

WESTERN ASSET HIGH INCOME OPPORTUNITY FUND INC.

Form N-CSR

December 08, 2006

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 811-7920

Western Asset High Income Opportunity Fund Inc.  
(Exact name of registrant as specified in charter)

125 Broad Street, New York, NY  
(Address of principal executive offices)

10004  
(Zip code)

Robert I. Frenkel, Esq.  
Legg Mason & Co., LLC  
300 First Stamford Place, 4th Fl.  
Stamford, CT 06902  
(Name and address of agent for service)

Registrant's telephone number, including area code: (800) 451-2010

Date of fiscal year September 30,  
end:

Date of reporting period: September 30, 2006

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ITEM 1. REPORT TO STOCKHOLDERS.

The Annual Report to Stockholders is filed herewith.

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**Western Asset High Income  
Opportunity Fund Inc.**

**ANNUAL REPORT**

**SEPTEMBER 30, 2006**

LOSE VALUE INVESTMENT PRODUCTS: NOT FDIC INSURED NO BANK GUARANTEE MAY

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Western Asset High Income  
Opportunity Fund Inc.

Annual Report September 30, 2006

What's  
Inside

Letter from the Chairman	I
Fund Overview	1
Fund at a Glance	5
Schedule of Investments	6
Statement of Assets and Liabilities	22
Statement of Operations	23
Statements of Changes in Net Assets	24
Financial Highlights	25
Notes to Financial Statements	26
Report of Independent Registered Public Accounting Firm	33
Financial Data	34
Board Approval of Management and Subadvisory Agreements	35
Additional Information	38
Annual Chief Executive Officer and Chief Financial Officer Certification	41
Dividend Reinvestment Plan	42

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Letter from the Chairman

**R. JAY GERKEN, CFA**

Chairman, President and Chief  
Executive Officer

Dear Shareholder,

While the U.S. economy continued to expand, it weakened considerably as the reporting period progressed. After expanding 4.1% in the third quarter of 2005, gross domestic product ( GDP ) (i) growth slipped to 1.7% during the fourth quarter of the year. The economy then rebounded sharply in the first quarter of 2006. Over this period, GDP rose 5.6%, its best showing since the third quarter of 2003. The economy then took a step backwards in the second quarter of 2006, as GDP growth was 2.6% according to the U.S. Commerce Department. The advance estimate for third quarter GDP growth was 1.6% the lowest growth rate since the first quarter of 2003.

After increasing the federal funds rate(ii) to 5.25% in June its 17th consecutive rate hike the Federal Reserve Board ( Fed )(iii) paused from raising rates at its August, September and October meetings. In its statement accompanying the October meeting, the Fed stated, Economic growth has slowed over the course of the year, partly reflecting a cooling of the housing market. Going forward, the economy seems likely to expand at a moderate pace. Readings on core inflation have been elevated, and the high level of resource utilization has the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations and the cumulative effects of monetary policy actions and other factors restraining aggregate demand. The Fed s next meeting is on December 12th and we believe any further rate movements will likely be data dependent.

Western Asset High Income Opportunity Fund Inc.

Both short- and long-term yields rose over the reporting period. However, after peaking in late June with two- and 10-year Treasuries hitting 5.29% and 5.25%, respectively rates fell sharply as the Fed paused from its tightening cycle. In addition, inflationary pressures eased as oil prices, which rose to a record \$78 a barrel in mid-July, fell 15% in the third quarter.(iv) Overall, during the 12 months ended September 30, 2006, two-year Treasury yields increased from 4.18% to 4.71%. Over the same period, 10-year Treasury yields moved from 4.34% to 4.64%. Looking at the 12-month period as a whole, the overall bond market, as measured by the Lehman Brothers U.S. Aggregate Index(v), returned 3.67%.

Given continued strong corporate profits and low default rates, high yield bonds generated positive returns during the reporting period. While there were several high profile company specific issues, mostly in the automobile industry, they were not enough to drag down the overall high yield market. During the 12-month period ended September 30, 2006, the Citigroup High Yield Market Index(vi) returned 7.59%.

Despite periods of weakness, emerging markets debt generated strong results over the 12-month period, as the JPMorgan Emerging Markets Bond Index Global(vii) returned 7.81%. A strong global economy, solid domestic spending and a pause in U.S. interest rate hikes supported many emerging market countries.

Please read on for a more detailed look at prevailing economic and market conditions during the Fund's fiscal year and to learn how those conditions have affected Fund performance.

### **Information About Your Fund**

As you may be aware, several issues in the mutual fund industry (not directly affecting closed-end investment companies, such as this Fund) have come under the scrutiny of federal and state regulators. Affiliates of the Fund's manager have, in recent years, received requests for information from various government regulators regarding market timing, late trading, fees, and other mutual fund issues in connection with various investigations. The regulators appear to be examining, among other things, the open-end funds

Western Asset High Income Opportunity Fund Inc.

response to market timing and shareholder exchange activity, including compliance with prospectus disclosure related to these subjects. Furthermore, the Fund's prior manager has been informed by the staff of the Securities and Exchange Commission of the potential for an administrative proceeding against the prior manager in connection with disclosures regarding dividends and distributions paid to shareholders. See Note 6 to the financial statements. The Fund is not in a position to predict the outcome of these requests and investigations, or whether these may affect the Fund.

Important information with regard to recent regulatory developments that may affect the Fund is contained in the Notes to Financial Statements included in this report.

As always, thank you for your confidence in our stewardship of your assets. We look forward to helping you meet your goals.

Sincerely,

R. Jay Gerken, CFA  
Chairman, President and Chief Executive Officer

*October 27, 2006*

All index performance reflects no deduction for fees, expenses or taxes. Please note that an investor cannot invest directly in an index.

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- (i) Gross domestic product is a market value of goods and services produced by labor and property in a given country.
  - (ii) The federal funds rate is the interest rate that banks with excess reserves at a Federal Reserve district bank charge other banks that need overnight loans.
  - (iii) The Federal Reserve Board is responsible for the formulation of a policy designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.
  - (iv) Source: *The Wall Street Journal*, 9/29/06.
  - (v) The Lehman Brothers 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.



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- (vi) The Citigroup High Yield Market Index is a broad-based unmanaged index of high yield securities.
- (vii) The JPMorgan Emerging Markets Bond Index Global tracks total returns for U.S. dollar denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds, and local market instruments. Countries covered are Algeria, Argentina, Brazil, Bulgaria, Chile, China, Colombia, Cote d Ivoire, Croatia, Ecuador, Greece, Hungary, Lebanon, Malaysia, Mexico, Morocco, Nigeria, Panama, Peru, the Philippines, Poland, Russia, South Africa, South Korea, Thailand, Turkey and Venezuela.

Western Asset High Income Opportunity Fund Inc.

III

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## Fund Overview

### Special Shareholder Notices

Following the purchase of substantially all of Citigroup Inc.'s asset management business in December 2005, Legg Mason, Inc. (Legg Mason) undertook an internal reorganization to consolidate the advisory services provided to the legacy Citigroup funds through a more limited number of advisers. As part of this reorganization, at a meeting held on June 22, 2006, the Fund's Board approved a new management agreement with Legg Mason Partners Fund Advisor, LLC (LMPFA), under which LMPFA became investment manager for the Fund effective August 1, 2006.

Western Asset Management Company (Western Asset) became subadviser for the Fund, under a new subadvisory agreement between LMPFA and Western Asset, effective August 1, 2006. LMPFA and Western Asset are wholly-owned subsidiaries of Legg Mason. The portfolio managers who are responsible for the day-to-day management of the Fund remain the same immediately prior to and immediately after the date of these changes.

LMPFA provides administrative and certain oversight services to the Fund. LMPFA has delegated to the subadviser the day-to-day portfolio management of the Fund. The management fee for the Fund remains unchanged.

The Fund was formerly known as High Income Opportunity Fund Inc.

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

A. During the reporting period, the bond market faced a number of challenges, including six additional short-term interest rate hikes by the Federal Reserve Board (Fed)(i), inflationary pressures and a continued economic expansion. However, as the period progressed, oil prices fell sharply, a cooling housing market triggered slower economic growth and the Fed paused from raising rates during their meetings in August and September 2006. Collectively, this led to a sharp rally in the overall bond market and the Lehman Brothers U.S. Aggregate Bond Index(ii) generated a positive 3.67% return during the last 12 months.

Riskier asset classes, such as high yield bonds, experienced periods of sharp volatility during the reporting period. This was often triggered by uncertainty regarding Fed policy and periodic investor flights to quality. However, for the 12-month period as a whole, the Citigroup High Yield Market Index(iii) returned 7.59%. High yield bonds performed well on the back of solid corporate profits and low default rates.

### Performance Review

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For the 12 months ended September 30, 2006, the Western Asset High Income Opportunity Fund Inc. returned 7.98%, based on its net asset value ( NAV )(iv) and 9.82% based on its New York Stock Exchange ( NYSE ) market price per share. In comparison, the Fund 's unmanaged benchmark, the Citigroup High Yield Market Index, returned 7.59% and its Lipper High Current Yields Closed-End Funds Category Average(v) increased 9.11% over the same time frame. Please note that Lipper performance returns are based on each fund 's NAV.

Western Asset High Income Opportunity Fund Inc. 2006 Annual Report

1

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During the 12-month period, the Fund made distributions to shareholders totaling \$0.5040 per share. The performance table shows the Fund's 12-month total return based on its NAV and market price as of September 30, 2006. **Past performance is no guarantee of future results.**

**Performance Snapshot as of September 30, 2006 (unaudited)**

<b>Price Per Share</b>	<b>12-Month Total Return</b>
\$7.12 (NAV)	7.98%
\$6.37 (Market Price)	9.82%

**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. Total returns assume the reinvestment of all distributions in additional shares.

**Q. What were the most significant factors affecting Fund performance?  
What were the leading contributors to performance?**

A. Early in the reporting period, the Fund's performance was driven by positive security and industry selection. Issue selection was particularly strong in CCC-rated and below securities and in the utilities and paper and forest products industries. The Fund's overweights to the airlines and telecommunications sectors and underweight to automotive also supported positive returns.

As the period progressed, an overweight in the building products sector and an underweight in the wireless telecom sector enhanced results. Elsewhere, overweight positions in a number of individual securities, including **NewPage Holding Corp.** and **Hawaiian Telcom Communications, Inc.**, were positive contributors to performance.

**What were the leading detractors from performance?**

A. Security selection in the telecommunications and cable and other media industries detracted from overall performance during the initial portion of the reporting period.

Later in the period, the Fund's short duration(vi) negatively impacted performance, especially during the last three months of the fiscal year as yields fell across the curve. The Fund's small allocation to investment grade bonds and emerging market debt detracted from results as they

underperformed their high yield counterparts. From a sector perspective, an underweight in the consumer cyclical subsector and an overweight in the transportation subsector negatively impacted the Fund.

**Q. Were there any significant changes to the Fund during the reporting period?**

A. Early in the period, we reinvested assets from a series of calls and tenders, primarily in the telecommunications industry, into automotive bonds, buying on weakness. We also decreased the Fund's exposure to the cable industry.

**Looking for Additional Information?**

The Fund is traded under the symbol HIO and its closing market price is available in most newspapers under the NYSE listings. The daily NAV is available on-line under

Western Asset High Income Opportunity Fund Inc. 2006 Annual Report

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symbol XHIOX 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.leggmason.com/InvestorServices](http://www.leggmason.com/InvestorServices).

In a continuing effort to provide information concerning the Fund, shareholders may call 1-888-777-0102, Monday through Friday from 8:00 a.m. to 6:00 p.m. Eastern Time, for the Fund's current net asset value, market price and other information.

Thank you for your investment in the Western Asset High Income Opportunity Fund Inc. As ever, 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

*October 27, 2006*

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.

Portfolio holdings and breakdowns are as of September 30, 2006 and are subject to change and may not be representative of the portfolio manager's current or future investments. The Fund's top ten holdings (as a percentage of net assets) as of this date were: General Motors Corp. (4.6%), Ford Motor Co. (2.9%), Sprint Capital Corp. (1.9%), Qwest Corp. (1.7%), Williams Cos. Inc. (1.7%), El Paso Corp. (1.4%), Tenet Healthcare Corp. (1.3%), EchoStar DBS Corp. (1.3%), Chesapeake Energy Corp. (1.2%) and Hertz Corp. (1.2%) Please refer to pages 6 through 20 for a list and percentage breakdown of the fund's holdings.

The mention of sector breakdowns is for informational purposes only and should not be construed as a recommendation to purchase or sell any securities. The information provided regarding such sectors is not a sufficient basis upon which to make an investment decision. Investors seeking financial advice regarding the appropriateness of investing in any securities or investment strategies discussed should consult their financial professional. Portfolio holdings are subject to change at any time and may not be representative of the portfolio manager's current or future investments. The Fund's top five sector holdings (as a percentage of net assets), as of September 30, 2006 were: Consumer Discretionary (29.9%), Telecommunication Services (11.0%), Financials (10.9%), Energy (10.5%) and Industrials (9.5%). The Fund's portfolio composition is subject to change at any time.

**RISKS:** The Fund invests in high-yield bonds, which are subject to additional risks such as the increased risk of default and greater volatility because of the lower credit quality of the issues. Fixed income investments are subject to interest rate risk. As interest rates rise, bond prices fall, reducing the value of the Fund's share price. The Fund may use derivatives, such as options and futures, which can be illiquid, may disproportionately increase losses, and have a potentially large impact on Fund performance. In addition, the Fund may invest in foreign

securities, which are subject to certain risks of overseas investing, including currency fluctuations and changes in political and economic conditions, which could result in significant fluctuations. Please see the Fund's prospectus for more information on these and other risks.

All index performance reflects no deduction for fees, expenses or taxes. Please note that an investor cannot invest directly in an index.

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

(ii) The Lehman Brothers 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.

(iii) The Citigroup High Yield Market Index is a broad-based unmanaged index of high yield securities.

(iv) NAV is calculated by subtracting total liabilities and outstanding preferred stock 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 at the Fund's market price as determined by supply of and demand for the Fund's shares.

(v) Lipper, Inc. is a major independent mutual-fund tracking organization. Returns are based on the 12-month period ended September 30, 2006, including the reinvestment of all distributions, including returns of capital, if any, calculated among the 8 funds in the Fund's Lipper category.

(vi) Duration is a common gauge of the price sensitivity of a fixed income asset or portfolio to a change in interest rates.

**Take Advantage of the Fund's Dividend Reinvestment Plan!**

As an investor in the Fund, you can participate in its Dividend Reinvestment Plan ( Plan ), a convenient, simple and efficient way to reinvest your distributions, if any, in additional shares of the Fund. Below is a short summary of how the Plan works.

**Plan Summary**

If you are a Plan participant who has not elected to receive your distributions in the form of a cash payment, then your distributions will be reinvested automatically in additional shares of the Fund.

The number of common stock shares in the Fund you will receive in lieu of a cash dividend is determined in the following manner. If the market price of the common stock is equal to or exceeds the net asset value ( NAV ) per share on the determination date, you will be issued shares by the Fund at a price reflecting the NAV, or 95% of the market price, whichever is greater.

If the market price is less than the NAV at the time of valuation (the close of business on the determination date), American Stock Transfer & Trust Company ( AST or Plan Agent ) will buy common stock for your account in the open market.

If the Plan Agent begins to purchase additional shares in the open market and the market price of the shares subsequently rises above the NAV previously determined before the purchases are completed, the Plan Agent will attempt to terminate purchases and have the Fund issue the remaining distribution in shares at the greater of the previously determined NAV or 95% of the market price. In that case, the number of Fund shares you receive will be based on the weighted average of prices paid for shares purchased in the open market and the price at which the Fund issues the remaining shares.

A more complete description of the current Plan appears in the section of this report beginning on page 42. To find out more detailed information about the Plan and about how you can participate, please call the Plan Agent at 1-877-366-6441.

Western Asset High Income Opportunity Fund Inc. 2006 Annual Report



Fund at a Glance (unaudited)

**Investment Breakdown**

**As a Percent of Total Investments**

**September 30, 2006**

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\* Amount represents less than 1%

Western Asset High Income Opportunity Fund Inc. 2006 Annual Report

## Schedule of Investments (September 30, 2006)

## WESTERN ASSET HIGH INCOME OPPORTUNITY FUND INC.

Face Amount	Rating	Security	Value
<b>CORPORATE BONDS &amp; NOTES 93.1%</b>			
<b>Aerospace &amp; Defense 1.1%</b>			
\$ 995,000	B+	Alliant Techsystems Inc., Senior Subordinated Notes, 6.750% due 4/1/16	\$ 982,562
850,000	B+	DRS Technologies Inc., Senior Subordinated Notes: 6.625% due 2/1/16	839,375
1,750,000	B	7.625% due 2/1/18	1,785,000
700,000	BB+	L-3 Communications Corp., Senior Subordinated Notes: 7.625% due 6/15/12	724,500
1,460,000	BB+	5.875% due 1/15/15	1,394,300
		<b>Total Aerospace &amp; Defense</b>	<b>5,725,737</b>
<b>Airlines 1.5%</b>			
840,000	NR	American Airlines Inc., Pass-Through Certificates, Series 2001-02, Class C, 7.800% due 4/1/08	840,525
336,635	B+	Continental Airlines Inc., Pass-Through Certificates: Series 2000-2, Class C, 8.312% due 4/2/11	313,281
2,000,000	B	Series 2001-2, Class D, 7.568% due 12/1/06	2,001,250
962,968	NR	United Airlines Inc., Pass-Through Certificates: Series 2000-1, Class B, 8.030% due 7/1/11 (a)	987,644
2,268,135	NR	Series 2000-2, Class B, 7.811% due 10/1/09 (a)	2,428,322