Market review

US Treasury yields fell during the first quarter of 2019, with 2-year note yields declining 23 basis points, 10-year yields decreasing 28 basis points, and 30-year yields down 20 basis points. (One basis point equals one hundredth of a percentage point.) The US Federal Reserve reversed course from forecasting two interest rate hikes in 2019 to now forecasting zero hikes. As expected, the Federal Open Market Committee (FOMC) held the federal funds rate in a range of 2.25% to 2.50%. The FOMC continued to reduce the Fed’s balance sheet for maturing Treasurys by $30 billion a month, and it announced plans to end this balance sheet runoff later this year: Starting in May, the Fed will lower the cap to $15 billion, and then conclude the runoff at the end of September. The Fed will begin reinvesting mortgage-backed securities (MBS) prepayments in Treasurys starting in October.

Inflation remained below the Fed’s 2% target. The intermediate part of the curve continued to outperform the long and short ends of the Treasury curve. Inflation expectations, as measured by 10-year Treasury inflation-protected securities (TIPS) break-even rates, rose by 16 basis points as oil prices climbed 29%. This retraced about 40% of the fall in break-evens from the fourth quarter.

Japan’s economy continued to lose momentum in the first quarter due to the slowdown in global growth, particularly in China. Weaker exports and factory output prompted the government and the Bank of Japan (BOJ) to reduce assessments of the economy as they prepared for some economists to forecast a first-quarter contraction. The lackluster economic projections, along with dovish positions by global central banks, appears to take any policy normalization off the table for the BOJ.

The European Central Bank (ECB) moved to a more dovish stance in the first quarter. The ECB left rates unchanged as expected but softened its forward guidance, saying it would not raise rates before 2020. ECB President Mario Draghi said that the risks to the economic outlook remain tilted to the downside. Euro-zone inflation remained below target at 1.4% year over year. Meanwhile, the Bank of Canada, Reserve Bank of Australia, and Reserve Bank of New Zealand have all tilted to the dovish side, joining the Fed and ECB as growth and inflation remain low.

Credit markets rebounded sharply in the first quarter of 2019, driven in large part by the Fed’s capitulation in its monetary policy noted earlier. With the removal of any Fed tightening risk for capital markets in 2019, investors were left with just two basic concerns: a slowdown in global gross domestic product (GDP) and hopes for a reconciliation in the US-China trade and tariff dispute. With 2018 earnings behind us, we see mounting evidence that both of these concerns are having an impact on corporate financials. For the quarter, higher-beta (higher-risk) sectors outperformed, led by energy as oil prices bounced back sharply (+32% for the quarter) amid declining inventories, Organization of the Petroleum Exporting Countries (OPEC) supply cut plans, and a positive market tone.

Telecommunications also outperformed with AT&T and Verizon driving strong performance in the sector, as both companies continued to make progress with balance sheet deleveraging. Investment grade supply was robust for the quarter, spurred by the notable improvement in market sentiment but still below last year’s record pace, with $334 billion coming to market in the first quarter of 2019, behind last year’s record pace of $361 billion (source: Bank of America). Issuance was led by the $15.5 billion deal / $16.5 billion tender from Anheuser-Busch InBev, which priced with approximately 25 basis points of concession.

US high yield bonds, as measured by the ICE BofAML US Cash Pay High Yield Index, returned 7.40% for the first quarter of 2019, while European and global high yield bonds returned 5.28% and 7.10%, respectively, as measured by the ICE BofAML Euro High Yield Index and ICE BofAML US Dollar Global High Yield Index. Returns for the quarter were strong across all the ratings categories as the Fed paved the way for risk assets to perform well. For the first quarter of 2019, CCC-rated bonds returned 7.90%, followed by BB-rated bonds (7.38%) and B-rated bonds (7.27%). First quarter 2019 new issuance totaled $65 billion, down 10% from a year earlier. Refinancing and general corporate purposes (GCP) represented 73% of issuance, while 26% was slated for leveraged buyout (LBO) and merger and acquisition activity. The expected US high yield default rate for 2019 is 2%.
Emerging markets debt posted strong returns in the first quarter of 2019. Sovereign debt, represented by the J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified, gained 6.95%, while the J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad Diversified, the benchmark for corporate debt, was up 5.15%. However, as expected, the strong returns in emerging markets debt were generated largely on the back of external factors such as the rally in global risk assets, coupled with the decline in US Treasury yields. To a large extent, emerging markets were held back by Argentina and Turkey, whose problems resurfaced yet again during the first quarter. The threat of populist measures from Mexico’s new president, the challenges involved in the passage of much-needed pension reform in Brazil, the possibility of additional sanctions on Russia, and the escalating crisis in Venezuela also weighed on market sentiment at different times during the quarter.

European credit lagged US credit over the quarter, although it did manage to generate positive total returns as German bund yields have dropped significantly amid global growth concerns. The Bloomberg Barclays Euro-Aggregate Corporate Index returned 3.20% for the quarter, led by subordinated and hybrid insurance debt that rebounded sharply early in the year amid the risk-on rally. This strong performance has come despite the ECB’s sharp downgrade to growth and inflation projections for the euro zone, raising the question as to whether this rally is truly sustainable. Total euro fixed-rate issuance was €153 billion in the first quarter of 2019, up more than 25% year over year, marking the strongest first quarter on record for fixed-rate issuance (source: CreditSights). Brexit remains an overhang to sentiment as the United Kingdom is inching closer to leaving the European Union (EU) in the near term if the British Parliament can’t secure a majority agreement on any withdrawal plan. The EU and the UK have agreed to delay Brexit until Oct. 31 to avoid a rolling series of extensions and cliff edges – a proposal that avoids a no-deal scenario on April 12 but will be difficult for Prime Minister Theresa May to sell at home.

Within the Fund
For the first quarter of 2019, Delaware Diversified Income Fund Institutional Class shares outperformed the Fund’s benchmark, the Bloomberg Barclays US Aggregate Index. The following presents key drivers of performance during the period:

Attribution review
What worked
- high grade credit overweight
- high yield corporates
- emerging market bonds
- convertible bonds
- bank loans.

What did not work
- local markets currency
- agency collateralized mortgage obligation (CMO) exposure.

The Fund’s allocation of nearly 15% to leveraged finance, including high yield and bank loans, was an important driver of performance. Interestingly, there was little return differentiation between the quality tiers of high yield, despite this being one of the strongest first quarters for the asset class. In addition to the sector allocation, security selection was also beneficial. A higher-quality bias within loans resulted in the Fund’s exposure to the asset class underperforming the broader loan market, but the allocation was still favorable when comparing its return to that of the Bloomberg Barclays US Aggregate Index.

Emerging markets also performed well. Although the Fund’s exposure to the asset class underperformed high yield, it did generate returns in excess of bank loans and high grade credit. Long-dated names such as Petrobras Global Finance BV and Mexichem SAB de CV are examples of issues that performed well. Paper manufacturer Suzano Austria GmbH was also additive. Local emerging market bonds were mixed, however. Disappointing performance from both local Turkey government bonds and Argentine Bonos del Tesoro weighed on the sector’s performance. Additionally, Digicel Group Two Ltd. exchanged bonds continued to come under pressure as fundamentals weighed on the outlook of the business.
High grade credit represented more than 30% of the Fund’s portfolio and was one of the strongest-performing asset classes for the quarter. A slight overweight to the sector was also beneficial. Industrials, at 15% of the Fund's portfolio, returned more than 6%, while down-in-capital-structure trades within the banking sector contributed to performance. Utilities were a contributor, but the Fund’s smaller allocation to the sector did not meaningfully add to performance. Despite still generating positive returns for the quarter, many short-dated holdings such as Northrop Grumman Corp., Pennsylvania Electric Co., and General Motors Financial Co. Inc. bonds lagged relative to the benchmark return for high grade credit.

Duration, a measure of the portfolio’s interest rate sensitivity, was additive to performance during the quarter.

Equity markets rallied more than 13% during the quarter, as measured by the S&P 500® Index. Strong equity performance helped drive solid performance in the Fund’s 4% allocation to convertible securities.

MBS detracted from performance due to an underweight to agency MBS and an allocation to out-of-benchmark CMOs, which included exposure to interest only (IOs). However, this was somewhat offset by solid security selection within to-be-announced (TBAs) and specified pools.

The Fund’s exposure to high-quality AAA-rated tranches of collateralized loan obligation (CLO) exposure generated a positive return but underperformed other structured product asset classes such as asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS).

Outlook

After a difficult fourth quarter of 2018, central banks are once again acting like abutments at the ends of bridges to absorb forces, and retaining walls to prevent the earth around the structure from moving. With this reinforcement, asset prices did an abrupt about-face during the quarter, leaving many asset classes trading back above their long-term averages as investors in the Northern Hemisphere welcomed spring. In our view, the intermediate-term risk for investors is that valuations are arguably less attractive, and the low-hanging investment opportunities from earlier in the quarter are now harder to come by. The policy shift by several central banks adds credence to the belief that risk assets should generally be well supported in this environment. However, as a result of valuations, we have taken some steps to harvest gains in higher-beta sectors, though we believe the Fund remains well positioned to benefit from the current climate of central banks reinforcing the economic abutments.
Average annual total returns (%) as of March 31, 2019

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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 Feb. 28, 2019 through Feb. 28, 2020. 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 upon 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 risks 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 foreign 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 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 composition that tracks the investment grade domestic bond market. The ICE BofAML Euro High Yield Index tracks the performance of euro-denominated below-investment-grade corporate debt publicly issued in the euro domestic or eurobond markets. The ICE BofAML US Cash Pay High Yield Index tracks the performance of US dollar-denominated below-investment-grade corporate debt, currently in a coupon paying period, that is publicly issued in the US domestic market. Qualifying securities must have at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule, and a minimum amount outstanding of $250 million. The ICE BofAML US Dollar Global High Yield Index tracks the performance of US dollar-denominated below-investment-grade corporate debt publicly issued in the US domestic and eurobond markets. The J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities, including Brady bonds, loans, and Eurobonds. The J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad Diversified tracks US dollar-denominated emerging market corporate bonds, limiting the weights of countries with larger corporate debt stocks by including only a specified portion of those countries’ eligible current face amounts of debt outstanding. The Bloomberg Barclays Euro-Aggregate Corporate Index is a rules-based benchmark measuring investment grade, euro-denominated, fixed-rate corporate bonds. Only bonds with a maturity of 1 year and above are eligible. The S&P 500 Index measures the performance of 500 mostly large-cap stocks weighted by market value, and is often used to represent performance of the US stock market. This document may mention bond ratings published by nationally recognized statistical rating organizations (NRSROs) Standard & Poor’s, Moody’s Investors Service, and Fitch, Inc. For securities rated by an NRSRO other than S&P, the rating is converted to the equivalent S&P credit rating. Bonds rated AAA are rated as having the highest quality and are generally considered to have the lowest degree of investment risk. Bonds rated AA are considered to be of high quality, but with a slightly higher degree of risk than bonds rated AAA. Bonds rated A are considered to have many favourable investment qualities, though they are somewhat more susceptible to adverse economic conditions. Bonds rated BBB are believed to be of medium-grade quality and generally riskier over the long term. Bonds rated BB, B, and CCC are regarded as having significant speculative characteristics, with BB indicating the least degree of speculation of the three.

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