What worked

- Interest rate hedging
- Collateralized loan obligation (CLO) investments
- Commercial mortgage-backed securities (CMBS), asset-backed securities (ABS), and cash

What did not work

- Emerging market bonds
- High yield bonds
- Collateralized mortgage obligation (CMO) barbell trade, including interest-only (IOs)
- Investment grade finance company bonds
- Fixed-rate mortgage-backed security (MBS) investments

Summary

For the full year 2018, Delaware Diversified Income Fund Institutional Class shares underperformed its benchmark, the Bloomberg Barclays US Aggregate Index, by 199 basis points. The Fund’s Institutional Class shares underperformed the average return of the Morningstar Intermediate-Term Bond Category by 148 basis points and lagged the Lipper Core Plus Bond Funds Average by 108 basis points for the quarter. (One basis point equals one hundredth of a percentage point.)

Fund returns were influenced by the rise in yields as central banks tightened monetary policy. Returns were also influenced by a significant expansion of credit yield premiums and currency price declines. The tighter US monetary policy pressured local-currency emerging market investments early in the year. High yield bond investments declined in the fourth quarter as slowing growth and tighter monetary policy caused price declines. Investments in an agency CMO barbell (which included IO securities) detracted from performance as volatility rose in the second half. Investments in high-quality ABS, CMBS, money market instruments, and rate hedging were the bright spots in a challenging year.

Market review

All capital markets encountered a volatile 2018 as central banks continued a campaign to normalize monetary policy. The US Federal Reserve raised the federal funds rate four times in 2018, ending in a target range of 2.25%–2.50%. The Fed also let its balance sheet decline by $300 billion. The European Central Bank (ECB) reduced its bond-buying program. By 2019, it will have eliminated its bond purchases and will only reinvest to maintain the size of its investment balance sheet. Volatility events occurred in earnest in the second quarter of 2018, with monetary policy divergences between central banks leading to a stronger US dollar environment. Emerging market countries were challenged by inflation, fiscal balance issues, or central bank independence problems (Turkey and Argentina). A surge in the London interbank offered rate (LIBOR), and a flattening yield curve, unnerved capital market participants and pushed credit yield premiums wider. Tech-stock leadership was also threatened as investors and Congress hit major companies with issues such as antitrust activity, client information abuse, and political bias.

Markets entered a new phase of heightened volatility and price decline in the fourth quarter. This culminated in a US equity market move into near bear-market territory and a collapse in energy prices. Markets were anticipating the fourth federal funds rate increase of the year, to a target range of 2.25%–2.50%. The swift pace of monetary tightening has been combined with a reduction in the Fed’s balance sheet of approximately $300 billion. As short-maturity interest rates further increased, the US yield curve moved toward an even flatter profile. Attractive money market rates competed against high valuations in the bond and equity markets and produced sharp corrections. The balance sheet effect worked against capital markets as participants have been asked to absorb more US Treasury note and MBS supply. Investors have also been spooked by the ongoing China-US trade wars, Brexit, Italy’s budget negotiations, and an overall slowing of global economic activity. The year was capped off with a partial shutdown of the US federal government and President Trump’s criticism of the Fed.
Within the Fund

US Treasury yields rose for most of 2018 as the Fed attempted to influence short rates, and better employment and US economic news moved longer maturity rates higher. The late-year downturn in global economic activity and inflation, and the volatility in equity markets, produced a sharp rate rally. Two-year Treasury note yields climbed by 60 basis points and 10-year Treasury note yields increased by 28 basis points for the full year. We increased US Treasury investments throughout the year as corporate sector holdings declined. We attempted to hedge against the rate rise and the flattening curve throughout most of the year with the help of interest rate futures. We kept the Fund’s interest rate sensitivity below that of the Bloomberg Barclays US Aggregate Index for most of the year. As Treasury rates approached 3.25%, we began to increase the Fund’s rate sensitivity to hedge credit sector volatility. Interest rate future actions added 66 basis points of performance relative to index levels (before expenses). US Treasury note holdings increased from 2.8% of the Fund’s portfolio to 10.8% at year end.

![US Treasury notes and bonds yield curve](image)

Investment grade corporate exposure detracted from overall Fund performance in 2018. Yield premiums increased throughout the year. Investment grade corporate investments detracted 17 basis points from relative returns. Finance and bank paper was the main contributor to Fund performance as heavy supply and pressure on bank stocks was influenced by the increase in rates and the flattening yield curve. The Fund’s investment grade bank exposure was 8.2% at year end. A full 34% of this exposure is in subordinate paper to add yield to the portfolio. Despite the weak equity and bond bank performance, we believe fundamentals are solid in this sector, especially for US banks.

We reduced the Fund’s investment grade corporate exposure through July as yield premiums widened but remained lower than long-term averages. The reductions occurred in finance, industrials, and utilities. The Fund’s exposure dropped from 34.2% in December 2017 to a low of 26% at the end of July. The contribution-to-duration from investment grade corporate exposure started the year at 131% and moved to slightly below 100% of the benchmark level. Investment grade yield premiums increased significantly in the fourth quarter. Yield premiums increased from an average of 106 basis points to 153 basis points. We took advantage of the weaker market environment by increasing investment grade corporate exposure to 31.2% at year end. The contribution-to-duration basis increased to 123% of benchmark levels. The increase in exposure took place mainly in the finance and industrial sectors. The largest industrial additions came in the cable space. The quarter included price pressure on auto manufacturers, as car sales have been challenged globally. We purchased short-maturity paper in the sector, and we are looking to add to this exposure if prices decline more. We are seeking to add to the investment grade corporate sector in the first quarter of 2019 as we believe yield premiums are attractive. New-issue volume was approximately $1.2 billion in 2018, a decline of 10% from 2017. Strategists are looking for a small decline in 2019. Maturing investment grade corporate bonds will likely help absorb more issuance relative to 2018.
The returns in both agency fixed-rate MBS and CMO structures were quite negative in 2018 and were a large negative factor for Fund performance. Total mortgage-backed exposure of 14.9% at year end had a negative return of -1.6% and took 70 basis points from relative returns (before expenses). We reduced the Fund’s overall MBS exposure by 2.3 percentage points. A significant sale of the CMO barbell trade occurred in the fourth quarter. We had engaged the Fund’s investments in a barbell of long sequential CMOs and inverse IOs as long-maturity exposure, which was offset by investments in straight IOs, representing short-maturity exposure. This barbell was a higher yield proxy for straight current-coupon mortgage-backed agency pass-through investments. This structure worked well in 2017 and early 2018. Performance started to deteriorate as yield premiums expanded on all MBS investments. As the market encountered more volatility in the third and fourth quarters of 2018, this barbell positioning succumbed to price declines and yield premium events.

We reduced the CMO barbell trade by 3.9 percentage points in the fourth quarter (from 7.7% to 3.8%). We reduced long-maturity CMOs by 2.4 percentage points, inverse IOs by 0.9 percentage points, and straight IOs by 0.5 percentage points. Total IO positioning is now at 2.4% of the Fund’s portfolio. The sales by this portfolio competed with other selling by MBS investors. Straight IO exposure caused a 3-basis-point deficit from relative returns (before expenses). Absolute subportfolio returns in this sector were -1.9% (before expenses). Inverse IO returns of -16.1% detracted 31 basis points from relative returns (before expenses). The sale of long-maturity CMOs produced a 23-basis-point deficit to relative returns (before expenses). We moved exposure into to-be-announced (TBA) mortgage pass-throughs and non-agency CMO investments. The premium bias of the mortgage pass-through portfolio also detracted from relative performance. Pass-through performance of 0.9% caused a 20-basis-point deficit during the year.
High yield corporate bond investments were 6% of the Fund’s portfolio at year end. Returns in this sector of -4.6% (before expenses) underperformed the ICE BofAML BB-B US High Yield Constrained Index (-2.1%). High yield returns detracted 37 basis points from relative returns (before expenses). An overweight to the energy sector and the insurance brokers influenced returns. Investments in Alta Mesa Holdings LP and CommScope Technologies LLC were notable underperformers. This subportfolio also had a high-quality bias and had more rate sensitivity than the ICE BofAML BB-B US High Yield Constrained Index. New issuance in 2018 totaled $187.4 billion, down 43% from a year earlier. Refinancing and general corporate purposes (GCP) represented 74% of issuance, while 22% was slated for leveraged buyout (LBO) and merger and acquisition activity. The expected US high yield default rate for 2019 is 2%. Despite growing expectations for slowing global growth and volatility in equity markets, we believe that current yields in the sector, combined with supportive fundamentals, low default rates, and a positive technical backdrop, should allow for positive returns in 2019. We increased the Fund’s high yield bond exposure by 0.8 percentage points in the fourth quarter as yield premiums widened. We will be looking for opportunities to add exposure in 2019.
The Fund’s emerging market investments returned -6.2% for 2018 and detracted 74 basis points from relative returns (before expenses). Emerging market investments were acutely affected by the environment that developed in the second and third quarters. The strong US dollar was particularly influential in the weakness that was seen in emerging market sectors. Countries with fiscal and current account deficits, inflation, and central bank independence issues (Argentina and Turkey) saw significant corrections to both their currencies and bonds. The J.P. Morgan Emerging Markets Bond Index Plus (EMBI+), a popular index of US dollar sovereign bonds, had a yield average premium expansion of 117 basis points during the year. The J.P. Morgan Government Bond Index–Emerging Markets (GBI-EM) had a nominal decline of -6.2% for the year. We employed significant risk management on the Fund’s emerging market holdings, especially during the second quarter. Local currency exposure of 6.4% at the start of the second quarter was reduced to 1% by year end (most of this reduction occurred in the second quarter). US dollar holdings of emerging market assets declined from 9% to 5.9% of the Fund’s portfolio. We also used emerging market credit default swap derivative protection to hedge some this exposure during the year. Ever since the volatility of the second and third quarters, yield premium expansion and currency declines have been muted. We are looking for fundamental catalysts that may allow for increased exposure in 2019.

CLO investments were 5% of the Fund at year end. The CLO market has benefited from the demand for an investment that has a coupon that floats quarterly with 3-month LIBOR. These investments had a return of 1.9% (before expenses). Four federal funds rate hikes benefited this sector in 2018. The Fund’s CLO sector investments are predominantly AAA-rated. For the year, they contributed 9 basis points of return over the benchmark (before expenses).

Convertible bond investments of 4.0% at year-end produced returns of -2.7% (before expenses). This performance subtracted 10 basis points from relative returns during the year (before expenses). The Fund’s convertible bond investments have an approximate 60% sensitivity to equity market moves. The fourth quarter correction in equity markets wiped away most of the positive returns that were achieved earlier.

CMBS, ABS, and cash had positive contributions to relative returns. The CMBS exposure of 7.8% at year end was virtually unchanged during the year. Despite weakness in the retail sector, yield premiums were somewhat stable in the CMBS sector relative to corporate sectors. Within this subportfolio, the combination of seasoned investments, and new issues of conservative loans and underwriting, produced returns of 0.8% (before expenses). The Fund’s overweight to this sector added 4 basis points to relative returns (before expenses). We added 1.4 percentage points of ABS exposure during the year to increase conservative positioning in the face of tightening monetary conditions. Year-end exposure of 3.2% includes AAA-rated issues of credit card and auto loan securitizations. Returns of 2.4% were among the strongest in fixed income sectors and added 5 basis points to relative returns (before expenses). Cash exposure helped greatly during a year of rising rates. The Fund’s cash exposure ranged between 1% and 3% during the year and produced returns of 1.7% (before expenses). This exposure added 6 basis points to relative returns (before expenses).
Delaware Diversified Income Fund

Outlook
The Fund has an income advantage over the benchmark due to its exposure to the corporate and structured product sectors. At the end of the year, this income advantage averaged about 146 basis points (before expenses). After the significant expansion of yield premiums in the fourth quarter, we will be looking for opportunities in the corporate credit markets. We plan to sell ABS, CLOs, and US Treasurys to fund these purchases.

Average annual total returns (%) as of December 31, 2018

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<th>4Q18</th>
<th>1 YEAR</th>
<th>3 YEAR</th>
<th>5 YEAR</th>
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<td>5/2/16</td>
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<td>Morningstar Intermediate-Term Bond Category</td>
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<td>2.15</td>
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<td>4.31</td>
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<td>Lipper Core Plus Bond Funds Average</td>
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<td>5.05</td>
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1. Returns for less than one year are not annualized. 2. Net expense ratio reflects a contractual waiver of certain fees and/or expense reimbursements from April 1, 2018 through April 1, 2019. Please see the fee table in the Fund’s prospectus for more information. 3. Includes maximum 4.50% front-end sales charge.

The performance quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 800 523-1918 or visiting delawarefunds.com/performance.

Total returns may reflect waivers and/or expense reimbursements by the manager and/or distributor for some or all periods shown. Performance would have been lower without such waivers or reimbursements.

Performance at NAV assumes that no front-end sales charge applied or the investment was not redeemed. Performance offer assumes that a front-end sales charge applied to the extent applicable.
Carefully consider the Fund’s investment objectives, risk factors, charges, and expenses before investing. This and other information can be found in the Fund’s prospectus and its summary prospectus, which may be obtained by visiting delawarefunds.com/literature or calling 800 523-1918. Investors should read the prospectus and the summary prospectus carefully before investing.

The views expressed represent the Manager’s assessment of the Fund and market environment as of the date indicated, and should not be considered a recommendation to buy, hold, or sell any security, and should not be relied on as research or investment advice. Unless otherwise noted, the sources of statistical information in this document were Bloomberg and Barclays. Information is as of the date indicated and subject to change.

Investing involves risk, including the possible loss of principal.

Fixed income securities and bond funds can lose value, and investors can lose principal, as interest rates rise. They also may be affected by economic conditions that hinder an issuer’s ability to make interest and principal payments on its debt. The Fund may also be subject to prepayment risk, the risk that the principal of a fixed income security that is held by the Fund may be prepaid prior to maturity, at the time when interest rates are lower than what the bond was paying. A portfolio may then have to reinvest that money at a lower interest rate.

- High yielding, non-investment-grade bonds (junk bonds) involve higher risk than investment grade bonds. • The high yield secondary market is particularly susceptible to liquidity problems when institutional investors, such as mutual funds and certain other financial institutions, temporarily stop buying bonds for regulatory, financial, or other reasons. In addition, a less liquid secondary market makes it more difficult for the Fund to obtain precise valuations of the high yield securities in its portfolio. • If and when the Fund invests in forward currency contracts or uses other investments to hedge against currency risks, the Fund will be subject to special risks, including counterparty risk. • The Fund may invest in derivatives, which may involve additional expenses and are subject to risk, including the risk that an underlying security or securities index moves in the opposite direction from what the portfolio manager anticipated. A derivatives transaction depends upon the counterparties’ ability to fulfill their contractual obligations. • International investments entail risks not ordinarily associated with US investments including fluctuation in currency values, differences in accounting principles, or economic or political instability in other nations. • Investing in emerging markets can be riskier than investing in established foreign markets due to increased volatility and lower trading volume. • The Fund may experience portfolio turnover in excess of 100%, which could result in higher transaction costs and tax liability. Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index.

The Bloomberg Barclays US Aggregate Index is a broad composite that tracks the investment grade domestic bond market. The Morningstar Intermediate-Term Bond Category compares funds that invest primarily in corporate and other investment grade US fixed income issues and typically have durations of 3.5 to 6.0 years. These funds are less sensitive to interest rates, and therefore less volatile, than funds that have longer durations. The Lipper Core Plus Bond Funds Average compares funds that invest at least 65% in domestic investment grade debt issues (rated in the top four grades) with any remaining investment in nonbenchmark sectors such as high yield, global, and emerging market debt. These funds maintain dollar-weighted average maturities of 5 to 10 years. The Bloomberg Barclays US Corporate Investment Grade Index is composed of US dollar-denominated, investment grade, SEC-registered corporate bonds issued by industrial, utility, and financial companies. All bonds in the index have at least one year to maturity. The Bloomberg Barclays US Corporate High-Yield Index is composed of US dollar-denominated, non-investment-grade corporate bonds for which the middle rating among Moody’s Investors Service, Inc., Fitch, Inc., and Standard & Poor’s is B1/B+/BB+ or below. The ICE BofAML BB-B US High Yield Constrained Index tracks the performance of US dollar-denominated high yield corporate debt rated BB1 through B3 (based on an average of Moody’s, S&P and Fitch) that is publicly issued in the US domestic market, but caps issuer exposure at 2%. The London interbank offered rate (LIBOR) is a composite of the rates of interest at which banks borrow from one another in the London market, and it is a widely used benchmark for short-term interest rates. The S&P/LSTA (Loan Syndications and Trading Association) Leveraged Loan Index is a broad index designed to reflect the market-value-weighted performance of US dollar-denominated institutional leveraged loan. The J.P. Morgan Emerging Markets Bond Index Plus (EMBI++) tracks total returns for actively traded external debt instruments in emerging markets. It includes US dollar-denominated Brady bonds, Eurobonds, and traded loans issued by sovereign entities. The J.P. Morgan Government Bond Index—Emerging Markets (GBI-EM) tracks local currency government bonds issued by emerging markets. All bonds in the index have at least one year to maturity.

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Institutional Class shares, Class R shares, and Class R6 shares are available only to certain investors. See the prospectus for more information.

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