HIGHLAND CAPITAL MANAGEMENT

Q2 2019

INCOME FUND

MARKET REVIEW

PERFORMANCE REVIEW

The Highland Income Fund (the "Fund," ticker: HFRO) had a total market return of 1.36% and a NAV return of 0.62% during the second quarter of 2019. These compare to a gross return of 1.58% for the Credit Suisse Leveraged Loan Index during the same period. Positive contributors 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, which was exited during the quarter.

As so often has been the case recently, the credit markets began the quarter on a path towards improvement but then encountered turbulence as renewed trade tensions and slowing growth came to the forefront. Most investors expected to encounter lower economic growth this year, but the potential for a prolonged trade dispute with China and the whimsical threat to apply tariffs on Mexican goods exacerbated those growth concerns. Similar to previous periods of trade instability, the market has since moved past its period of heightened angst, realizing that threats are sometimes just that, threats, and presuming that our Commander in Chief is ultimately more rational than he may appear at times. Regardless of how this trade dispute is eventually resolved, the President has already won a battle near and dear to his heart, forcing the Fed to alter the course of its interest rate policy. Over the span of a few quarters, we have transitioned from the potential for further hikes, to the Fed being in pause mode, and now to the possibility of two rate cuts by the end of the year. This has buoyed the broader risk markets, as the Fed's altered course should help cushion the impact of trade negotiations that appear poised to extend beyond the timeframe that most investors had assumed at the beginning of the year. Although lower interest rates are obviously a headwind for leveraged loans, we believe that a more constructive backdrop for risk assets will benefit loans as well.

TOTAL RETURN ANALYSIS (%)*

AS OF 6/30/2019	Incept.	YTD	1-YR	3-YR	5-YR	10-YR	Since Incept.
HFRO NAV	11.06.17	4.24	1.47	6.02	2.42	7.51	4.02
HFRO Market Price		11.82	-5.45	4.64	1.62	7.08	3.81
CS Leveraged Loan		5.42	4.15	5.43	3.85	6.29	4.23

Returns shown are net of fees and expenses.

TOP HOLDINGS (% OF NET ASSETS)[1]

Creek Pine Holdings, LLC	19.1
FREMF 2019 KF60	5.8
EDS Legacy Partners	5.7
Metro Goldwyn Mayer (MGM)	3.3
Jernigan Capital	2.5

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.

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.

Note: Effective May 20, 2019, the Highland Floating Rate Opportunities Fund was renamed the Highland Income Fund. In addition to these changes, the Fund's investment strategies were revised and the Fund will no longer invest at least 80% of its assets in floating rate loans and other securities deemed to be floating rate instruments. For more information, please review the Fund's prospectus at highlandfunds.com or call 877.665.1287.

In May, the Fund changed its name to the Highland Income Fund. The Fund's ticker and investment objective (i.e., to provide a high level of current income consistent with the preservation of capital) did not change, but the Fund expanded its investment strategy and removed the policy of investing at least 80% of net assets in floating rate instruments. Under the new strategy, the Fund will expand upon its focus on floating rate investments to also include investments in securities or related instruments directly or indirectly secured by real estate. It is not envisioned that it will become a real estate only fund. However, at this point in the credit cycle, we believe that it is prudent to expand the investment scope to include other assets with similar income characteristics that may not be as correlated to traditional floating rate investments. We believe that this approach leverages Highland's existing real estate capabilities and provides a wider array of investment opportunities.

MARKET ENVIRONMENT[1]

The credit markets continued to generally improve during the second quarter. For the quarter, leveraged loans provided a solid 1.63% gain but that again trailed the performance of both high yield (+2.43%) and investment grade (+4.41%) bonds. Within leveraged loans and high yield, the bifurcation of performance by rating category remained consistent, with higher rated issuances continuing to outperform.

Market and risk sentiment deteriorated in May as trade tensions escalated but recovered as the market became more comfortable that the Fed was laying the groundwork for an upcoming rate cut. With lower expected interest rates and a Fed poised to help buffer the economy from a prolonged trade negotiation, the relative outperformance of fixed rate debt was to be expected. However, leveraged loan performance was respectable, especially against the backdrop of continued retail outflows from the asset class. Outflows again moderated a bit during the quarter to $8.8 billion (versus $11.1 billion in the first quarter and the nearly $15 billion in the period from Thanksgiving through year end 2018) but remained sizeable. Loan issuance is down 34% on a net basis (excluding repricings and refinancings) year-to-date and is helping to mitigate the impact of the outflows. CLO demand also remains supportive. Net CLO issuance (excluding resets and refinancings) is only down about 7% year-to-date and remains near the forecasted range of down 10% to 15% for the full year.

The push and pull between lower forecasted interest rates against an improving backdrop for risk assets prevented further improvement in the average price of loans within the J.P. Morgan Leveraged Loan Index. Prices increased slightly to 96.91 from 96.79 at the end of March, and the average 3-year discount margin decreased to 411 bps from 440 bps. Weakening LIBOR rates once again pushed yields relatively lower to 6.43% from 7.00% at the end of the first quarter. Default activity accelerated in terms of par amount during the second quarter, which witnessed $11.5 billion in defaulted bonds and loans. This was the highest quarterly total since the first quarter of 2018 when iHeart defaulted. Nonetheless, the default activity that we have witnessed remains driven largely by idiosyncratic issues and is not indicative of a broader softening in economic conditions. Loan default rates on a lagging 12-month basis increased slightly during the quarter to 1.30% but remain well below the long-term average of just over 3%. Absent a material deterioration in economic performance, we continue to not anticipate an appreciable rise in the default rate during the near-term.

OUTLOOK

Leading economic indicators have begun to soften and earnings growth is slowing, but we continue to believe that a recession is not imminent. Much of the softening is likely reflective of the impact of U.S.-China trade negotiations lasting longer than many had expected. As we discussed last quarter, we believe the dispute will ultimately be resolved but that there was a good likelihood of the resolution being delayed. While not an ideal situation, an accommodative Fed (as well as central banks globally) certainly makes it more palatable. Lower interest rates are not favorable for leveraged loans, but a prudent Fed has the opportunity to provide a conducive environment for credit overall and to not preemptively bring an end to the current cycle.

We believe this backdrop will be beneficial for both the Fund's traditional leveraged loan investments as well as those within its expanded scope. The YTM/YTW differential between loans and high yield remains less than 30 bps[2], and we believe that the structural seniority combined with the potential for a steepening yield curve make loans appear attractive on a relative basis. In addition, if you look at the historical relationship between loans and high yield, loan yields should be about 50 bps lower than where they currently reside.[3] As we enter these later stages of the credit/economic cycle, the Fund's loan holdings remain focused on more defensively positioned investments. However, we expect that the Fund's additional investment flexibility allows us to better position the Fund as periods of specific issuer stress and/or market volatility arise. We continue to believe that upcoming opportunities will be defined around more idiosyncratic situations that favor a more active approach to investment management, and the ability to pursue those opportunities, regardless of asset class, can be beneficial.

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. **Real Estate Industry Risk:** Issuers principally engaged in real estate industry, including real estate investment trusts, may be subject to risks similar to the risks associated with the direct ownership of real estate, including: (i) changes in general economic and market conditions; (ii) changes in the value of real estate properties; (iii) risks related to local economic conditions, overbuilding and increased competition; (iv) increases in property taxes and operating expenses; (v) changes in zoning laws; (vi) casualty and condemnation losses; (vii) variations in rental income, neighborhood values or the appeal of property to tenants; (viii) the availability of financing and (ix) changes in interest rates and leverage.

1. Top Holdings: 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). MGM is an equity position received through prior debt holdings. Jernigan Capital is a preferred equity security. 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. Top Holdings are non-income producing, illiquid, and may be deemed an affiliate of Highland Capital Management Fund Advisors, L.P. Current and future portfolio holdings are subject to change and risk. Holdings are calculated as a percentage of the Fund's market value.
2. Source: J.P. Morgan North American Credit Research, July 2019
3. J.P. Morgan High Yield and Leveraged Loan Research, July 16, 2019
4. Barclays Credit Research, July 12, 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.

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.

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.

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., Member FINRA/SIPC.

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