Highland Capital Management

# Q2 2020

# MERGER ARBITRAGE FUND

The Highland Merger Arbitrage Fund (the "Fund") (Class Z shares) returned 3.99% in the second quarter of 2020. In comparison, the Barclays Aggregate Bond Index returned 2.90%, the S&P Merger Arbitrage Index returned 2.71%, the HFRI Merger Arbitrage Index returned 5.38%, and the S&P 500 returned 20.54%. Year-to-date (through June 30, 2020), the Fund is up 3.35% and has now recovered from the -1.88% drawdown incurred in March.

What a difference a few months can make. After one of the sharpest selloffs in history (as measured by the CBOE Volatility Index also known as the VIX), global risk assets have rallied and the S&P 500 is now only down -3.09% year-to-date after being down as much as -30.43% as of market close on March 23rd. The rally has been driven by the re-opening of businesses following COVID-19 related lockdowns, fiscal and monetary stimulus, as well as optimism around the prospects for the development of a vaccine or treatment for COVID-19. Although optimism is running high, we would reiterate our commentary from last quarter that it remains to be seen how much economic activity can be recovered while keeping cases down to a level deemed acceptable. US quarterly GDP (SAAR) declined -5.0% in the first quarter of 2020 vs. the fourth quarter of 2019 and the impacts of the COVID-19 pandemic weren't even felt until late in the quarter. While there are many large, diverse corporations in the S&P 500 that may be well positioned to weather a pandemic such as this, we can't help but notice the toll the pandemic has been taking on small businesses. According to the June edition of the MetLife & U.S. Chamber of Commerce Small Business Coronavirus Impact Poll, ~20% of small businesses remain closed, with another 38% partially open. Moreover, 36% of small businesses believe they can only continue operations for 6 months or less before having to shut down permanently. While it is impossible to predict what the next 6 to 12 months will hold, we see risk that the economic damage being done at the local level could cause a chain reaction and eventually be felt by larger corporations, even those deemed to be relatively insulated from the effects of the pandemic. We would also point out that there is precedent for pandemic conditions to ease during summer months only to make a resurgence coinciding with flu season as was the case for the

## TOTAL RETURN ANALYSIS (%)*

| AS OF 06/30/2020 | YTD | 1-YR | 3-YR | Since Incept. |
|---|---|---|---|---|
| Class A | 3.22 | 7.71 | 5.16 | 6.59 |
| Class A (w/load) | -2.46 | 1.77 | 3.20 | 5.50 |
| Class C | 2.89 | 7.00 | 4.49 | 6.02 |
| Class C (w/load) | 1.89 | 6.00 | 4.49 | 6.02 |
| Class Z | 3.35 | 8.02 | 5.53 | 6.81 |
| Bloomberg Barclays Capital U.S. Aggregate Bond | 6.14 | 8.74 | 5.32 | 3.90 |

*Returns shown are net of fees and expenses, Fund inception date 1/20/2015*

## TOP 5 DEALS (TARGET/ACQUIRER)

| | |
|---|---|
| LogMeIn (LOGM) / Francisco Partners | 17.2 |
| IBERIABANK (IBKC) / Firt Horizon National (FHN) | 9.7 |
| Advanced Disposal Services (ADSW) / Waste Management (WM) | 8.1 |
| Portola Pharmaceuticals (PTLA) / Alexion Pharmaceuticals (ALXN) | 7.0 |
| Legg Mason (LM) / Franklin Resources (BEN) | 6.4 |

**FEES AND EXPENSES**
Gross: Class A: 5.32%, Class C: 5.91%, Class Z: 5.00%; Net: Class A: 4.46%, Class C: 5.14%, Class Z: 4.26%
Class A Max Sales Charge: 5.50%. Class C Contingent Deferred Sales Charge ("CDSC") is 1% within the first year from each purchase. 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 Cap will continue through at least October 31, 2020 and may not be terminated prior to this date without the action or consent of the Fund's Board of Trustees.

**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.**

Influenza Pandemic of 1918 which didn't peak until the fall of 1918. Additionally, the lead up into the US presidential election in November presents the potential for geopolitical volatility. So, while there are some reasons for cautious optimism, such as the initial results of several vaccines in development, we ultimately think that heightened uncertainty relative to prior years will continue to persist in the near future.

Not surprisingly, we have seen a sharp decline in monthly M&A activity, with a nadir in April of just over $5 billion of announced deals in our broad coverage universe, down -94% vs. April of 2019. We analyzed data compiled from Bloomberg back to the late 1990's and have never seen monthly M&A activity that low. Clearly, in the middle of a pandemic and economic lockdown businesses prioritize the stability of existing operations, while growth plans are largely put on hold. Moreover, the physical nature of a lockdown creates natural obstacles in the process of negotiating a merger, such as on-site due diligence. While monthly M&A activity is notoriously lumpy, we continue to anticipate that 2020 will most likely see meaningfully lower announced deal volume than 2019. That said, we do see signs of pent-up demand for M&A and believe there is opportunity for a fast recovery in deal volume as conditions normalize. For one, May and June M&A volumes each more than doubled sequentially (albeit off a low base) as economies reopened. Additionally, we would note that as Australia and New Zealand enjoyed low COVID-19 transmission during the quarter, the Asia Pacific region in June posted its strongest monthly deal flow since 2016, which is another encouraging sign that M&A could quickly rebound. We would emphasize that transaction volume is just one driver of returns; deal selection and deal spread are just as important as deal flow, if not more important. While available M&A volume remains limited, we think this is somewhat offset by attractive deal spreads. We would point to the Fund's performance in the second quarter, as well as in 2020 year-to-date, as testimony that positive returns can still be generated in a down market.

The Fund's 3.99% return in the second quarter outpaced the Barclays Aggregate Bond Index and the S&P Merger Arbitrage Index which returned 2.90% and 2.71%, respectively. However, the fund lagged the HFRI Merger Arbitrage Index and the S&P 500 which returned 5.38% and 20.54%, respectively. On a month-by-month basis the Fund returned 1.86%, 0.41%, and 1.67% in the months of April, May, and June, respectively.

Year-to-date the Fund has returned 3.35%, outpacing the S&P Merger Arbitrage Index which returned -1.62%, the HFRI Merger Arbitrage Index which returned -6.10%, and the S&P 500 which returned -3.09%. This fund has lagged the Barclays Aggregate Bond Index which has returned 6.14% year-to-date.

The biggest contributor to the Fund's performance in the second quarter was its position in Tallgrass Energy (TGE) which was acquired by Blackstone and contributed ~0.67% to returns in the second quarter. The fund also generated ~0.65% from its position in the specialty purpose acquisition company (SPAC) Landcadia Holdings II (LCA) which announced its planned merger with Golden Nugget Online Gaming in late June. The biggest detractor from performance was the Fund's position in Taubman Centers (TCO) which was being acquired by Simon Property Group (SPG). The position impacted performance by -0.21% in the quarter, although we did divest the position prior to SPG's motion to terminate the merger which is currently being litigated.

We would like to thank our shareholders for their continued support of the fund. We take our fiduciary responsibilities very seriously and continuously strive to provide our shareholders with high quality performance.

## RISK CONSIDERATIONS

**Please consider the investment objectives, risks, charges, and expenses of Highland Funds carefully before investing. A prospectus with this and other information about Highland's mutual funds can be found on the Literature tab of www.highlandfunds.com. You may also obtain a prospectus for our mutual funds by calling 877-665-1287. Pease read the prospectus carefully before investing. For performance data current to the most recent month-end, please visit our website at www.highlandfunds.com.**

Before investing in the Fund, you should carefully consider the Fund's investment objectives, risks, charges and expenses. For a copy of a prospectus or summary prospectus which contains this and other information, please visit our website at highlandfunds.com or call 1-877-665-1287. Please read the fund prospectus carefully before investing.

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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.

On May 12, 2016, the Predecessor Fund transferred its assets to the Fund in exchange for the Fund's Class Z shares. The investment policies, objectives, guidelines and restrictions of the Fund are in all material respects equivalent to those of the Predecessor Fund. In addition, the Predecessor Fund's portfolio manager is the current portfolio manager of the Fund. As a mutual fund registered under the 1940 Act, the Fund is subject to certain restrictions under the 1940 Act and the Internal Revenue Code of 1986, as amended (the "Code") to which the Predecessor Fund was not subject. Had the Predecessor Fund been registered under the 1940 Act and been subject to the provisions of the 1940 Act and the Code, its investment performance could have been adversely affected, but these restrictions are not expected to have a material effect on the Fund's investment program.

**Barclays US Aggregate Bond Index.** The Barclays US Aggregate Bond Index is a broad-based, unmanaged, market-weighted index that is comprised of investment grade, US dollar-denominated, fixed-rate taxable debt instruments. **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. **Leverage Risk.** Leverage may increase the risk of loss, cause fluctuations in the market value of the Fund's portfolio to have disproportionately large effects or cause the NAV of the Fund generally to decline faster than it would otherwise. **Micro, Small and Mid-Cap Securities Risk.** Investments in securities of companies with micro, small or medium capitalizations involve certain risks that may differ from, or be greater than, those for larger companies, such as higher volatility, lower trading volume, fewer business lines and lack of public information. Non-Diversification Risk. As a non-diversified fund, the Fund may invest a larger portion of its assets in the securities of one or a few issuers than a diversified fund. A non-diversified fund's investment in fewer issuers may result in the fund's shares being more sensitive to the economic results of those issuers. An investment in the Fund could fluctuate in value more than an investment in a diversified fund. **Non-U.S. Securities Risk.** Investments in securities of non-U.S. issuers involve certain risks not involved in domestic investments (for example, expropriation or political or economic instability). Short Sales Risk. The risk of short sales theoretically involves unlimited loss potential since the market price of securities sold short may continuously increase. **Hedging Risk.** Although intended to limit or reduce investment risk, hedging strategies may also limit or reduce the potential for profit. There is no assurance that hedging strategies will be successful.

All exposure and position size calculations based on percent of long market value. Long market value includes the notional value of swaps.

**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.

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.

Only eligible investors may purchase Class Z Shares. Please refer to the prospectus for information and conditions.

1. Source: Bloomberg
2. Source: Prequin
3. Source: Novus

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