

## FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Fund:

As can be seen in the table below, the net asset value of the Fund rose substantially during the most recent fiscal quarter. A variety of factors contributed to the strength and, despite a dramatic recovery in the prices of preferred securities, we believe the sector remains undervalued relative to other market segments.

### TOTAL RETURN ON NET ASSET VALUE<sup>(1)</sup> FOR PERIODS ENDED MAY 31, 2009

	Actual Returns			Average Annualized Returns			
	Three Months	Six Months	One Year	Three Years	Five Years	Ten Years	Life of Fund <sup>(2)</sup>
Flaherty & Crumrine Preferred Income Fund.....	45.2%	28.3%	-27.3%	-14.7%	-6.9%	0.5%	6.6%
Lipper Domestic Investment Grade Funds <sup>(3)</sup> .....	10.9%	13.5%	-5.9%	1.1%	2.6%	4.7%	6.3%

(1) Based on monthly data provided by Lipper Inc. in each calendar month during the relevant period. Distributions are assumed to be reinvested at NAV in accordance with Lipper's practice, which differs from the methodology used in the footnotes to the financial statements.

(2) Since inception on January 31, 1991.

(3) Reflects the equally-weighted average performance returns of all closed-end funds in Lipper's Domestic Investment-Grade funds category in each month during the period. The category currently includes closed-end funds in the U.S. Mortgage and Corporate Debt BBB Rated sub-categories and has included other sub-categories in prior periods. Although the investment strategies used by the Fund differ significantly from the strategies used by these other fixed-income funds, the Fund seeks to accomplish a similar objective.

After several quarters of sharply declining prices, the preferred market was poised for a rebound. But even with eye-popping appreciation over the past few months, prices on the vast majority of preferred securities remain well below the highs of last year.

The state of the market appeared to hit rock bottom in early March, when the financial system was rumored to be on the brink of collapse. Since that time cooler heads have prevailed and the rumors appear to have been greatly exaggerated. Many financial companies have taken steps to strengthen their balance sheets and a few have already returned funds received from the government for emergency assistance.

We have recently watched with fascination the stunning reversal of a long-term trend. Over the past decade, large and mid-sized financial companies in need of new capital often chose to issue preferred and hybrid securities rather than sell common stock. This strategy seemed to satisfy both their common shareholders and regulators; investors, including PFD, became quite comfortable purchasing these securities. Hundreds of billions of dollars of this "senior equity" has been issued. Recently (and dramatically), the emphasis has flip-flopped, and many financial companies have been taking steps to replace preferred securities with common stock, or have simply sold additional common stock.

These steps are very beneficial to owners of preferred securities and have been the main driver of the recent recovery in preferred prices. Prices have improved as issuers typically pay above-market levels in order to exchange a sufficient amount of preferred securities for common stock. The credit quality of preferred securities that remain outstanding improves because common stock ranks junior to preferred securities, so the more common stock a company has outstanding (relative to preferred), the greater the protection against adversity. This trend is important to the Fund, so we've posted a more detailed discussion in the "Discussion Topics" below.

The Fund's holdings in financial issuers (mostly banks and insurance companies) were responsible for much of its poor performance over the past year, and they were the primary contributors to its positive performance over this past quarter. The extraordinary steps taken by the various federal government entities appear to be helping, but the ultimate recovery of the financial sector will hinge on a broad economic recovery. We discuss the economic outlook on the Fund's website, [www.preferredincome.com](http://www.preferredincome.com).

We don't want to neglect the non-financial portion of the portfolio, but for most of these holdings things have been blissfully uneventful for some time. The Fund is required to maintain at least 25% of the portfolio in the utility industry, but since the industry comprises only 5% of the entire preferred universe, we tend to have greater concentrations in certain credits. By overweighting utilities, the Fund outperformed the broader preferred market when financials were collapsing, but it also meant the Fund underperformed during the past quarter. All things considered, however, utilities have been a good thing to own.

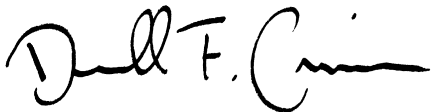
Unfortunately, the Fund does have a few investments in companies that have stopped making dividend or interest payments on their securities. These positions are identified in the portfolio listing as "non-income producing". The prices of these securities have declined to reflect the market consensus on the outlook for the issuers, and thus are fully reflected in the net asset value of the Fund. In addition, as discussed below, we take these situations into consideration when determining the amount of the Fund's monthly distribution to shareholders.

The Fund is undergoing an important change unrelated to the preferred markets just discussed – after months of hard work and negotiations, the Fund has secured new financing which is being used to redeem all remaining shares of its auction preferred stock (APS). As discussed previously, the auction market ceased functioning early last year and ever since we have been working to secure a suitable replacement. With the demise of the auction market, we determined the most efficient alternative is a committed financing agreement with a bank (a fancy term for a loan), but before we could proceed there were obstacles which had to be overcome. In recent days, the last of these were addressed and the new loan was secured.

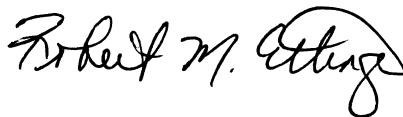
Replacing APS with bank debt should benefit the Fund in several ways. Initially, and we expect over the long run, the bank loan will be less expensive than the APS. This will especially be true if (and when) short term interest rates increase. In addition, we should have greater flexibility managing assets of the Fund, and while we don't envision doing anything differently from the way we do things now, there are likely to be instances when the additional flexibility will be important.

More information is always available on the Fund's website, including discussion of many of the topics in this letter. This calendar year, we have written about preferred securities valuations, the Citicorp exchange offer, the U.S. government's Capital Assistance Plan, the results of the "stress tests" of key financial institutions and, most recently, our interest rate hedging strategy. We encourage you to visit the website at [www.preferredincome.com](http://www.preferredincome.com).

Sincerely,

Handwritten signature of Donald F. Crumrine in black ink.

Donald F. Crumrine  
Chairman of the Board

Handwritten signature of Robert M. Ettinger in black ink.

Robert M. Ettinger  
President

July 20, 2009

## DISCUSSION TOPICS

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

As the table below demonstrates, the preferred market performed very well during the first six months of the Fund's fiscal year ending May 31<sup>st</sup>, although the recovery didn't actually begin until early March. While no index comprehensively reflects the preferred market, Merrill Lynch publishes four different indices which attempt to measure performance of some sectors of the investment-grade preferred securities market: the Merrill Lynch 8% Capped DRD Preferred Stock Index (which includes traditional tax-advantaged preferred stocks); the Merrill Lynch 8% Capped Hybrid Preferred Securities Index (which includes fully-taxable, exchange-traded preferred securities); the Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index (which includes fully-taxable capital securities); and the Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index (which includes both tax-advantaged and taxable preferred securities with adjustable dividends). Set forth below are the six month total returns for these indices:

#### Total Returns of Merrill Lynch Preferred Securities Indices\* for the Six Months Ended May 31, 2009

Merrill Lynch 8% Capped DRD Preferred Stock Index <sup>SM</sup> .....	+3.8%
Merrill Lynch 8% Capped Hybrid Preferred Securities Index <sup>SM</sup> .....	+12.3%
Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index <sup>SM</sup> .....	+17.7%
Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index <sup>SM</sup> .....	+31.3%

\* The Merrill Lynch 8% Capped DRD Preferred Stock Index<sup>SM</sup> 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 Merrill Lynch 8% Capped Hybrid Preferred Securities Index<sup>SM</sup> 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 Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index<sup>SM</sup> 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%. The Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index<sup>SM</sup> includes adjustable rate preferred securities issued by US corporations and government agencies with issuer concentration capped at a maximum of 7%. All index returns include interest and dividend income and, unlike the Fund's returns, are unmanaged and do not reflect any expenses.

As the following table demonstrates, the Fund's total return on its securities portfolio (before leverage) outperformed these indices, with the exception of the Merrill index measuring adjustable rate preferreds. However, adjustable rate preferred securities constitute only approximately 3% of the entire preferred market, about the same weighting as these securities are held in the Fund. In contrast to the experience last year, the strategy of using leverage to increase current income has magnified the positive returns over the Fund's fiscal year-to-date, and, even net of its expenses, caused the NAV of the Fund to outperform these unleveraged indices (except for adjustable rate preferreds).

The following table reflects performance of each investment tool used by the Fund to achieve its objective, namely: (a) investing in a portfolio of securities; (b) hedging that portfolio of securities against significant increases in long-term interest rates (although no hedges were in place over the Fund's fiscal year-to-date (see the following discussion on interest rate hedging)); and (c) issuing auction-rate preferred stock

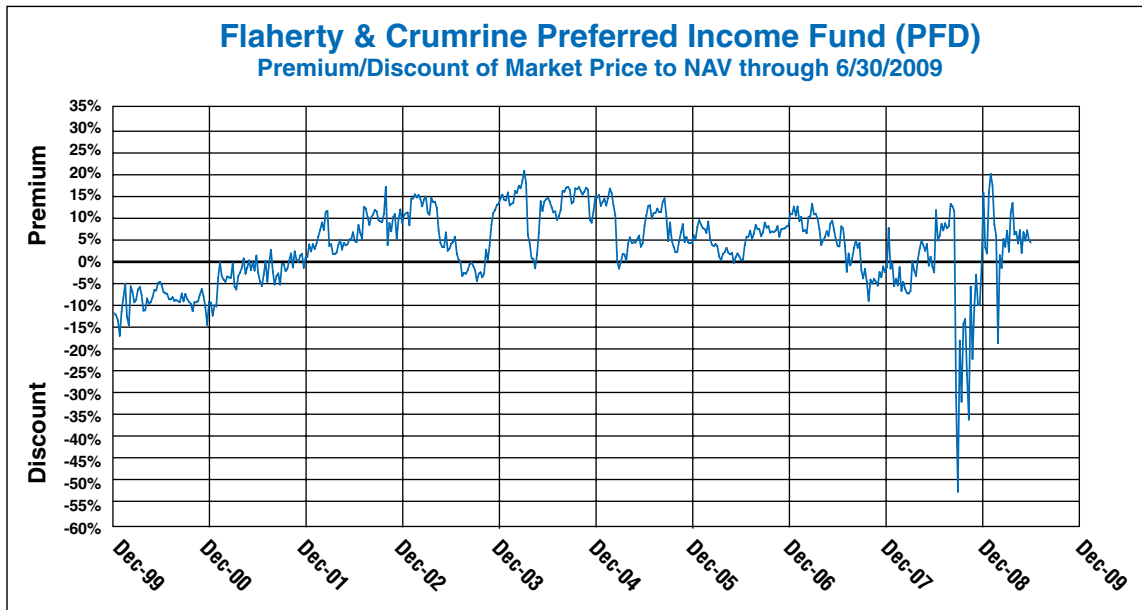
to leverage and enhance returns to Common Stock shareholders. The table then adjusts for the impact of the Fund's operating expenses to arrive at a total return on NAV (which factors in all of these items).

**Components of PFD's Total Return on NAV  
for the Six Months Ended May 31, 2009**

Total Return on Unleveraged Securities Portfolio (including principal and income).....	+18.9%
Return from Interest Rate Hedging Strategy .....	0.0%
Impact of Leverage .....	+10.7%
Expenses .....	-1.3%
<i>Total Return on NAV</i>	
	+28.3%

**Total Return on Market Price of Fund Shares**

While our focus is primarily on managing the Fund's investment portfolio, an investor's actual return is comprised of monthly dividend payments plus changes in the Fund's market price. The improvement in investor psychology impacting valuation of the Fund's securities has also favorably affected the relationship between the intrinsic value of the Fund (its NAV) and its market price. Over the Fund's fiscal year-to-date through May 31<sup>st</sup>, the excellent return on NAV plus the market price discount to NAV transitioning to a premium combined to produce a total return on *market value* of +38.0%. During the 2<sup>nd</sup> fiscal quarter alone, total return on *market value* was +39.7%.



Even following the recovery over the past several months in both the Fund's NAV and market price, as of June 30<sup>th</sup> the Fund still returns a high current yield based on market price of 9.5%.

## Monthly Distributions to Fund Shareholders

The monthly distribution paid to shareholders is intended to reflect current market conditions, but we also must make assumptions about the future. We begin with an estimate of the sustainable income generated from the investment portfolio, and end with a forecast of expenses. While it sounds simple, in periods of rapid change, forecasting income and expenses becomes more art than science. There are always a lot of moving parts when the Fund sets the monthly distribution, and the present is no different.

With regard to income earned by the Fund, the financial crisis has claimed many victims and there are now a few holdings in the Fund's portfolio that are not presently making dividend or interest payments. These are identified as "non-income producing" in the portfolio listing that follows. If these companies are not able to resolve their present difficulties, they are unlikely to resume making distributions. We are monitoring these situations very closely and will make adjustments as necessary. Because these non-income producing holdings have already fallen in price to nominal values, the risk to NAV from holding them is minimal.

In addition, some distributions received by the Fund may be classified as "return of capital". This is an accounting concept that results when an issuer has sufficient funds to make dividend payments, but its retained earnings balance is less than the amount distributed. In such instances, the Fund receives payment, but it must be treated differently from other distributions by both the Fund and Fund shareholders.

On the plus side, we expect the steps being taken to replace auction preferred stock with a bank loan will reduce the expense incurred by the Fund on its leverage. Following is a discussion of the Fund's leverage. Terms of the bank loan are described in footnote 7 of the financial statements.

## The Fund's Leverage

As we've discussed in prior reports, collapse of the auction preferred stock market in February 2008 caused the Fund's outstanding auction preferred stock (APS) to reset at relatively high "maximum rates." As a result, the Fund has since sought reasonable alternatives to its use of auction preferred stock for leverage. Only recently has the Fund been able to overcome two significant hurdles to refinancing all its outstanding APS.

The Investment Company Act of 1940 presented the first hurdle for the Fund. The Investment Company Act only requires the Fund to have 200% asset coverage for its outstanding preferred stock. In other words, the Fund must have \$2 in assets for every \$1 of APS outstanding. For much of the Fund's history, it comfortably had preferred asset coverage well in excess of 200%. For debt, however, the Fund must have 300% asset coverage – \$3 in assets for every \$1 borrowed.

Unprecedented market conditions in the past year made it very difficult to maintain even 200% asset coverage, let alone the 300% for borrowed money. As a result, in October 2008, the Fund applied for exemptive relief from the Securities and Exchange Commission to allow it to use debt to refinance its then-outstanding APS that would only be subject to a 200% asset coverage requirement. After several revisions to the Fund's application, on June 1<sup>st</sup> the Fund finally received SEC exemptive relief that allows 200% asset coverage on this refinancing debt. Importantly, though, this relief only lasts until October 31, 2010. By that date, the Fund must have 300% asset coverage whenever it borrows money.

The other hurdle, of course, came from finding a loan on terms sufficiently reasonable to make sense for the Fund's common stock shareholders. Like any other borrower during the financial crisis, it took a little bit of time to obtain this financing. Happily, with the exemptive relief now in hand, on June 26<sup>th</sup>, the Fund was able to announce that it had secured this funding and that it could now redeem all outstanding APS.

The recent recovery in the Fund's portfolio has helped the Fund significantly improve its asset coverage. As of June 30<sup>th</sup>, the Fund's leverage had asset coverage of 282%. It is important to note that refinancing the Fund's source of leverage does not affect the dollar amount of leverage used by the Fund. In other words, leverage will continue to provide a similar impact (whether positive or negative) to the Fund's common shareholders as it has in prior periods.

## **Preferred Market Conditions**

The preferred securities market has recovered significantly over the past several months, as the financial market's concern about broad nationalization of the U.S. banking system has abated and the pace of economic deterioration has moderated. With preferred securities priced in early March for a much worse experience than existed during the Great Depression, even a difficult recession looked pretty good.

A critical factor in the preferred market's improvement has been a meaningful shift in the role of preferred stock and hybrid securities in the capital structure of banks and financial companies. We anticipate these changes will have a long-term positive impact on the preferred market, even though we may encounter further uncertainty before it all plays out.

Falling between debt and equity on a company's balance sheet, preferred securities have long been used as an effective way for companies to get some of the benefits of common equity without diluting the interests of their common stock shareholders. In the years leading up to the financial crisis, the portion of overall capital comprised of preferred securities increased substantially, often as a means to finance common stock repurchases. Compared to ten years ago, the balance sheet of a typical bank, insurance or finance company has become more skewed toward preferred securities and less toward common stock. This emphasis on preferred over common was supported by regulators and rating agencies alike. Preferred capital increased still further when the federal government decided to inject capital into troubled banks and insurance companies. (Although, while it did so through investment in preferred securities, these securities rank at a level *junior* to existing taxable preferreds and *pari passu* (or equal to) existing traditional preferred stocks.)

As we have discussed in recent letters, three factors – excess supply, deleveraging and credit deterioration – were primarily responsible for the steep drop in prices of preferred securities. But many preferred prices became so distressed that companies realized if they issued common stock and used the proceeds to *purchase* their own preferred securities at deep discounts to par, they could simultaneously reduce their dividend expense and increase their common equity ratio.

Some companies executed this recapitalization formally via public offers to exchange preferred shares into common stock, which directly adds to common equity. Other companies simply purchased preferred shares in the open market; the discount to par is booked as a gain, which adds to earnings and thus to common equity. In either event, these efforts were done at substantial premiums to the previously existing market prices for their preferreds, giving a major boost to the preferred market. In addition, by adding to common equity and reducing preferreds on the balance sheet, these companies improved the creditworthiness of their remaining preferred securities, which has aided investor confidence tremendously. As confidence has re-emerged, other investors have waded back in, reinforcing these higher preferred prices.

In another sign of life in the preferred market, a few new issues have been brought to market in recent weeks. The new deals have been structured to attract non-institutional investors (\$25 par value and listed on the NYSE), and have been met with healthy demand.

We still expect some bumps in the road. The economy remains weak and there are plenty of troubled loans to work out. In addition, although the preferred exchanges and buybacks have been beneficial for the market, virtually all of them have been done at discounts to par value. However, we think the crisis phase of the market has passed, and investors should begin to refocus on individual credits rather than worry about the solvency of the financial system as a whole.

### **Impact on the Fund of Rating Agency Downgrades of Preferred Securities**

As the financial crisis intensified, the three primary credit rating agencies – Moody's Investors Service, Standard and Poor's, and Fitch Ratings – downgraded many preferred securities, with some falling from investment grade to below investment grade. Not surprisingly, these downgrades have been concentrated among financial issuers, but utilities and other industries also have seen downgrades. Upgrades have been few and far between. In most cases, we agreed with the direction of the rating actions early in the crisis. Financial institutions faced unprecedented risks as the financial crisis unfolded, and those risks needed to be reflected in issuers' ratings, although we think preferred ratings were sometimes reduced to levels that were inconsistent with their senior and subordinated debt ratings. We have been more baffled by some recent downgrades, however, given brightening economic prospects, much improved money and credit markets, and strengthened capital positions at many (though not all) financial institutions.

Regardless of our own views, the rating agencies still matter in the management of the Fund, so it's worth taking a moment to understand how these rating actions affect it. First, and perhaps most obviously, the price of a preferred tends to fall, if only temporarily, when it is downgraded. This affects NAV, of course, but it also affects the Fund's leverage ratio. If many of the Fund's holdings decline in value, the Fund may (and at several points over the past nine months, did) need to sell securities in order to reduce leverage, typically resulting in a loss. Even if preferred prices subsequently recover, lower leverage means that NAV will not recover to the same extent.

Second, the Fund is required to meet certain asset coverage tests, and ratings determine how much of a security's market value may be used to cover fund liabilities. If a security is downgraded, especially if it is downgraded from investment grade to below investment grade, its coverage value generally decreases (even if its price does not). At a minimum, this reduces the "excess" coverage of the Fund. If enough securities are downgraded, the Fund may have to reduce borrowings, or sell lower-rated securities and buy higher-rated ones; both probably mean lower levels of income for the Fund. Of course, we try to manage the Fund to avoid that outcome, but downgrades definitely make it more difficult.

Finally, the Fund has an investment policy that limits holdings of securities without an investment grade rating by at least one agency to 25% of total assets. The Fund is not required to sell assets if downgrades push holdings above the limit, but it cannot add to such holdings until they are again below the limit. Historically, this has not been a significant constraint on the management of the Fund. Our focus is on investment-grade issuers, and most preferreds from these issuers were rated investment grade. Recent ratings actions have pushed many preferreds below investment grade at one or more rating agencies, even when the issuer's senior debt remains solidly investment grade. For example, Moody's rates Wells Fargo senior unsecured debt A1 but its preferred stock only Ba3, fully 8 notches lower. (This is one of those situations where we think the ratings are inconsistent: either Ba3 is too low for the preferreds or A1 is too high

for the senior debt.) If the rating agencies continue to downgrade preferreds, the limit on below investment grade holdings could prevent the Fund from buying securities that it believes are attractive, which could reduce income or total return going forward.

Although ratings actions have been overwhelmingly negative in recent quarters – and overdone in our view for many preferreds – we think the outlook is starting to improve, especially for financial institutions. As noted elsewhere in this letter, banks and insurance companies have raised a substantial amount of common equity capital over the past several months, both from common stock offerings and through preferred-to-common stock exchanges. Looking ahead, banks are going to hold thicker common equity cushions than they have historically. All of these things are positive for preferreds longer-term. While the Fund has a bit less maneuvering room than normal due to rating agency downgrades, we do not think those actions will have a substantial impact on the ability of the Fund to meet its objectives.

## PORTFOLIO OVERVIEW

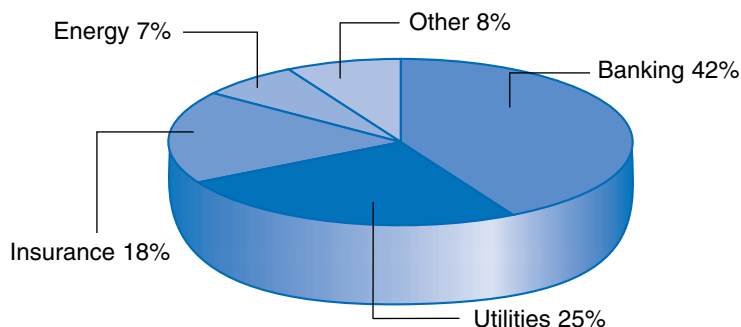
May 31, 2009 (Unaudited)

### Fund Statistics on 5/31/09

Net Asset Value	\$	7.18
Market Price	\$	7.35
Premium		2.37%
Yield on Market Price		10.29%
Common Stock Shares Outstanding		10,638,947

### Industry Categories

### % of Portfolio



### Moody's Ratings % of Portfolio

AA	4.6%
A	7.9%
BBB	52.0%
BB	18.3%
Below "BB"	7.5%
Not Rated	4.4%

Below Investment Grade\* 22.0%

\* Below investment grade by both Moody's and S&P.

### Top 10 Holdings by Issuer

### % of Portfolio

PNC Financial Services	7.1%
Bank of America	5.3%
Banco Santander	4.6%
Liberty Mutual Group	4.4%
Interstate Power & Light	4.2%
Sovereign Bancorp	3.9%
Kinder Morgan	3.2%
Metlife	3.1%
HSBC Plc	2.8%
Capital One Financial	2.7%

### % of Portfolio\*\*

Holdings Generating Qualified Dividend Income (QDI) for Individuals	53%
Holdings Generating Income Eligible for the Corporate Dividends Received Deduction (DRD)	44%

\*\* This does not reflect year-end results or actual tax categorization of Fund distributions. These percentages can, and do, change, perhaps significantly, depending on market conditions. Investors should consult their tax advisor regarding their personal situation.

**PORTFOLIO OF INVESTMENTS****May 31, 2009 (Unaudited)**

<u>Shares/\$ Par</u>		<u>Value</u>
<b>Preferred Securities — 91.3%</b>		
<b>Banking — 41.7%</b>		
\$ 3,000,000	Astoria Capital Trust I, 9.75% 11/01/29, Series B .....	\$ 2,839,722
	Banco Santander:	
47,248	Adj. Rate Pfd. ....	560,479** <sup>(1)</sup>
207,500	6.50% Pfd. ....	3,646,294** <sup>(1)</sup>
79,400	6.80% Pfd. ....	1,355,557** <sup>(1)</sup>
	Bank of America Corporation:	
108,000	Adj. Rate Pfd., Series 5 .....	1,614,600*
3,000	Series II STRIPES Custodial Receipts, Pvt. ....	7,530*†
200,000	6.25% Pfd. ....	3,034,000*
48,700	6.70% Pfd. ....	774,330*
\$ 4,800,000	Capital One Capital III, 7.686% 08/15/36 .....	3,224,866
\$ 5,210,000	CBG Florida REIT Corporation, 7.114%, 144A**** .....	783,115
	CIT Group, Inc.:	
\$ 905,000	6.10% 03/15/67 .....	383,801
154,500	6.35% Pfd., Series A .....	1,353,806*
32,500	5.189% Pfd., Series B .....	820,625*
50,000	Cobank, ACB, 7.00% Pfd., 144A**** .....	1,277,850*
\$ 4,400,000	Comerica Capital Trust II, 6.576% 02/20/37 .....	2,415,996
9,000	FBOP Corporation, Adj. Rate Pfd., 144A**** .....	2,700,000*
1,250	First Republic Preferred Capital Corporation, 10.50% Pfd., 144A**** .....	652,500
22,500	First Republic Preferred Capital Corporation II, 8.75% Pfd., Series B, 144A**** ..	348,750
2,250	First Tennessee Bank, Adj. Rate Pfd., 144A**** .....	759,375*
\$ 1,500,000	First Union Capital II, 7.95% 11/15/29 .....	1,211,493
	Goldman Sachs:	
\$ 2,300,000	Capital II, 5.793% .....	1,335,159
11	Pass-Through Certificates, Class B, 144A**** .....	0*†
2,500	STRIPES Custodial Receipts, Pvt. ....	25*
	HSBC USA, Inc.:	
52,000	Adj. Rate Pfd., Series D .....	816,010*
176,000	Adj. Rate Pfd., Series G .....	2,476,760*
2,500	\$2.8575 Pfd. ....	83,500*
22,800	Keycorp Capital IX, 6.75% Pfd. 12/15/66 .....	398,373
\$ 550,000	Lloyds Banking Group PLC, 6.657%, 144A**** .....	217,582** <sup>(1)</sup>
31,500	PFGI Capital Corporation, 7.75% Pfd. ....	540,423
274,200	PNC Financial Services, 9.875% Pfd., Series F .....	6,827,580*
\$ 1,600,000	PNC Preferred Funding Trust III, 8.70%, 144A**** .....	1,186,765
\$ 1,500,000	Regions Financing Trust II, 6.625% 05/15/47 .....	1,042,026

The accompanying notes are an integral part of the financial statements.

**PORTFOLIO OF INVESTMENTS (Continued)**

May 31, 2009 (Unaudited)

<u>Shares/\$ Par</u>		<u>Value</u>
<b>Preferred Securities — (continued)</b>		
<b>Banking — (continued)</b>		
171,480	Sovereign Bancorp, 7.30% Pfd., Series C .....	\$ 3,222,538*
20,100	Sovereign Capital Trust V, 7.75% Pfd. 05/22/36 .....	409,487
1,750	Sovereign REIT, 12.00% Pfd., Series A, 144A**** .....	1,141,875
	U.S. Bancorp, Auction Pass-Through Trust, Cl. B:	
11	Series 2006-5, Variable Rate Pfd., 144A**** .....	275*†
11	Series 2006-6, Variable Rate Pfd., 144A**** .....	275*†
\$ 1,000,000	Washington Mutual Preferred Funding IV, 9.75%, 144A**** .....	750††
\$ 1,600,000	Webster Capital Trust IV, 7.65% 06/15/37 .....	1,041,357
		<u>50,505,449</u>
<b>Financial Services — 0.0%</b>		
	Lehman Brothers Holdings, Inc.:	
15,000	5.67% Pfd., Series D .....	6,000*††
19,500	5.94% Pfd., Series C .....	5,850*††
25,000	6.50% Pfd., Series F .....	3,188*††
27,500	7.95% Pfd. ....	1,925*††
		<u>16,963</u>
<b>Insurance — 14.6%</b>		
27,500	Arch Capital Group Ltd., 8.00% Pfd., Series A .....	609,469** <sup>(1)</sup>
	AXA SA:	
\$ 2,500,000	6.379%, 144A**** .....	1,553,750** <sup>(1)</sup>
\$ 2,500,000	6.463%, 144A**** .....	1,505,850** <sup>(1)</sup>
35,900	Axis Capital Holdings, 7.50% Pfd., Series B .....	2,496,174 <sup>(1)</sup>
90,600	Delphi Financial Group, 7.376% Pfd. 05/15/37 .....	1,160,813
\$ 3,000,000	Everest Re Holdings, 6.60% 05/15/37 .....	1,531,932
	Liberty Mutual Group:	
\$ 4,500,000	7.80% 03/15/37, 144A**** .....	2,208,532
\$ 500,000	10.75% 06/15/58, 144A**** .....	310,450
\$ 500,000	MetLife Capital Trust IV, 7.875% 12/15/37, 144A**** .....	390,927
\$ 4,000,000	MetLife Capital Trust X, 9.25% 04/08/38, 144A**** .....	3,407,544
	Renaissancere Holdings Ltd.:	
73,050	6.08% Pfd., Series C .....	1,254,999** <sup>(1)</sup>
19,700	6.60% Pfd., Series D .....	380,210** <sup>(1)</sup>
119,500	Scottish Re Group Ltd., 7.25% Pfd. ....	276,344** <sup>(1)</sup> †
\$ 750,000	USF&G Capital, 8.312% 07/01/46, 144A**** .....	638,854
		<u>17,725,848</u>

The accompanying notes are an integral part of the financial statements.

**PORTFOLIO OF INVESTMENTS (Continued)****May 31, 2009 (Unaudited)**

<u>Shares/\$ Par</u>		<u>Value</u>
<b>Preferred Securities — (continued)</b>		
<b>Utilities — 25.3%</b>		
	Alabama Power Company:	
300	4.52% Pfd. ....	\$ 20,512*
5,734	4.72% Pfd. ....	409,444*
25,000	6.45% Pfd. ....	552,345*
5,000	Baltimore Gas & Electric Company, 6.70% Pfd., Series 1993 .....	462,812*
2,780	Central Vermont Public Service Corporation, 8.30% Sinking Fund Pfd., Pvt. ....	279,737*
\$ 2,491,000	COMED Financing III, 6.35% 03/15/33 .....	1,472,948
\$ 2,998,000	Dominion Resources, Inc., 7.50% .....	2,078,666
	Duquesne Light Company:	
9,190	4.15% Pfd. ....	243,535*
910	4.20% Pfd. ....	23,342*
5,490	\$2.10 Pfd., Series A .....	149,877*
25,000	Entergy Arkansas, Inc., 6.45% Pfd. ....	518,750*
	Georgia Power Company:	
12,600	6.125% Pfd. ....	306,338*
20,000	6.50% Pfd., Series 07-A .....	1,658,126*
2,010	Great Plains Energy, Inc., 4.50% Pfd. ....	153,001*
50,000	Hawaiian Electric Company, Inc., 5.25% Pfd., Series H, Pvt. ....	760,940*
32,650	Indianapolis Power & Light Company, 5.65% Pfd. ....	2,194,694*
194,000	Interstate Power & Light Company, 8.375% Pfd., Series B .....	5,104,625*
	Pacific Enterprises:	
22,430	\$4.50 Pfd. ....	1,597,438*
10,000	\$4.75 Pfd., Series 53 .....	746,563*
1,095	PacifiCorp, 5.40% Pfd. ....	85,821*
\$ 500,000	PECO Energy Capital Trust III, 7.38% 04/06/28, Series D .....	411,231
\$ 2,475,000	Puget Sound Energy, Inc., 6.974% 06/01/67 .....	1,683,000
	Southern California Edison:	
25,000	6.00% Pfd., Series C .....	1,953,908*
11,500	6.125% Pfd. ....	922,875*
\$ 1,000,000	Southern Union Company, 7.20% 11/01/66 .....	610,000
\$ 750,000	TXU Electric Capital V, 8.175% 01/30/37 .....	341,250
	Union Electric Company:	
14,150	4.56% Pfd. ....	905,600*
18,800	\$7.64 Pfd. ....	1,847,688*
\$ 4,400,000	Wisconsin Energy Corporation, 6.25% 05/15/67 .....	3,172,532
		<u>30,667,598</u>

The accompanying notes are an integral part of the financial statements.

**PORTFOLIO OF INVESTMENTS (Continued)**

May 31, 2009 (Unaudited)

<u>Shares/\$ Par</u>		<u>Value</u>
<b>Preferred Securities — (continued)</b>		
<b>Energy — 7.1%</b>		
\$ 4,500,000	Enbridge Energy Partners LP, 8.05% 10/01/37 .....	\$ 2,951,374
\$ 2,600,000	Enterprise Products Partners, 7.034% 01/15/68 .....	1,822,634
3,500	Kinder Morgan GP, Inc., 8.33% Pfd., 144A**** .....	3,845,844*
		<u>8,619,852</u>
<b>Miscellaneous Industries — 2.6%</b>		
40,000	Ocean Spray Cranberries, Inc., 6.25% Pfd., 144A**** .....	2,566,252*
\$ 1,000,000	Stanley Works, 5.902% 12/01/45 .....	561,343
		<u>3,127,595</u>
<b>Total Preferred Securities</b>		
	(Cost \$153,380,932) .....	<u>110,663,305</u>
<b>Corporate Debt Securities — 3.3%</b>		
<b>Insurance — 3.3%</b>		
\$ 4,729,000	Liberty Mutual Insurance, 7.697% 10/15/97, 144A**** .....	2,787,046
\$ 2,000,000	UnumProvident Corporation, 7.25% 03/15/28, Senior Notes .....	1,192,622
		<u>3,979,668</u>
<b>Total Corporate Debt Securities</b>		
	(Cost \$5,887,621) .....	<u>3,979,668</u>
<b>Money Market Fund — 4.2%</b>		
5,084,817	BlackRock Provident Institutional, T-Fund .....	5,084,817
<b>Total Money Market Fund</b>		
	(Cost \$5,084,817) .....	<u>5,084,817</u>

The accompanying notes are an integral part of the financial statements.

**PORTFOLIO OF INVESTMENTS (Continued)****May 31, 2009 (Unaudited)**

<b>Total Investments</b> (Cost \$164,353,370 <sup>***</sup> ) .....	98.8%	\$ 119,727,790
<b>Other Assets And Liabilities</b> (Net) .....	1.2%	<u>1,432,933</u>
<b>Total Net Assets Available to Common and Preferred Stock</b> .....	<u>100.0%†</u>	<u>\$ 121,160,723</u>
<b>Auction Preferred Stock (APS) Redemption Value</b> .....		<u>(44,800,000)</u>
<b>Total Net Assets Available To Common Stock</b> .....		<u>\$ 76,360,723</u>

\* Securities eligible for the Dividends Received Deduction and distributing Qualified Dividend Income.

\*\* Securities distributing Qualified Dividend Income only.

\*\*\* Aggregate cost of securities held.

\*\*\*\* Securities exempt from registration under Rule 144A of the Securities Act of 1933. These securities may be resold in transactions exempt from registration to qualified institutional buyers. At May 31, 2009, these securities amounted to \$28,284,161 or 23.3% of net assets. These securities have been determined to be liquid under the guidelines established by the Board of Directors.

<sup>(1)</sup> Foreign Issuer.

† Non-income producing.

†† The issuer has filed for bankruptcy protection. As a result, the Fund may not be able to recover the principal invested and also does not expect to receive income on this security going forward.

‡ The percentage shown for each investment category is the total value of that category as a percentage of net assets available to Common and Preferred Stock.

**ABBREVIATIONS:**

**Pfd.** — Preferred Securities

**Pvt.** — Private Placement Securities

**STRIPES** — Structured Residual Interest Preferred Enhanced Securities

**STATEMENT OF ASSETS AND LIABILITIES**

**May 31, 2009 (Unaudited)**

**ASSETS:**

Investments, at value (Cost \$164,353,370) . . . . .	\$ 119,727,790
Receivable for investments sold . . . . .	64,798
Dividends and interest receivable . . . . .	1,638,055
Prepaid expenses . . . . .	<u>148,676</u>
Total Assets . . . . .	121,579,319

**LIABILITIES:**

Dividends payable to Common Stock Shareholders . . . . .	\$ 65,848
Investment advisory fee payable . . . . .	59,015
Administration, Transfer Agent and Custodian fees payable . . . . .	36,690
Audit fees payable . . . . .	32,836
Legal fees payable . . . . .	68,649
Directors' fees payable . . . . .	6,013
Accrued expenses and other payables . . . . .	22,184
Accumulated undeclared distributions to Auction Preferred Stock Shareholders . . . . .	<u>127,361</u>
Total Liabilities . . . . .	<u>418,596</u>

<b>Auction Preferred Stock (448 shares outstanding) redemption value . . . . .</b>	<u>44,800,000</u>
--	-------------------

**NET ASSETS AVAILABLE TO COMMON STOCK . . . . .** \$ 76,360,723

**NET ASSETS AVAILABLE TO COMMON STOCK** consist of:

Distributions in excess of net investment income . . . . .	\$ (1,022,784)
Accumulated net realized loss on investments sold . . . . .	(30,478,348)
Unrealized depreciation of investments . . . . .	(44,625,580)
Par value of Common Stock . . . . .	106,389
Paid-in capital in excess of par value of Common Stock . . . . .	<u>152,381,046</u>
Total Net Assets Available to Common Stock . . . . .	<u><u>\$76,360,723</u></u>

**NET ASSET VALUE PER SHARE OF COMMON STOCK:**

Common Stock (10,638,947 shares outstanding) . . . . .	<u><u>\$ 7.18</u></u>
--	-----------------------

**STATEMENT OF OPERATIONS**  
**For the Six Months Ended May 31, 2009 (Unaudited)**

**INVESTMENT INCOME:**

Dividends† . . . . .		\$ 3,099,671
Interest . . . . .		<u>2,445,347</u>
Total Investment Income . . . . .		5,545,018

**EXPENSES:**

Investment advisory fee . . . . .	\$ 340,036	
Administrator's fee . . . . .	58,169	
Auction Preferred Stock broker commissions and auction agent fees	66,831	
Audit fees . . . . .	34,096	
Legal fees . . . . .	96,675	
Insurance expense . . . . .	63,235	
Transfer Agent fees . . . . .	33,656	
Directors' fees . . . . .	39,130	
Custodian fees . . . . .	8,473	
Compliance fees . . . . .	19,694	
Other . . . . .	<u>36,314</u>	
Total Expenses . . . . .		<u>796,309</u>

**NET INVESTMENT INCOME** . . . . . 4,748,709

**REALIZED AND UNREALIZED GAIN/(LOSS) ON INVESTMENTS**

Net realized loss on investments sold during the period . . . . .		(8,544,571)
Change in net unrealized appreciation/depreciation of investments . . . . .		<u>21,460,788</u>

**NET REALIZED AND UNREALIZED GAIN ON INVESTMENTS** . . . . . 12,916,217

**DISTRIBUTIONS TO AUCTION PREFERRED STOCK SHAREHOLDERS:**

From net investment income (including changes in accumulated undeclared distributions) . . . . .		<u>(878,812)</u>
--	--	------------------

**NET INCREASE IN NET ASSETS TO COMMON STOCK  
RESULTING FROM OPERATIONS** . . . . . \$ 16,786,114

† For Federal income tax purposes, a significant portion of this amount may not qualify for the inter-corporate dividends received deduction ("DRD") or as qualified dividend income ("QDI") for individuals.

**STATEMENTS OF CHANGES IN NET ASSETS AVAILABLE TO COMMON STOCK<sup>(1)</sup>**

	<u>Six Months Ended May 31, 2009 (Unaudited)</u>	<u>Year Ended November 30, 2008</u>
<b>OPERATIONS:</b>		
Net investment income . . . . .	\$ 4,748,709	\$ 13,492,692
Net realized loss on investments sold during the period. . . . .	(8,544,571)	(18,269,870)
Change in net unrealized appreciation/depreciation of investments. . . . .	21,460,788	(53,709,204)
Distributions to APS* Shareholders from net investment income, including changes in accumulated undeclared distributions . . . . .	<u>(878,812)</u>	<u>(4,493,991)</u>
<b>Net increase/(decrease) in net assets resulting from operations</b>	<b>16,786,114</b>	<b>(62,980,373)</b>
<b>DISTRIBUTIONS:</b>		
Dividends paid from net investment income to Common Stock Shareholders <sup>(1)</sup> . . . . .	(4,010,331)	(9,155,620)
Tax return of capital to Common Stock Shareholders. . . . .	<u>—</u>	<u>(556,396)</u>
<b>Total Distributions to Common Stock Shareholders . . . . .</b>	<b>(4,010,331)</b>	<b>(9,712,016)</b>
<b>FUND SHARE TRANSACTIONS:</b>		
Increase from shares issued under the Dividend Reinvestment and Cash Purchase Plan. . . . .	<u>307,565</u>	<u>415,249</u>
<b>Net increase in net assets available to Common Stock resulting from Fund share transactions . . . . .</b>	<b>307,565</b>	<b>415,249</b>
<b>NET INCREASE/(DECREASE) IN NET ASSETS AVAILABLE TO COMMON STOCK FOR THE PERIOD . . . . .</b>	<b><u>\$ 13,083,348</u></b>	<b><u>\$ (72,277,140)</u></b>
<b>NET ASSETS AVAILABLE TO COMMON STOCK:</b>		
Beginning of period . . . . .	\$ 63,277,375	\$135,554,515
Net increase/(decrease) in net assets during the period . . . . .	<u>13,083,348</u>	<u>(72,277,140)</u>
End of period (including distributions in excess of net investment income of \$(1,022,784) and \$(882,350), respectively) . . . . .	<u>\$ 76,360,723</u>	<u>\$ 63,277,375</u>

\* Auction Preferred Stock.

<sup>(1)</sup> May include income earned, but not paid out, in prior fiscal year.

**FINANCIAL HIGHLIGHTS****For a Common Stock share outstanding throughout each period.**

Contained below is per share operating performance data, total investment returns, ratios to average net assets and other supplemental data. This information has been derived from information provided in the financial statements and market price data for the Fund's shares.

	Six Months Ended May 31, 2009 (Unaudited)	Year Ended November 30,				
		2008	2007	2006	2005	2004
<b>PER SHARE OPERATING PERFORMANCE:</b>						
Net asset value, beginning of period	\$ 5.98	\$ 12.85	\$ 15.80	\$ 15.26	\$ 15.49	\$ 15.85
<b>INVESTMENT OPERATIONS:</b>						
Net investment income	0.45	1.27	1.35	1.29	1.22	1.24
Net realized and unrealized gain/(loss) on investments	1.21	(6.80)	(2.90)	0.62	(0.07)	(0.31)
<b>DISTRIBUTIONS TO APS* SHAREHOLDERS:</b>						
From net investment income	(0.08)	(0.42)	(0.37)	(0.32)	(0.21)	(0.11)
Total from investment operations	1.58	(5.95)	(1.92)	1.59	0.94	0.82
<b>DISTRIBUTIONS TO COMMON STOCK SHAREHOLDERS:</b>						
From net investment income	(0.38)	(0.87)	(1.03)	(1.05)	(1.17)	(1.18)
From return of capital	—	(0.05)	—	—	—	—
Total distributions to Common Stock Shareholders	(0.38)	(0.92)	(1.03)	(1.05)	(1.17)	(1.18)
Net asset value, end of period	\$ 7.18	\$ 5.98	\$ 12.85	\$ 15.80	\$ 15.26	\$ 15.49
Market value, end of period	\$ 7.35	\$ 5.67	\$ 12.41	\$ 16.98	\$ 16.44	\$ 17.42
Total investment return based on net asset value**	27.80%***	(48.39%)	(12.90%)	10.74%	5.78%	4.73%
Total investment return based on market value**	37.98%***	(49.34%)	(21.73%)	10.47%	1.33%	5.76%
<b>RATIOS TO AVERAGE NET ASSETS AVAILABLE TO COMMON STOCK SHAREHOLDERS:</b>						
Total net assets, end of period (in 000's)	\$ 76,361	\$ 63,277	\$ 135,555	\$ 165,475	\$ 158,277	\$ 159,101
Operating expenses	2.56%***	1.99%	1.49%	1.49%	1.48%	1.48%
Net investment income†	12.42%***	8.38%	6.57%	6.39%	6.38%	7.14%
<b>SUPPLEMENTAL DATA:††</b>						
Portfolio turnover rate	21%****	67%	59%	71%	54%	27%
Total net assets available to Common and Preferred Stock, end of period (in 000's)	\$121,161	\$ 118,077	\$215,555	\$245,475	\$238,277	\$239,101
Ratio of operating expenses to total average net assets available to Common and Preferred Stock	1.42%***	1.15%	0.99%	0.99%	0.99%	0.99%

\* Auction Preferred Stock (formerly known as Money Market Cumulative Preferred™ Stock).

\*\* Assumes reinvestment of distributions at the price obtained by the Fund's Dividend Reinvestment and Cash Purchase Plan.

\*\*\* Annualized.

\*\*\*\* Not Annualized.

† The net investment income ratios reflect income net of operating expenses and payments to APS Shareholders.

†† Information presented under heading Supplemental Data includes APS.

The accompanying notes are an integral part of the financial statements.

**FINANCIAL HIGHLIGHTS (Continued)**

**Per Share of Common Stock (Unaudited)**

	<u>Total Dividends Paid</u>	<u>Net Asset Value</u>	<u>NYSE Closing Price</u>	<u>Dividend Reinvestment Price <sup>(1)</sup></u>
December 31, 2008 .....	\$0.0630	\$6.50	\$5.90	\$6.56
January 30, 2009 .....	0.0630	6.08	7.05	6.70
February 27, 2009 .....	0.0630	5.11	5.43	5.16
March 31, 2009 .....	0.0630	5.30	5.50	5.30
April 30, 2009 .....	0.0630	5.81	6.02	5.81
May 29, 2009 .....	0.0630	7.18	7.35	7.18

<sup>(1)</sup> Whenever the net asset value per share of the Fund's Common Stock is less than or equal to the market price per share on the reinvestment date, new shares issued will be valued at the higher of net asset value or 95% of the then current market price. Otherwise, the reinvestment shares of Common Stock will be purchased in the open market.

The table below sets out information with respect to Auction Preferred Stock currently outstanding.

<u>Date</u>	<u>Total Shares Outstanding (1)</u>	<u>Asset Coverage Per Share (2)</u>	<u>Involuntary Liquidation Preference Per Share (3)</u>
05/31/09*	448	\$270,732	\$100,000
11/30/08	548	216,717	100,000
11/30/07	800	270,586	100,000
11/30/06	800	307,433	100,000
11/30/05	800	298,367	100,000
11/30/04	800	299,078	100,000

(1) See note 6.

(2) Calculated by subtracting the Fund's total liabilities (excluding the APS and accumulated undeclared distributions to APS) from the Fund's total assets and dividing that amount by the number of APS shares outstanding.

(3) Excludes accumulated undeclared dividends.

\* Unaudited.

## **NOTES TO FINANCIAL STATEMENTS (Unaudited)**

---

### **1. Organization**

Flaherty & Crumrine Preferred Income Fund Incorporated (the “Fund”) was incorporated as a Maryland corporation on September 28, 1990, and commenced operations on January 31, 1991 as a diversified, closed-end management investment company under the Investment Company Act of 1940, as amended (the “1940 Act”). The Fund’s investment objective is to provide its common shareholders with high current income consistent with the preservation of capital.

### **2. Significant Accounting Policies**

The following is a summary of significant accounting policies consistently followed by the Fund in the preparation of its financial statements. The preparation of the financial statements is in conformity with U.S. generally accepted accounting principles (“US GAAP”) and requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities in the financial statements and the reported amounts of increases and decreases in net assets from operations during the reporting period. Actual results could differ from those estimates.

*Portfolio valuation:* The net asset value of the Fund’s Common Stock is determined by the Fund’s Administrator no less frequently than on the last business day of each week and month. It is determined in accordance with policies and procedures approved by the Board of Directors of the Fund by dividing the value of the Fund’s net assets available to Common Stock by the number of shares of Common Stock outstanding. The value of the Fund’s net assets available to Common Stock is deemed to equal the value of the Fund’s total assets less (i) the Fund’s liabilities and (ii) the aggregate liquidation value of the outstanding Auction Preferred Stock (“APS”).

The Fund’s preferred and debt securities are valued on the basis of current market quotations provided by independent pricing services or dealers approved by the Board of Directors of the Fund. Each quotation is based on the mean of the bid and asked prices of a security. In determining the value of a particular preferred or debt security, a pricing service or dealer may use information with respect to transactions in such investments, quotations, market transactions in comparable investments, various relationships observed in the market between investments, and/or calculated yield measures based on valuation technology commonly employed in the market for such investments. Common stocks that are traded on stock exchanges are valued at the last sale price or official close price on the exchange, as of the close of business on the day the securities are being valued or, lacking any sales, at the last available mean price. Futures contracts and option contracts on futures contracts are valued on the basis of the settlement price for such contracts on the primary exchange on which they trade. Investments in over-the-counter derivative instruments, such as interest rate swaps and options thereon (“swaptions”), are valued using prices supplied by a pricing service, or if such prices are unavailable, prices provided by a single broker or dealer that is not the counterparty or, if no such prices are available, at a price at which the counterparty to the contract would repurchase the instrument or terminate the contract. Investments for which market quotations are not readily available or for which management determines that the prices are not reflective of current market conditions are valued at fair value as determined in good faith by or under the direction of the Board of Directors of the Fund, including reference to valuations of other securities which are comparable in quality, maturity and type.

## NOTES TO FINANCIAL STATEMENTS (Unaudited) (Continued)

Investments in money market instruments and all debt and preferred securities which mature in 60 days or less are valued at amortized cost. Investments in money market funds are valued at the net asset value of such funds.

In September 2006, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards No. 157 “Fair Value Measurements” (“SFAS 157”) effective for fiscal years beginning after November 15, 2007. This standard clarifies the definition of fair value for financial reporting, establishes a framework for measuring fair value and requires additional disclosures about the use of fair value measurements. The Fund has adopted SFAS 157 as of December 1, 2007. The three levels of the fair value hierarchy under SFAS 157 are described below:

- Level 1 – quoted prices in active markets for identical securities
- Level 2 – other significant observable inputs (including quoted prices for similar securities, interest rates, prepayment speeds, credit risk, etc.)
- Level 3 – significant unobservable inputs (including the Fund’s own assumptions in determining the fair value of investments)

The inputs or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in those securities. A summary of the inputs used to value the Fund’s net assets as of May 31, 2009 is as follows:

Valuation Inputs	Investments in Securities (Market Value)	Other Financial Instruments (Unrealized Appreciation/ Depreciation)*
Level 1 – Quoted Prices . . . . .	\$ 40,775,995	\$ —
Level 2 – Other Significant Observable Inputs . . . . .	78,951,795	—
Level 3 – Significant Unobservable Inputs . . . . .	—	—
<b>Total . . . . .</b>	<b>\$119,727,790</b>	<b>\$ —</b>

\* Other financial instruments are derivative instruments not reflected in the Portfolio of Investments, such as futures, forwards and swaps which are valued at the unrealized appreciation/depreciation on the investment. As of May 31, 2009, the Fund does not have any other financial instruments.

*Securities transactions and investment income:* Securities transactions are recorded as of the trade date. Realized gains and losses from securities sold are recorded on the specific identified cost basis. Dividend income is recorded on ex-dividend dates. Interest income is recorded on the accrual basis. The Fund also amortizes premiums and accretes discounts on fixed income securities using the effective yield method.

*Statement of Financial Accounting Standards on No. 161:* In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, “Disclosures about Derivative Instruments and Hedging Activities” (“SFAS 161”). SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. SFAS 161 requires enhanced disclosures about the Fund’s derivative and hedging activities. The Fund has adopted SFAS 161 as of December 1, 2008. For the six months ended May 31, 2009, the Fund did not hold or transact in any derivatives.

## **NOTES TO FINANCIAL STATEMENTS (Unaudited) (Continued)**

---

*Options:* Purchases of options are recorded as an investment, the value of which is marked-to-market at each valuation date. When the Fund enters into a closing sale transaction, the Fund will record a gain or loss depending on the difference between the purchase and sale price. The risks associated with purchasing options and the maximum loss the Fund would incur are limited to the purchase price originally paid.

When the Fund writes an option, an amount equal to the premium received by the Fund is recorded as a liability, the value of which is marked-to-market at each valuation date. When a written option expires, the Fund realizes a gain equal to the amount of the premium originally received. When the Fund enters into a closing purchase transaction, the Fund realizes a gain (or loss if the cost of the closing purchase transaction exceeds the premium received when the option was written) without regard to any unrealized gain or loss on the underlying security, and the liability related to such option is eliminated. When a call option is exercised, the Fund realizes a gain or loss from the sale of the underlying security and the proceeds from such sale are increased by the amount of the premium originally received. When a put option is exercised, the amount of the premium originally received will reduce the cost of the security which the Fund purchased upon exercise.

The risk in writing a call option is that the Fund may forego the opportunity for profit if the market price of the underlying security increases and the option is exercised. The risk in writing a put option is that the Fund may incur a loss if the market price of the underlying security decreases and the option is exercised.

*Repurchase agreements:* The Fund may engage in repurchase agreement transactions. The Fund's investment adviser reviews and approves the eligibility of the banks and dealers with which the Fund may enter into repurchase agreement transactions. The value of the collateral underlying such transactions is at least equal at all times to the total amount of the repurchase obligations, including interest. The Fund maintains possession of the collateral through its custodian and, in the event of counterparty default, the Fund has the right to use the collateral to offset losses incurred. There is the possibility of loss to the Fund in the event the Fund is delayed or prevented from exercising its rights to dispose of the collateral securities.

*Federal income taxes:* The Fund intends to continue to qualify as a regulated investment company by complying with the requirements under subchapter M of the Internal Revenue Code of 1986, as amended, applicable to regulated investment companies and intends to distribute substantially all of its taxable net investment income to its shareholders. Therefore, no federal income tax provision is required.

In June 2006, the FASB issued FASB Interpretation 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes." This standard defines the threshold for recognizing the benefits of tax-return positions in the financial statements as "more-likely-than-not" to be sustained upon challenge by the taxing authority and requires measurement of a tax position meeting the more-likely-than-not criterion, based on the largest benefit that is more than 50 percent likely to be realized. FIN 48 became effective as of the beginning of the first fiscal year beginning after December 15, 2006, with early application permitted if no interim financial statements have been issued. At adoption, companies must adjust their financial statements to reflect only those tax positions that are more-likely-than-not to be sustained as of the adoption date. The tax periods open to examination by the Internal Revenue Service include the fiscal years ended November 30, 2008, 2007, 2006 and 2005. The Fund's major tax jurisdictions are federal

## NOTES TO FINANCIAL STATEMENTS (Unaudited) (Continued)

and California. As of May 31, 2009, the Fund has evaluated the adoption of FIN 48 and determined that there is no material impact on the financial statements.

*Dividends and distributions to shareholders:* The Fund expects to declare dividends on a monthly basis to shareholders of Common Stock (“Shareholders”). Distributions to Shareholders are recorded on the ex-dividend date. Any net realized short-term capital gains will be distributed to Shareholders at least annually. Any net realized long-term capital gains may be distributed to Shareholders at least annually or may be retained by the Fund as determined by the Fund’s Board of Directors. Capital gains retained by the Fund are subject to tax at the capital gains corporate tax rate. Subject to the Fund qualifying as a regulated investment company, any taxes paid by the Fund on such net realized long-term capital gains may be used by the Fund’s Shareholders as a credit against their own tax liabilities. The Fund may pay distributions in excess of the Fund’s net investment company taxable income and this excess would be a tax-free return of capital distributed from the Fund’s assets.

Income and capital gain distributions are determined and characterized in accordance with income tax regulations which may differ from US GAAP. These differences are primarily due to (1) differing treatments of income and gains on various investment securities held by the Fund, including timing differences, (2) the attribution of expenses against certain components of taxable investment income, and (3) federal regulations requiring proportionate allocation of income and gains to all classes of shareholders.

Distributions from net realized gains for book purposes may include short-term capital gains, which are included as ordinary income for tax purposes, and may exclude amortization of premium on certain fixed income securities, which are not reflected in ordinary income for tax purposes. The tax character of distributions paid, including changes in accumulated undeclared distributions to APS Shareholders, during 2009 and 2008 was as follows:

	<u>Distributions paid in fiscal year 2009</u>		<u>Distributions paid in fiscal year 2008</u>		
	<u>Ordinary Income</u>	<u>Long-Term Capital Gains</u>	<u>Ordinary Income</u>	<u>Long-Term Capital Gains</u>	<u>Return of Capital</u>
Common	N/A	N/A	\$9,155,620	\$0	\$556,396
Preferred	N/A	N/A	\$4,493,991	\$0	\$0

As of November 30, 2008, the components of distributable earnings (i.e., ordinary income and capital gain/loss) available to Common and Preferred Stock Shareholders, on a tax basis, were as follows:

<u>Capital (Loss) Carryforward</u>	<u>Undistributed Ordinary Income</u>	<u>Undistributed Long-Term Gain</u>	<u>Net Unrealized Appreciation/(Depreciation)</u>
\$(21,725,359)	\$0	\$0	\$(66,294,786)

## **NOTES TO FINANCIAL STATEMENTS (Unaudited) (Continued)**

---

At November 30, 2008, the composition of the Fund's \$21,725,359 accumulated realized capital losses was \$778,250, \$2,761,487 and \$18,185,622 incurred in 2004, 2007 and 2008, respectively. These losses may be carried forward and offset against any future capital gains through 2012, 2015 and 2016, respectively.

*Excise tax:* The Internal Revenue Code of 1986, as amended, imposes a 4% nondeductible excise tax on the Fund to the extent the Fund does not distribute by the end of any calendar year at least (1) 98% of the sum of its net investment income for that year and its capital gains (both long-term and short-term) for its fiscal year and (2) certain undistributed amounts from previous years.

*Additional Accounting Standards:* In April 2009, the FASB issued Staff Position No. 157-4 "Determining Fair Value when the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly" ("FSP 157-4"). FSP 157-4 clarifies the process for measuring the fair value of financial instruments when the markets become inactive and quoted prices may reflect distressed transactions. FSP 157-4 provides a non-exclusive list of factors a reporting entity should consider when determining whether there has been a significant decrease in the volume and level of activity for an asset or liability when compared with normal market activity. Under FSP 157-4, if a reporting entity concludes there has been a significant decrease in volume and level of activity for the asset or liability (or similar assets or liabilities), transactions or quoted prices may not be determinative of fair value. Further analysis of the transactions or quoted prices is needed, and an adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with FASB Statement No. 157 – Fair Value Measurements. FSP 157-4 is effective for interim and annual reporting periods ending after June 15, 2009, and must be applied prospectively. Early adoption is permitted for periods ending after March 15, 2009. Earlier adoption for periods ending before March 15, 2009 is not permitted. Management is currently evaluating the impact the adoption of FSP 157-4 will have on the Fund's financial statement disclosures.

In May 2009, the FASB issued Statement of Financial Accounting Standards No. 165, "Subsequent Events" ("SFAS 165"). SFAS 165 is effective for interim or annual financial periods ending after June 15, 2009. One of the primary objectives of this new Statement is to introduce the concept of the financial statements being available to be issued as a measurement date for evaluating subsequent events. This concept would pertain more to private companies. Entities that have an expectation of widely distributing their financial statements to shareholders, including public entities (such as the Fund), are required to evaluate subsequent events through the date that the financial statements are issued.

### **3. Investment Advisory Fee, Administration Fee, Transfer Agent Fee, Custodian Fee, Directors' Fees and Chief Compliance Officer Fee**

Flaherty & Crumrine Incorporated (the "Adviser") serves as the Fund's investment adviser. The Fund pays the Adviser a monthly fee at an annual rate of 0.625% of the value of the Fund's average monthly total managed assets up to \$100 million and 0.50% of the Fund's average monthly total managed assets of \$100 million or more. For purposes of calculating the fees payable to the Adviser, Administrator and Custodian, the Fund's total managed assets means the total assets of the Fund

## **NOTES TO FINANCIAL STATEMENTS (Unaudited) (Continued)**

---

(including any assets attributable to the Fund's auction preferred stock that may be outstanding or otherwise attributable to the use of leverage) minus the sum of accrued liabilities (other than debt, if any, representing financial leverage). For purposes of determining total managed assets, the liquidation preference of any preferred shares issued by the Fund is not treated as a liability.

PNC Global Investment Servicing (U.S.) Inc. ("PNC") serves as the Fund's Administrator. As Administrator, PNC calculates the net asset value of the Fund's shares attributable to Common Stock and generally assists in all aspects of the Fund's administration and operation. As compensation for PNC's services as Administrator, the Fund pays PNC a monthly fee at an annual rate of 0.10% of the first \$200 million of the Fund's average weekly total managed assets, 0.04% of the next \$300 million of the Fund's average weekly total managed assets, 0.03% of the next \$500 million of the Fund's average weekly total managed assets and 0.02% of the Fund's average weekly total managed assets above \$1 billion.

PNC also serves as the Fund's Common Stock dividend-paying agent and registrar (Transfer Agent). As compensation for PNC's services, the Fund pays PNC a fee at an annual rate of 0.02% of the first \$150 million of the Fund's average weekly net assets attributable to Common Stock, 0.0075% of the next \$350 million of the Fund's average weekly net assets attributable to Common Stock, and 0.0025% of the Fund's average weekly net assets attributable to Common Stock above \$500 million, plus certain out of pocket expenses. For the purpose of calculating such fee, the Fund's average weekly net assets attributable to Common Stock are deemed to be the average weekly value of the Fund's total assets minus the sum of the Fund's liabilities. For this calculation, the Fund's liabilities are deemed to include the aggregate liquidation preference of any outstanding Fund preferred shares.

PFPC Trust Company ("PFPC Trust") serves as the Fund's custodian. PFPC Trust is an indirect subsidiary of PNC Financial Services. As compensation for PFPC Trust's services as custodian, the Fund pays PFPC Trust a monthly fee at the annual rate of 0.010% of the first \$200 million of the Fund's average weekly total managed assets, 0.008% of the next \$300 million of the Fund's average weekly total managed assets, 0.006% of the next \$500 million of the Fund's average weekly total managed assets and 0.005% of the Fund's average weekly total managed assets above \$1 billion.

The Fund currently pays each Director who is not a director, officer or employee of the Adviser a fee of \$9,000 per annum, plus \$500 for each in-person meeting of the Board of Directors or any committee and \$150 for each telephone meeting. The Audit Committee Chairman receives an additional annual fee of \$2,500. The Fund also reimburses all Directors for travel and out-of-pocket expenses incurred in connection with such meetings.

The Fund currently pays the Adviser a fee of \$37,500 per annum for Chief Compliance Officer services and reimburses out-of-pocket expenses incurred in connection with providing services in this role.

**NOTES TO FINANCIAL STATEMENTS (Unaudited) (Continued)**

**4. Purchases and Sales of Securities**

For the six months ended May 31, 2009, the cost of purchases and proceeds from sales of securities excluding short-term investments, aggregated \$21,671,143 and \$23,809,784, respectively.

At May 31, 2009, the aggregate cost of securities for federal income tax purposes was \$164,561,788, the aggregate gross unrealized appreciation for all securities in which there is an excess of value over tax cost was \$5,399,071 and the aggregate gross unrealized depreciation for all securities in which there is an excess of tax cost over value was \$50,233,069.

**5. Common Stock**

At May 31, 2009, 240,000,000 shares of \$0.01 par value Common Stock were authorized.

Common Stock Transactions were as follows:

	<u>Six Months Ended</u> 05/31/09		<u>Year Ended</u> 11/30/08	
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>
Shares issued under the Dividend Reinvestment and Cash Purchase Plan . . . . .	<u>53,299</u>	<u>\$307,565</u>	<u>39,898</u>	<u>\$415,249</u>

**6. Auction Preferred Stock (APS) (formerly known as Money Market Cumulative Preferred™ Stock)**

The Fund's Articles of Incorporation authorize the issuance of up to 10,000,000 shares of \$0.01 par value preferred stock. The APS is senior to the Common Stock and results in the financial leveraging of the Common Stock. Such leveraging tends to magnify both the risks and opportunities to Common Stock Shareholders. Dividends on shares of APS are cumulative.

The Fund is required to meet certain asset coverage tests with respect to the APS. If the Fund fails to meet these requirements and does not correct such failure, the Fund may be required to redeem, in part or in full, APS at a redemption price of \$100,000 per share plus an amount equal to the accumulated and unpaid dividends on such shares in order to meet these requirements. Additionally, failure to meet the foregoing asset requirements could restrict the Fund's ability to pay dividends to Common Stock Shareholders and could lead to sales of portfolio securities at inopportune times.

If the Fund allocates any net gains or income ineligible for the dividends received deduction to shares of the APS, the Fund is required to make additional distributions to APS Shareholders or to pay a higher dividend rate in amounts needed to provide a return, net of tax, equal to the return had such originally paid distributions been eligible for the dividends received deduction.

An auction of the APS is generally held every 49 days. Existing APS Shareholders may submit an order to hold, bid or sell such shares at par value on each auction date. APS Shareholders may also trade shares in the secondary market, if any, between auction dates. Since mid-February 2008, the normal functioning of the market for auction preferred stock of U.S. closed-end funds, including the Fund, has been disrupted, and the Fund's APS holders have not been able to sell their shares through the auction process.

## NOTES TO FINANCIAL STATEMENTS (Unaudited) (Continued)

The Fund announced the redemption of APS shares as noted in the table below. Mandatory redemptions are required under certain circumstances, as discussed above. Shares were redeemed at a redemption price equal to the liquidation preference of \$100,000 per share, plus the amount of accumulated but unpaid dividends for each redemption date, respectively.

Description	\$ Amount of APS	Announcement Date	Payment Date
Mandatory Redemption	\$8,100,000	October 14, 2008	November 12, 2008*
Optional Redemption	\$15,000,000	October 28, 2008	November 12, 2008*
Mandatory Redemption	\$2,100,000	October 21, 2008	November 20, 2008*
Optional Redemption	\$10,000,000	February 24, 2009	April 7, 2009*

\* Shares were redeemed on the dates reflected; however, from the Fund's perspective, the November 12 and November 20 mandatory redemptions were effective as of October 24, 2008, the November 12 optional redemption was effective as of November 7, 2008 and the April 7 optional redemption was effective as of February 24, 2009. In all cases, the earlier effective date was due to the unconditional deposit of funds with the paying agent.

At May 31, 2009, 448 shares of APS were outstanding at the annualized rate of 2.70%. The dividend rate, as set by the auction process, is generally expected to vary with short-term interest rates. As a result of ongoing disruptions in the auction market, the Fund is paying a dividend rate equal to the maximum rate, as defined in the Fund's Articles Supplementary. The maximum rate is equal to the greater of (i) 175% of the reference rate and (ii) 2.50% plus the reference rate. "Reference Rate" means the applicable "AA" Non-Financial Composite Commercial Paper Rate. These rates may vary in a manner unrelated to the income received on the Fund's assets, which could have either a beneficial or detrimental impact on net investment income and gains available to Common Stock Shareholders. While the Fund expects to structure its portfolio holdings and hedging transactions to lessen such risks to Common Stock Shareholders, there can be no assurance that such results will be attained.

The Fund announced on June 26, 2009 (subsequent to the reporting period) the redemption of the remaining 448 shares of APS. The redemption was completed on July 14, 2009. Shares were redeemed at a redemption price equal to the liquidation preference of \$100,000 per share, plus the amount of accumulated but unpaid dividends. Total consideration for the liquidation preference of the redemptions was approximately \$44.8 million. The Fund utilized proceeds from its new debt facility (See Note 7) to finance this redemption. After this redemption, borrowings from its debt facility will be the Fund's sole source of leverage.

### 7. Committed Financing Agreement

The Fund entered into a committed financing agreement ("Financing Agreement") on June 26, 2009 (subsequent to the reporting period) which allows the Fund to borrow up to \$44.8 million on a secured basis. The primary use of the proceeds will be to redeem the outstanding shares of APS (See Note 6), although the balance may be utilized by the Fund in the normal course of business as financial leverage.

Under the terms of the Financing Agreement, the lender charges an annualized rate of 1.00% on the undrawn (committed) balance, and Three-Month London Interbank Offered Rate (LIBOR) – reset every three months – *plus* 1.10% on the drawn (borrowed) balance. The Fund paid the Lender an

## **NOTES TO FINANCIAL STATEMENTS (Unaudited) (Continued)**

---

arrangement fee (at the origination of the facility) equal to 0.50% of the committed amount of \$44.8 million. The arrangement fee will be amortized to expense over a period of eighteen months, unless accelerated due to the termination of the Financing Agreement. If the Fund elects to renew the Financing Agreement, a renewal fee equal to 0.50% of the then-committed amount shall be paid to the Lender on each 540<sup>th</sup> calendar day following the date of the original Financing Agreement. LIBOR rates may vary in a manner unrelated to the income received on the Fund's assets, which could have either a beneficial or detrimental impact on net investment income and gains available to Common Stock Shareholders.

The Fund is required to meet certain asset coverage requirements under the Financing Agreement and under the 1940 Act. In accordance with the asset coverage requirements, at least two-thirds of the Fund's assets are expected to be pledged as collateral assuming the full committed amount is drawn. Securities pledged as collateral are identified in the portfolio of investments. If the Fund fails to meet these requirements, or maintain other financial covenants required under the Financing Agreement, the Fund may be required to repay immediately, in part or in full, the amount borrowed under the Financing Agreement. Additionally, failure to meet the foregoing requirements or covenants could restrict the Fund's ability to pay dividends to Common Stock Shareholders and could necessitate sales of portfolio securities at inopportune times. The Financing Agreement has no stated maturity, but may be terminated by either party without cause with six months' advance notice

### **8. Portfolio Investments, Concentration and Investment Quality**

The Fund invests primarily in a diversified portfolio of preferred securities. This includes traditional preferred stocks eligible for the inter-corporate dividends received deduction ("DRD") and fully taxable preferred securities. Under normal market conditions, at least 80% of the value of the Fund's net assets will be invested in preferred securities. Also, under normal market conditions, the Fund invests at least 25% of its assets in securities issued by companies in the utilities industry and at least 25% of its total assets in securities issued by companies in the banking industry. The Fund's portfolio may therefore be subject to greater risk and market fluctuation than a portfolio of securities representing a broader range of investment alternatives.

The Fund may invest up to 25% of its assets at the time of purchase in securities rated below investment grade. These securities must be rated at least either "Ba3" by Moody's Investors Service, Inc. or "BB-" by Standard & Poor's or, if unrated, judged to be comparable in quality by the Adviser, in any case, at the time of purchase. However, these securities must be issued by an issuer having a class of senior debt rated investment grade outstanding.

The Fund may invest up to 15% of its assets in common stocks and, under normal market conditions, up to 20% of its assets in debt securities. Certain of its investments in hybrid, i.e., fully taxable, preferred securities will be subject to the foregoing 20% limitation to the extent that, in the opinion of the Adviser, such investments are deemed to be debt-like in key characteristics. Typically, a security will not be considered debt-like (a) if an issuer can defer payment of income for eighteen months or more without triggering an event of default and (b) if such issue is a junior and fully subordinated liability of an issuer or its ultimate guarantor.

## **NOTES TO FINANCIAL STATEMENTS (Unaudited) (Continued)**

---

In addition to foreign money market securities, the Fund may invest up to 30% of its total assets in the securities of companies organized or having their principal place of business outside the United States. All foreign securities held by the Fund will be denominated in U.S. dollars.

### **9. Special Investment Techniques**

The Fund may employ certain investment techniques in accordance with its fundamental investment policies. These may include the use of when-issued and delayed delivery transactions. Securities purchased or sold on a when-issued or delayed delivery basis may be settled within 45 days after the date of the transaction. Such transactions may expose the Fund to credit and market valuation risk greater than that associated with regular trade settlement procedures. The Fund may also enter into transactions, in accordance with its investment policies, involving any or all of the following: short sales of securities, purchases of securities on margin, futures contracts, interest rate swaps, swap futures, options on futures contracts, options on securities, swaptions and certain credit derivative transactions, including, but not limited to, the purchase and sale of credit protection. As in the case of when-issued securities, the use of over-the-counter derivatives, such as interest rate swaps, swaptions, and credit default swaps may expose the Fund to greater credit, operations, liquidity, and valuation risk than is the case with regulated, exchange traded futures and options. These transactions are used for hedging or other appropriate risk-management purposes, or, under certain other circumstances, to increase return. No assurance can be given that such transactions will achieve their desired purposes or will result in an overall reduction of risk to the Fund.

### **10. Securities Lending**

The Fund may lend up to 15% of its total assets (including the value of the loan collateral) to certain qualified brokers in order to earn additional income. The Fund receives compensation in the form of fees or interest earned on the investment of any cash collateral received. The Fund also continues to receive interest and dividends on the securities loaned. The Fund receives collateral in the form of cash or securities with a market value at least equal to the market value of the securities on loan, including accrued interest. In the event of default or bankruptcy by the borrower, the Fund could experience delays and costs in recovering the loaned securities or in gaining access to the collateral. The Fund has the right under the lending agreement to recover the securities from the borrower on demand. As of May 31, 2009, there were no securities on loan by the Fund.

### **11. Section 19 Notices**

Section 19 of the Investment Company Act of 1940 requires registered investment companies to include a notice with the payment of a dividend if a portion of that dividend may come from sources other than undistributed net income (other sources could include realized gains from the sale of securities and non-taxable return of capital). Copies of the Section 19 notices for the Fund are available on the website at [www.preferredincome.com](http://www.preferredincome.com).

**NOTES TO FINANCIAL STATEMENTS (Unaudited) (Continued)**

The amounts and sources of distributions reported below are only estimates and are not being provided for tax reporting purposes. Form 1099-DIV will be sent to shareholders in January 2010 reporting the amount and tax characterization of distributions for the 2009 calendar year.

**Source of Distributions as of 5/31/09**

	<b>Net Investment Income</b>	<b>Net Realized Capital Gains</b>	<b>Return of Capital</b>	<b>Total Per Common Share</b>
Calendar 2009 Distributions . . . . .	\$0.29925	\$0.00	\$0.01575	\$0.315
Percentage of Total Distributions . . . . .	95.0%	0.0%	5.0%	—

## **ADDITIONAL INFORMATION (Unaudited)**

---

### **Dividend Reinvestment and Cash Purchase Plan**

Under the Fund's Dividend Reinvestment and Cash Purchase Plan (the "Plan"), a shareholder whose Common Stock is registered in his or her own name will have all distributions reinvested automatically by PNC as agent under the Plan, unless the shareholder elects to receive cash. Distributions with respect to shares registered in the name of a broker-dealer or other nominee (that is, in "street name") may be reinvested by the broker or nominee in additional shares under the Plan, but only if the service is provided by the broker or nominee, unless the shareholder elects to receive distributions in cash. A shareholder who holds Common Stock registered in the name of a broker or other nominee may not be able to transfer the Common Stock to another broker or nominee and continue to participate in the Plan. Investors who own Common Stock registered in street name should consult their broker or nominee for details regarding reinvestment.

The number of shares of Common Stock distributed to participants in the Plan in lieu of a cash dividend is determined in the following manner. Whenever the market price per share of the Fund's Common Stock is equal to or exceeds the net asset value per share on the valuation date, participants in the Plan will be issued new shares valued at the higher of net asset value or 95% of the then current market value. Otherwise, PNC will buy shares of the Fund's Common Stock in the open market, on the New York Stock Exchange ("NYSE") or elsewhere, on or shortly after the payment date of the dividend or distribution and continuing until the ex-dividend date of the Fund's next distribution to holders of the Common Stock or until it has expended for such purchases all of the cash that would otherwise be payable to the participants. The number of purchased shares that will then be credited to the participants' accounts will be based on the average per share purchase price of the shares so purchased, including brokerage commissions. If PNC commences purchases in the open market and the then current market price of the shares (plus any estimated brokerage commissions) subsequently exceeds their net asset value most recently determined before the completion of the purchases, PNC will attempt to terminate purchases in the open market and cause the Fund to issue the remaining dividend or distribution in shares. In this case, the number of shares received by the participant will be based on the weighted average of prices paid for shares purchased in the open market and the price at which the Fund issues the remaining shares. These remaining shares will be issued by the Fund at the higher of net asset value or 95% of the then current market value.

Plan participants are not subject to any charge for reinvesting dividends or capital gains distributions. Each Plan participant will, however, bear a proportionate share of brokerage commissions incurred with respect to PNC's open market purchases in connection with the reinvestment of dividends or capital gains distributions. For the six months ended May 31, 2009, \$581 in brokerage commissions were incurred.

The automatic reinvestment of dividends and capital gains distributions will not relieve Plan participants of any income tax that may be payable on the dividends or capital gains distributions. A participant in the Plan will be treated for Federal income tax purposes as having received, on the dividend payment date, a dividend or distribution in an amount equal to the cash that the participant could have received instead of shares.

## **ADDITIONAL INFORMATION (Unaudited) (Continued)**

---

In addition to acquiring shares of Common Stock through the reinvestment of cash dividends and distributions, a shareholder may invest any further amounts from \$100 to \$3,000 semi-annually at the then current market price in shares purchased through the Plan. Such semi-annual investments are subject to any brokerage commission charges incurred by PNC under the Plan.

A shareholder whose Common Stock is registered in his or her own name may terminate participation in the Plan at any time by notifying PNC in writing, by completing the form on the back of the Plan account statement and forwarding it to PNC, or by calling PNC directly. A termination will be effective immediately if notice is received by PNC not less than 10 days before any dividend or distribution record date. Otherwise, the termination will be effective, and only with respect to any subsequent dividends or distributions, on the first day after the dividend or distribution has been credited to the participant's account in additional shares of the Fund. Upon termination and according to a participant's instructions, PNC will either (a) issue certificates for the whole shares credited to the shareholder's Plan account and a check representing any fractional shares or (b) sell the shares in the market. Shareholders who hold Common Stock registered in the name of a broker or other nominee should consult their broker or nominee to terminate participation.

The Plan is described in more detail in the Fund's Plan brochure. Information concerning the Plan may be obtained from PNC at 1-800-331-1710.

### **Proxy Voting Policies and Proxy Voting Record on Form N-PX**

The Fund files Form N-PX with its complete proxy voting record for the 12 months ended June 30<sup>th</sup> no later than August 31<sup>st</sup> of each year. The Fund filed its latest Form N-PX with the Securities and Exchange Commission ("SEC") on August 7, 2008. This filing, as well as the Fund's proxy voting policies and procedures, are available (i) without charge, upon request, by calling the Fund's transfer agent at 1-800-331-1710 and (ii) on the SEC's website at [www.sec.gov](http://www.sec.gov). In addition, the Fund's proxy voting policies and procedures are available on the Fund's website at [www.preferredincome.com](http://www.preferredincome.com).

### **Portfolio Schedule on Form N-Q**

The Fund files a complete schedule of portfolio holdings with the SEC for the first and third fiscal quarters on Form N-Q, the latest of which was filed for the quarter ended February 28, 2009. The Fund's Form N-Q is available on the SEC's website at [www.sec.gov](http://www.sec.gov) or may be viewed and obtained from the SEC's Public Reference Room in Washington D.C. Information on the operation of the Public Reference Section may be obtained by calling 1-800-SEC-0330.

### **Portfolio Management Team**

In managing the day-to-day operations of the Fund, the Adviser relies on the expertise of its team of money management professionals, consisting of Messrs. Crumrine, Ettinger, Stone and Chadwick. The professional backgrounds of each member of the management team are included in the "Information about Fund Directors and Officers" section of this report.

**ADDITIONAL INFORMATION (Unaudited) (Continued)****Certifications**

Included in the Annual Written Affirmation submitted to the NYSE, Donald F. Crumrine, as the Fund's Chief Executive Officer, has certified that, as of May 16, 2009, he was not aware of any violation by the Fund of applicable NYSE corporate governance listing standards. The Fund's reports to the SEC on Forms N-CSR and N-Q contain certifications by the Fund's principal executive officer and principal financial officer that relate to the Fund's disclosure in such reports and that are required by Rule 30a-2(a) under the 1940 Act.

**Meeting of Shareholders**

On April 21, 2009, the Fund held its Annual Meeting of Shareholders for the following purpose: election of Directors of the Fund ("Proposal 1"). The proposal was approved by the shareholders and the results of the voting are as follows:

**Proposal 1: Election of Directors.**

<u>Name</u>	<u>For</u>	<u>Withheld</u>
<b>Common Stock</b>		
Robert F. Wulf . . . . .	9,043,485	445,348
<b>Preferred Stock</b>		
Donald F. Crumrine . . . . .	316	0

David Gale, Morgan Gust and Karen H. Hogan continue to serve in their capacities as Directors of the Fund.

## ADDITIONAL INFORMATION (Unaudited) (Continued)

### Information about Fund Directors and Officers

The business and affairs of the Fund are managed under the direction of the Fund's Board of Directors. Information pertaining to the Directors and officers of the Fund is set forth below.

Name, Address, and Age	Position(s) Held with Fund	Term of Office and Length of Time Served*	Principal Occupation(s) During Past Five Years	Number of Funds in Fund Complex Overseen by Director	Other Directorships Held by Director**
<b>NON-INTERESTED DIRECTORS:</b>					
<b>David Gale</b> Delta Dividend Group, Inc. 220 Montgomery Street Suite 1920 San Francisco, CA 94104 Age: 60	Director	Class I Director since January 1997	President of Delta Dividend Group, Inc. (investments)	4	
<b>Morgan Gust</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 62	Director	Class III Director since January 1991	Owner and operator of various entities engaged in agriculture and real estate; Former President of Giant Industries, Inc. (petroleum refining and marketing) from March 2002 through June 2007	4	CoBiz, Financial, Inc. (financial services)
<b>Karen H. Hogan†</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 48	Director	Class I Director since April 2005	Active Committee Member and Volunteer to several non-profit organizations; from September 1985 to January 1997, Senior Vice President of Preferred Stock Origination at Lehman Brothers and Previously, Vice President of New Product Development	4	

\* The Fund's Board of Directors is divided into three classes, each class having a term of three years. Each year the term of office of one class expires and the successor or successors elected to such class serve for a three year term. The three year term for each class expires as follows:

**Class I Directors** – three year term expires at the Fund's 2011 Annual Meeting of Shareholders; directors may continue in office until their successors are duly elected and qualified.

**Class II Directors** – three year term expires at the Fund's 2012 Annual Meeting of Shareholders; directors may continue in office until their successors are duly elected and qualified.

**Class III Director** – three year term expires at the Fund's 2010 Annual Meeting of Shareholders; director may continue in office until his successor is duly elected and qualified.

\*\* Each Director also serves as a Director for Flaherty & Crumrine Preferred Income Opportunity Fund, Flaherty & Crumrine/Claymore Preferred Securities Income Fund, and Flaherty & Crumrine/Claymore Total Return Fund.

† As a Director, until July 14, 2009, represented holders of shares of the Fund's Auction Preferred Stock.

**ADDITIONAL INFORMATION (Unaudited) (Continued)**

<b>Name, Address, and Age</b>	<b>Position(s) Held with Fund</b>	<b>Term of Office and Length of Time Served*</b>	<b>Principal Occupation(s) During Past Five Years</b>	<b>Number of Funds in Fund Complex Overseen by Director</b>	<b>Other Directorships Held by Director**</b>
<b>NON-INTERESTED DIRECTORS:</b>					
<b>Robert F. Wulf</b> P.O. Box 753 Neskowin, OR 97149 Age: 72	Director and Audit Committee Chairman	Class II Director since January 1991	Financial Consultant; Trustee, University of Oregon Foundation; Trustee, San Francisco Theological Seminary	4	
<b>INTERESTED DIRECTOR:</b>					
<b>Donald F. Crumrine†, ††</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 61	Director, Chairman of the Board and Chief Executive Officer	Class II Director since January 1991	Chairman of the Board and Director of Flaherty & Crumrine Incorporated	4	

\* The Fund's Board of Directors is divided into three classes, each class having a term of three years. Each year the term of office of one class expires and the successor or successors elected to such class serve for a three year term. The three year term for each class expires as follows:

**Class I Directors** – three year term expires at the Fund's 2011 Annual Meeting of Shareholders; directors may continue in office until their successors are duly elected and qualified.

**Class II Directors** – three year term expires at the Fund's 2012 Annual Meeting of Shareholders; directors may continue in office until their successors are duly elected and qualified.

**Class III Director** – three year term expires at the Fund's 2010 Annual Meeting of Shareholders; director may continue in office until his successor is duly elected and qualified.

\*\* Each Director also serves as a Director for Flaherty & Crumrine Preferred Income Opportunity Fund, Flaherty & Crumrine/Claymore Preferred Securities Income Fund, and Flaherty & Crumrine/Claymore Total Return Fund.

† As a Director, until July 14, 2009, represented holders of shares of the Fund's Auction Preferred Stock.

†† "Interested person" of the Fund as defined in the 1940 Act. Mr. Crumrine is considered an "interested person" because of his affiliation with Flaherty & Crumrine Incorporated, which acts as the Fund's investment adviser.

**ADDITIONAL INFORMATION (Unaudited) (Continued)**

Name, Address, and Age	Position(s) Held with Fund	Term of Office and Length of Time Served	Principal Occupation(s) During Past Five Years
<b>OFFICERS:</b>			
<b>Robert M. Ettinger</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 50	President	Since October 2002	President and Director of Flaherty & Crumrine Incorporated
<b>R. Eric Chadwick</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 34	Chief Financial Officer, Vice President and Treasurer	Since July 2004	Director of Flaherty & Crumrine Incorporated since June 2006; Vice President of Flaherty & Crumrine Incorporated
<b>Chad C. Conwell</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 36	Chief Compliance Officer, Vice President and Secretary	Since July 2005	Chief Compliance Officer of Flaherty & Crumrine Incorporated since September 2005; Vice President of Flaherty & Crumrine Incorporated since July 2005; Attorney with Paul, Hastings, Janofsky & Walker LLP from September 1998 to June 2005
<b>Bradford S. Stone</b> 392 Springfield Avenue Mezzanine Suite Summit, NJ 07901 Age: 49	Vice President and Assistant Treasurer	Since July 2003	Director of Flaherty & Crumrine Incorporated since June 2006; Vice President of Flaherty & Crumrine Incorporated
<b>Laurie C. Lodolo</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 45	Assistant Compliance Officer, Assistant Treasurer and Assistant Secretary	Since July 2004	Assistant Compliance Officer of Flaherty & Crumrine Incorporated since August 2004; Secretary of Flaherty & Crumrine Incorporated

## **ADDITIONAL INFORMATION (Unaudited) (Continued)**

---

### **BOARD CONSIDERATION AND APPROVAL OF CONTINUANCE OF INVESTMENT ADVISORY AGREEMENT**

During the six month period ended May 31, 2009, the Board of Directors of the Fund approved, on January 27, 2009, the continuation of the existing investment advisory agreement with the Adviser (the "Investment Advisory Agreement"). The following paragraphs summarize the material information and factors considered by the Board, including the Non-Interested Directors, as well as their conclusions relative to such factors.

In considering whether to approve the Fund's Investment Advisory Agreement, the Directors considered and discussed a substantial amount of information and analysis provided, at the Board's request, by the Adviser. The Directors also considered detailed information regarding performance and expenses of other investment companies thought to be generally comparable to the Fund. The Directors discussed with management this and other information relating to the Investment Advisory Agreement during the Special Meeting held on January 16, 2009 for that specific purpose and requested additional information about comparative expenses and performance, among other matters. On January 27, 2009, the Directors approved the continuance of the Investment Advisory Agreement. In reaching their determinations relating to continuance of the Investment Advisory Agreement, the Directors considered these discussions and all other factors they believed relevant, including the factors discussed below. In their deliberations, the Directors did not identify any particular information that was all-important or controlling, and Directors may have attributed different weights to the various factors. The Directors evaluated this information, and all other information available to them, for the Fund, and their determinations were made separately in respect of each other fund advised by the Adviser. In particular, the Directors focused on the following with respect to the Fund.

#### **Nature, Extent and Quality of Services.**

The Directors reviewed in detail the nature and extent of the services provided by the Adviser and the quality of those services over the past year and since inception. The Directors noted that these services included managing the Fund's investment program, as well as providing significant administrative services beyond what the Investment Advisory Agreement required. The Directors noted that the Adviser also provided, generally at its expense: office facilities for use by the Fund; personnel responsible for supervising the performance of administrative, accounting and related services; and investment compliance monitoring. The Directors also considered the Adviser's sound financial condition and the Adviser's commitment to its business. The Directors evaluated the Adviser's services based on their direct experience serving as Directors for many years, focusing on (i) the Adviser's knowledge of the preferred securities market generally and the sophisticated hedging strategies the Fund had employed until recently, the reasons why that strategy has been ineffective during the current market dislocation, and why the Adviser has suspended its customary hedging strategy, and (ii) the Adviser's culture of compliance. The Directors reviewed the personnel responsible for providing services to the Fund and observed that, based on their experience and interaction with the Adviser: (1) the Adviser's personnel exhibited a high level of personal integrity, diligence and attention to detail in carrying out their responsibilities under the Investment Advisory Agreement; (2) the Adviser was

## **ADDITIONAL INFORMATION (Unaudited) (Continued)**

---

responsive to requests of the Board and its personnel were available between Board meetings to answer questions from Directors; and (3) the Adviser had kept the Board apprised of developments relating to the Fund. The Directors also considered the continued efforts undertaken by the Adviser to maintain an effective compliance program. The Directors concluded that the nature and extent of the services provided were reasonable and appropriate in relation to the Fund's investment goals and strategies, the corporate and regulatory environment in which the Fund operates, and the level of services provided by the Adviser, and that the quality of the Adviser's service continues to be high.

### **Investment Performance.**

The Directors took note of the extraordinary market conditions prevailing over almost the past two years and at present, and expressed their confidence in the Adviser's investment strategies despite recent disappointing absolute performance during this period of continued unprecedented and frequently frantic behavior of market participants. The Directors considered the Fund's relative performance since inception, including its performance in recent fiscal periods. The Directors reviewed the Fund's performance compared to relevant indices and funds thought to be generally comparable to the Fund and examined the differences between the Fund and certain funds in the comparison group. The Directors were assured of the Fund's adherence to its respective investment mandate and, based on their understanding of the Adviser's investment approach and market conditions, expressed their belief that the Adviser's absolute performance would improve as markets normalized.

### **Profitability.**

The Directors considered the Adviser's methodology for determining its profitability with respect to the Fund, and the Adviser's profit margin on an after-tax basis attributable to managing the Fund. The Directors noted that declining assets under management has led to declining Adviser profitability, but noted with approval the Adviser's continued commitment to maintain existing personnel and service levels. The Directors also considered that the Adviser provided, at a lower cost, services to separate account clients and determined that the difference was justified in light of the additional services and costs associated with managing registered investment companies, such as the Fund. The Directors accepted the Adviser's statement that it did not realize material indirect benefits from its relationship with the Fund and did not obtain soft dollar credits from securities trading.

### **Economies of Scale.**

The Directors noted that the Fund, as a closed-end investment company, was not expected to increase materially in size and, based on recent adverse market conditions and related deleveraging, the Fund's size had declined significantly. Thus, in both these circumstances, the Adviser would not benefit from economies of scale. The Directors considered whether economies of scale could be realized because the Adviser advises other similar funds. Based on their experience, the Directors accepted the Adviser's explanation that significant economies of scale would not be realized because of the complexity of managing preferred securities for separate funds and other portfolios. Nonetheless, the Directors noted that the Fund's advisory fee schedule declines as assets increase beyond a certain level (commonly known as a "breakpoint"), and that breakpoints provide for a sharing with shareholders

**ADDITIONAL INFORMATION (Unaudited) (Continued)**

---

of benefits derived as a result of economies of scale arising from increased assets. Accordingly, the Directors determined that the existing advisory fee levels reflect possible economies of scale.

In light of their discussions and considerations as described above, the Directors made the following determinations as to the Fund:

- the nature and extent and quality of the services provided by the Adviser are reasonable and appropriate and the quality of the services is high;
- the Fund's overall performance over time has been satisfactory and its performance for the recent period is reflective of market conditions, given the Adviser's portfolio management strategy;
- the fee paid to the Adviser was reasonable in light of (i) comparative performance and expense and advisory fee information, considered over relevant time periods, (ii) the cost of the services provided and profits to be realized, and (iii) the benefits derived or to be derived by the Adviser from the relationship with the Fund; and
- there were not at this time significant economies of scale to be realized by the Adviser in managing the Fund's assets, and the fee was structured to provide for a sharing of the benefits of economies of scale.

Based on these conclusions, the Directors determined that approval of the Investment Advisory Agreement was in the best interests of the Fund and its shareholders.

[This page intentionally left blank]



## Directors

Donald F. Crumrine, CFA  
Chairman of the Board  
David Gale  
Morgan Gust  
Karen H. Hogan  
Robert F. Wulf, CFA

## Officers

Donald F. Crumrine, CFA  
Chief Executive Officer  
Robert M. Ettinger, CFA  
President  
R. Eric Chadwick, CFA  
Chief Financial Officer,  
Vice President and Treasurer  
Chad C. Conwell  
Chief Compliance Officer,  
Vice President and Secretary  
Bradford S. Stone  
Vice President and  
Assistant Treasurer  
Laurie C. Lodolo  
Assistant Compliance Officer,  
Assistant Treasurer and  
Assistant Secretary

## Investment Adviser

Flaherty & Crumrine Incorporated  
e-mail: [flaherty@pfdincome.com](mailto:flaherty@pfdincome.com)

## Questions concerning your shares of Flaherty & Crumrine Preferred Income Fund?

- If your shares are held in a Brokerage Account, contact your Broker.
- If you have physical possession of your shares in certificate form, contact the Fund's Transfer Agent & Shareholder Servicing Agent —  
PNC Global Investment Servicing  
(U.S.) Inc.  
P.O. Box 43027  
Providence, RI 02940-3027  
1-800-331-1710

**This report is sent to shareholders of Flaherty & Crumrine Preferred Income Fund Incorporated for their information. It is not a Prospectus, circular or representation intended for use in the purchase or sale of shares of the Fund or of any securities mentioned in this report.**



Flaherty & Crumrine  

---

---

PREFERRED INCOME FUND

# Semi-Annual Report

May 31, 2009

[www.preferredincome.com](http://www.preferredincome.com)