

FLAHERTY & CRUMRINE PREFERRED AND INCOME FUND

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

The first half of Fiscal 2020 has been a tale of two very different quarters. A lot has changed in our world since the arrival of COVID-19, and markets have struggled to find their way amid much uncertainty. Total return¹ on net asset value (“NAV”) was -7.4% for the fiscal quarter² and -6.3% for the first half of the fiscal year. Total return on market price of Fund shares over the same periods was 8.2% and -4.3%, respectively.

TOTAL RETURN ON NET ASSET VALUE FOR PERIODS ENDED MAY 31, 2020							
	<u>Actual Returns</u>			<u>Average Annualized Returns</u>			
	<u>Three Months</u>	<u>Six Months</u>	<u>One Year</u>	<u>Three Years</u>	<u>Five Years</u>	<u>Ten Years</u>	<u>Life of Fund⁽¹⁾</u>
Flaherty & Crumrine Preferred and Income Fund . . .	-7.4%	-6.3%	2.0%	3.7%	6.1%	10.6%	9.4%
Bloomberg Barclays U.S. Aggregate Index ⁽²⁾	1.6%	5.4%	9.4%	5.1%	3.9%	3.9%	5.9%
S&P 500 Index ⁽³⁾	3.6%	-2.1%	12.8%	10.2%	9.9%	13.1%	10.0%

(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.

The first fiscal quarter of 2020 was largely a continuation of 2019’s familiar themes. Financial conditions eased materially in 2019; credit quality remained healthy, especially for “financial” issuers; preferreds and contingent capital securities (“CoCos”) continued to offer a yield advantage compared to senior debt, presenting an attractive option for income investors in a low-yield environment. Many of the pressing issues from 2019 were also showing improvement, such as Brexit and US-China trade negotiations – leaving many investors looking to the November election as the next catalyst for market disruption.

All of that was upended in the second fiscal quarter by a novel coronavirus. It is clear the world was blindsided by COVID-19 and thoroughly unprepared for a pandemic of this speed and magnitude. Government response in the U.S. has been a patchwork of federal, state and local orders. The response was uneven, with some states imposing strict social distancing rules in mid-March and others waiting weeks after the first states acted. Removal of those restrictions has been equally uneven, with some areas moving slowly and others rapidly to reopen businesses and public activities. Scientific knowledge of this novel coronavirus is advancing but not as quickly as we would all prefer.

In response to COVID-19, and a sudden halt in economic activity brought on by measures to flatten its spread, prices of stocks and fixed-income securities in the first three weeks of March moved lower rapidly and relentlessly. While wider credit spreads were to be expected, markets were thin and investors in need of liquidity were forced to accept lower and lower prices.

¹ Following the methodology required by the Securities and Exchange Commission, total return assumes dividend reinvestment.
² March 1, 2020 – May 31, 2020

As prices declined, leverage ratios at some funds rushed higher and resulted in even more selling as leveraged investors raised cash to pay down borrowings. All told, over the course of a few weeks in March, it appears closed-end preferred funds alone repaid over \$1 billion in leverage; open-end preferred funds saw outflows of almost \$2 billion; and preferred ETFs saw outflows of more than \$1.5 billion. Moreover, it appears similar trades were occurring in most segments of fixed-income markets (loans, municipals, high yield, investment-grade corporate credit). Overall, we estimate at least \$5 billion left the preferred market in March. In light of the preferred market's modest size, this was a significant amount of activity.

Selling of such magnitude over a short period of time resulted in drastic price changes and dislocations in every market segment – exceeding moves attributable to fundamental credit concerns. However, the extent of outflows and the amount of deleveraging so early in the process helped markets make a dramatic recovery since the lows of March 23, in many cases cutting losses by more than half. This impact of COVID-19 is far from over, and much economic loss is yet to be quantified – but at least we feel that markets have returned to evaluating “credit” more than chasing “liquidity”.

In response to this crisis, the Federal Reserve reestablished monetary-policy tools from 2008-2009 – and in many cases enhanced and expanded programs to better match specifics of this event. The Fed has moved swiftly, been transparent with markets, and committed very large amounts to ensure our financial system continues to operate effectively. The government also enacted fiscal policies to help companies and consumers weather the storm. The combined dollar amounts are staggering and could have negative repercussions at a later time, but we believe they are necessary responses to this crisis.

COVID-19 and related social-distancing orders resulted in a material decline in global demand for oil as economic activity suddenly slowed in many countries. A second, and seemingly unnecessary, oil crisis developed as OPEC+ participants argued over much-needed production cuts – with Saudi Arabia actually increasing oil production and driving prices even lower. Even though they only comprise about 2% of the Funds' benchmark, energy companies were by far the worst performing sector in the benchmark with a -41% total return over the first calendar quarter and a -9% total return over the first half of the fiscal year. As a result, even the portfolio's moderate overweight exposure of 6.8% to energy companies as of May 31, 2020 was a significant drag on performance since the drop in the price of oil began. However, unlike exploration and production companies, the portfolio's energy holdings are pipeline and midstream companies that have significantly less commodity price exposure and have the ability, we believe, to tolerate a period of slack demand and lower energy prices.

We have long held that U.S. banks were strong credits, and we continue to believe they will brave this crisis. Losses should be limited mostly to earnings events, and their strong levels of capital and loan-loss reserves should support preferreds. U.S. banks generally have suspended stock buybacks (and must continue to suspend them until at least September 30), and average dividend payout ratios are conservative in the 30-40% range. Notably, all U.S. banks passed their Federal Reserve stress-tests in late June (more details on these in the discussion topics that follow).

European banks as a group did not enjoy so strong a position entering this crisis, but we believe certain European banks remain very solid credits. Dividend payout ratios were much higher for European banks, and, as a precaution, their common stock dividends have been eliminated until further notice. While this did spook CoCo investors initially, subsequent communications from regulators indicated support for CoCo coupons to continue.

Amidst mostly unsettling headlines in 2020, we were pleased to announce an increase in the Fund's dividend rate starting with the May, 2020 dividend. The Fund's cost of leverage is benchmarked to one-month LIBOR – which was at 0.1825% as of May 29, 2020. This results in all-in leverage cost today of approximately 1.0%, down from an average of about 3.1% in fiscal year 2019. We currently expect LIBOR to remain low for the foreseeable future, which should continue to support the Fund's dividend rate. In addition, although leverage is dynamic and may need to be adjusted in the future, the Fund did not reduce leverage during the fiscal period.

COVID-19 already has proven to be a terrible event in both human and economic terms, and it is still very much with us. Although markets have calmed considerably from their drastic initial moves, no one yet knows the full magnitude of this calamity. Mandated safer-at-home orders have slowly been supplemented with continued social-distancing and mask requirements, along with a cautious, staggered approach to re-opening our economy. There remains too much uncertainty to predict timing on any of this with any specificity.

In the meantime, we continue to monitor credits and security valuations closely and work to position our portfolios to meet their objectives – and for the best chance of recovery in asset values as the pandemic recedes. We remain cautiously optimistic on the preferred and CoCo markets, especially from the viewpoint of long-term income investors. Flow data indicates investors are returning to fixed-income, absorbing record levels of new issue debt over the last two months. However, we acknowledge that there is limited modern historical precedent for this pandemic and its global economic impact, making our “crystal ball” unusually cloudy.

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

Sincerely,

The Flaherty & Crumrine Portfolio Management Team

July 2, 2020