FRANKLIN TEMPLETON

WESTERN ASSET

Western Asset Diversified Income Fund

Commentary | as of June 30, 2025

Key Takeaways

- **Markets:** During the second quarter, increased volatility was marked by geopolitical shocks and macro crosscurrents. The market saw bouts of risk-off sentiment, most notably following the "Liberation Day" tariff announcement on April 2 and the brief U.S., Iran and Israel conflict. Markets subsequently rebounded as most tariffs were delayed, and Iran and Israel agreed to a tentative ceasefire. The front end of the U.S. Treasury (UST) yield curve declined, while long-end yields rose on concerns of rising deficits and potential inflation reacceleration. Throughout the quarter, credit spreads tightened and emerging market (EM) local yields fell. The S&P 500 Index returned 10.57%, and the U.S. dollar weakened versus most EM and developed market (DM) currencies.
- **Contributors:** The Fund's duration positioning and sector exposures contributed to performance.
- **Detractors:** There were no significant detractors from relative performance.
- **Outlook:** Global growth is expected to slow given heightened unpredictability, but should remain positive. Overall monetary policy remains restrictive and we believe that central banks will continue to cut rates. The Fed remains well positioned to provide support if the U.S. economy falters. While fundamentals remain positive, spreads are at the tight end of historical ranges in some sectors and warrant caution.

Performance Review

- The Fund's duration positioning added value as government bond yields declined following Israel's attack on Iran. Although tensions have temporarily subsided, there remains a risk that the ceasefire could break down, potentially driving oil prices higher and putting upward pressure on inflation. We are also closely monitoring fiscal developments in the U.S., where uncertainty around tariff revenues and funding requirements could lead to higher U.S. Treasury yields. In light of these risks and rising concerns about stagflation, we currently favor U.S. steepener trades with a focus on the belly of the curve.
- The Fund's high-yield bonds and bank loans contributed to returns as spreads tightened. Despite macro volatility and geopolitical risks, we remain confident that strong credit fundamentals and manageable leverage will limit default risk. We do not anticipate a near-term rise in defaults, given favorable maturity profiles and bondholder-friendly liability management. We remain cautious on consumer products, retail, and home construction sectors. In bank loans, spreads are stable. We have reduced exposure to blue-chip airlines and exited chemicals early due to rising leverage and weaker growth prospects. Our energy allocation is focused on select midstream companies with strong balance sheets. If Middle East tensions escalate, we expect increased opportunities in the defense sector.
- The Fund's securitized credit exposure contributed positively to the Fund's returns. In non-agency commercial mortgage-backed securities (CMBS), performance is expected to closely follow broader credit and equity markets. Rising goods costs may pressure rents in lodging, retail, and multifamily sectors, while weaker foreign trade could weigh on industrial demand. Tariff-driven delays in rate cuts may further challenge commercial real estate values and refinancing. Despite these risks, we see selective opportunities in mispriced credits but remain cautious amid near-term volatility. In the non-agency residential mortgage-backed security (MBS) space, housing fundamentals are strong, underpinned by a persistent shortage of homes. We prefer new-issue securities at the top of the credit stack and seasoned bonds with upgrade potential as they de-lever. Tariffs are expected to have a minimal impact, potentially limiting new construction and supporting higher home prices. Meanwhile, collateralized loan obligation (CLO) performance will likely mirror macro sentiment, especially in lower-rated tranches. We remain selective, avoiding below-investment-grade CLOs with concentrated exposure to autos, chemicals, and building products. We favor shorter spread durations and plan to add or rotate positions on any spread widening, given the sector's attractive yields.
- Emerging markets (EM) also contributed positively to the Fund's performance. Improved growth in developed markets increased investor risk appetite, even as some EM economies slowed. Resilient growth in China and resistance to U.S. tariff threats have helped reduce risk premia. With the European Central Bank and other G10 central banks nearing the end of their rate-cutting cycles ahead of the U.S. Fed, we expect the U.S. dollar to gradually weaken in the coming months. This environment supports a constructive outlook for EM, with potential for attractive returns driven by high real yields and moderate currency appreciation.

Outlook

- U.S. government policy has caused severe volatility in fixed-income markets over the last several months. Global growth is expected to slow given heightened unpredictability, but should remain positive. U.S. growth is downshifting due to a myriad of factors, including tariff uncertainty, waning benefits from immigration, and reduced government spending in recent years. A significant fiscal boost from European defense and German infrastructure spending should support eurozone growth and provide relief from tariff-related uncertainty. Deflationary pressures in China persist and confidence is weak amid property market concerns, but sentiment is improving with fiscal stimulus and policy easing.
- Overall monetary policy remains restrictive and we believe that central banks will continue to cut rates. The Fed remains well positioned to provide support if the U.S. economy falters. Public debt levels continue to rise and yield curves may steepen further given concerns over fiscal policies.
- While fundamentals remain positive, spreads are at the tight end of historical ranges in some sectors and warrant caution. We will continue to look for further periods of volatility to add to spread products.

Fund Characteristics	Fund
Effective Duration	4.08 Years

Sector Allocation (% of Total)

Sector	Fund
High-Yield Credit	42.57
Collateralized Loan Obligation	12.53
Bank Loans	10.88
Commercial Mortgage Backed Securities	8.71
Non-Agency Retail Mortgage Backed Security	7.05
Investment-Grade Credit	3.94
EM USD Sovereigns	2.80
EM USD Corporate	2.60
Asset-Backed Securities	2.32
Other	1.83
Cash & Cash Equivalents	4.76

Credit Quality Allocation (% of Total)

Rating	Fund
AAA	0.48
AA	1.20
A	-0.06
BBB	6.42
BB	30.86
B	28.35
CCC	10.41
CC	0.06
C	0.22
D	0.05
NR	17.26
Cash & Cash Equivalents	4.76

Average annual total returns (%) - as of June 30, 2025

Product	Ticker	Listed Exchange	3-Mo*	6-Mo*	YTD*	1-Yr	3-Yr	5-Yr	10-Yr	Inception	Inception Date
Market Price Return	WDI	NYSE - XNYS	5.87	10.62	10.62	16.00	15.04	—	—	3.24	6/25/2021
NAV Returns	—	—	3.16	4.33	4.33	8.28	10.08	—	—	2.56	6/25/2021
Benchmark	—	—	3.53	4.57	4.57	10.29	9.93	—	—	3.79	—

*Cumulative total returns

Benchmark(s)

Benchmark =Bloomberg U.S. Corporate High Yield - 2% Issuer Cap Index

Performance shown represents past performance and is no guarantee of future results. *Current performance may be higher or lower than the performance shown. Investment return and principal value will fluctuate so shares, when sold, may be worth more or less than the original cost. Returns based on Market Price or NAV, and assume the reinvestment of all distributions at the Dividend Reinvestment Plan Price or NAV, respectively. All returns include the deduction of management fees, operating expenses and all other fund expenses, and do not reflect the deduction of brokerage commissions or taxes that investors may pay on distributions or the sale of shares. When applicable, performance would have been lower if fees had not been waived in various periods. An investor cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expense or sales charges. Returns for periods of less than one year are not annualized. Please visit franklintempleton.com for the most recent month-end performance.*
The total annual operating expenses are as of the fund's annual report available at the time of publication. Actual expenses may be higher and may impact portfolio returns.
The difference between total assets and net assets, if any, is due primarily to the fund's use of borrowings and other liabilities; netassets do not include borrowings. The fund may employ leverage in the form of loans, preferred stock, reverse repurchase agreementsand/or other instruments. When the fund engages in transactions that have a leveraging effect on the fund's portfolio, the value of thefund will be more volatile and all other risks will tend to be compounded.

What are the Risks?

All investments involve risks, including possible loss of principal. Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. **Low-rated, high-yield bonds** are subject to greater price volatility, illiquidity and possibility of default. **Asset-backed, mortgage-backed or mortgage-related securities** are subject to prepayment and extension risks. **International investments** are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in **emerging markets**. **Derivative instruments** can be illiquid, may disproportionately increase losses, and have a potentially large impact on performance. **Leverage** increases the volatility of investment returns and subjects investments to magnified losses and a decline in value. **Diversification** does not assure against market loss.

Glossary

A **collateralized loan obligation (CLO)** is a single security backed by a pool of debt.

Commercial mortgage-backed securities (CMBS) are a type of mortgage-backed security backed by commercial mortgages rather than residential real estate. CMBS tend to be more complex and volatile than residential mortgage-backed securities due to the unique nature of the underlying property assets.

The **G10** is a group of the 11 leading industrial countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. They meet on an annual basis to discuss economic, monetary and financial matters.

Risk premia refers to the amount by which the return of a risky asset is expected to outperform the known return on a risk-free asset.

The **S&P 500 Index** features 500 leading U.S. publicly traded companies, with a primary emphasis on market capitalization. Source: © S&P Dow Jones Indices LLC. All rights reserved.

Stagflation is a seemingly contradictory condition described by slow economic growth and relatively high unemployment, or economic stagnation, which is at the same time accompanied by rising prices (i.e. inflation).

The **yield curve** shows the relationship between yields and maturity dates for a similar class of bonds.

Important Information

The information provided is not a complete analysis of every material fact regarding any country, market, industry, security or fund. Because market and economic conditions are subject to change, comments, opinions and analyses are rendered as of the date of this material and may change without notice. A portfolio manager's assessment of a particular security, investment or strategy is not intended as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy; it is intended only to provide insight into the fund's portfolio selection process. Holdings are subject to change.

Distributions are not guaranteed and are subject to change. The Closed-End Funds are not sold or distributed by Franklin Distributors, LLC, or any affiliate of Franklin Resources, Inc. Unlike open-end funds, shares are not continually offered. Like other public companies, closed-end funds have a one-time initial public offering, and once their shares are first issued, are generally bought and sold through non-affiliated broker/dealers and trade on nationally recognized stock exchanges. Share prices will fluctuate with market conditions and, at the time of sale, may be worth more or less than your original investment. Shares of exchange-traded closed-end funds may trade at a discount or premium to their original offering price, and often trade at a discount to their net asset value. Investment return, market price and net asset value will fluctuate with changes in market conditions. The Funds are subject to investment risks, including the possible loss of principal invested.

The **Bloomberg U.S. Corporate High Yield - 2% Issuer Cap Index** measures the performance of U.S. dollar-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. The Index limits the maximum exposure to any one issuer to 2%. Source: Bloomberg Indices.

Important data provider notices and terms available at www.franklintempletondatasources.com. All data is subject to change.

Effective Duration is a duration calculation for bonds with embedded options. Effective duration takes into account that expected cash flows will fluctuate as interest rates change. Duration measures the sensitivity of price (the value of principal) of a fixed-income investment to a change in interest rates. The higher the duration number, the more sensitive a fixed-income investment will be to interest rate changes.

Credit Quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings shown are based on each portfolio security's rating as provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd. and typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. For this purpose, if two or more of the agencies have assigned differing ratings to a security, the highest rating is used. Securities that are unrated by all three agencies are reflected as such. The credit quality of the investments in the fund's portfolio does not apply to the stability or safety of the fund. These ratings are updated monthly and may change over time. **Please note, the Fund itself has not been rated by an independent rating agency.**

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