

FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Fund:

The Fund is off to a strong start in the new fiscal year. During the three month period ending February 29th, total return¹ on net asset value of the Fund was +11.0%. Total return based on market price of Fund shares for the period was +17.1%. A portion of the Fund's NAV return in the quarter was recovery from the prior two quarters when total return was -4.8%. To provide context for return during the period, the comparable measure on the S&P 500 was +10.1%, and +2.0% for the Barclays Capital U.S. Aggregate Index.

A number of factors contributed to the strong performance. U.S. investor confidence turned positive after several months of decline. The labor picture is improving, corporate earnings have been rising, and the housing market is finally picking up. Europe appears to have stepped back from the precipice of economic disaster, as policy makers have flooded the continent with liquidity. Interest rates around the globe hover near historically low levels and are not expected to rise substantially anytime soon. All of this has stimulated demand for high-yielding assets, especially preferred securities.

Returns of this magnitude are rare, even in periods of above-average market volatility such as we've experienced over the past several years. And while we enjoy double digit quarterly returns as much as the next shareholder, we know it is unlikely to be replicated.

With spring training in full swing it is hard to resist dusting off some baseball analogies. Your Fund is like a part of the lineup built to get singles and doubles and lead the league in on-base percentage. Other investments are intended to hit home runs, and we trust shareholders will determine if these also belong on their team. We've tortured you with this to make a point — investors shouldn't expect this type of quarterly Fund performance to be repeated.

Again, for several quarters we have seen signs of improvement in the U.S. economy, though the pace of growth has been well short of robust. The sovereign debt crisis in Europe appears to be moderating, although economic risks remain elevated in that region. Neither area is out of the woods and recovery could be easily derailed, but we believe the worst is behind us. Our Quarterly Economic Outlook can be viewed on the Fund's website.

We expect new bank capital guidelines to be issued by the Federal Reserve very soon. Patient readers will recall we have said this before, and eventually we will be right! With the new rules set to go into effect in January 2013, time is running out for the regulators. The new guidelines, when issued, will provide the final pieces of the regulatory capital overhaul which grew out of the financial crisis. We've known for some time that most forms of trust preferred and hybrid preferred securities will eventually no longer count towards regulatory capital requirements. We're waiting to learn what can be used instead.

Even without clear guidelines from regulators, a handful of banks recently have issued new preferred stock with terms *expected* to conform to the new rules. These securities are all *perpetual, non-cumulative preferred stock*. This is the basic form of capital we believe will ultimately replace much of the bank preferred capital currently outstanding.

We don't think the transition will be immediate; nor is it likely that all of the older "non-qualifying" capital will be replaced with newer "good" Tier 1 capital. We have tried to anticipate the shift and stay ahead of the pack by selling some securities which may be called in the near term and reinvesting in suitable replacements. This type of proactive management has always been part of our investment approach.

¹ Following the methodology required by the SEC, total return assumes dividend reinvestment and includes income and principal change, plus the impact of the Fund's leverage and expenses.

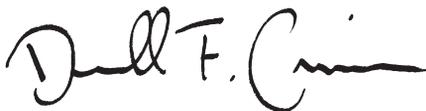
Another fundamental part of our investment process is the hard work of credit analysis. The experience of the past few years has reinforced our commitment to rely on our own independent and objective research focused on the preferred level of the capital structure. The national rating agencies (Moody's, S&P, and Fitch) often seem to shoot where the rabbit was, especially when it comes to preferred securities.

Although we sometimes disagree with the agencies on their overall ratings of specific credits, we often disagree with their ratings on preferred securities. This divergence typically results from agencies' mechanical "notching" of preferred securities down from a company's senior debt rating. In simplified terms, notching is the formulaic lowering of a security's rating by a predetermined number of rating categories simply based on where it fits in a company's capital structure. In our view, this methodology is arbitrary.

Our approach is to study every *issuer* to understand its business and financial condition, and every *issue* to understand its terms and conditions. Because we are investing in subordinated securities, it is essential that we understand the precise terms, many of which can be buried deep in the legal terms of the issue. With this knowledge we are better equipped to understand the full scope of risk associated with a specific security, and only then can we start to address questions of valuation.

As always, we encourage you to visit the Fund's website www.preferredincome.com for a more in-depth discussion of conditions in both preferred markets and the broader economy.

Sincerely,



Donald F. Crumrine
Chairman

April 16, 2012



Robert M. Ettinger
President