HCMFA

2020 Commentary

Highland Income Fund

Performance Overview

For the twelve-month period ended December 31, 2020, Highland Income Fund (the "Fund" or "HFRO") experienced a total market price return of -8.29% and a total NAV return of 0.13%. Over the same period, the Fund's benchmark, the Credit Suisse Leveraged Loan Index (the "Index"), returned 2.78%.

Manager's Discussion

2020 was a year marked by unprecedented medical, economic and social challenges that will have lasting effects around the world. The Fund felt the effects of the pandemic in the turmoil that swept through markets in the first quarter; however, we saw resiliency in the Fund's net asset value during that time. In the first quarter the Fund's NAV returned -6.98% while the Credit Suisse Leveraged Loan Index declined -13.2%. Performance was bolstered by the Fund's hedge positions that provided approximately 14% of positive contribution during the quarter. Many of the Fund's tops themes including Creek Pine Holdings and Metro Goldwyn Mayer were positive contributors to performance during the year. Fieldwood Energy, real estate positions and loans were among the largest detractors to performance during the year.

The Fund's largest position, Creek Pine Holdings, continues to perform well. We originally invested in the asset in May 2018 as participating preferred in a joint venture with a consortium of institutional investors lead by Catchmark Timber Trust (ticker: CTT). The asset comprises 1.1 million acres of prime East Texas timberlands. The timberlands are located near top quartile mills and within approximately 100 miles of three of the top five U.S. homebuilding markets; Austin, Dallas, and Houston. These markets provide strong, growing, and compelling demand fundamentals. The joint venture assumes long-term sawtimber and pulpwood supply agreements with Georgia-Pacific and International Paper.

On June 24, 2020, Catchmark announced that the joint venture has amended its wood supply agreement with Georgia Pacific intended to achieve market-based pricing on timber sales. Under the amended supply agreement, the asset will also be able to increase reimbursement for extended haul distances, sell timber to other third parties, and expand its ability to sell large timberland parcels to third party buyers. The supply agreement with Georgia Pacific has also been extended by two years, with optimized harvest volume obligations to enhance and preserve long-term value. Speaking of the transaction, Catchmark CEO, Brian Davis, said "we expect these amendments to increase cash flows from timber sales at market-based prices based on customary pricing mechanisms, improve the value and marketability of the property for the long-term, and significantly enhanced the investments ability to make opportunistic timberland sales as well as recapitalize our investment." John Rasor at Catchmark added "our operations can now realize the full potential of the investments premier timberland holdings to optimize future cash flow and value." The Amended and Restated Joint Venture Agreement further provides for an increase in the 10.25% cumulative return on the preferred investors' interests in triple net lease ("NNN") subsidiary real estate investment trust of 0.5% per quarter, subject to a maximum increase of 2.0% and subject to decrease in other circumstances. This is very positive news and renegotiation of this agreement has been central to our investment thesis.

Throughout the course of the year the Fund has increased its allocation to SafStor. This is the largest position in the Fund's wholly owned REIT, NFRO REIT Sub, LLC. SafStor owns, develops, and redevelops single and multi-story self-storage properties. The Company focuses on currently undersupplied markets that offer low delinquency rates, high population growth with above average household income, and greater barriers to entry. Property management is performed by reputable operators such as Extra Space Storage and CubeSmart. As of December 31, 2020, the Fund has invested in the development of 19 individual storage facilities. The weighted average yield on cost is 8.6% for all SafStor properties. Stabilized cap rates for similar properties average approximately 5.5%, reflecting the potential for SafStor properties to see significant increases in value once stabilized. Additionally, we expect appreciation of the storage portfolio once development is complete. Self Storage has widely been viewed as recession resistant due to strong relative performance in previous recessions. 2020 was no different as the asset class proved to a safe haven while self-storage total returns have outperformed most REIT sectors since the pandemic started to devastate financial markets in February 2020.

We continue to follow an investment approach centered around a diverse set of opportunities. To this end and in addition to its traditional core portfolios of leveraged loans, CLO debt, and special situations, the Fund has increased its allocations to Real Estate. At this point in the credit cycle, we believe it 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 positions the Fund to better weather bouts of market turbulence should they arise in the future.

As we begin a new year, we are cognizant that the virus will continue to dominate economic outlook. Newly placed restrictions across the globe and surging case counts will most likely bring negative growth in the first quarter. However, positive news on vaccine trials gives us some confidence that the economy can expand in the second and third quarters. Additional fiscal stimulus could also potentially boost growth mid-year. We are cautiously optimistic about returns in the credit markets. 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 flexible investment strategy will position it to positively traverse 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.

We thank you for your continued support and investment in the Fund.

Total Return Analysis (%) *As of 12/31/2020

	Incept.	YTD	1-YR	3-YR	5-YR	10-YR
HFRO NAV	1.13.00	0.13	0.13	1.41	4.22	5.05
HFRO Market Price		-8.29	-8.29	-5.68	0.31	3.06
CS Leveraged Loan		2.78	2.78	3.99	5.19	4.47

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 call 877-665-1287.

Disclosures

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.

Investors should consider the investment objectives, risks, charges and expenses of the Highland Income Fund carefully before investing. This and other information can be found in the Fund's prospectus, which may be obtained by calling 1-800-357-9167 or visiting www.highlandfunds.com. Please read the prospectus carefully before you invest.

The distribution may include a return of capital. Please refer to the 19(a)-1 Source of Distribution Notice on the Highland Funds website for Section 19 notices that provide estimated amounts and sources of the fund's distributions, which should not be relied upon for tax reporting purposes.

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.

An investment in the Fund is not appropriate for all investors, and the Fund cannot guarantee investors that it will achieve its investment objective. The Fund is designed for long-term investors who can accept the risks entailed by the Fund's investments, some of which may have reduced liquidity and high volatility. The Fund's share price will fluctuate with changes in the market value of the Fund's portfolio securities. Common stocks are subject to market, economic and business risks that cause their prices to fluctuate. The Fund is non-diversified and may invest a larger portion of its assets in the securities of fewer issuers than a more diversified fund. Please see the "Investment and Risk Information" section of the prospectus for more information.

Cap Rate. The capitalization rate (also known as cap rate) is used in the world of commercial real estate to indicate the rate of return that is expected to be generated on a real estate investment property. This measure is computed based on the net income which the property is expected to generate and is calculated by dividing net operating income by property asset value and is expressed as a percentage. It is used to estimate the investor's potential return on their investment in the real estate market. **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.** Senior 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, July 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 gross assets. Top holdings include long only positions.

30 Day SEC Yield: A standard yield calculation developed by the Securities and Exchange Commission (SEC) that

Disclosures

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 Highland Capital Management Fund Advisors, L.P

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