

FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of the Preferred Income Fund:

The Fund's performance during the first fiscal quarter of 2008, which ended on February 29th, is summarized below:

Total Return on Net Asset Value ¹ :	+ 0.2%
Total Return on Market Value ² :	- 1.3%

While these returns were not impressive on an absolute basis, they actually were quite good given the turbulent securities markets we saw during the quarter. We believe the Fund's portfolio of investments remains sound and will continue to provide common stock shareholders with high current income.

Conditions in the financial markets remain difficult as many of the adverse trends that surfaced in the second half of 2007 have persisted during the first few months of 2008. The dramatic downturn in the housing market is clearly at the root of our current economic problems. The housing bubble, fueled by lenders willing to fund anyone who could fog a mirror, is correcting itself at a jarring pace. In addition, the impact has been magnified because the alchemists of Wall Street, with an assist from the rating agencies, took these leaden mortgages and turned them not into gold, but rather into an alphabet soup of mortgage-backed securities, some of which turned out to be toxic waste.

The Fund never invested in these structured mortgage products, but we did underestimate the impact they would have on many of the companies we own. Since the beginning of the credit crisis last year, financial companies have written off more than \$200 billion of bad loans and investments, and they have lost about 27.4%³ of their equity market value. While common equity holders will ultimately bear the brunt of these losses, the preferred securities of many financial companies have fallen sharply in market price. Financial companies comprise more than 75% of the preferred security universe, and, given the mandate of the Fund, the portfolio will always own a lot of these financial issues.

As of February 29th, 60.3% of the portfolio was invested in preferred securities of the financial sector. Commercial banks comprised 30% of the total portfolio, along with 16% in finance companies (including investment banks and brokers), 14% in insurance companies and 0.3% in the housing agencies Freddie Mac and Fannie Mae. The remainder of the portfolio is mostly utilities, other energy companies, and cash.

Another topic in the news recently is the collapse of the auction rate preferred market. A wide range of entities have issued this type of security, and for years it was an effective way to borrow money. Last fall, the auction process began to break down. In February the auction market suddenly collapsed and the long-term viability of the product became in doubt.

Many closed-end funds have issued auction rate preferred as a means to enhance income for the common shareholders. Historically, rates *paid* by the Fund (on the preferred stock) have been well below what the Fund *earns* on its investments.

¹ Based on monthly data provided by Lipper Inc. in each calendar month during the quarter. Distributions are assumed to be reinvested at NAV in accordance with Lipper's practice, which may differ from other methodology used elsewhere in this report.

² Based on Bloomberg data; distributions are assumed to be reinvested at market price.

³ The return on the Standard and Poor's 500 Financial index for the period 6/30/07 through 2/29/08, price change only.

As you know, PFD employs leverage and therefore has two classes of shareholders—common stock and auction preferred stock. Both share in the income generated by the investment portfolio, but in a different way. The amount paid to holders of the preferred stock is determined periodically via a Dutch auction process. These auctions are designed to determine a rate that will “clear” the market, i.e., attract enough buyers to absorb any shares being sold. There is, however, a maximum rate at each auction based on a formula. If the maximum rate is not sufficient to attract enough buyers, the auction is said to “fail” and holders wishing to sell cannot. The terminology is unfortunate: a “failed” auction means sellers can’t sell, but it has nothing to do with the Fund’s ability to distribute income.

The dividend paid to common stock shareholders is simply the income left over after paying preferred stock dividends and other expenses of the Fund. Thus, the higher the rates paid by the Fund on its preferred stock, the less income available for common shareholders. Under current market conditions, even with preferred stock dividends being at the current maximum rate, *the yield earned on the portfolio remains well above the cost of leverage.*

The breakdown of the auction market is a symptom of a larger malady affecting financial markets—illiquidity. Just as banks and other traditional lenders have dramatically cut back on making certain types of loans, investors have become much less willing to part with cash. Since July 2007, additions to money market funds (a substitute for cash) have increased by nearly one trillion dollars.

And while many are hoarding cash, others are scrambling to raise it. It is clear that as a nation we had purchased too many things with borrowed money. This was obviously the case in the housing market, and now many homeowners are being forced to sell. In the securities markets, it has become apparent that many hedge funds and other investment firms were operating without sufficient capital and are also being forced to sell assets. There is ample evidence that in aggregate, hedge funds have been shrinking their investment portfolios, and we have observed several of our trading partners at brokerage firms aggressively trying to reduce their trading positions.

Another source of selling pressure has come from a steady supply of new issues, as companies have sought to shore up their balance sheets after taking big write downs. It wasn’t long ago that the decision to issue new equity, whether common or preferred, was based on strategic or opportunistic factors. Now, many companies are being forced to issue to rebuild capital for defensive reasons, and they are paying rates that are historically high (in relation to risk-free U.S. Treasury securities).

Every financial bubble eventually bursts and asset prices fall to sustainable levels. Tulips and dot-com companies are one thing, but the U.S. housing market is a whole different ballgame in terms of its economic impact. In order for the U.S. economy to avoid a deep and lasting recession, the housing sector will need to stabilize. For this to happen, the glut of homes for sale must shrink. This in turn will likely require some relief for over-extended borrowers and a return to more normal mortgage markets. For that to happen, home prices will need to fall to a “clearing” level that certainly is lower than today’s prices. However, lower home prices, while necessary, may amplify current economic weakness. Needless to say, the path to economic recovery will be bumpy and hard to navigate.

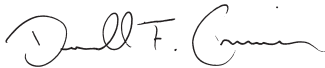
We are cautiously optimistic that the extraordinary steps taken by the Federal Reserve Bank will be effective in avoiding a severe economic downturn. The Fed’s objective is to make certain that capital markets in general, and the banking system in particular, are functioning properly and providing adequate liquidity to businesses and individuals. The financial system is far more complex today than just a few years ago, making the Fed’s job much more difficult. We encourage you to read our Quarterly Economic Update on the Fund’s website for a more detailed discussion of current conditions in the housing sector and our thoughts on the economy in general.

Our job remains the same—research each and every credit in the portfolio, and try to construct the best portfolio of securities that will enable the Fund to meet its objectives. While market sentiment is certainly depressed at the moment, we see tremendous long-term value in preferred securities at today's prices.

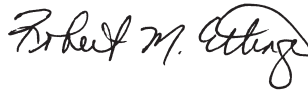
During periods of unusual market volatility, these letters provide a welcome opportunity to step back and discuss a wide variety of items affecting your Fund. Some of these deserve more attention than space here allows and are covered in greater depth on the Fund's website. Other situations, like the status of our auction preferred stock, are rapidly changing, and we'll post to the website as much up-to-date information as possible.

We may never know the origins of the old curse "may you live in interesting times," but whoever coined it certainly got his wish.

Sincerely,



Donald F. Crumrine
Chairman of the Board



Robert M. Ettinger
President

April 9, 2008