HIGHLAND CAPITAL MANAGEMENT

Q4 2019

INCOME FUND

MARKET REVIEW

PERFORMANCE REVIEW

The Highland Income Fund (the "Fund," ticker: HFRO) had a total market return of -5.08% but a flat NAV return during the fourth quarter of 2019. These compare to a gross return of 1.68% for the Credit Suisse Leveraged Loan Index. While a widening of the Fund's discount was the primary contributor to its performance lag, there were a handful of positions within the special situation allocation that contributed to the underperformance as well.

The broader risk markets have become increasingly optimistic over the past couple of months. Resolution on the trade front seems more likely, at least for a "phase 1" agreement. As investors have pushed aside their trade fears, their focus has also shifted away from the weakening in economic indicators. Data that was not too long ago portending an extended period of slower economic growth is now assumed to be transitory once a trade deal is consummated. While the credit markets were slow to adopt this enthusiasm, market conditions began improving at the end of the year, and loans started to "feel good" again. Unless we see an uptick in inflationary pressures, we likely have a Fed that is content to sit on its hands for now, and that in combination with easy monetary policies globally, should be broadly supportive for risk assets.

MARKET ENVIRONMENT[1]

The choppiness of the third quarter continued into October and November before the credit markets staged a nice rebound into the end of the year. During those first couple of months, the markets remained focused on the U.S.-China trade negotiations as well as the softening economic indicators. As clarity on the trade front ensued and it became more apparent that the Fed was on hold, credit markets finished the year on a high note. Although high yield outperformed leveraged loans during the fourth quarter (2.88% versus 1.85%), returns for both asset classes were respectable and capped off a year that exceeded expectations,

TOTAL RETURN ANALYSIS (%)*

AS OF 12/31/2019	Incept.	YTD	1-YR	3-YR	5-YR	10-YR	Since Incept.
HFRO NAV	11.06.17	2.54	2.54	2.76	2.38	5.80	3.83
HFRO Market Price		4.15	4.15	-0.37	0.50	4.82	3.35
CS Leveraged Loan		8.17	8.17	4.48	4.54	5.18	4.31

Returns shown are net of fees and expenses.

TOP HOLDINGS (% OF PORTFOLIO)[2]

Creek Pine Holdings, LLC	14.1
NFRO REIT Sub, LLC	6.4
FREMF 2019-KF60	4.1
EDS Legacy Partners Owner, LLC	3.8
SFR WLIF II, LLC	3.5

FEES AND EXPENSES

Net expense ratio: 3.26%. 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 Semi-Annual Report dated June 30, 2019. 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.

with annual returns of 14.08% and 8.64%, respectively. These returns were aided somewhat by a reversal of the flight to quality theme that we had experienced for much of 2019, as we finally started to see investors dip into lower quality credits during the fourth quarter. Loan pricing was supported by retail outflows that moderated further to $7.0 billion (from $8.0, $8.8, and $11.1 billion in the third, second, and first quarters, respectively). Outflows persisted each month during the quarter, but December's figure of $1.0 billion was the lowest in the past 15 months. The more favorable market technical environment was also supported by a continued dearth in loan issuance and resilient CLO demand. For the full year, net loan issuance was down 36%, but net CLO issuance was down only 9%, at the low end of the forecasted down 10% to 15% range. In another sign of the strengthening loan market in December, repricing activity came out of hibernation in earnest. Over $23 billion of loans were repriced during the month, which was a high for the year and accounted for 61% of monthly issuance.

After declining to around 95.50 in October, the average loan price within the J.P. Morgan Leveraged Loan Index increased to 96.72 by the end of the year, as improved market sentiment and more favorable technicals asserted themselves. Although the average 3-year discount margin was relatively flat at 437 bps, the index yield decreased slightly to 6.29%, as LIBOR rates declined further. Default activity was a bit lower quarter-over-quarter. Although 2019 experienced a heightened level of defaults, commodity-sensitive sectors (energy and metals/mining) still account for the majority, and loan default rates remain modest at 1.64% on a trailing 12-month basis, slightly lower than where they began the year. Absent a material deterioration in economic performance, we continue to not anticipate an appreciable rise in the default rate during the near-term.

OUTLOOK[3]

It was quite a year in sub-investment grade credit. Following the Fed's misstep in late 2018, credit rebounded nicely to begin the year. For high yield, it was generally a smooth ride upwards, as a Fed retreat combined with equity market enthusiasm encouraged inflows and propelled the asset class higher. For leveraged loans, performance was a bit more subdued and choppier, which was in large part driven by the lower interest rate environment and persistent retail outflows. Nonetheless, a consistent theme for both high yield and loans was preference for quality. With lingering trade uncertainty and concerns over global growth, investors were hesitant to move down in quality. Within high yield, there had never been a previous year in which the asset class provided at least a 5% return and CCCs did not outperform BBs. This cautiousness was also evident in rising return dispersion, which emphasizes the importance of credit selection in the current environment.

As we begin a new year, we are cautiously optimistic about the credit markets, but it will be very difficult to replicate 2019. We expect the positive but relatively low economic growth environment to persist. We are entering an election year and are likely to continue to be faced with trade headlines, which may constrain growth from accelerating further. However, this is not necessarily a negative for credit, as a hesitant Fed (combined with easy money globally) should provide a supportive backdrop for risk assets. Obviously, a reacceleration in growth and a concurrent rise in yields could be a good outcome for loans as well. Nonetheless, we expect the loan market technical to be more balanced in 2020. Most expect net loan and CLO issuance to be down 10% to 20% this year. Continued loan retail outflows are possible, but the magnitude should be smaller going forward. This may prevent the price discount from narrowing much, but a coupon-ish year of around 6% does not seem unreasonable. However, we do expect some reversal of the quality trade experienced for much of last year. We believe that further upside for double-Bs is likely limited and that investors will increasingly look into the more downtrodden single-Bs for alpha generation. We do not believe, though, that there will be a widespread rally in CCC credits. There may be some catalyst-driven instances that have a successful outcome, but there still seems to be some persisting cautiousness amongst credit investors. Regardless of the opportunity set, we expect that the Fund's investment flexibility will position it well as it traverses this next stage of the credit cycle. 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 (and avoid others), regardless of asset class, should be beneficial 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. **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. Source: J.P. Morgan North American Credit Research, January 2020
2. 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). 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 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.
3. Source: Barclays Research, December 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

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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