

FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Fund:

Fiscal 2013 presented many challenges, but your Fund delivered respectable performance. Total return on net asset value (“NAV”)¹ was +2.8% for the fourth fiscal quarter² and +5.0% for the full fiscal year. As seen in the following table, over longer measurement periods, Fund performance has been excellent.

TOTAL RETURN ON NET ASSET VALUE FOR PERIODS ENDED NOVEMBER 30, 2013 (Unaudited)

	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	2.8%	-2.0%	5.0%	12.5%	27.8%	6.5%	9.9%
Barclays Capital U.S. Aggregate Index ⁽²⁾ ..	1.4%	-0.6%	-1.6%	3.1%	5.3%	4.7%	6.4%
S&P 500 Index ⁽³⁾	11.2%	11.9%	30.3%	17.7%	17.6%	7.7%	9.8%

(1) Since inception on January 31, 1991.

(2) The Barclays Capital 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 table includes performance of two indices, Barclays Capital 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 broad alternative-asset categories.

Total return based on market price of Fund shares was +3.2% for the quarter, as market price slightly outperformed NAV. This was a welcome change from a dramatic drop in market price relative to NAV during the two previous quarters. For fiscal 2013, total return on market price was a disappointing -8.1%.

On December 11th, the Fund announced a special dividend of \$0.08 per share, in addition to its regular monthly dividend of \$0.09. In recent letters we have cautioned that issuer redemptions of older, higher-yielding securities or rising cost of leverage might put downward pressure on the Fund’s net investment income. The cost of leverage has remained low, and we have tried to be proactive in managing investments and leverage to produce high, sustainable income for shareholders. The proof of the pudding is in the eating—as of January 10, 2014 the current pre-tax monthly distribution rate on market price was 8.56%, and 58.7% of its 2013 dividends were characterized as qualified dividend income (with very favorable 15% and 20% tax rates).

Our outlook for the preferred market is guardedly positive. We expect economic growth will accelerate gradually, but further increases in interest rates will be measured and monetary policy will remain

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.

² September 1—November 30, 2013

accommodative for some time to come. Financial companies, the largest component of the preferred universe, are now healthier and more transparent than any time in memory. Against this backdrop, preferred securities should remain attractive for long-term investors.

Between early May and mid-September, intermediate and long-term interest rates rose significantly, as investors expressed concern over looming changes in monetary policy at the Federal Reserve (for Fed watchers, the so-called “tapering” of quantitative easing). Since then, these rates are little changed. The economy is on a path of recovery, but data suggest tepid and uneven growth. At present, we believe interest rates are consistent with moderate acceleration of economic activity in 2014, although our outlook for growth is slightly below consensus.

Short term interest rates are still hovering near zero (the key rates being fed funds and LIBOR). We monitor these closely as they drive the Fund’s cost of leverage. As the economy improves, these rates eventually will rise; however, we expect short-term interest rates to remain at or near current levels throughout 2014.

In addition to interest rates, regulatory developments remain center stage for the preferred market. A massive overhaul of rules and regulations overseeing banking and financial institutions is mostly complete, and implementation is well underway. We know with certainty preferred securities (in various forms) will continue to be a key component of capital for these industries. As rules are finalized, we gain a clearer sense about the types and amounts of preferred securities companies will likely utilize.

Many of the new rules are intended to keep companies from engaging in risky business practices that might lead to future crises. This will likely prove futile, as many risks are revealed only in hindsight. However, we believe the rules for reporting *will* result in greater transparency. Improved reporting makes the playing field more level, so the advantage will go to those who can make better decisions, rather than those receiving selective disclosure. And just maybe, markets will impose greater discipline on management. New rules also require financial companies to carry much more capital than before, which should make them more resilient in future downturns.

Our investment approach is simple to state and, hopefully, hard to replicate:

- Produce in-depth, independent and objective credit research;
- Dissect and analyze details of the securities in which we invest; and
- Apply our long experience managing preferred securities portfolios to balance risks and returns revealed by those efforts.

It doesn’t always work perfectly, but it has worked pretty well for more than thirty years.

In the section below, we dig deeper into topics mentioned here as well as others of interest to shareholders. In addition, we encourage you to visit the Fund’s website, www.preferredincome.com for timely and important information.

Sincerely,

The Flaherty & Crumrine Portfolio Management Team:

R. Eric Chadwick
Donald F. Crumrine
Robert M. Ettinger
Bradford S. Stone

January 10, 2014

DISCUSSION TOPICS

(Unaudited)

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

The table below reflects performance over both the recent six months and the Fund's fiscal year 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; 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 Fiscal Year Ended November 30, 2013

	<i>Six Months*</i>	<i>One Year</i>
Total Return on Unleveraged Securities Portfolio (including principal change and income)	-0.8%	4.6%
Return from Interest Rate Hedging Strategy	N/A	N/A
Impact of Leverage (including leverage expense)	-0.6%	1.7%
Expenses (excluding leverage expense)	-0.6%	-1.3%
<i>Total Return on NAV</i>	-2.0%	5.0%

* Actual, not annualized.

For comparison, the following table displays returns over the same time periods on three indices compiled by Bank of America Merrill Lynch, reflecting various segments of the preferred securities market. Because these index returns exclude all expenses and the impact of leverage, they compare most directly to the top line in the Fund's performance table above (Total Return on Unleveraged Securities Portfolio).

Total Returns of Bank of America Merrill Lynch Preferred Securities Indices* for Periods Ended November 30, 2013

	<i>Six Months⁽¹⁾</i>	<i>One Year</i>
BofA Merrill Lynch 8% Capped DRD Preferred Stock Index SM	-6.5%	-3.4%
BofA Merrill Lynch 8% Capped Hybrid Preferred Securities Index SM	-4.4%	-1.7%
BofA Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index SM	-1.1%	4.3%

* The Bank of America Merrill Lynch 8% Capped DRD Preferred Stock IndexSM (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 IndexSM (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 IndexSM (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%. All index returns include interest and dividend income, but, unlike the Fund's returns, are unmanaged and do not reflect any expenses.

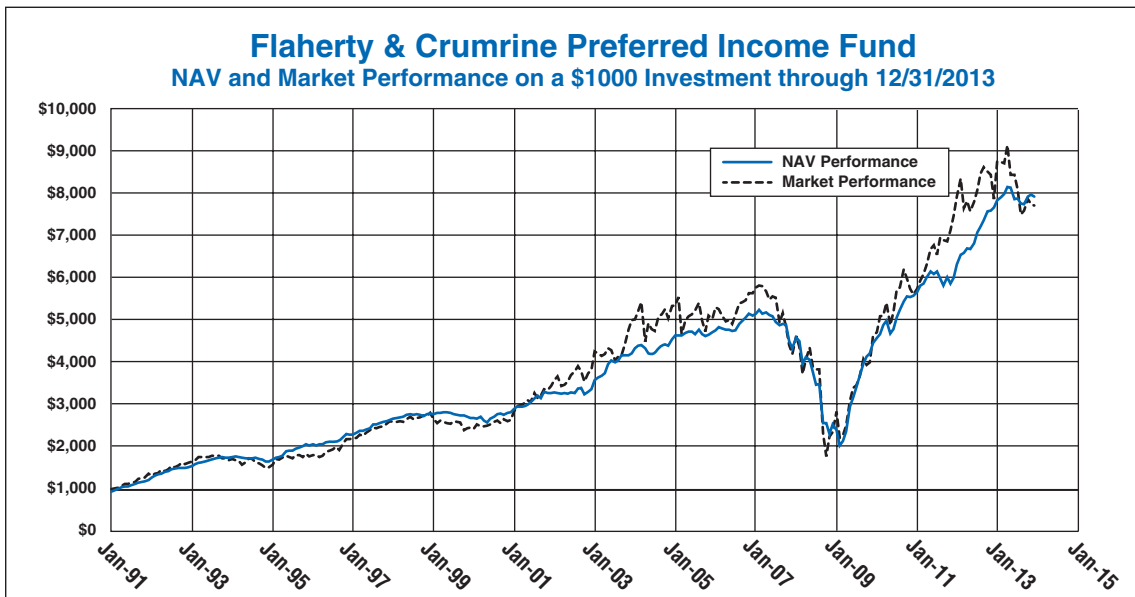
(1) Actual, not annualized.

Over the past six-month and one-year time periods, the Fund's (unleveraged) securities portfolio beat each of the three preferred market indices shown above. During fiscal 2013, the Fund's total return on NAV also exceeded the returns on the indices, aided by the Fund's use of leverage. While leverage can reduce returns during periods of adverse market conditions, during the recent fiscal year the low cost of leverage enhanced both income distributed by the Fund and its total return over the period.

Total Return on Market Price of Fund Shares

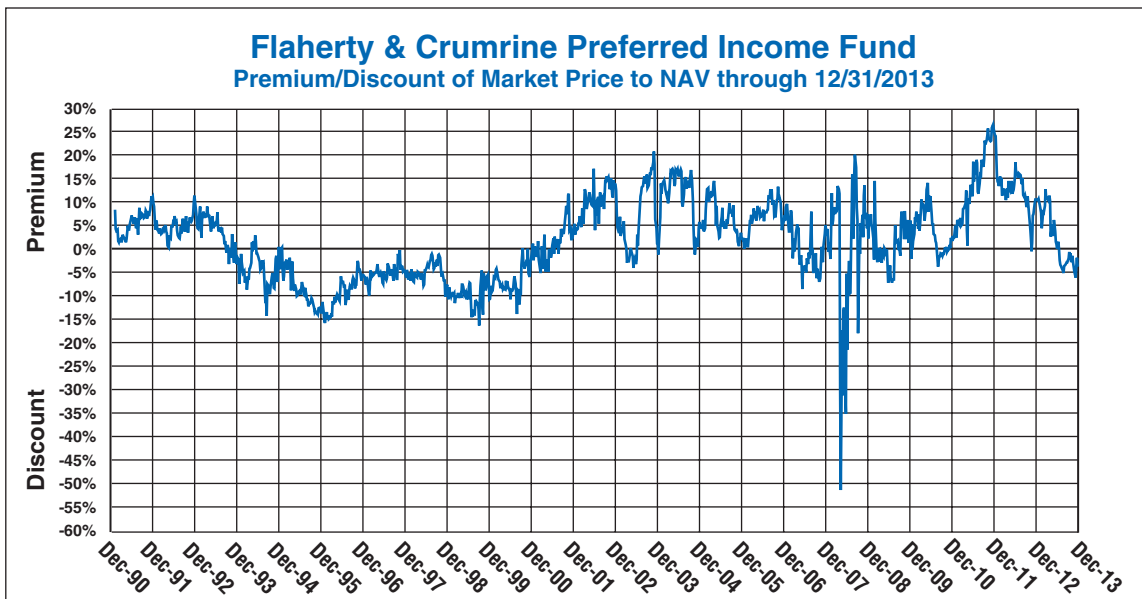
While our focus is primarily on managing the Fund's investment portfolio, our shareholders' actual return is comprised of the Fund's monthly dividend payments *plus* changes in its *market price*. During the twelve-month period ending November 30, 2013, total return on market price of Fund shares declined by 8.1%.

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 Fund NAV and 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. Virtually all fixed-income asset classes experienced increased volatility over this period.



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, the resulting premium or discount of the Fund, 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, over the life of the Fund this often has not been the case. While the Fund began fiscal 2013 with its market price at a premium to NAV, by the end of the fiscal year the Fund was trading at a discount, and, as a result, the total return earned on market price trailed the total return on NAV shown in the table above.

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.



Based on a closing price of \$12.26 on December 31st, the current annualized yield on market price of Fund shares (assuming its current monthly distribution of \$0.09 does not change) is 8.81%. In our opinion, this distribution rate measures up favorably with most comparable fixed-income investment opportunities.

Preferred Market Conditions

Three factors dominated the preferred market in 2013—credit quality, market size and interest rates. Since the depths of the financial crisis in 2008/09, improving credit quality and contraction in market size have boosted the preferred market. More recently, the market has been battered by concerns over rising interest rates as the economy strengthens.

We focus on companies in financial industries such as banking and insurance because they are the dominant issuers of preferred securities, and of course comprise the bulk of the Fund’s investments. The nature of preferred capital, subordinated to debt but not dilutive like equity, makes it particularly useful to regulated companies in these more-leveraged industries.

The financial crisis exposed unwise and risky practices at many financial companies, with several getting swallowed up or shut down. But well-managed companies also paid a steep price for the sins of the few. In the U.S., the Dodd-Frank Financial Regulatory Reform Bill, the most sweeping regulatory change in decades, dramatically altered the way all financial companies operate. Similar changes are being made abroad. The new rules restrict certain risky activities and force companies to have more “skin in the game.” In our view, these changes (along with increased transparency) have improved fundamental credit quality.

Among other things, financial companies must alter the amount and tenor of preferred capital they issue. Most “trust preferred” issues have been redeemed, frequently replaced with new issues structured to satisfy requirements of the new rules. As is often the case, what’s old is new again—traditional perpetual, non-cumulative preferred stock is once again being issued by domestic banks. Many of these new issues fit nicely in the Fund’s portfolio.

Non-US banks have been utilizing a newer structure, generically-called contingent-capital securities (“CoCo”). These typically mandate principal be written down or wiped out if certain financial thresholds are breached. So far, we have adopted a wait and see attitude on CoCo securities; a repeat of the financial crisis, real or perceived, may impact this structure more harshly than others.

The jump in intermediate and long term interest rates this the past summer resulted in price declines for most fixed-income securities, including preferreds. Although interest rates have been relatively stable in recent months, some interesting anomalies have developed in the preferred market.

With equity markets at or near all-time highs, some investors chose to take money off the table and sell appreciated stocks. For some, realizing gains creates tax liabilities. Strategies to reduce this tax bill usually start with realizing losses, if available, on other portfolio holdings. We believe the poorer performing preferred securities were targeted for tax-loss selling, and in turn, lower prices led to more selling. This is nothing new, a phenomenon we’ve seen before; we’ll do our best to take advantage of the opportunity.

Monthly Distributions to Fund Shareholders

Fiscal-year 2013 presented many challenges related to interest rates and valuations of preferred securities, but income continues to be a very bright spot for the Fund. Our regular readers will recall our description of near-ideal conditions for generating high current income—attractive yields on preferred securities owned by the Fund combined with historically low rates for leverage used in our strategy.

The Fund once again made a special distribution of income in December. For calendar year 2013, total distributions to shareholders (including the special distribution) were 7.4% higher than the sum of ordinary monthly distributions during the year.

We have warned in recent years that low interest rates would have an impact on top-line income of the Fund, and it has. A number of higher-coupon securities have been redeemed by issuers, often times refinanced with new securities paying lower coupons. This trend was in full force during the first half of the year. If there is a silver lining to market weakness that began in early summer, it is that higher rates and wider spreads all but stopped issuer redemptions during the second half of the year. Market weakness also allowed the Fund to reallocate some of the portfolio to take advantage of higher yields.

Although reinvestment risk is always part of owning preferred securities, the reinvestment process related to trust preferred securities is essentially complete. Going forward, reinvestment risk will be a function of more traditional factors—interest rates and spreads on preferred securities. The Fund still owns certain securities with relatively high coupons, and those securities may be subject to redemption over the coming year or two. However, we factored in our best estimates of redemptions and reinvestment rates and concluded there was no reason to modify the existing distribution rate to shareholders.

When it comes to projecting income available to shareholders in future years, the elephant in the room is the expected cost of leverage. The use of leverage is an important part of the Fund’s strategy for producing high current income, and we could not produce the Fund’s current level of income without it. We expect leverage costs—which for the Fund are currently 3-month LIBOR +0.75%, reset quarterly—will remain low into 2015, and maybe longer, given our economic outlook and guidance from the Federal Reserve. That said, any early increase in short-term rates would have a negative impact on distributable income.

Some might ask: if you expect the cost of leverage to increase, why not remove leverage from the Fund? The answer is twofold. First, so long as the cost of leverage is below income earned on preferred securities—which has almost always been the case—income available to shareholders will be higher *with*

leverage than it would be *without* leverage. Second, following the same logic, removing leverage today would result in a material reduction in the current dividend rate given the current wide spread between yields on preferred securities and cost of leverage. So even if leverage costs increase, benefits to distributable income over time are still substantial.

We want shareholders to understand the Fund's strategy for producing high current income, including risk factors that affect distribution rates—both positive and negative. 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.

Economic Conditions

The U.S. economy strengthened in the second half of the year and appears to be on solid footing heading into 2014. Inflation-adjusted gross domestic product (real GDP) should post about 3% annualized growth in 2013's second half after rising just 1.8% in the first half. Private economists forecast real GDP growth of 2.6% in 2014; the Federal Reserve is more optimistic, expecting 2.8-3.2% growth.

The economic outlook remains mixed but mostly improving. Job gains have accelerated in recent months, and wages are slowly picking up. However, consumers continue to deleverage and pay down debt, restraining consumption. Housing remains a bright spot that should add to economic growth despite higher mortgage rates. Business investment should improve a bit, and government spending should be less of a drag on growth in 2014 than it was last year. Finally, global economic growth is improving, although recovery remains fragile in Europe and a number of developing countries.

On balance, we expect 2.2-2.5% real GDP growth in 2014, slower than the Fed's relatively optimistic outlook. For monetary policy, moderate growth means no rate hikes and only gradual reductions in securities purchases this year—an outlook that appears largely incorporated into current prices. Long-term interest rates should drift higher, but further rate increases are likely to be modest. We are mindful, however, that there may be periodic “growth scares” that could push rates upward quickly; investors should be prepared for volatility in 2014.

More positively, credit conditions continue to improve. A growing economy, lower leverage and stronger balance sheets mean better fundamental credit quality for preferred securities, and we foresee this improvement continuing for some time to come. We expect yield spreads on preferred securities to narrow over time.

Putting this together, we expect returns on preferred securities to be “coupon” or “coupon minus” in 2014 rather than “coupon plus” experienced from 2009-2012. However, despite this more challenging market environment, we believe preferred securities remain attractive relative to short-duration bond alternatives, and investors should return to them as fears of rapidly rising interest rates subside.

Hedging Long-Term Interest Rate Risk

As long-time shareholders know, the Fund suspended its long-term interest rate hedging program as the financial crisis intensified in the autumn of 2008. There were three principal reasons why we suspended the program. First, correlation between preferred securities and the Fund's hedging instruments (Treasury bond futures, interest rate swaps, and options on both) switched from positive to negative during the financial crisis. Second, hedging cost rose dramatically, as the yield curve steepened and options prices rose sharply. Finally, preferred securities were exceptionally cheap and likely to offer higher returns to shareholders than investments in hedge instruments. Adding them up, we believed that hedging did not make sense.

Until spring of 2013, that judgment was correct. Preferred securities' prices generally rose and were at best loosely correlated to Treasuries. Beginning in early May, however, correlation increased substantially. The benchmark 30-year Treasury bond's yield increased from a low of 2.82% to nearly 4% as of December 31, 2013, and preferred securities traded down by a similar amount.

With positive correlation reestablished between long-term Treasuries and preferred securities, we can be reasonably confident that an interest-rate hedging strategy would in fact be a hedge rather than just a bet on higher Treasury rates. However, the cost of hedging remains high. The Treasury yield curve is steep (approaching 400 basis points from overnight to 30-years), and option prices are also high. Given our outlook for only moderate economic growth, we believe markets have priced in a larger increase in interest rates than we are likely to experience. We may be wrong about that, but rates would have to rise quite substantially from current levels for hedging to be profitable, given what is already priced into today's yield curve.

Finally, we think yields on preferred securities in a range of 6.75-7.25% (with outliers on either side) are attractive compared to a 4% long-bond yield—and even compared to Treasuries at 5%, if and when they get there. Spreads of 300 basis points over Treasuries provide substantial protection against higher rates.

We are monitoring hedge alternatives closely and will consider hedging again if circumstances warrant it. For now, we think costs of hedging the impact of changes in long-term interest rates on the Fund's preferred securities portfolio outweigh any benefits.

Federal Tax Advantages of 2013 Calendar Year Distributions

In calendar year 2013, approximately 58.7% of distributions made by the Fund was eligible for treatment as qualified dividend income, or QDI. For taxpayers in the 15% marginal tax bracket, QDI is taxed by the federal government at 0% instead of an individual's ordinary income tax rate; for taxpayers in the 25%-35% marginal tax brackets, QDI is taxed at 15%; and for taxpayers in the 39.6% marginal tax bracket, QDI is taxed at 20%.

For an individual in the 28% marginal tax bracket, this means that the Fund's total distributions will only be taxed at a blended 20.4% rate versus the 28% rate which would apply to distributions by a fund investing in traditional corporate bonds. This tax advantage means that, all other things being equal, such an individual who held 100 shares of Common Stock of the Fund for the calendar year would have had to receive approximately \$119 in distributions from a fully-taxable bond fund to net the same after-tax amount as the \$108 in distributions paid by the Fund.

For detailed information about tax treatment of particular distributions received from the Fund, please see the Form 1099 you receive from either the Fund or your broker.

Corporate shareholders also receive a federal tax benefit from the 22.5% distributions that were eligible for the inter-corporate dividends received deduction, or DRD.

It is important to remember that composition of the portfolio and income distributions can change from one year to the next, and that the QDI or DRD portions of 2014's distributions may not be the same (or even similar) to 2013.