

## FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Fund (“PFD”):

The Fund turned in another strong quarter as preferred securities continued to benefit from a global search for yield, a benign economic backdrop, and favorable market technicals. Total return<sup>1</sup> on net asset value (“NAV”) was 4.9% for the fiscal quarter<sup>2</sup> and 12.2% for the first half of the fiscal year. Total return on market price of Fund shares over the same periods was 7.0% and 18.8%, respectively.

The table below shows Fund returns over various measurement periods, and they continue to be very strong. The table includes performance of two indices, Bloomberg Barclays U.S. Aggregate and S&P 500, as proxies for bond and stock markets, respectively. While neither is a benchmark for Fund performance, they provide context for returns on broad asset categories.

### TOTAL RETURN ON NET ASSET VALUE FOR PERIODS ENDED MAY 31, 2017

	Actual Returns			Average Annualized Returns			
	Three Months	Six Months	One Year	Three Years	Five Years	Ten Years	Life of Fund <sup>(1)</sup>
Flaherty & Crumrine Preferred Income Fund .....	4.9%	12.2%	14.0%	9.1%	11.5%	8.4%	10.1%
Bloomberg Barclays U.S. Aggregate Index <sup>(2)</sup> .....	1.5%	2.5%	1.6%	2.5%	2.2%	4.5%	6.0%
S&P 500 Index <sup>(3)</sup> .....	2.6%	10.8%	17.5%	10.1%	15.4%	6.9%	9.9%

(1) Since inception on January 31, 1991.

(2) The Bloomberg Barclays U.S. Aggregate Index is an unmanaged index considered representative of the U.S. investment grade, fixed-rate bond market.

(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.*

Flows into bond and stock markets have been impressive in 2017, and this demand coupled with limited supply continued to push prices higher. As has been widely reported, stock-market volatility has reached near-record lows. Combined with low interest rates, this environment has been very supportive of risk assets.

One of the best-performing segments of the portfolio has been fixed-to-float securities that trade at a discount to par value and are nearing (or have entered) their floating rate period. For much of 2016, this segment lagged the broader market as investors were concerned about interest rates remaining low forever. However, rate hikes by the Federal Reserve both flattened the yield curve and raised prospects for further monetary tightening, narrowing the current and expected yield gap between floating-rate and fixed-rate

<sup>1</sup> Following the methodology required by the Securities and Exchange Commission, total return assumes dividend reinvestment.

<sup>2</sup> March 1, 2017—May 31, 2017

preferreds. Rather than a floating-rate security with a very low coupon, investors are hopeful these will now produce reasonable income with low duration—and this could lead to prices migrating back toward par value. Securities that were trading around 75% of par value are now up to the low 90% range, with many nearing par value. As of May 31, 2017, the Fund had approximately 67% in fixed-to-float securities—although there is a broad mix of dates when coupons begin to float.

It is difficult to identify laggards in the portfolio over this period as most securities turned in positive performances—but of course some did better than others. Securities with higher fixed-rate coupons and shortening call protection produced great levels of income for many years. However, given prices well above par value, it simply wasn't possible in the current interest-rate environment for their total returns to keep pace with the discount securities mentioned above.

As a reminder, there is a direct inverse relationship in fixed-income securities (including preferreds) between price and yield, and higher prices have led to lower yields on securities. The yield curve has flattened this year, and mid- to longer-term Treasury yields have remained low. At the same time, yield spreads on preferreds (above comparable Treasury yields) have narrowed. This has resulted in excellent price gains and total return for the Fund, but it also means portfolio yield has been coming down.

We maintain various levels of call protection across the portfolio to avoid concentrated exposure to any one interest-rate scenario, but in this sustained low-rate environment, reinvestment rates are below most coupons currently in the portfolio. Additionally, while securities moving from fixed to floating-rate have performed quite well this year, their floating-rate coupons are still well below their prior fixed-rate coupons. Combined with higher leverage costs, the result is likely to be lower overall levels of income that can be distributed by the Fund. We encourage you to read the topic that follows in this report for a more detailed discussion of monthly distributions to Fund Shareholders.

Lack of new-issue supply in the preferred market has been a leading factor behind market strength, as demand for preferreds must be satisfied mostly in secondary markets. If preferreds were the only asset class moving higher, we might be more guarded about the magnitude of recent price performance. However, broader bond and equity markets around the world have continued to show strength based on a supportive economic and technical backdrop. Global interest rates remain low, economic growth is moderate in developed economies, and inflation generally remains below target. We expect the path to higher U.S. interest rates will be gradual and likely accompanied by a flatter yield curve over the near-term. Combined with excellent overall credit quality at issuers of preferreds, we expect returns on preferred securities to remain competitive—albeit generated more from coupon than additional price appreciation.

We encourage you to read the discussion topics that follow, as we dig deeper into subjects mentioned here as well as others of interest to shareholders. In addition, visit the Fund's website, [www.preferredincome.com](http://www.preferredincome.com), for timely and important information.

Sincerely,

The Flaherty & Crumrine Portfolio Management Team

June 30, 2017

# DISCUSSION TOPICS

(Unaudited)

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

The table below presents a breakdown of the components that comprise the Fund's total return on NAV over the recent six months. These components include: (a) the total return on the Fund's portfolio of securities; (b) any returns from hedging the portfolio against significant increases in long-term interest rates; (c) the impact of utilizing leverage to enhance returns to shareholders; and (d) the Fund's operating expenses. When all of these components are added together, they comprise the total return on NAV.

### Components of PFD's Total Return on NAV for the Six Months Ended May 31, 2017<sup>1</sup>

Total Return on Unleveraged Securities Portfolio (including principal change and income) . . . . .	8.9%
Return from Interest Rate Hedging Strategy . . . . .	N/A
Impact of Leverage (including leverage expense) . . . . .	4.0%
Expenses (excluding leverage expense) . . . . .	(0.7)%

<sup>1</sup> Actual, not annualized

*Total Return on NAV* **12.2%**

For the six months ended May 31, 2017 the BofA Merrill Lynch 8% Constrained Core West Preferred & Jr Subordinated Securities Index<sup>SM</sup> (P8JC)<sup>1</sup> returned 7.8%. This index reflects the various segments of the preferred securities market constituting the Fund's primary focus. Since this index return excludes all expenses and the impact of leverage, it compares most directly to the top line in the Fund's performance table above (Total Return on Unleveraged Securities Portfolio).

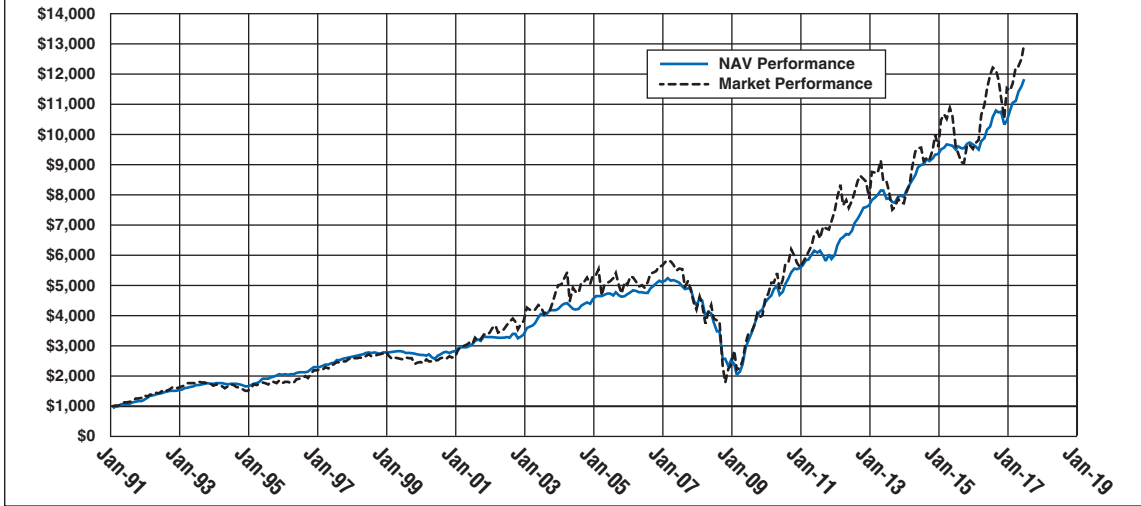
## Total Return on Market Price of Fund Shares

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 the *market price* of Fund shares. During the six-month period ending May 31, 2017, total return on market price of Fund shares was 18.8%.

Historically, the preferred securities market has experienced price volatility consistent with those of other fixed-income securities. However, since mid-2007 it has become clear that preferred-security valuations, including both the Fund's NAV and the market price of its shares, can move dramatically when there is volatility in financial markets. The chart below contrasts the relative stability of the Fund's earlier period with the more recent volatility in both its NAV and market price. Many fixed-income asset classes experienced increased volatility over this period.

<sup>1</sup> The BofA Merrill Lynch 8% Constrained Core West Preferred & Jr Subordinated Securities Index<sup>SM</sup> (P8JC) includes U.S. dollar-denominated investment-grade or below investment-grade, fixed rate, floating rate or fixed-to-floating rate, retail or institutionally structured preferred securities of U.S. and foreign issuers with issuer concentration capped at 8%. All index returns include interest and dividend income, and, unlike the Fund's returns, are unmanaged and do not reflect any expenses.

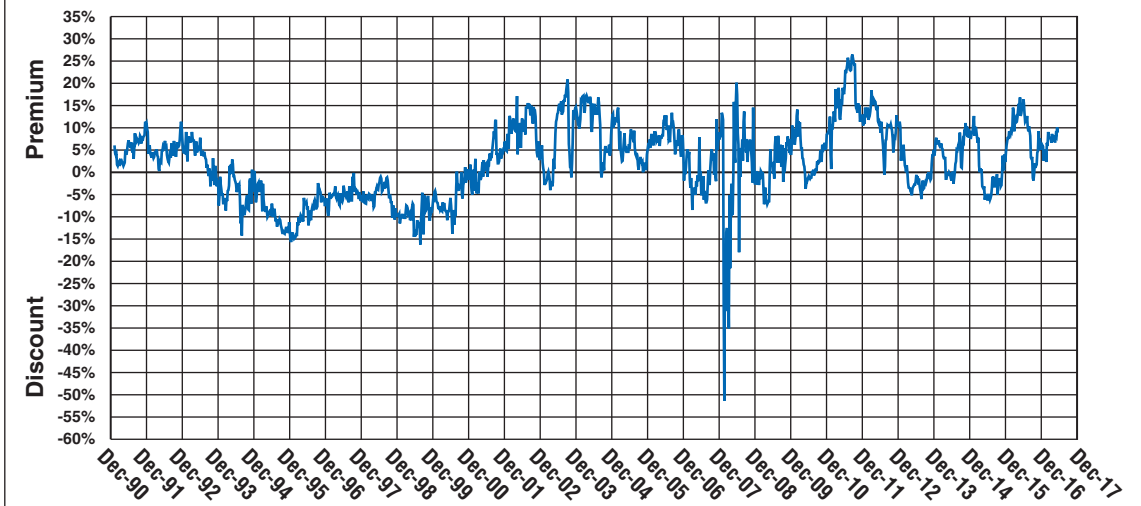
## Flaherty & Crumrine Preferred Income Fund (PFD) NAV and Market Performance on a \$1,000 Investment Through 6/30/17



In a more perfect world, the market price of Fund shares and its NAV, as shown in the above chart, would track more closely. If so, any premium or discount (calculated as the difference between these two inputs and expressed as a percentage) would remain relatively close to zero. However, as can be seen in the chart below, this often has not been the case.

Although divergence between NAV and market price of a closed-end fund is generally driven by supply/demand imbalances affecting its market price, we can only speculate about why the relationship between the Fund's market price and NAV hasn't been closer.

## Flaherty & Crumrine Preferred Income Fund (PFD) Premium/Discount of Market Price to NAV Through 6/30/17



Based on a closing price of \$15.74 on June 30<sup>th</sup> and assuming its current monthly distribution of \$0.088 does not change, the annualized yield on market price of Fund shares is 6.7%. Of course, there can be no guarantee that the Fund's dividend will not change based on market conditions.

## **U.S. Economic and Credit Outlook**

The U.S. economy continues to grow at a moderate pace. Inflation-adjusted gross domestic product (real GDP) rose by 1.4% in the first quarter of 2017 and 2.1% over four quarters ending in March. Economists expect growth of 2.3% (Q4 to Q4) in 2017 overall.<sup>2</sup> That is slightly better than the economy's 2% average growth pace since 2011—and in-line with our own view—but it's disappointing to investors who anticipated still-faster growth under a Trump administration.

So far, little progress has been made on Trump administration policies that might affect the U.S. economy, either positively or negatively. Some regulatory burdens have been eased at the margin, but health-care reform, tax reform, fiscal stimulus, and trade and immigration policies remain largely undecided. Political stasis reinforces our view that policy change will be limited and, therefore, likely to affect economic growth and monetary policy only at the margin.

More positively, U.S. consumers remain in good shape. Employment rose by 1.6% and hourly wages were up 2.5% over 12 months ending in May. Personal income and consumption were up 3.5% and 4.2%, respectively, over the same period, while inflation was subdued. Job growth is likely to slow as the economy nears full employment (the unemployment rate was 4.3% in May), but higher wages and investment income should keep income growth around its current pace. Housing is buoyant with home sales hovering near recovery highs. Real residential investment rose 12.9% in the first quarter, and home prices have risen at a 5-6% rate. We expect personal consumption to hold at or a little above its recent pace, and housing should remain a bright spot for at least several more years.

Business spending also picked up. Real business investment rose by 10.4% in the first quarter after languishing in 2016. We expect that growth rate to ease since capacity is not yet strained, but business investment should at least keep pace with overall economic expansion.

Other segments of the U.S. economy, namely government consumption, inventories and net exports, will wax and wane from one quarter to the next, but we don't expect them to drive medium-term economic growth. It's worth noting, however, that U.S. import and export volumes rose impressively (up 6.5-7%) from 1Q2016 to 1Q2017, reflecting a quickening pace of global activity.

Inflation increased early in 2017, driven by higher labor costs, a rebound in energy prices on OPEC production cutbacks, and a weaker U.S. dollar. However, energy prices sagged recently. As a result, the consumer price index peaked at 2.7% year-over-year (YoY) in March but slowed to 1.9% YoY in May. Core CPI (excluding food and energy prices) also slowed from 2.2% to 1.7% YoY over the same period. We can't predict where energy prices will go from here, but unless they rebound substantially, headline inflation is likely to remain low for the next several quarters—although wage pressures should gradually drive inflation toward the Federal Reserve's target.

Moderate but steady economic growth along with higher inflation earlier in the year prompted the Federal Reserve to tighten monetary policy, raising its benchmark rate by 75 basis points (0.75%) since the start of the Fund's fiscal year. The Fed also outlined plans to gradually reduce the size of its portfolio, something it probably will begin in the third quarter. Despite a 75 bp jump in short-term rates, the 30-year Treasury yield actually fell from 3.07% to 2.84% over six months ending June 30. A flatter yield curve has implications for the Fund's dividends, which we discuss in a separate topic below.

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<sup>2</sup> *The Livingston Survey*, June 16, 2017, Federal Reserve Bank of Philadelphia.

Although higher rates are bad news for short-term borrowers, they have been very good news for financial institutions. Most banks today are “asset-sensitive”, meaning their assets reprice more quickly than their liabilities. As short-term rates rose, bank earnings improved substantially. Banks dramatically increased capital and liquidity since the financial crisis, but earnings had lagged. With earnings now picking up, it appears that a long period of capital accumulation at U.S. banks is coming to a close. In June, the Federal Reserve concluded its annual review of whether large banks have adequate capital and gave them a green light to return a greater share of earnings to shareholders through common stock buybacks and dividends. As investors in preferred securities, we are heartened by stronger earnings but worry about capital erosion. We believe banks (and their regulators) will balance capital returns with balance sheet strength, but it is something we will watch closely.

Looking beyond banks, credit fundamentals remain good in most other sectors. Energy companies have learned to live with lower prices for their products, and higher domestic production has boosted prospects for pipeline companies. Like banks, property and casualty insurance companies have benefitted from higher rates. However, life insurance companies, which purchase long-duration assets to match their long-term liabilities, should do better if long-term rates move up a bit too. REITs generally demonstrate high occupancy and strong fixed-charge coverage, although some retail-oriented REITs face rising vacancies. Utilities operate in a challenging environment of flat-to-lower demand for electricity along with rising costs for transmission, distribution and various environmental and renewables mandates. They remain strong financially, but leverage is creeping up. On balance, credit quality in the Fund’s portfolio remains sound—although a long period of improving credit fundamentals appears to be transitioning to one of overall stability.

As we noted in our opening letter, preferred securities attracted strong demand in the first half of this fiscal year, pushing down both overall preferred yields and their spreads to benchmark Treasuries. Although yields are materially lower, they are supported by a benign macroeconomic environment and good credit quality. We believe preferred securities remain attractive relative to other fixed-income alternatives, especially on an after-tax basis for taxable U.S. investors.

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

Over the past 18 months, the Federal Reserve has raised its target for the federal funds rate by a total of 1.00%, after seven years of near-zero interest rates. A target rate of 1.25% is still accommodative and consistent with the Fed’s go-slow approach. However, the Fed has hiked four times this cycle and Federal Open Market Committee (FOMC) members are still projecting another possible increase later in 2017.

In response, short-term interest rates have continued to move higher to reflect actual and expected adjustments in the Fed’s target. The Fund’s cost of leverage is linked to 3-month LIBOR, and the average cost of leverage was 1.0% for fiscal 2015, 1.4% for fiscal 2016, and the current rate would be 2.2% if reset today (actual resets occur quarterly). In addition to increases in 3-month LIBOR, the spread payable by the Fund over this rate also increased from 0.75% to 0.90% as of December 1, 2016. Although increased bank regulation has been a positive for credit quality and investments in the portfolio, costs associated with stiffer regulation get passed on to clients of a bank—and our leverage is bank-financed.

We have written many times about why the Fund continues to use leverage when short-term rates are moving higher and the implications of a possible hedging program for the cost of leverage. Rather than repeat the discussion here, we would point readers to this topic in the November 30, 2015 Annual Report, which can be found on the website at [www.preferredincome.com](http://www.preferredincome.com).

In addition to increased cost of leverage, the Fund experienced modest issuer redemptions in the investment portfolio, requiring reinvestment of proceeds. In today's rate environment, reinvestment coupons are lower than coupons being redeemed. This reinvestment process puts pressure on top-line earnings from the portfolio, again reducing distributable income.

These factors are incorporated into our dividend-setting process, and are also a normal part of the way credit markets function. Interest rates are not static, and neither are credit spreads. The portfolio is designed to have a wide range of coupons, call protection, and security structures—and each aspect will change over time. We seek to maintain a level of call protection in the portfolio to stagger the impact of changes in interest rates and credit spreads, but the portfolio will normally contain at least a portion subject to being called based on current market conditions. Leverage is utilized in the Fund to increase income and returns to shareholders, and leverage remains beneficial to distributable income even though its cost has increased.

The primary objective of the Fund is to produce high current income, and we believe the Fund will continue to meet that objective—even though distributable income may be reduced as we proceed through this economic cycle. Reductions are simply a reflection of changes in interest rates and credit spreads that have cumulated over time, but relative to fixed-income alternatives, the level of income produced should remain attractive. Fund shareholders have benefited from years of record-low interest rates and low leverage costs, but rates are beginning to come back into balance as the economic outlook improves. We believe the Fund's strategy of investing in preferred securities and using leverage in an efficient manner will continue to produce a competitive distribution rate for shareholders.