HIGHLAND CAPITAL MANAGEMENT

Q4 2018

FLOATING RATE OPPORTUNITIES FUND

MARKET REVIEW

PERFORMANCE REVIEW

The Highland Floating Rate Opportunities Fund (HFRO, the "Fund") had a total market return of -15.64% but a NAV return of -3.29% during the fourth quarter of 2018. These compare to a gross return of -3.08% for the Credit Suisse Leveraged Loan Index during the same period. Positive contributions to performance were predominantly driven by Creek Pine Holdings and others within our special situation allocation.[1] Detractors to performance were consistent with the previous couple of quarters and primarily related to the MGM equity position and a few stressed investments.

Although leveraged loans withstood much of the increase in broader market volatility in October, the asset class began to succumb to the pressure during November and December. We believe the negative performance was due to a confluence of events, primarily of which were the ongoing U.S.-China trade dispute and the debate over whether the Fed was moving too quickly with its interest rate hikes into a slowing growth environment. Both of these issues have obvious impacts on the expectations for global growth going forward, and the rise of animal spirits during management commentary over their cautious outlooks during third quarter earnings calls was not helpful as well. However, the uncertainty over the path of interest rates also removed one of the main pillars of the floating rate debt investment thesis. In addition, what began as a crude oversupply situation that drove prices downward morphed into fears over weakening demand growth, adding yet more kindling to the market bonfire of global growth concerns. All of this coupled with the unwillingness of many market participants to hold risk into year-end created a perfect storm of sorts for the leveraged loan asset class.

TOTAL RETURN ANALYSIS (%)*

AS OF 12/31/2018	Incept.	YTD	1-YR	3-YR	5-YR	10-YR	Since Incept.
HFRO NAV	11.06.17	1.53	1.53	6.22	2.99	7.87	3.96
HFRO Market Price		-12.16	-12.16	2.06	-0.14	6.58	3.31
CS Leveraged Loan		1.14	1.14	5.03	3.33	8.30	3.62

Returns shown are net of fees and expenses.

Effective June 13, 2011, the Highland Floating Rate Fund and Highland Floating Rate Advantage Fund merged to form the Highland Floating Rate Opportunities Fund. The performance data presented above reflects that of Highland Floating Rate Advantage Fund, the Predecessor Fund, for periods prior to June 13, 2011.

Effective shortly after close of business on November 3, 2017, the Highland Floating Rate Fund converted from an open-end fund to a closed-end fund, and began trading on the NYSE under the symbol HFRO on November 6, 2017. The performance data presented above reflects that of Class Z shares of the Fund when it was an open-end fund, HFRZX. Month-end returns since December 2017 reflect market prices. The closed-end Fund pursues the same investment objective and strategy as it did before its conversion.

A significant portion of the fund's performance for the period was attributable to the performance of the Fund's equity investments. No assurance can be given that the Fund's equity investments will perform similarly in the future.

FEES AND EXPENSES

Net expense ratio: 1.79%. Performance results reflect the contractual waivers and/or reimbursements of fund expenses by the Advisor. Absent this limitation, performance results would have been lower. The expense ratio is reported in the Fund's Annual Report dated June 30, 2018. The expense cap expired on October 31, 2016.

The performance data quoted here represents past performance and is no guarantee of future results. Investment returns and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For performance data current to the most recent month-end, please visit our website at www.highlandfunds.com.

Nonetheless, the Fund has remained disciplined in its overall investment approach, continuing to eschew many of the lower quality new issues in favor of selectively increasing exposure to existing positions and other situations where we are able to deploy our deep fundamental investment approach to uncover opportunities that we believe are underappreciated by the broader market. The Fund has continued to maintain a diverse mix of invested assets, many of which are higher quality, seasoned issues that have helped weather this recent bout of broader market turbulence and have provided the Fund with some opportunities to redeploy that capital into other positions that appear more attractively priced.

MARKET ENVIRONMENT[2]

Although both asset classes posted negative returns during the quarter, leveraged loans were more resilient than high yield (-3.16% versus -4.79%, respectively). Against the backdrop of heightened market volatility and lower Treasury yields, investment grade bonds eked out their second consecutive quarter of positive performance at 0.06%. Although it was the tale of two cities with leveraged loans and high yield outperforming investment grade during the first half of the year and vice versa in the second half, leveraged loans was the only asset class of the three that posted a positive return for the full year of 2018 (at 1.08%).

Amidst the broader market volatility, leveraged loans witnessed some of the largest retail outflows on record during the quarter, with nearly $15 billion during the period from Thanksgiving through the end of the year. Nonetheless, CLO activity (net issuance, excluding resets and refinancings) remained resilient. The $28 billion of CLO issuance in the fourth quarter was only down marginally from the $32 to $38 billion pace experienced during the first three quarters of the year. The pace of leveraged loan issuance actually picked up a bit during the quarter, with net new issuance (excluding repricings and refinancings) increasing to $64 billion but remaining well below levels experienced at the beginning of the year. Nonetheless, December net issuance of $8 billion was the lowest since January of 2015, at the onset of the energy downturn. This was largely reflective of the broader market volatility and risk aversion experienced during the month, which contributed to the average price of loans within the J.P. Morgan Leveraged Loan Index decreasing to 94.54 from 99.02 at the end of September. As a result, the average 3-year discount margin widened considerably to 526 bps from 437 bps, and yields rose to 8.13% from 6.80%, with some additional help from a continued rise in LIBOR rates during the quarter. The benign default environment continues, with only one additional default experienced during the quarter. Despite this, loan default rates on a lagging 12-month basis declined further, to 1.63% from 1.77% (excluding the iHeart default in the first quarter, the current rate is only 1.02%). Absent a material deterioration in economic performance, we do not anticipate an appreciable rise in the default rate during the near-term.

OUTLOOK

As we look forward into 2019, we remain constructive on the leveraged loan asset class. As early as last September/October, many economists were forecasting the Fed to raise interest rates three to four times in 2019. Now, many expect that the Fed may not move at all this year, and some of the most aggressive rate forecasts only call for a couple of hikes in the back half of the year. We agree that the Fed is "listening" more to the market and is likely to pause its interest rate march, especially as the U.S.-China negotiations continue. However, we do not believe that we need to see continued interest rate hikes for leveraged loans to work in this environment. Broader market volatility is likely to remain elevated during the near-term, but we do not believe that a recession is imminent. Further stabilization in the markets (via confirmation of a Fed pause and/or resolution on the China trade front) should benefit loans as well. With average loan prices beginning the year in 95 context, a coupon level return of around 6% could be achievable. Default rates remain low, and without increased economic softness, rates should remain relatively low in the near-term. Furthermore, we believe that CLO demand (while down from last year's levels) will provide technical support for leveraged loans despite a potentially wavering retail investor.

As we think about positioning into this later cycle dynamic, we believe that opportunities will be defined around more idiosyncratic opportunities within leveraged loans. Whereas 2018 could be considered largely a beta year (a rising tide lifting all boats), the opportunities in 2019 may favor a more active approach to investment management. The Fund remains focused on investing in issuers with reasonable capital structures that we believe to be undervalued and that have the ability to continue generating free cash flow even in a declining economic growth environment.

RISK CONSIDERATIONS

The information herein contains forward-looking statements. These forward-looking statements are based on our current expectations and assumptions regarding the fund's portfolio and performance, the economy and other future conditions and forecasts of future events, circumstances and results. As with any projection or forecast, they are inherently susceptible to uncertainty and changes in circumstances. The fund's actual results may vary materially from those expressed or implied in its forward-looking statements.

Credit Risk. The risk that the Fund could lose money if the issuer or guarantor of a fixed income security, or the counterparty of a derivatives contract or repurchase agreement, is unable or unwilling (or is perceived to be unable or unwilling) to make a timely payment of principal and/or interest, or to otherwise honor its obligations. **Currency Risk.** The risk that the values of foreign investments may be affected by changes in the currency rates or exchange control regulations. **Debt Securities Risk.** The Fund's ability to invest in high-yield debt securities generally subjects the Fund to greater risk than securities with higher ratings. **Derivatives Risk.** Derivatives, such as futures and options, are subject to the risk that changes in the value of a derivative may not correlate perfectly with the underlying asset, rate or index. Derivatives also expose the Fund to the credit risk of the derivative counterparty. Derivative contracts may expire worthless and the use of derivatives may result in losses to the Fund. **Liquidity Risk.** The risk that, due to low trading volume, lack of a market maker, large position size, or legal restrictions (including daily price fluctuation limits or "circuit breakers"), the Fund may not be able to sell particular securities or unwinding derivative positions at desirable prices. Because loan transactions often take longer to settle than transactions in other securities, the Fund may not receive the proceeds from the sale of a loan for a significant period of time. No assurance can be given that the Fund will have sufficient liquidity in the event of abnormally large redemptions. **Non-Diversification Risk.** As a non-diversifed fund, the Fund may invest a larger portion of its assets in the securities of one or a few issuers than a diversifed fund. **Non-Payment Risk. S**enior Loans, like other corporate debt obligations, are subject to the risk of non-payment of scheduled interest and/or principal. Non-payment would result in a reduction of income to the Fund, a reduction in the value of the Senior Loan experiencing non-payment and a potential decrease in the NAV of the Fund. **Senior Loans Risk.** The risks associated with senior loans are similar to the risks of below investment grade securities in that they are considered speculative. In addition, as with any debt instrument, senior loans are also generally subject to the risk of price declines and to increases in prevailing interest rates. Senior loans are also subject to the risk that, as interest rates rise, the cost of borrowing increases, which may also increase the risk and rate of default. In addition, the interest rates of floating rate loans typically only adjust to changes in short-term interest rates; long-term interest rates can vary dramatically from short-term interest rates. Therefore, senior loans may not mitigate price declines in a rising long-term interest rate environment. **Short Sales Risk.** The risk of short sales theoretically involves unlimited loss potential since the market price of securities sold short may continuously increase.

1. Creek Pine Holdings consist of approximately 1.1 million acres of timberlands located primarily in East Texas and is structured as a 10.25% preferred security (paid-in-kind). Pay-in-kind securities are financial instruments that pay investors in the form of additional securities rather than cash coupons. The securities used to pay the interest or dividends are usually identical to the underlying securities. Pay-in-kind securities tend to pay a higher rate of interest but are considered higher risk. Creek Pine Holdings is considered non-income producing, illiquid, and may be deemed an affiliate of Highland Capital Management Fund Advisors, L.P.
2. Source: J.P. Morgan North American Credit Research, January 2019

30 Day SEC Yield: A standard yield calculation developed by the Securities and Exchange Commission (SEC) that allows for fairer comparisons of bond funds.
Credit Suisse (CS) Leveraged Loan Index: designed to mirror the investable universe of the $US-denominated leveraged loan market. The index inception is January 1992. Total return of the index is the sum of three components: principal, interest, and reinvestment return. The cumulative return assumes that coupon payments are reinvested into the index at the beginning of each period. Unlike the Fund, the index is not an investment, does not incur fees or expenses, and is not professionally managed. It is not possible to invest directly in to the index.
The S&P 500 Total Return Index is an index of a basket of 500 stocks designed to provide a broad snapshot of the overall U.S. equity market. The total return index series reflects both ordinary and special dividends.. Investors cannot invest directly into an index.
Leveraged Loans are loans to companies that typically already have a high amount of debt and are often characterized by lower credit ratings or higher interest rates.
A high yield bond, also known as a junk bond, is a type of bond that offers a high rate of interest because of its higher risk of default. A high yield bond has a lower credit rating than government bonds or investment-grade corporate bonds, but has higher interest income or yield.
Investment Grade is a rating that indicates that a municipal or corporate bond has a relatively low risk of default.
CLO is a security backed by a pool of debt, often low-rated corporate loans. Collateralized loan obligations are similar to collateralized mortgage obligations (CMO), except that the underlying loans are of a different type and character.
LIBOR is a benchmark rate that some of the world's leading banks charge each other for short-term loans. It stands for Intercontinental Exchange London Interbank Offered Rate and serves as the first step to calculating interest rates on various loans throughout the world.
Discount Margin (DM) is the average expected return earned in addition to the index underlying, or reference rate, of the floating rate security. The size of the discount margin depends on the price of the floating rate security. The return of floating rate securities changes over time, so the discount margin is an estimate based on the security's expected pattern between issue and maturity.

RISK CONSIDERATIONS, CON'T

This market commentary contains information about prior investments made by the Adviser of the Fund. This information was prepared by the Adviser based on its experience in the industry and on assumptions of fact and opinion as to future events which the Adviser believed to be reasonable when made. There can be no assurance that the Adviser and/or the Fund will be as successful as these earlier investments. Prior investment returns are not indicative of future results. It should not be assumed that investment recommendations made in the future will be profitable or will equal the performance of the securities included herein.

Closed-end funds, unlike open-end funds, are not continuously offered. There is a one-time public offering and once issued, shares of closed-end funds are sold in the open market through a stock exchange and frequently trade at prices lower than their net asset value, which may increase an investor's risk of loss. Net Asset Value (NAV) is total assets less total liabilities, which includes preferred shares, divided by the number of common shares outstanding. At the time of sale, your shares may have a market price that is above or below NAV, and may be worth more or less than your original investment. For additional information, please contact your investment adviser or visit our website www.highlandfunds.com.

Index returns are for illustrative purposes only and do not represent actual Fund performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Most fixed rate securities experience price declines when interest rates rise. Senior loans are short- duration, floating-rate securities. So, as short-term interest rates rise, yields on bank loans increase. The short duration of senior loans helps keep their prices relatively stable, although rising interest rates may increase the risk of non-payment, which may decrease their price.

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