Flaherty & Crumrine Incorporated

Market Update for Shareholders of Flaherty & Crumrine Preferred Income Fund (PFD), Flaherty & Crumrine Preferred Income Opportunity Fund (PFO)

The market values of preferred securities, along with most other fixed income securities, have been experiencing substantial declines as a result of the ongoing financial crisis. A number of financial institutions have required government support recently; others have succumbed to takeovers by financially stronger entities; and at least one has filed for bankruptcy protection. As each problem firm is addressed, the market immediately turns to the next potential victim—driving down the value of that company's preferred and common shares.

By Wednesday of last week, indices that track the preferred market were down in value by more than 30% since August 31, 2008.[1] The market declined by as much as 20% in just the first three days of the week. The market was able to recover towards the end of the week after the Treasury announced plans to support financial companies. Nonetheless, these indices were still down more than 15% for the month through Friday.

The changes in market values have been severe in both directions and the pace at which conditions have changed has been rapid. The plan currently being proposed by the Treasury, which must be negotiated and approved by Congress, would certainly provide much needed support for the value of securities issued by financial companies. At this point it is unclear, however, how this plan will evolve in the coming days or weeks.

The Funds – which invest in preferred securities – have largely sidestepped the problems with Fannie Mae, Freddie Mac, and Lehman Brothers Holdings, although not completely. The exposure to Fannie Mae and Freddie Mac was 0.4%, 0.3% (PFD, PFO, respectively) on the valuation date before they went into conservatorship, and exposure to Lehman Brothers Holdings was 0.5%, 0.6%, respectively, on the valuation date before it went into bankruptcy. The Funds did not have any exposure to AIG. A more detailed list of holdings by issuer is available at www.preferredincome.com.

Even though these specific problems did not have a material impact on the Funds' portfolios, almost all preferred securities we hold are sharply down in value in the last several weeks as evidenced by the decline in the Funds' net asset values. The Funds continue to have substantial exposure to the financial sector via holdings of banks, financial services companies, and insurance companies. While we do not anticipate bankruptcies for any of our remaining holdings, ongoing uncertainties surrounding financial companies could negatively impact the Funds' holdings further.

The Funds are subject to several different asset coverage requirements that arise from the use of leverage in the Funds. Monitoring asset coverage is always part of the ongoing management of the Funds, and generally the Funds have a comfortable cushion above the asset coverage limits. The net asset values of the Funds have been declining for some time now as the market for preferred securities has weakened, which has reduced the cushion above the required asset coverage limits. As market values declined and the Funds began to approach asset coverage limits, the Funds adjusted their holdings (certain assets receive better asset coverage treatment than others) and sold assets to raise cash.

Proceeds from asset sales may be invested in higher quality, lower yielding securities or held in cash, or in some cases used to reduce leverage, to restore the required level of asset coverage. As market values decline, however, additional sales may be needed. If asset values move higher, the asset coverage will improve and additional asset sales will not be required. As of September 19, 2008, the leverage ratio was 50.1% for PFD and 49.6% for PFO (as compared to 40.5% and 40.3%, respectively, as of May 31, 2008).

Whether the steps we have taken to meet asset coverage requirements will have a material impact on the common stock dividend is unclear at this point, but any reductions in leverage balance to meet asset coverage requirements will likely reduce total income available to common stock shareholders. The amount of any reduction in the common stock dividend will be determined by the depth and length of the current decline in asset values, which cannot be predicted. We will continue to monitor the impact of the recent events as it affects the dividends to be paid.

While market conditions have resulted in actions recently to meet asset coverage requirements, the approach to managing the Funds and the investment objective has not changed. To achieve each Fund's primary objective of high current income, the Funds continue to invest in preferred and debt securities, with a strong focus on the credit quality of each issuer. The decline in value in the preferred market has been unprecedented, and appears to be driven mostly by fear and illiquidity, rather than credit fundamentals. We continue to see tremendous long-term value in the preferred market, but the path to recovery could be long and bumpy.

Flaherty & Crumrine Incorporated
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[1] Merrill Lynch publishes several indices which track the preferred securities market: the Merrill Lynch 8% Capped DRD Preferred Stock Index℠ which includes investment grade preferred securities issued by both corporations and government agencies that qualify for the corporate dividends received deduction with issuer concentration capped at a maximum of 8%; the Merrill Lynch 8% Capped Hybrid Preferred Securities Index℠ which includes taxable, fixed-rate, U.S. dollar denominated investment-grade, preferred securities listed on a U.S. exchange with issuer concentration capped at a maximum of 8%; and the Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index℠ which includes adjustable rate preferred securities issued by US corporations and government agencies with issuer concentration capped at a maximum of 7%. All index returns include interest and dividend income and, unlike the Funds' returns on net asset value, are unmanaged and do not reflect any expenses.

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