HIGHLAND CAPITAL MANAGEMENT

Q1 2019

FLOATING RATE OPPORTUNITIES FUND

MARKET REVIEW

PERFORMANCE REVIEW

The Highland Floating Rate Opportunities Fund (HFRO, the "Fund") had a total market return of 10.35% and a NAV return of 2.50% during the first quarter of 2019. These compare to a gross return of 3.78% for the Credit Suisse Leveraged Loan Index during the same period. Positive contributions to performance continue to be predominantly driven by Creek Pine Holdings and others within our special situation allocation. Detractors to performance were consistent with the previous few quarters and primarily related to the MGM equity position and a couple distressed investments, such as Ditech Holdings.

The first week of January witnessed a quick reversal of much of the market damage experienced in December, but average leveraged loan price levels remain below where they resided when the sell-off began to intensify in November. As we discussed in our previous quarterly commentary, we believe that the asset class performance at the end of the year was driven by a confluence of factors – specifically, the ongoing U.S.-China trade dispute, the debate over the Fed moving too quickly along its interest rate hike path, and the typical seasonal reduction in liquidity into year-end. We attribute much of the initial recovery in loan prices to the alleviation of pressure from this last factor. However, as we moved through January and the remainder of the first quarter, the risks posed by the other two factors receded as well. In a pretty drastic pivot from its previous stance, the Fed now appears to be in pause mode and more attune to market signals (or at least to the Chairman's dining companions on Pennsylvania Avenue…). The market has also become more optimistic about a constructive resolution in the trade negotiations. All of these factors have helped support broader risk markets, credit included.

TOTAL RETURN ANALYSIS (%)*

AS OF 3/31/2019	Incept.	YTD	1-YR	3-YR	5-YR	10-YR	Since Incept.
HFRO NAV	11.06.17	3.60	2.59	7.93	2.67	8.18	4.04
HFRO Market Price		10.34	-7.46	6.27	1.72	7.67	3.79
CS Leveraged Loan		3.78	3.33	5.87	3.83	7.95	4.13

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.

Despite the oscillating perception of risk in the market, the Fund has remained disciplined in its overall investment approach. It continues to focus on higher quality new issues, 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 maintained a diverse mix of invested assets, many of which are higher quality, seasoned issues, as well as increased exposure to more bespoke investment opportunities, such as Creek Pine Holdings. We believe that this investment approach positions the Fund well to weather additional bouts of market turbulence should they arise.

MARKET ENVIRONMENT

After experiencing a difficult period of performance at the end of 2018, the credit markets bounced back decisively to start the year. During the first quarter, leveraged loans provided a 3.89% gain, but that performance trailed both high yield (+7.27%) and investment grade (+4.91%) bonds.[1] Within leveraged loans and high yield, performance by rating category was generally bifurcated, with higher rated issuances outperforming.

Given the Fed pause and improving overall market sentiment, the relative outperformance of fixed rate debt was not unusual. This also contributed to continued retail outflows of leveraged loans. Outflows moderated during the quarter but still amounted to approximately $10 billion. However, this was partially offset by lower leveraged loan issuance and relatively resilient CLO demand. Net new loan issuance (excluding repricings and refinancings) was $54 billion during the first quarter, down 30% year-over-year. In contrast to the finicky retail loan flows, net CLO issuance (excluding resets and refinancings) is only about 9% lower versus the first quarter of last year and remains near the forecasted range of down 10% to 15% for the full year.[2]

As credit and the broader risk markets healed during the first quarter, the average price of loans within the J.P. Morgan Leveraged Loan Index experienced a notable improvement, increasing from 94.54 to 96.79 at the end of March.[2] As a result, the average 3-year discount margin decreased to 440 bps from 526 bps, and yields declined to 7.00% from 8.13%, as weakening LIBOR rates pushed yields relatively lower. Although this quarter witnessed nine defaults, totaling $9.3 billion in bonds and loans, the overall default environment remains relatively benign. Windstream accounted for over half of the volume ($4.8 billion), and the impetus for that default was an unfavorable court ruling, which may have hastened the inevitable but was not indicative of a recent softening in broader economic activity. Nonetheless, loan default rates on a lagging 12-month basis remain concluded March at 1.00%, the lowest level since April 2012. Absent a material deterioration in economic performance, we continue to not anticipate an appreciable rise in the default rate during the near-term.

OUTLOOK

Despite the market's concerns over a flattening yield curve, we continue to not believe that a recession is imminent. Some macroeconomic indicators have softened, and earnings growth is slowing when compared to the tax reform stimulated results last year. However, most of the indicators we follow are not signaling a significant slowdown in the near-term. Markets are already assuming a U.S.-China trade deal occurs, and we also share that view, as we believe that Trump views the health of the economy and the markets as the ultimate barometer of his success in the Oval Office and that an elongated feud is in no one's best interests. However, we would caution that we could see the timing of the ultimate resolution be pushed out and/or agreements completed in piecemeal. With China's restimulation efforts just now beginning to make their way through the economy, they may feel emboldened to delay resolution in order to gain a slightly better hand in negotiations. Nonetheless, we believe that achieving finality in this saga will be incrementally positive for broader risk markets.

With that backdrop, we remain constructive on the leveraged loan asset class. The Fed pause has caused retail investors to reevaluate their floating rate debt exposure, but with a similar YTM/YTW to high yield and structural seniority, we continue to have a favorable view of loans. However, we believe that positioning has become increasingly more important as we enter these later stages of the credit/economic cycle. Even though volatility has seemingly returned to hibernation, we believe that periods of elevated market volatility are still likely over the course of this year and into next. Loan spreads have begun declining, and we are seeing some instances of mispriced risk once again. Although CLO demand remains robust, the wavering retail investor could contribute to bifurcating performance amongst issuers and rating categories should volatility rise again. We continue to believe that opportunities will be defined around more idiosyncratic situations within leveraged loans that favor a more active approach to investment management. The Fund remains focused on these opportunities and remaining more defensively positioned within the remainder of its loan allocation. It also continues to explore diversifying, non-traditional investments that we believe may provide attractive risk-adjusted return opportunities for the Fund.

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. Source: J.P. Morgan North American Credit Research, April 2019
2. J.P. Morgan High Yield and Leveraged Loan Research, April 1, 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.

Prepared by NexPoint Securities, Inc. ("NexPoint"), Member FINRA/SIPC.

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