

Western Asset Mortgage Defined Opportunity Fund Inc.

Form N-CSR/A

August 28, 2015

[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: December 31, 2014

Table of Contents

ITEM 1. REPORT TO STOCKHOLDERS.

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

Table of Contents

Annual Report

December 31, 2014

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	
Letter from the chairman	II
Investment commentary	III
Fund overview	1
Fund at a glance	6
Spread duration	7
Effective duration	8
Schedule of investments	9
Statement of assets and liabilities	22
Statement of operations	23
Statements of changes in net assets	24
Statement of cash flows	25
Financial highlights	26
Notes to financial statements	27
Report of independent registered public accounting firm	43
Board approval of management and subadvisor agreements	44
Additional information	50
Annual chief executive officer and principal financial officer certifications	56
Other shareholder communications regarding accounting matters	57
Dividend reinvestment plan	58
Important tax information	60

Fund objectives

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

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, 2014. 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,

Kenneth D. Fuller

Chairman, President and Chief Executive Officer

January 30, 2015

II Western Asset Mortgage Defined Opportunity Fund Inc.

Table of Contents

Investment commentary

Economic review

Despite weakness in early 2014, the U.S. economy expanded at a solid pace during the twelve months ended December 31, 2014 (the reporting period). The U.S. Department of Commerce reported that in the first quarter of 2014, U.S. gross domestic product (GDP) contracted 2.1%. This was the first negative GDP report in three years and partially attributed to severe winter weather. Thankfully, this setback was very brief, as second quarter GDP growth was 4.6%. The rebound in GDP growth was driven by several factors, including an acceleration in personal consumption expenditures (PCE), increased private inventory investment and exports, as well as an upturn in state and local government spending. The economy then gained further momentum as third quarter GDP growth was 5.0%, its strongest reading since the third quarter of 2003. This was driven by contributions from PCE, exports, nonresidential fixed investment and government spending. After the reporting period ended, the U.S. Department of Commerce's initial estimate showed that fourth quarter 2014 GDP growth was 2.6%. Moderating growth was due to several factors, including an upturn in imports, a downturn in federal government spending and decelerations in nonresidential fixed investment and in exports.

The U.S. manufacturing sector was another tailwind for the economy. Based on figures for the Institute for Supply Management's Purchasing Managers Index (PMI) U.S. manufacturing expanded during all twelve months of the reporting period (a reading below 50 indicates a contraction, whereas a reading above 50 indicates an expansion). After a reading of 56.5 in December 2013, the PMI fell to 51.3 in January 2014, but generally rose over the next several months, reaching a high of 59.0 in August, its best reading since March 2011. While the PMI dipped to 56.6 in September, it rose back to 59.0 in October. Manufacturing activity then moderated over the last two months of the year and the PMI was 55.5 in December. However, for 2014 as a whole the PMI averaged 55.8, the best annual reading since 2010.

The improving U.S. job market was another factor supporting the overall economy during the reporting period. When the period began, unemployment, as reported by the U.S. Department of Labor, was 6.6%. Unemployment generally declined throughout the reporting period and reached a low of 5.6% in December 2014, the lowest level since June 2008.

The Federal Reserve Board (Fed) took a number of actions as it sought to meet its dual mandate of fostering maximum employment and price stability. As it has since December 2008, the Fed kept the federal funds rate^{iv} at a historically low range between zero and 0.25%. The Fed also ended its asset purchase program that was announced in December 2012. At that time, the Fed said it would continue purchasing \$40 billion per month of agency mortgage-backed securities (MBS), as well as \$45 billion per month of longer-term Treasuries. Following the meeting that concluded on December 18, 2013, the Fed announced that it would begin reducing its monthly asset purchases, saying "Beginning in January 2014, the Committee will add to its holdings of agency MBS at a pace of \$35 billion per month rather than \$40 billion per month, and will add to its holdings of longer-term Treasury securities at a pace of \$40 billion per month rather than \$45 billion per month. At each of the Fed's next six meetings (January, March, April, June, July and September 2014), it announced further

Table of Contents

Investment commentary (cont d)

\$10 billion tapering of its asset purchases. At its meeting that ended on October 29, 2014, the Fed announced that its asset purchase program had concluded. During its last meeting of the year that concluded on December 17, 2014, the Fed said that “Based on its current assessment, the Committee judges that it can be patient to maintain the 0 to 1/4 percent target range for the federal funds rate for a considerable time.” Finally, at its meeting that ended on January 28, 2015, after the reporting period ended, the Fed said “Based on its current assessment, the Committee judges that it can be patient in beginning to normalize the stance of monetary policy.”

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

Sincerely,

Kenneth D. Fuller

Chairman, President

and Chief Executive Officer

January 30, 2015

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 Institute for Supply Management’s PMI is based on a survey of purchasing executives who buy the raw materials for manufacturing at more than 350 companies. It offers an early reading on the health of the U.S. manufacturing sector.

ⁱⁱⁱ The Federal Reserve Board (Fed) is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices and a sustainable pattern of international trade and payments.

^{iv} 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.

Table of Contents

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 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 or illiquid securities. Below investment grade securities are securities rated below the Baa or BBB categories at the time of purchase by one or more nationally recognized statistical rating organizations or unrated securities that we determine to be of comparable quality.

At 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 Anup Agarwal.

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

A. The U.S. spread sectors (non-Treasuries) generated positive results and largely outperformed equal-duration¹ Treasuries over the twelve months ended December 31, 2014. Risk aversion was prevalent at times given mixed economic data, questions surrounding the outlook for global growth, changing monetary policy by the Federal Reserve Board (Fed), and numerous geopolitical issues. However, these factors

Table of Contents

Fund overview (cont d)

were largely overshadowed by solid demand from investors looking to generate incremental yield in the low interest rate environment.

Short-term Treasury yields moved higher, whereas longer-term Treasury yields declined during the twelve months ended December 31, 2014. Two-year Treasury yields rose from 0.38% at the beginning of the period to 0.67% at the end of the period. Their peak of 0.73% occurred on December 23, December 24 and December 26, 2014, and they were as low as 0.30% in early February 2014. Ten-year Treasury yields were at a peak of 3.04% when the reporting period began and reached a low of 2.07% on December 16, 2014. They ended the reporting period at 2.17%. All told, the Barclays U.S. Aggregate Indexⁱⁱⁱ returned 5.97% for the twelve months ended December 31, 2014.

As was the case for the overall fixed-income market, agency MBS generated solid results during the reporting period. Agency MBS were supported by declining interest rates and generally solid demand. During the twelve months ended December 31, 2014, the overall agency MBS market, as measured by the Barclays U.S. Mortgage Backed Securities Index^{iv}, returned 6.08%. Elsewhere, RMBS, as measured by the BofA Merrill Lynch U.S. Floating Rate Home Equity Loan Asset Backed Securities Index^v, returned 3.33%. While CMBS also produced positive results during the twelve months ended December 31, 2014, they underperformed the overall fixed-income market, as the Barclays CMBS Index^{vi} gained 4.21%.

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

A. We made several adjustments to the Fund's portfolio during the reporting period. We reduced our exposure to option adjustable-rate mortgage (ARM) agency MBS and modestly pared our allocation to investment grade corporate bonds. In contrast, we increased our exposures to Alt-A non-agency MBS, government sponsored enterprise (GSE) risk-transfer securities and CMBS.

During the reporting period, Treasury futures were used to manage duration and yield curve^{vii} exposure. Credit default swaps on CMBS indices were used to hedge downside market risk. Elsewhere, we used foreign exchange forwards to hedge our currency exposure to euro-denominated CMBS. Overall, these 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 34%. At the end of the period, approximately 33% of the Fund's gross assets were levered. The use of leverage was beneficial for the Fund's absolute performance during the period.

Performance review

For the twelve months ended December 31, 2014, Western Asset Mortgage Defined Opportunity Fund Inc. returned 17.55% based on its net asset value (NAVⁱⁱⁱ) and 16.76% based on its New York Stock Exchange (NYSE) market price per share. The Fund's unmanaged benchmark, the BofA Merrill Lynch U.S. Floating Rate Home Equity Loan Asset Backed Securities Index, returned 3.33% for the same period. The Lipper U.S. Mortgage Closed-End Funds

Table of Contents

Category Average^{ix} returned 7.80% 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 \$3.09 per share.* The performance table shows the Fund's twelve-month total return based on its NAV and market price as of December 31, 2014. **Past performance is no guarantee of future results.**

Performance Snapshot as of December 31, 2014

Price Per Share	12-Month Total Return**
\$24.75 (NAV)	17.55%
\$23.84 (Market Price)	16.76%

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 its allocation to non-agency MBS. Non-agency MBS were supported by generally strong investor demand, attractive yields, continued principal paydowns and limited new supply. The Fund's allocations to ABS and CMBS were also additive to performance. Elsewhere, the Fund's investment-grade and high-yield corporate bonds were beneficial for performance.

In terms of the Fund's investment-grade bond holdings, Noble Group and United Airlines were among the best performers. Standout high-yield corporate bond holdings included Cemex, William Lyon Homes and Vedanta Resources PLC.

Q. What were the leading detractors from performance?

A. Select structured securities and GSE risk-transfer securities detracted from absolute performance during the reporting period.

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.

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.

*For the tax character of distributions paid during the fiscal year ended December 31, 2014, please refer to page 42 of this report.

Table of Contents

Fund overview (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,

Western Asset Management Company

January 20, 2015

***RISKS:** The Fund's investments are subject to liquidity risk, 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 which are subject to greater 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.

Table of Contents

- i 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.
- ii The Federal Reserve Board (Fed) is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.
- iii The 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.
- iv The 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.
- v The BofA Merrill Lynch 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 The Barclays CMBS Index measures the performance of the commercial mortgage-backed securities market.
- vii The yield curve is the graphical depiction of the relationship between the yield on bonds of the same credit quality but different maturities.
- viii 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.
- ix 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, 2014, including the reinvestment of all distributions, including returns of capital, if any, calculated among the 10 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 December 31, 2014 and December 31, 2013. This bar graph does not include derivatives, such as futures contracts, forward foreign currency contracts and swap 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 December 31, 2014

Total Spread Duration

DMO 4.30 years

Benchmark 3.82 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	BofA Merrill Lynch U.S. Floating Rate Home Equity Loan Asset-Backed Securities Index
DMO	Western Asset Mortgage Defined Opportunity Fund Inc.
EM	Emerging Markets
HY	High Yield
IG Credit	Investment Grade Credit
MBS	Mortgage-Backed Securities

Table of Contents

Effective duration (unaudited)

Interest rate exposure December 31, 2014

Total Effective Duration
DMO 4.24 years
Benchmark 0.05 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	BofA Merrill Lynch U.S. Floating Rate Home Equity Loan Asset-Backed Securities Index
DMO	Western Asset Mortgage Defined Opportunity Fund Inc.
EM	Emerging Markets
HY	High Yield
IG Credit	Investment Grade Credit
MBS	Mortgage-Backed Securities

Table of Contents**Schedule of investments**

December 31, 2014

Western Asset Mortgage Defined Opportunity Fund Inc.

Security	Rate	Maturity Date	Face Amount	Value
Residential Mortgage-Backed Securities 115.3%				
ABFS Mortgage Loan Trust, 2002-3 M1	5.902%	9/15/33	1,275,658	\$ 1,029,602
Accredited Mortgage Loan Trust, 2003-3 A1	5.210%	1/25/34	1,256,386	1,226,994
AFC Home Equity Loan Trust, 2003-3 1A	0.920%	10/25/30	2,109,051	1,876,275 (a)(b)
American Home Mortgage Assets, 2005-2 2A1A	2.951%	1/25/36	1,762,686	1,231,248 (a)(c)
American Home Mortgage Assets, 2006-4 1A12	0.380%	10/25/46	2,833,656	1,925,183 (a)(c)
American Home Mortgage Investment Trust, 2005-1 6A	2.327%	6/25/45	122,267	119,656 (a)(c)
American Home Mortgage Investment Trust, 2005-SD1 1A1	0.620%	9/25/35	362,233	279,522 (a)(b)(c)
American Home Mortgage Investment Trust, 2007-2 11A1	0.400%	3/25/47	1,350,923	844,905 (a)(c)
American Home Mortgage Investment Trust, 2007-2 2A	0.970%	3/25/47	13,293,270	1,806,655 (a)
American Home Mortgage Investment Trust, 2007-A 4A	1.055%	7/25/46	2,668,731	1,012,031 (a)(b)(c)
Ameriquest Mortgage Securities Inc., 2002-4 M3	5.420%	2/25/33	2,034,344	1,730,895 (a)
Ameriquest Mortgage Securities Inc., 2002-D M1	3.905%	2/25/33	2,220,000	1,690,621 (a)
Argent Securities Inc., 2005-W5 A2D	0.490%	1/25/36	4,524,176	3,545,185 (a)
Argent Securities Inc., 2006-M2 A2B	0.280%	9/25/36	3,777,362	1,481,893 (a)
Argent Securities Inc., 2006-M2 A2C	0.320%	9/25/36	2,607,015	1,027,632 (a)
Argent Securities Inc., 2006-M2 A2D	0.410%	9/25/36	688,069	273,999 (a)
Argent Securities Inc., 2006-M3 A2C	0.330%	10/25/36	4,240,749	1,886,090 (a)
ARM Trust, 2005-05 1A1	2.576%	9/25/35	342,073	272,332 (a)(c)
ARM Trust, 2005-07 2A21	2.575%	10/25/35		