

FLAHERTY & CRUMRINE PREFERRED INCOME FUND

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

Fixed-income investors shifted into a more defensive position during the quarter, which contributed to modest weakness in preferred securities prices. Total return¹ on net asset value (“NAV”) was -1.5% for the fiscal quarter² and -1.9% for the first half of the fiscal year. Total return on market price of Fund shares over the same periods was -1.8% and -9.8%, respectively.

The table below shows Fund NAV returns over various measurement periods. 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, 2018

	Actual Returns			Average Annualized Returns			
	Three Months	Six Months	One Year	Three Years	Five Years	Ten Years	Life of Fund ⁽¹⁾
Flaherty & Crumrine Preferred Income Fund . . .	-1.5%	-1.9%	2.1%	7.1%	7.8%	11.2%	9.8%
Bloomberg Barclays U.S. Aggregate Index ⁽²⁾ . . .	0.6%	-1.0%	-0.4%	1.4%	2.0%	3.7%	5.7%
S&P 500 Index ⁽³⁾	0.2%	3.1%	14.4%	11.0%	13.0%	9.1%	10.1%

(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.

Interest rates are a top concern for many investors, and we often receive questions about the performance of preferred securities in a rising-rate environment. Preferred securities’ prices normally decline when Treasury yields rise; i.e., they have positive “duration.” However, our investments in fixed-to-float structures (which pay a fixed distribution rate for a set period then float at a spread over a benchmark yield) greatly reduces portfolio duration compared to a portfolio comprised of mostly fixed-rate securities. As of May 31, 2018, 72% of the portfolio was invested in fixed-to-float or currently-floating securities. A dozen years ago, the preferred market was dominated by fixed-rate securities, often with long interest rate durations, and some investors still think of preferreds as being highly sensitive to Treasury yields. Today, with fixed-to-float and floating rate preferred securities having become more common, there are many short-and intermediate-duration preferred securities available.

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

² March 1, 2018 – May 31, 2018

One may expect yields to be considerably lower on fixed-to-float securities compared to fixed-rate securities, but this generally has not been the case. Investors continue to receive attractive yields on preferred securities even though duration is moderate – and issuer credit quality generally is in excellent shape. Higher Treasury yields may dampen preferred returns over the next year or two, but over a longer time horizon, total returns should remain more than competitive with fixed-income alternatives.

While the Federal Reserve raised its benchmark rate as expected in March and June, shareholders may be surprised that 10-year and 30-year Treasury yields actually ended *lower* on May 31 (2.82% and 2.99%, respectively) compared to February 28 (2.87% and 3.13%, respectively), although higher rates persisted for much of the second fiscal quarter. Investors shifted into more defensive interest-rate positions, resulting in relative underperformance of 10-year fixed-to-float securities compared to five-year and shorter issues. This was in response to an improving economic outlook across the globe, a flattening yield curve, and anticipation of additional Federal Reserve rate increases in the future.

Rates were not the only reason for defensive positioning, as can be seen by lower Treasury yields at quarter-end. Political risks arose once again, with instability in Spain and Italy prompting weakness in foreign preferreds and increased trade rhetoric (and tariff actions) causing concern about possible negative effects on global economic growth and credit quality.

Preferred prices were also negatively affected during the quarter by new-issue supply. Supply has not been overwhelming, but issuers needed to offer yield concessions to entice buyers – and new-issue yield concessions put downward pressure on secondary market prices. We view this as an opportunity to invest proceeds of called securities at significantly higher yields, which should contribute positively to performance over time. Recall it wasn't long ago we were writing about 4-handle preferred coupons, but those same issuers today are pricing new securities in the mid- to high-5% area, and yields have reached 7% for issuers in some industries. This is welcome relief from the low-yield environment experienced in recent years.

No particular segment of the portfolio stood out during the quarter, as modest weakness was broad-based and macro in nature. It is worth noting once again that issuer credit quality remains in great shape and should be supportive even in light of higher rates and political uncertainty. A number of non-financial industries are increasing leverage for operational purposes or acquisitions, but for the most part they are not regular issuers of preferred securities. We continue to position the portfolio with an emphasis on credit quality and security-specific structure (e.g., fixed-to-float for moderate interest-rate risk, call protection for income stability), and we are taking advantage of higher yields on new-issue preferred securities.

We are all familiar with the certainty of taxes, but it seems like many investors have moved away from evaluating investments on an after-tax basis – and to their detriment when it comes to preferred securities. In fairness, qualified dividend income (QDI) was an elusive concept for many years, as it was new for individuals in 2003 and initially subject to sunset provisions. However, it was made permanent in 2012 and offers a tremendous benefit to U.S. individuals receiving QDI. Evaluating investments solely on a pre-tax basis certainly makes comparisons across markets much simpler, but “simple” often translates into missed opportunity.

In taxable accounts, QDI can result in a gross-up factor as high as 1.287³ versus pre-tax yields – meaning a 6.0% pre-tax yield, for example, is 7.72% on a taxable-equivalent basis. We have witnessed a multi-year shift in investor awareness away from investment tax considerations, resulting in almost no yield difference between tax-advantaged and fully-taxable preferreds (both types are issued) – which implies the QDI benefit is largely underappreciated. In calendar 2017, 79.4% of PFD’s distributions were QDI-eligible (as reported on Form 1099, box B). For illustration, a market yield of 7.0%⁴ on PFD (higher than the 6.0% used above due to the Fund’s use of leverage) would be a taxable-equivalent yield of 8.6% (assuming 79.4% QDI). Although distribution rates and QDI composition do change each year, shareholders should be aware that QDI is an important benefit of investing in preferred securities and should not be ignored.

We encourage you to read the discussion topics that follow, as we dig deeper into subjects of interest to shareholders – including leverage costs and distribution rates. In addition, visit the Fund’s website, www.preferredincome.com, for timely and important information.

Sincerely,

The Flaherty & Crumrine Portfolio Management Team

June 30, 2018

³ Assumes marginal tax bracket of 37% and 3.8% Medicare tax on investment income.

⁴ Market yields vary with changes in distribution rates and market price of Fund shares. 7.0% used for illustration purposes only. Investors should consult their tax advisors regarding their personal situation.