Western Asset Mortgage Defined Opportunity Fund Inc.
Form N-CSR
March 04, 2019

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: December 31, 2018

ITEM 1. REPORT TO STOCKHOLDERS.

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

Annual Report December 31, 2018

WESTERN ASSET

MORTGAGE DEFINED OPPORTUNITY FUND INC. (DMO)

Beginning in January 2021, as permitted by regulations adopted by the Securities and Exchange Commission, the Fund intends to no longer mail paper copies of the Fund s shareholder reports like this one, unless you specifically request paper copies of the reports from the Fund or from your financial intermediary (such as a broker-dealer or bank). Instead, the reports will be made available on a website, and you will be notified by mail each time a report is posted and provided with a website link to access the report.

If you invest through a financial intermediary and you already elected to receive shareholder reports electronically (e-delivery), you will not be affected by this change and you need not take any action. If you have not already elected e-delivery, you may elect to receive shareholder reports and other communications from the Fund electronically by contacting your financial intermediary.

You may elect to receive all future reports in paper free of charge. If you invest through a financial intermediary, you can contact your financial intermediary to request that you continue to receive paper copies of your shareholder reports. That election will apply to all Legg Mason funds held in your account at that financial intermediary. If you are a direct shareholder with the Fund, you can call the Fund at 1-888-888-0151, or write to the Fund by regular mail at P.O. Box 505000, Louisville, KY 40233 or by overnight delivery to Computershare, 462 South 4th Street, Suite 1600, Louisville, KY 40202 to let the Fund know you wish to continue receiving paper copies of your shareholder reports. That election will apply to all Legg Mason Funds held in your account held directly with the fund complex.

What s inside

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 annual report of Western Asset Mortgage Defined Opportunity Fund Inc. for the twelve-month reporting period ended December 31, 2018. Please read on for a detailed look at prevailing economic and market conditions during the Fund s reporting period and to learn how those conditions have affected Fund performance.

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.

We look forward to helping you meet your financial goals.

Sincerely,

Jane Trust, CFA

Chairman, President and Chief Executive Officer

January 31, 2019

Investment commentary

Economic review

Economic activity in the U.S. was mixed during the twelve months ended December 31, 2018 (the reporting period). Looking back, the U.S. Department of Commerce reported that first quarter 2018 U.S. gross domestic product (GDP[i]) growth was 2.2%. GDP growth then accelerated to 4.2% during the second quarter of 2018 the strongest reading since the third quarter of 2014. Third quarter 2018 GDP growth was 3.4%. The deceleration in GDP growth in the third quarter of 2018 reflected a downturn in exports and decelerations in nonresidential fixed investment and personal consumption expenditures. Imports increased in the third quarter after decreasing in the second. These movements were partly offset by an upturn in private inventory investment. Finally, the U.S. Department of Commerce s initial reading for fourth quarter 2018 GDP growth was delayed due to the partial shutdown of the U.S. government.

Job growth in the U.S. was solid overall and supported the economy during the reporting period. As reported by the U.S. Department of Labor, when the reporting period ended on December 31, 2018, the unemployment rate was 3.9%, versus 4.1% when the period began. The percentage of longer-term unemployed also declined during the reporting period. In December 2018, 20.5% of Americans looking for a job had been out of work for more than six months, versus 21.5% when the period began.

The Federal Reserve Board (the Fed[ii]) continued tightening monetary policy during the reporting period, as it raised interest rates four times in 2018 and further reduced its balance sheet. As widely expected, the Fed raised the federal funds rate[iii] at its meetings that ended on March 21, 2018 (to a range between 1.50% and 1.75%), June 13, 2018 (to a range between 1.75% and 2.00%), September 26, 2018 (to a range between 2.00% and 2.25%) and December 19, 2018 (to a range between 2.25% and 2.50%). At its meeting that concluded on January 30, 2019, after the reporting period ended, the Fed kept interest rates on hold and said, In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate .

As always, thank you for your confidence in our stewardship of your assets.

Sincerely,

Jane Trust, CFA

Chairman, President and

Chief Executive Officer

January 31, 2019

All investments are subject to risk including the possible loss of principal. Past performance is no guarantee of future results.

[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.

Fund overview

Q. What is the Fund s investment strategy?

A. 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 (MBS), consisting primarily of non-agency residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS).

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

The Fund also may invest, to a lesser degree, in other permitted investments, including cash and cash equivalents; Treasury securities; non-mortgage related asset-backed securities (ABS) backed by various asset classes including, but not limited to, small balance commercial mortgages, aircrafts, automobiles, credit cards, equipment, manufactured housing, franchises, recreational vehicles and student loans; and investment grade and below investment grade fixed income securities including bonds, debentures, notes, commercial paper and other similar types of debt instruments including hybrid securities. The Fund also may invest in any newly developed mortgage-related derivatives that may hereafter become available for mortgage investing.

The Fund may invest in derivative instruments, such as options contracts, futures contracts, options on futures contracts, indexed securities, credit linked notes, credit default swaps and other swap agreements for investment, hedging and risk management purposes with certain limitations. Notwithstanding the foregoing, the Fund may invest without limitation in Treasury futures, Eurodollar futures, interest rate swaps, swaptions or similar instruments and combinations thereof.

The Fund is not limited in its ability to invest in below investment grade (commonly referred to as high yield or junk securities) or illiquid securities. Below investment grade securities are securities rated below the Baa3 or BBB- categories at the time of purchase by one or more nationally recognized statistical rating organizations or unrated securities that we determined to be of comparable credit quality.

At Western Asset Management Company, LLC (formerly known as Western Asset Management Company) (Western Asset), the Fund s subadviser, we utilize a fixed-income team approach, with decisions derived from interaction among various investment management sector specialists. The sector teams are comprised of Western Asset s senior portfolio management personnel, research analysts and an in-house economist. Under this team approach, management of client fixed-income portfolios will reflect a consensus of interdisciplinary views within the Western Asset organization. The individuals responsible for development of investment strategy, day-to-day portfolio management, oversight and coordination of the Fund are S. Kenneth Leech, Greg E. Handler and Harris A. Trifon. Mr. Trifon has been part of the Fund s portfolio management team since January 2019 and has been employed by Western Asset as an investment professional since 2014. From 2009 to 2014, Mr. Trifon worked as Director, Fixed Income Research at Deutsche Bank.

Fund overview (cont d)

Q. What were the overall market conditions during the Fund s reporting period?

A. Fixed income markets generally posted weak results over the twelve-month reporting period ended December 31, 2018. Spread sectors (non-Treasuries) experienced periods of elevated volatility as they were impacted by a number of factors, including generally solid economic growth in the U.S., moderating growth overseas, four interest rate hikes by the Federal Reserve Board (the Fed[i]), concerns over a global trade war, geopolitical issues and, more recently, a partial shutdown of the U.S. government.

Both short- and long-term U.S. Treasury yields moved higher and the yield curve[ii] flattened during the reporting period. 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 2.48%. The high for the period of 2.98% occurred on November 8, 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 2.69%. The peak for the period of 3.24% took place on November 8, 2018.

The overall agency RMBS market posted a modest gain, but lagged equal-duration[iii] Treasuries during the reporting period. This relative underperformance was partially driven by the Fed unwinding its balance sheet and paring its holdings of agency MBS. Interest rate volatility, especially during the fourth quarter of 2018, also negatively impacted the agency MBS market. In contrast, structured products, including non-agency RMBS, CMBS and ABS, generated solid results and outperformed equal duration Treasuries during the reporting period. Structured products in general were supported by overall positive fundamentals, solid consumer balance sheets and lending conditions that remained constrained.

Q. How did we respond to these changing market conditions?

A. A number of adjustments were made to the Fund during the reporting period. Within the non-agency RMBS market, we instituted a number of relative value trades by reducing the Fund s exposure to holdings that performed well and exceeded our expectations, while investing in securities that we felt offered more attractive relative values. We also modestly added to the Fund s position in credit risk transfer (CRT) securities issued by Freddie Mac and Fannie Mae.

In terms of the Fund s position in CMBS, we increased the Fund s exposure to shorter term floating rate new-issue single asset/single borrower commercial loans, while reducing its allocation to conduit (pooled) non-agency CMBS at the beginning of the fourth quarter of 2018, as spreads had tightened. We also reduced the Fund s overall exposure to the ABS sector. More specifically, we increased the Fund s positions in consumer loan ABS, while paring its allocation to rental car and student loan ABS.

During the reporting period, we utilized Treasury futures to manage the Fund s duration and yield curve exposure. Overall, the use of these derivatives contributed to performance. CMBS index swaps (CDS), which were used to manage the Fund s exposure to CMBS, were additive to results. The strategy also used foreign exchange forwards to manage currency risk. The use of this derivatives did not meaningfully impact performance.

Finally, we actively utilized leverage in the Fund. When the reporting period began, the Fund s leverage as a percentage of gross assets was roughly 31%. At the end of the period, approximately 31% of the Fund s gross assets were levered. Overall, leverage contributed to results given the positive total return of the assets of the Fund in 2018.

Performance review

For the twelve months ended December 31, 2018, Western Asset Mortgage Defined Opportunity Fund Inc. returned 9.26% based on its net asset value (NAV[iv]) and -1.16% 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[v], returned 2.29% for the same period. The Lipper U.S. Mortgage Closed-End Funds Category Average[vi] returned 3.12% over the same time frame. Please note that Lipper performance returns are based on each fund s NAV.

During the twelve-month period, the Fund made distributions to shareholders totaling $3.86 per share*. The performance table shows the Fund s twelve-month total return based on its NAV and market price as of December 31, 2018. **Past performance is no guarantee of future results.**

Performance Snapshot as of December 31, 2018

Price Per Share	12-Month Total Return**
$19.28 (NAV)	9.26%
$20.39 (Market Price)	-1.16%

All figures represent past performance and are not a guarantee of future results.

**** 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 at NAV.

Total return assumes the reinvestment of all distributions in additional shares in accordance with the Fund s Dividend Reinvestment Plan.

Q. What were the leading contributors to performance?

A. On an absolute basis, the leading contributor to the Fund s performance during the reporting period was our allocation to legacy non-agency RMBS (issued pre-2007). This sector continues to benefit from a favorable technical backdrop as the outstanding mount continued to run down. Our exposure to CTR securities issued by Fannie Mae and Freddie Mac also generated solid results. Elsewhere, within the CMBS market, new-issue single asset/single borrower securities were the most additive for returns. Finally, our allocation to ABS modestly contributed to performance.

Q. What were the leading detractors from performance?

A. The Fund generated a strong absolute return during the reporting period. Modestly detracting from absolute performance was the Fund s cash position. While cash remained a small portion of the portfolio, it was a drag on relative performance given the upward trend in the marketplace during the reporting period.

* For the tax character of distributions paid during the fiscal year ended December 31, 2018, please refer to page 42 of this report.

Fund overview (cont d)

Certain legacy CMBS positions were also a modest headwind for returns.

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.

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,

Western Asset Management Company, LLC

January 24, 2019

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.

[i] 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.

[ii] The yield curve is the graphical depiction of the relationship between the yield on bonds of the same credit quality but different maturities.

[iii] Duration is the measure of the price sensitivity of a fixed-income security to an interest rate change of 100 basis points. Calculation is based on the weighted average of the present values for all cash flows.

[iv] 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.

[v] 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.

[vi] Lipper, Inc., a wholly-owned subsidiary of Reuters, provides independent insight on global collective investments. Returns are based on the twelve-month period ended December 31, 2018, including the reinvestment of all distributions, including returns of capital, if any, calculated among the 9 funds in the Fund s Lipper category.

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 December 31, 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.

Spread duration (unaudited)

Economic exposure December 31, 2018

Total Spread Duration

DMO	7.70 years
Benchmark	2.64 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

Effective duration (unaudited)

Interest rate exposure December 31, 2018

Total Effective Duration

DMO	5.35 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

Schedule of investments

December 31, 2018

Western Asset Mortgage Defined Opportunity Fund Inc.

Security	Rate	Maturity Date	Face Amount	Value
Residential Mortgage-Backed Securities [(a)] **112.1%**				
ACE Securities Corp. Home Equity Loan Trust, 2005-RM1 M4 (1 mo. USD LIBOR + 1.020%)	3.526%	3/25/35	$ 3,145,405	$ 3,058,171 [(b)]
Adjustable Rate Mortgage Trust, 2005-5 1A1	3.989%	9/25/35	160,029	128,983 [(b)]
Adjustable Rate Mortgage Trust, 2005-7 2A21	3.877%	10/25/35	367,852	335,766 [(b)]
Adjustable Rate Mortgage Trust, 2005-12 5A1 (1 mo. USD LIBOR + 0.500%)	3.006%	3/25/36	264,059	127,569 [(b)]
Aegis Asset Backed Securities Trust, 2005-3 M3 (1 mo. USD LIBOR + 0.490%)	2.996%	8/25/35	3,460,000	2,840,478 [(b)]
AFC Trust, 2000-3 1A (1 mo. USD LIBOR + 0.750%)	3.256%	10/25/30	1,090,820	1,008,596 [(b)(c)]
Ajax Mortgage Loan Trust, 2016-C A	4.000%	10/25/57	2,282,867	2,285,877 [(c)]
Alternative Loan Trust, 2005-11CB 3A3, IO (-1.000 x 1 mo. USD LIBOR + 5.000%)	2.494%	6/25/35	1,991,217	141,959 [(b)]
Alternative Loan Trust, 2005-14 3A1	2.640%	5/25/35	226,382	163,072 [(b)]
Alternative Loan Trust, 2005-36 4A1	3.742%	8/25/35	464,038	429,524 [(b)]
Alternative Loan Trust, 2005-J10 1A1 (1 mo. USD LIBOR + 0.500%)	3.006%	10/25/35	1,059,281	870,088 [(b)]
Alternative Loan Trust, 2006-HY10 1A1	3.175%	5/25/36	339,073	286,367 [(b)]
Alternative Loan Trust, 2006-J8 A5	6.000%	2/25/37	107,041	75,736
Alternative Loan Trust, 2007-3T1 2A1	6.000%	3/25/27	170,445	174,637
Alternative Loan Trust, 2007-23CB A8 (-4.000 x 1 mo. USD LIBOR + 28.400%)	18.375%	9/25/37	601,528	796,139 [(b)]
Alternative Loan Trust, 2007-OA8 1A1 (1 mo. USD LIBOR + 0.180%)	2.686%	6/25/47	1,463,836	1,236,126 [(b)]
American Home Mortgage Assets Trust, 2005-2 2A1A	3.818%	1/25/36	984,567	812,539 [(b)]
American Home Mortgage Investment Trust, 2007-2 2A (1 mo. USD LIBOR + 0.800%)	3.306%	3/25/47		