duration measures the sensitivity to changes in spreads. The spread over Treasuries is the annual risk-premium demanded by investors to hold non-Treasury securities. Spread duration is quantified as the % change in price resulting from a 100 basis points change in spreads. For a security with positive spread duration, an increase in spreads would result in a price decline and a decline in spreads would result in a price increase. This chart highlights the market sector exposure of the Fund's sectors relative to the selected benchmark sectors as of the end of the reporting period.

ABS	Asset-Backed Securities
Benchmark	ICE BofAML U.S. Floating Rate Home Equity Loan Asset Backed Securities Index
DMO	Western Asset Mortgage Defined Opportunity Fund Inc.
HY	High Yield
MBS	Mortgage-Backed Securities

Table of Contents

Effective duration (unaudited)

Interest rate exposure June 30, 2018

Total Effective Duration

DMO 5.44 years

Benchmark 0.03 years

Effective duration measures the sensitivity to changes in relevant interest rates. Effective duration is quantified as the % change in price resulting from a 100 basis points change in interest rates. For a security with positive effective duration, an increase in interest rates would result in a price decline and a decline in interest rates would result in a price increase. This chart highlights the interest rate exposure of the Fund's sectors relative to the selected benchmark sectors as of the end of the reporting period.

ABS	Asset-Backed Securities
Benchmark	ICE BofAML U.S. Floating Rate Home Equity Loan Asset Backed Securities Index
DMO	Western Asset Mortgage Defined Opportunity Fund Inc.
HY	High Yield
MBS	Mortgage-Backed Securities

Table of Contents**Schedule of investments (unaudited)**

June 30, 2018

Western Asset Mortgage Defined Opportunity Fund Inc.

Security	Rate	Maturity Date	Face Amount	Value
Residential Mortgage-Backed Securities (a) 91.2%				
Ace Securities Corp., 2005-RM1 M4 (1 mo. USD LIBOR + 1.020%)	3.111%	3/25/35	\$ 3,140,313	\$ 3,018,796 (b)(c)
Adjustable Rate Mortgage Trust, 2004-2 CB1 (1 mo. USD LIBOR + 1.150%)	3.241%	2/25/35	1,807,576	1,598,307 (b)(c)
Adjustable Rate Mortgage Trust, 2005-05 1A1 (6 mo. USD LIBOR + 2.020%)	3.769%	9/25/35	171,722	140,876 (b)(c)
Adjustable Rate Mortgage Trust, 2005-07 2A21 (12 mo. USD LIBOR + 1.900%)	3.700%	10/25/35	462,830	427,439 (b)(c)
Adjustable Rate Mortgage Trust, 2005-12 5A1 (1 mo. USD LIBOR + 0.500%)	2.591%	3/25/36	282,946	147,921 (b)(c)
Aegis Asset-Backed Securities Trust, 2005-3 M3 (1 mo. USD LIBOR + 0.490%)	2.581%	8/25/35	3,460,000	2,882,787 (b)(c)
AFC Home Equity Loan Trust, 2003-3 1A (1 mo. USD LIBOR + 0.750%)	2.841%	10/25/30	1,183,099	1,098,281 (b)(c)(d)
American Home Mortgage Assets, 2005-2 2A1A	3.525%	1/25/36	995,357	831,028 (b)(c)
American Home Mortgage Investment Trust, 2007-2 2A (1 mo. USD LIBOR + 0.800%)	2.891%	3/25/47	12,735,445	905,249 (b)(c)
American Home Mortgage Investment Trust, 2007-A 4A (1 mo. USD LIBOR + 0.900%)	2.991%	7/25/46	2,065,326	958,070 (b)(c)(d)
Argent Securities Inc., 2006-M2 A2C (1 mo. USD LIBOR + 0.150%)	2.241%	9/25/36	2,212,861	967,059 (b)(c)
Argent Securities Inc., 2006-M2 A2D (1 mo. USD LIBOR + 0.240%)	2.331%	9/25/36	584,039	256,726 (b)(c)
Banc of America Alternative Loan Trust, 2005-9 1CB5, IO (-1.000 x 1 mo. USD LIBOR + 5.100%)	3.009%	10/25/35	3,306,980	210,584 (b)(c)
Banc of America Funding Corp., 2004-B 6A1	2.265%	12/20/34	396,177	309,790 (b)(c)
Banc of America Funding Corp., 2004-C 3A1 (12 mo. USD LIBOR + 1.980%)	3.593%	12/20/34	508,986	490,367 (b)(c)
Banc of America Funding Corp., 2006-D 2A1	3.506%	5/20/36	39,837	36,171 (b)(c)
Banc of America Funding Corp., 2006-D 6A1 (12 mo. USD LIBOR + 2.300%)	3.685%	5/20/36	963,817	895,453 (b)(c)
Banc of America Funding Corp., 2006-F 1A1 (1 year Treasury Constant Maturity Rate + 2.500%)	4.071%	7/20/36	285,335	283,172 (b)(c)
Banc of America Funding Corp., 2014-R5 1A2 (6 mo. USD LIBOR + 1.500%)	3.347%	9/26/45	3,750,000	3,057,878 (b)(c)(d)
Banc of America Funding Corp., 2015-R2 09A2	2.481%	3/27/36	4,580,591	3,925,091 (b)(c)(d)
Banc of America Funding Corp., 2015-R3 2A2	2.090%	2/27/37	2,514,685	2,150,820 (b)(c)(d)
Bayview Financial Asset Trust, 2007-SR1A M1 (1 mo. USD LIBOR + 0.800%)	2.891%	3/25/37	2,786,164	2,646,513 (b)(c)(d)
Bayview Financial Asset Trust, 2007-SR1A M2 (1 mo. USD LIBOR + 0.900%)	2.991%	3/25/37	3,392,044	3,240,908 (b)(c)(d)
Bayview Financial Asset Trust, 2007-SR1A M3 (1 mo. USD LIBOR + 1.150%)	3.241%	3/25/37	1,536,813	1,502,520 (b)(c)(d)

See Notes to Financial Statements.

Table of Contents

Western Asset Mortgage Defined Opportunity Fund Inc.

Security	Rate	Maturity Date	Face Amount
----------	------	------------------	----------------