

## FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Fund:

Total return on net asset value<sup>1</sup> was +2.1% during the second fiscal quarter of 2012<sup>2</sup>. In combination with strong performance in the prior quarter, total return for the first half of fiscal 2012 was +13.3%. The following table highlights investment performance of the Fund along with other performance measures of interest to investors.

### TOTAL RETURN ON NET ASSET VALUE FOR PERIODS ENDED MAY 31, 2012

	Actual Returns			Average Annualized Returns			
	Three Months	Six Months	One Year	Three Years	Five Years	Ten Years	Life of Fund <sup>(1)</sup>
<b>Flaherty &amp; Crumrine Preferred Income Fund</b> .....	2.1%	13.3%	7.9%	31.0%	5.4%	7.3%	9.8%
Barclays Capital U.S. Aggregate Index <sup>(2)</sup> . . .	1.5%	3.5%	7.1%	7.1%	6.7%	5.7%	6.9%
S&P 500 Index <sup>(3)</sup> .....	-3.5%	6.2%	-0.4%	14.9%	-0.9%	4.1%	8.7%

(1) Since inception on January 31, 1991.

(2) The Barclays Capital U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. It is generally considered to be representative of the domestic, investment-grade, fixed-rate, taxable bond market. Unless otherwise noted, index returns reflect the reinvestment of dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. This index was formerly known as the Lehman Brothers U.S. Aggregate Index.

(3) The S&P 500 is a capitalization-weighted index of 500 common stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

*Current performance may be lower or higher than the quoted past performance, which cannot guarantee future results. In addition, NAV performance will vary from market price performance, and you may have a taxable gain or loss when you sell your shares.*

Total return based on market price of Fund shares during the second quarter was -9.2% as the premium over NAV declined sharply. For the six-month period total return on market price was +6.4%. We know price changes in Fund shares are important, but we encourage shareholders with a long-term investment horizon to focus more on net asset value performance.

Conditions in the preferred market remain positive as evidenced by strong demand for several new issues. In one of the most active periods in recent memory, more than \$15 billion of new preferred capital has been raised since early March. A portion of the proceeds was used to redeem older, more expensive issues, so some investors are scrambling to replace lost income; beyond reinvesting, investors have increasingly turned to preferred securities as many competing investments offer lower yields and often greater volatility.

<sup>1</sup> 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.

<sup>2</sup> March 1, 2012 through May 31, 2012.

Economic conditions in the U.S. have softened recently, but we continue to expect moderate growth. We are more concerned about developments in Europe, although we still expect the European Monetary Union to muddle through what is likely to be a prolonged crisis. No one doubted the path to global recovery would be bumpy, but the potholes seem bigger and more numerous than expected.

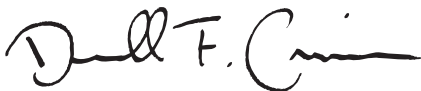
On June 7<sup>th</sup>, after much delay, the Federal Reserve proposed detailed new bank capital requirements as mandated by the 2010 Dodd-Frank Act. The proposed rules are intended to ensure banks maintain strong capital and are thus able to continue lending during severe economic downturns. Among many other effects, the new rules should gradually cause a shift in the type of preferred securities issued by banks and certain finance companies from trust preferred securities to traditional preferred stock. Under current market conditions, this shift is likely to put downward pressure on the Fund's investment income. We encourage you to read a more detailed discussion in the section below.

In April, shareholders approved changes to rules regarding the Fund's investments in certain industries. In the weeks since, we have shifted a portion of the investment portfolio out of utilities and into financials. The move is more fine-tuning than a major strategic change, but we believe it will serve the Fund well as we go forward.

From time to time we are asked why we do or do not own a particular security; recently there have been a few questions about the Fund's exposure to European credits. As set forth in one of the discussion topics that follow, we believe the risks presented by these positions are manageable and consistent with the risk-tolerance of the Fund. As a reminder, the essence of our work is to study risk and assess value. We have no aversion to risk but we despise surprises. Our team is a skeptical bunch and we spend a lot of time thinking about what can go wrong. With an in-depth understanding of each credit and individual security we can evaluate price relative to risks and assemble a portfolio to meet the Fund's objective of high current income consistent with preservation of capital.


These topics and others are discussed in greater detail in the following discussion topics. As always, we encourage you to visit the Fund's website [www.preferredincome.com](http://www.preferredincome.com) for a more in-depth discussion of conditions in both preferred markets and the broader economy.

Sincerely,



Donald F. Crumrine  
Chairman

June 29, 2012



Robert M. Ettinger  
President

## DISCUSSION TOPICS

### The Fund's Portfolio Results and Components of Total Return on NAV

The table below reflects performance over the recent six months of each element comprising total return for the Fund, namely: (a) investing in a portfolio of securities; (b) possibly hedging that portfolio of securities against significant increases in long-term interest rates, although no interest rate hedge was in place during this period; and (c) utilizing leverage to enhance returns to shareholders. Next, we compute the impact of the Fund's operating expenses. All of the parts are summed to determine total return on NAV.

#### Components of PFD's Total Return on NAV for the Six Months Ended May 31, 2012

	<i>Six Months*</i>
Total Return on Unleveraged Securities Portfolio (including principal change and income) . . . . .	+9.7%
Return from Interest Rate Hedging Strategy . . . . .	N/A
Impact of Leverage (including leverage expense) . . . . .	+4.3%
Expenses (excluding leverage expense) . . . . .	-0.7%
	<i>Total Return on NAV</i> <b>+13.3%</b>

\* Actual, not annualized.

For comparison, the following table displays returns over the same time period on four indices compiled by Bank of America Merrill Lynch, reflecting various segments of the preferred market. In addition, we have included a composite of these four indices weighted by the size of each segment. In our view, this composite represents a broad measure of the entire preferred market. Because the index returns exclude all expenses and the impact of leverage, they compare most directly to the top line in the Fund's performance table.

#### Total Returns of Bank of America Merrill Lynch Preferred Securities Indices\* for the Six Months Ended May 31, 2012

	<i>Six Months</i>
BofA Merrill Lynch 8% Capped DRD Preferred Stock Index <sup>SM</sup> . . . . .	+6.5%
BofA Merrill Lynch 8% Capped Hybrid Preferred Securities Index <sup>SM</sup> . . . . .	+7.3%
BofA Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index <sup>SM</sup> . . . . .	+8.5%
BofA Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index <sup>SM</sup> . . . . .	+11.2%
Composite Preferred Market Benchmark Index . . . . .	+7.9%

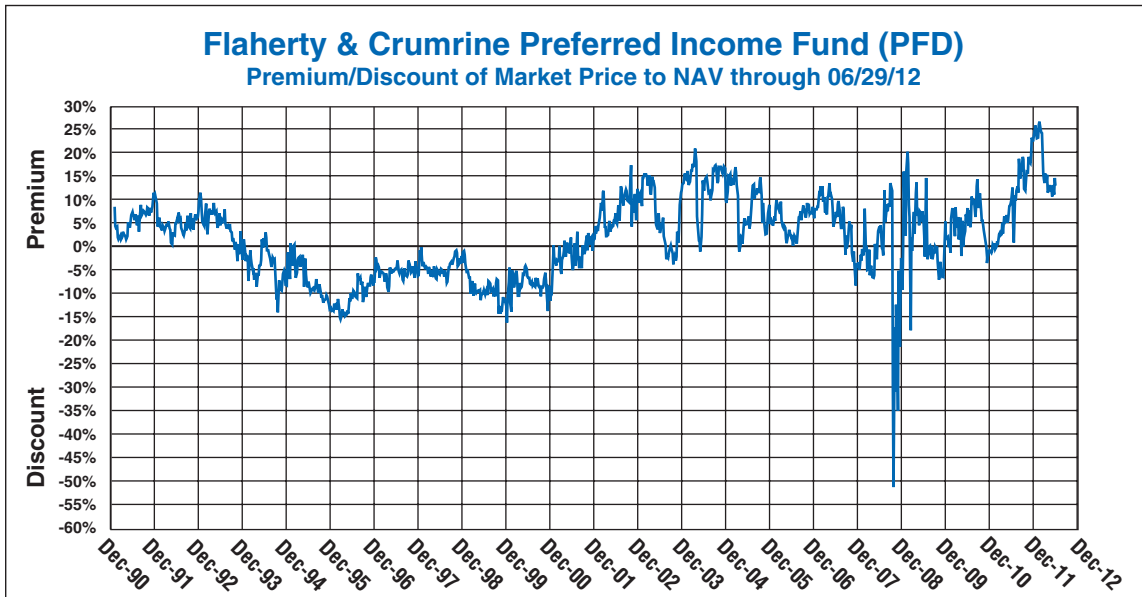
\* The Bank of America Merrill Lynch 8% Capped DRD Preferred Stock Index<sup>SM</sup> (P8D0) includes investment grade preferred securities issued by both corporations and government agencies that qualify for the corporate dividend received deduction with issuer concentration capped at a maximum of 8%. The Bank of America Merrill Lynch 8% Capped Hybrid Preferred Securities Index<sup>SM</sup> (P8HO) includes taxable, fixed-rate, U.S. dollar-denominated investment-grade, preferred securities listed on a U.S. exchange with issuer concentration capped at 8%. The Bank of America Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index<sup>SM</sup> (C8CT) includes investment grade fixed rate or fixed-to-floating rate \$1,000 par securities that receive some degree of equity credit from the rating agencies or their regulators with issuer concentration capped at a maximum of 8%. The Bank of America Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index<sup>SM</sup> (P0AC) includes adjustable rate preferred securities issued by U.S. corporations and government agencies with issuer concentration capped at a maximum of 7%. The Composite Preferred Market Benchmark Index is calculated by Bank of America Merrill Lynch and weights the above four indices according to each index's daily market value. All index returns include interest and dividend income, and, unlike the Fund's returns, are unmanaged and do not reflect any expenses.

Although total return on the Fund's unleveraged securities portfolio performed very satisfactorily compared with the Bank of America Merrill Lynch preferred indices, its NAV net of the impact of expenses and leverage (the bottom line on the Fund performance table) performed even better over the period.

### Total Return on Market Price of Fund Shares

While our focus is primarily on managing the Fund's investment portfolio, our shareholders' actual return is comprised of the Fund's monthly dividend payments *plus* changes in its *market price*. During the six-month period ending May 31, 2012, total return on market price of Fund shares was +6.4%.

In a perfect world, market price of Fund shares would closely track the Fund's net asset value. As can be seen from the graph below, over the life of the Fund this often has not been the case. We can only speculate about why the relationship between market price and NAV isn't stronger.



As preferred market participants we tend to focus primarily on staid fixed-income markets; we are less impacted by the vicissitudes of equity markets. It is clear, however, the price of Fund shares can move dramatically when there is volatility in stock prices.

Based on a closing price of \$14.20 on June 29<sup>th</sup>, the current annualized yield on market price of Fund shares (assuming the current monthly distribution of \$0.093 does not change) is 7.86%. In our opinion, this distribution rate measures up favorably with most comparable investment opportunities.

### Preferred Market Conditions

Conditions in the market for preferred securities are mostly positive, benefitting from ongoing improvement in credit quality and favorable technical factors. At the same time, all investors must battle the headwinds of slow economic growth in the U.S. and the European economic crisis. At present, there are two notable trends which for a long time to come will have a marked impact on the universe of preferred securities.

The first trend, *refinancing*, has been in motion for several years. Numerous issuers have taken advantage of the current low interest-rate environment to redeem outstanding preferred securities, replacing them with less expensive new issues. Of course, for investors the impact is a decline in investment income.

The decision by an issuer to refinance a callable security is straightforward—the company compares the all-in cost of a new issue to the cost of outstanding issues, and, if the savings are sufficient, redeems and refunds the outstanding securities. Recently, the threshold for savings appears to have fallen as issuers scramble to reduce borrowing costs wherever possible. In the past, as a general rule, issuers would refinance when the coupon-rate difference was 1% or more. For some issuers, the required margin has dropped in half. We estimate over the past year, \$13 billion of U.S. bank preferred securities with a weighted average coupon of 7.16% have been replaced with a weighted average coupon of 6.37%.

The second important trend, *par redemptions of bank trust preferred securities*, has been anticipated since the Dodd-Frank Act was passed in 2010, but has picked up momentum recently. The legislation required the Federal Reserve to issue new guidelines for bank capital requirements, defining both acceptable structures and minimum amounts (discussed further below). The release of these proposed rules on June 7<sup>th</sup> triggered a special provision written into many trust preferred securities allowing the issuer to redeem the security at par. (Absent this provision, many of these issues could not be called for several years.)

Since the release, 10 issuers have redeemed or announced redemptions of over \$24 billion of trust preferred securities. Very little of the redeemed issues have been replaced with new securities. As a result, investors are scrambling to find suitable reinvestment opportunities. Banks have roughly \$67 billion remaining in trust preferred securities and we expect much of this to be redeemed between now and early January.

Over time, we expect banks to replace most outstanding trust preferred securities with traditional preferred stock. However, the substitution of preferred stock for trust preferred will be neither dollar-for-dollar nor simultaneous. While some banks may replace called trust preferred quickly, many banks are shrinking their balance sheets and have plenty of common equity capital. Those banks may take their time to issue new preferred stock. This may create some dislocations in the preferred market, and it certainly will make reinvesting proceeds from called securities challenging.

Beyond those longer-term trends, market participants are assessing events unfolding in Europe. Preferred securities issued by European companies, primarily banks and insurance companies, exceed \$97 billion. As discussed as a separate topic below, the European financial crisis, which began in sovereign debt markets, has now spread to all markets and has precipitated a recession across most of the continent. Investors concerned about the impact on credit quality have either taken their money out of the region or moved into the highest quality issuers. While we expect Europe to muddle through and hold together as a monetary union, it is likely to be a prolonged crisis that will inject volatility into preferred securities' returns.

### **Analysis of Proposed Bank Capital Guidelines**

On June 7, 2012, the Federal Reserve released its long-awaited proposed rules on bank capital requirements and calculating risk-weighted assets. Although these proposals are not yet final—that will happen after a public comment period and final vote by regulators—they answer many questions investors in preferred securities have been asking since the passage of Dodd-Frank nearly two years ago.

First, if the proposed rules are adopted, banks will be allowed to count non-cumulative perpetual preferred stock as Tier 1 capital. Income from this traditional preferred stock qualifies for the inter-corporate

dividends received deduction (DRD) for corporations and is qualified dividend income to individuals. In addition, most trust preferred securities will begin losing Tier 1 capital treatment in 2013, with full phase-out in 2016. Trust preferred securities that no longer qualify as Tier 1 capital generally will continue to count as Tier 2 capital without limit.

Second, banks will be required to hold substantially more common equity capital under the new capital rules, which closely follow the Basel 3 framework we have discussed in the past. When fully phased-in, the new rules will require *at least* 9.5% common equity to risk-weighted assets for a large bank to avoid restrictions on dividend and bonus payments. This compares to the current regulatory minimum of just 2.5% common equity (although common equity capital at most banks is well above that minimum requirement). In addition, there are more deductions from the regulatory definition of common equity for certain forms of capital, which will further increase the amount of common equity capital that banks will need to hold.

Finally, although the proposed rules on risk-weighted assets are quite complex, they generally increase the risk weights applied to assets on bank balance sheets. This means that both the numerator (capital requirement) and denominator (risk-weighted assets) for bank capital calculations will increase. When the dust settles, we expect that large banks will carry roughly double the amount of common-equity capital than they did prior to the financial crisis for a given set of risky assets, adding substantially to the capital cushion beneath preferred securities. From a credit standpoint, however, the new rules are good news for investors in preferred securities and ensure that present healthy levels of bank capital only get healthier.

### **Risks Related to European Financial Crisis**

Conditions in the Eurozone have deteriorated over the past several months as markets have again begun to question leaders' resolve in solving the sovereign debt crisis. The root of the problem is that Europe's desire for expansive (and expensive) government services is at odds with many member countries' ability to afford them. Economic reality eventually will win out, but populist policies may delay reforms and increase economic risk in Europe and elsewhere. Most European economies are now in recession, and market sentiment has weakened considerably. Fiscal austerity will keep peripheral countries (Greece, Ireland, Italy, Portugal, and Spain) in moderate to severe recessions through the balance of 2012 and into 2013.

Longer-term growth in Europe will depend upon both budget discipline (to defuse the sovereign debt crisis) and structural reforms (to raise potential growth, reduce unemployment, and increase the tax base). Although they have more work to do, the peripheral countries have made significant—and painful—progress toward those goals.

Importantly, European policy makers have made stability of the banking system a clear priority. Banks are being required to meet stricter capital requirements by the end of June, and virtually all major European banks are in compliance with those requirements. The mostly smaller banks that are unable to meet capital requirements will receive state aid. The European Central Bank has provided ample liquidity to European banks, including roughly €1 trillion of 3-year term loans—with the possibility of more if banks need it. These steps have helped stabilize the banking system, which has helped European preferred securities' prices. Deposit flight from the periphery to core EMU banks remains a risk, however, as permanent firewalls have yet to be erected to contain it.

Despite worsening of the crisis in recent months, we think Europe will muddle through and stay together as a currency union. Faced with walking off a cliff or taking a responsible (albeit difficult) path, we think political leaders will choose responsibly. The Fund's investments in European preferreds earn attractive

yields and are concentrated in what we believe are the strongest issuers in the region. We recognize, however, that the politics and economics in Europe are difficult to read, and we expect continued volatility ahead.

### **Monthly Distributions to Fund Shareholders**

The Fund makes monthly distributions of income to shareholders consistent with its primary objective of providing high current income. The Fund earns its income by investing its assets in income-producing securities and by employing leverage to borrow additional money and invest the proceeds in more income-producing securities.

As we have mentioned in recent communications, conditions have been nearly ideal in the last couple of years for the Fund's income strategy, and shareholders have benefited in the form of high current income.

The use of leverage continues to be very positive for both income and total return. Given the sluggish economic picture and outlook from the Federal Reserve, it does not appear that short-term interest rates are headed higher in the near term. Of course, that could change and it is important for shareholders to understand that the Fund has not hedged any of this exposure and higher short-term interest rates would have a negative impact on income available for distribution.

As discussed in a separate topic above, the Federal Reserve has proposed new bank capital rules, providing issuers an opportunity to redeem bank trust preferred securities ahead of their normal call schedule. Several have already done so, and we expect this trend to continue as banks have the opportunity to redeem securities with relatively high coupons in an environment where they are struggling to produce income of their own.

While we intentionally stayed ahead of redemptions in many instances, the Fund does have holdings in bank trust preferred securities that will be redeemed in the near future (approximately 13.6% of its total net assets as of May 31, 2012) and which have a weighted average current yield of approximately 7.93% as of May 31, 2012. Those proceeds will have to be reinvested at lower rates on average—how much lower will depend on a number of factors. New issue preferred securities in the last couple of months have been coming at yields in the range of 5.75-6.70%. We have also found a number of opportunities to reinvest in the secondary market at rates in the range of 7.00-8.00%—much closer to the coupons we will lose on bank trust preferred securities (which range from 6.75-8.25%).

All these factors will take time to develop, so we do not expect any immediate changes to the Fund's distribution rate. However we are realistic that the Fund is not immune to the pressures that exist in an environment where the 10-year U.S. Treasury security is yielding 1.60%. While the distribution rate may be lower at some point in the future, we believe preferred securities offer attractive total return potential and the Fund will continue to offer a competitive distribution rate.

### **Changes to Fund Industry Concentration Policy**

On April 19<sup>th</sup>, the Fund's shareholders approved a change in its concentration policy so that it will invest at least 25% of its total assets in the financials sector under normal market conditions. Formerly, the Fund invested at least 25% of its total assets in the utilities industry under normal market conditions and at least 25% of its total assets in the banking industry. The change was recommended because utility issues now comprise a much smaller part of the preferred universe, and financials a much larger part, and the old rules could start to pinch if this trend continues (as we expect).

The new concentration policy requires the Fund to invest, under normal market conditions, at least 25% of its total assets in the financials sector, which for this purpose is comprised of the bank, thrifts & mortgage

finance, diversified financial services, finance, consumer finance, capital markets, asset management & custody, investment banking & brokerage, insurance, insurance brokers and real estate investment trust (REIT) industries. From time to time, the Fund may have 25% or more of its total assets invested in any one of these industries.

The Fund now has flexibility to go above or below 25% in any one type of company in the financials sector as long as at least 25% of its total assets is invested in the financials sector in aggregate. For example, the Fund could have more than 25% of its total assets in insurance companies, while at other times it could have that portion invested in banks. At all times, though, the Fund would have at least 25% of its total assets invested in the financials sector.

***The following describes risks associated with investing in the financials sector. As noted above, the Fund already is subject to these risks because of its current large position in preferred securities of various types of financial services companies.***

Because the Fund will invest at least 25% of its total assets in the financials sector, it will be more susceptible to adverse economic or regulatory occurrences affecting this sector, such as changes in interest rates, loan concentration and competition. To the extent that the Fund invests 25% or more of its total assets in any of the industries that comprise the financials sector, it may be more exposed to the particular risks associated with that industry.

U.S. and foreign laws and regulations require banks and bank holding companies to maintain minimum levels of capital and liquidity and to establish loan loss reserves. A bank's failure to maintain specified capital ratios may trigger dividend restrictions, suspensions on payments on subordinated debt and preferred securities, and limitations on growth. Bank regulators have broad authority in these instances and can ultimately impose sanctions, such as imposing resolution authority, conservatorship or receivership, on such non-complying banks even when these banks continue to be solvent, thereby possibly resulting in the elimination of stockholders' equity. Unless a bank holding company has subsidiaries other than banks that generate substantial revenues, the holding company's cash flow and ability to declare dividends may be impaired severely by restrictions on the ability of its bank subsidiaries to declare dividends or ultimately to redeem its securities (as they mature).

Similarly, U.S. and foreign laws and regulations require insurance companies to maintain minimum levels of capital and liquidity. An insurance company's failure to maintain these capital ratios may also trigger dividend restrictions, suspensions on payments of subordinated debt, and limitations on growth. Insurance regulators (at the state-level in the United States) have broad authority in these instances and can ultimately impose sanctions, including conservatorship or receivership, on such non-complying insurance companies even when these companies continue to be solvent, thereby possibly resulting in the elimination of shareholders' equity. In addition, insurance regulators have extensive authority in some categories of insurance of approving premium levels and setting required levels of underwriting.

Companies engaged in stock brokerage, commodity brokerage, investment banking, investment management or related investment advisory services are closely tied economically to the securities and commodities markets and can suffer during a decline in either market. These companies also are subject to the regulatory environment and changes in regulations, pricing pressure, availability of funds to borrow and interest rates.

Investments in real estate investment trusts ("REITs") expose the Fund to risks similar to investing directly in real estate. The value of these underlying investments may be affected by changes in the value of underlying real estate, the quality of property management, the creditworthiness of the issuer of the



investments, and changes in property taxes, interest rates and real estate regulatory environment. Investments in REITs are also affected by general economic conditions.

Governmental fiscal and monetary policies and general economic and political conditions can affect availability and cost of funds to companies in the financials sector, loan demand and asset quality and thereby impact the earnings and financial condition of those companies. In addition, enactment of new legislation and regulation, as well as changes in interpretation and enforcement of existing laws and regulations, may directly affect the manner of operations and profitability of participants in the financials sector. Downturns in a national, regional or local economy or in the general business cycle or depressed conditions in an industry, for example, may adversely affect the quality or volume of a bank's loan portfolio or an insurance company's investment portfolio, particularly if the portfolio is concentrated in the affected region, industry or market sector. From time to time, general economic conditions have adversely affected financial institutions' energy, agricultural, commercial and/or residential real estate, less-developed country, venture capital, technology, telecommunications, and highly-leveraged loan portfolios.

Since September 2008, the financials sector experienced unprecedented turbulence. The U.S. economy's recession, led by the downturn in the housing industry, adversely affected the quality of most financial services companies' loan and securities portfolios. In response, U.S. and foreign governments and rating agencies are requiring banks to maintain higher quality and levels of capital.