HIGHLAND CAPITAL MANAGEMENT

Q2 2020

INCOME FUND

MARKET REVIEW

PERFORMANCE REVIEW

The Highland Income Fund (the "Fund," ticker: HFRO) had a total market return of -2.96% but a NAV return of 1.68% during the second quarter of 2020. These compare to a gross return of 9.71% for the Credit Suisse Leveraged Loan Index. There were a handful of specific positions that underperformed expectations, and the hedge positions were a negative contributor as well. As you may recall, the Fund established a hedging program last year to insulate performance from a potential widening in credit spreads, and these positions were a significant source of positive contribution in the first quarter. Given the uncertain macroeconomic backdrop, the Fund maintained some of these hedge positions, which negatively impacted performance given the broad rally in risk assets experienced during the quarter. Year-to-date, it is important to note that the Fund is down 5.45% (on a NAV basis) versus the -4.76% gross return of the Credit Suisse Leveraged Loan Index.

The Fund's investment in Creek Pine Holdings continues to be a positive contributor. 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

TOTAL RETURN ANALYSIS (%)*

AS OF 6/30/2020

	Incept.	YTD	1-YR	3-YR	5-YR	10-YR
HFRO Market Price		-31.87	-36.55	-12.99	-5.95	0.45
HFRO NAV	11.06.17	-6.44	-6.90	0.15	2.30	4.77
CS Leveraged Loan		-4.76	-2.27	2.13	2.94	4.34

Returns shown are net of fees and expenses.

TOP HOLDINGS (% OF PORTFOLIO)[2]

Creek Pine Holdings, LLC	15.8%
NFRO REIT Sub, LLC	7.3%
NexPoint Real Estate Finance (NREF)	6.1%
Metro Goldwyn Mayer, Inc. (MGM)	3.0%
CCS Medical, Incx.	3.8%

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.

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." This is very positive news and renegotiation of this agreement has been central to our investment thesis.

Although a resolution to the pandemic remains uncertain, markets rallied strongly during the quarter on the back of unprecedented amounts of fiscal and monetary stimulus globally. Investors are obviously much more optimistic than they were during those dark days near the end of March, but the market's recovery has been quicker and stronger than even some of the most bullish prognostications. Much of this is attributable to the Fed's actions. Even though the Fed is often derided for being too slow to respond, it has acted quickly and decisively in this instance, and all signs would seem to indicate that it will remain extremely accommodative until the economy has returned to a solid footing and potentially for a period thereafter.

MARKET ENVIRONMENT[1]

Although loan prices have begun to plateau, they continued their end of March rally for much of the quarter. After bottoming near 76 on March 23rd, the average loan price in the S&P/LSTA Leveraged Loan Price Index began the second quarter at 82.9 and improved to almost 90 by the end. While there is still room for improvement to the pre-COVID levels in the upper-90s, credit and loan market conditions have vastly improved. Nonetheless, loan price dispersion remains elevated and reflective of the uncertain environment. The 3-year discount margin at 676 bps is wide to historical averages but is comparable to the current spread-to-worst for the high yield market at 664 bps (excluding the contribution of energy for both).

Loans outperformed high yield by a slight margin in the second quarter, returning 9.78% and 9.46%, respectively. As the market conditions continued to improve, the flight to quality theme of the first quarter began to reverse itself as investor optimism regained strength. This was evident in both asset classes but more so in loans, which saw split B/CCC-rated issuances provide a 13.86% return versus 11.46% and 6.59% for B and BB-rated loans, respectively. Nonetheless, loan investors remain selective about reaching for yield in the lower rated issuances (as evidenced by the elevated price dispersion), and this is likely to remain the case unless there is a clear resolution to the pandemic and/or retail inflows improve significantly, the latter of which is unlikely without the former. Loan outflows have begun to moderate after the extreme $13.4 billion witnessed in March, but they have persisted ($2.9 billion, $1.4 billion, and $0.6 billion in April, May, and June, respectively).

Loan issuance started to show signs of life in the quarter but remains down 25% year-to-date and pales in comparison to the record issuance experienced in the high yield market. We expect loan issuance to remain subdued for the remainder of the year given the current interest rate environment and the lack of M&A activity. Although equity arbs are still not particularly attractive for CLOs, issuance activity is beginning to reemerge but is still down 34% year-over-year. Not surprisingly, both loan and high yield default rates have continued to climb. June witnessed the 6th highest default volume on record, and 60 companies have defaulted during the first half of 2020 (totaling approximately $100 billion of loans and bonds). Loan default rates on a trailing 12-month basis have risen to 3.96% (up 258 bps year-over-year), the highest level in five years. Given the uncertain economic climate and the unevenness of the recovery, we expect loan and high yield default rates to continue climbing by a further 400 bps, to a range of 8-10% by year-end. Due to the higher exposure to consumer cyclical and energy issuers within the high yield market, default rates are likely to remain higher there versus the loan market.

OUTLOOK

Although we previously wrote how we did not expect a V-shaped recovery in the economy, employment gains and PMI data have certainly been better than feared. Some of this was likely due to the more rapid pace of reopenings in some states. Bolstered by the Fed's actions, the market has certainly embraced this data as evidence that the economy is quickly on pace to regain its former strength. That may very well be the case, but we remain a bit cautious at this stage given the spate of virus flare-ups that we are currently experiencing in some of the quicker to reopen states and the restrictions that are being put back in place as a result. Not to mention that we are in the midst of an election cycle that is unlikely to be a sure thing for the incumbent. All of this should give rise to increased uncertainty over the coming months.

Our sense is that the easy part of the recovery is now behind us and that the return to pre-COVID economic strength may be more difficult and lengthy than some anticipate. Even with an effective vaccine in place, COVID has caused fundamental changes to how we live and work, which are likely to persist for some time. When economies experience shifts such as this, there will always be winners and losers, and this instance is no different. Amazon may be doing great, but there are a lot of brick-and-mortar retailers and their employees not faring as well. We've already experienced a number of bankruptcies, and more are likely to come during the near-term. Other companies have been fortunate to access the credit markets to enhance liquidity and avoid a trip to the courthouse. However, with debt laden balance sheets, how eager are these companies going to be hiring people even after this pandemic has passed? This is not to say all is lost. Our economy can and will adapt to the post-COVID world (both good and bad), but it often takes time.

With this in mind, we continue to manage the portfolio conservatively. We have not increased leverage, and we have maintained some of the hedge protection that protected the Fund against the turbulence during the first quarter. As loan prices have rebounded, we have selectively reduced exposure to some higher Beta credits and have been cautious about additions to the portfolio. Although the average loan price remains is now in the low-90s, price dispersion has increased, with nearly 70% of the loan market now trading at 95 or better. Even though we have experienced some recent outperformance from lower-rated issuances, we expect investors to remain selective with the more discounted names, especially in the absence of more robust retail investor loan demand. Within the Fund's CLO allocation, we have taken advantage of the price reflation to exit some positions and to swap into higher quality tranches while attempting to minimize principal erosion. With proper underwriting diligence, we continue to believe that the CLO secondary space can offer attractive risk-adjusted return potential in this environment. There were not significant additions to the real estate portfolio during the second quarter, but we continue to proactively look for similar dislocated investment opportunities. We remain of the belief that the Fund's broader investment mandate and more active approach to management will help it better navigate this current uncertain investment 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. **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 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.

RISK CONSIDERATIONS, CON'T

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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