

## FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Fund

After several quarters of extreme volatility, the Fund's second fiscal quarter performance was relatively tame. During the three month period ending May 31, 2010, the total return on net asset value of the Fund was +0.3%. Over the same period, the total return based on the market price of the Fund's shares was -4.2%. The following table presents the Fund's performance over longer time periods as well as the returns on two broad investment measures, one for common stocks and one for corporate bonds.

### TOTAL RETURN ON NET ASSET VALUE FOR PERIODS ENDED MAY 31, 2010

	Actual Returns			Average Annualized Returns			
	Three Months	Six Months	One Year	Three Years	Five Years	Ten Years	Life of Fund <sup>(1)</sup>
Flaherty & Crumrine Preferred Income Fund . . . . .	0.3%	11.2%	58.8%	-2.8%	-0.1%	6.1%	8.8%
Barclays Capital U.S. Aggregate Index <sup>(2)</sup> . . . . .	1.8%	2.1%	8.4%	6.9%	5.3%	6.5%	6.9%
S&P 500 Index <sup>(3)</sup> . . . . .	-0.9%	0.4%	21.0%	-8.7%	0.3%	-0.8%	8.3%

(1) Since inception on January 31, 1991.

(2) The Barclays Capital U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. It is generally considered to be representative of the domestic, investment-grade, fixed-rate, taxable bond market. Unless otherwise noted, index returns reflect the reinvestment of dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. This index was formerly known as the Lehman Brothers U.S. Aggregate Index.

(3) The S&P 500 is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Conditions in the market for preferred securities have largely stabilized in recent months, though to varying degrees for different market sectors. Issues of companies in industries other than financial services (primarily utilities) have performed consistently well, with far less price volatility than witnessed in prior quarters. Prices on financial issues (primarily banks and insurance companies) bounced around a bit more, but in light of the continued effects of the financial crisis, this is to be expected.

When markets seem calm on the surface, there is usually something to be wary of lurking below. At present, we don't need to look too far. The items we consider most relevant to the Fund are discussed in greater detail in the discussion section below. These include the overhaul of financial regulation, changes to standards for capital, and turmoil in the Euro-zone. We continue to believe that the Fund is well positioned to weather each.

As managers of your Fund, our job revolves around evaluating risk. Investment decisions, like most decisions, essentially boil down to evaluating risk and then determining what risk is worth.<sup>1</sup> When it comes to preferred securities, we think we have an edge in both; the preferred market is our primary focus and has been for a very long time.

The financial crisis pulled back the curtain on the national system of money and banking, and exposed a number of problems. In our view, the most fundamental cause of the crisis was a severe imbalance between risk and opportunity. More specifically, an asymmetry existed between those bearing risk and those reaping rewards. As a result, a lot of really bad decisions were made, and when the proverbial chickens came home to roost, the entire financial system laid an egg.

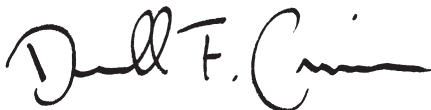
Many of these ill-fated decisions involved inappropriate use of leverage. The poster child for debt-run-amok was, of course, the residential real estate market. However, abuse of leverage wasn't limited to residential real estate—easy access to cheap money fueled a widespread borrowing binge, with individuals, corporations and governments spending too much time at the “cheap money” punchbowl.

Leverage is an important component of the Fund's investment strategy as well, so we understand the challenges of operating a business funded in part with borrowed money. Fortunately, the Fund is designed to use leverage prudently, with limitations on the amount of debt employed at any point in time. Because of these restrictions, the Fund avoided many of the severe problems faced by other borrowers. That's not to say it hasn't been challenging. When asset prices fell, the Fund was required to reduce leverage proportionately by selling securities at prices that were severely depressed; conversely, as prices recovered, we have been able to borrow additional sums for the purpose of buying additional preferred securities at attractive prices.

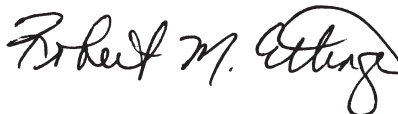
The bottom line for shareholders is that the Fund is working as intended – a steady improvement in the Fund's investment portfolio over the past few quarters, along with effective use of relatively inexpensive leverage, enabled the Fund to raise the monthly distribution to shareholders to \$0.0825 from \$0.072, an increase of 14.6%. This is in addition to the dividend increase last December of 14.3%.

More information is always available on the Fund's website at [www.preferredincome.com](http://www.preferredincome.com).

Sincerely,



Donald F. Crumrine  
Chairman of the Board



Robert M. Ettinger  
President

July 14, 2010

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<sup>1</sup> Readers interested in the subject may want to read “Against the Gods, the Remarkable Story of Risk” by Peter L. Bernstein, an excellent discussion of the history of risk and risk analysis.

## DISCUSSION TOPICS

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

The table below reflects performance of each investment strategy available for use by the Fund to achieve its objective, namely: (a) investing in a portfolio of securities; (b) possibly hedging that portfolio against significant increases in long-term interest rates (although no hedge positions were in place during the six months ended May 31<sup>st</sup>); and (c) utilizing leverage to enhance returns to shareholders. Next, we compute the impact of the Fund's operating expenses. All of the parts are then summed to determine total return on the Fund's NAV.

#### Components of PFD's Total Return on NAV for the Six Months Ended May 31, 2010

	<i>Six Months*</i>
Total Return on Unleveraged Securities Portfolio (including principal and income) .....	+8.4%
Return from Interest Rate Hedging Strategy.....	0.0%
Impact of Leverage (including leverage expense).....	+3.6%
Expenses (excluding leverage expense).....	-0.8%
<i>Total Return on NAV</i>	<b>+11.2%</b>

\* Actual, not annualized.

The recovery in preferred security valuations continued over the Fund's fiscal year-to-date, but at a slower pace than during 2009. However, over this recent six month period the Fund's investment portfolio outperformed all sectors of the preferred securities market, as can be seen by comparing total return on the Fund's portfolio (the first row of the above table) to the results of various Bank of America Merrill Lynch preferred indices in the following table.

#### Total Returns of Bank of America Merrill Lynch Preferred Securities Indices\* for the Six Months Ended May 31, 2010

	<i>Six Months*</i>
BofA Merrill Lynch 8% Capped DRD Preferred Stock Index <sup>SM</sup> .....	+8.1%
BofA Merrill Lynch 8% Capped Hybrid Preferred Securities Index <sup>SM</sup> .....	+7.3%
BofA Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index <sup>SM</sup> .....	+8.0%
BofA Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index <sup>SM</sup> .....	+2.5%

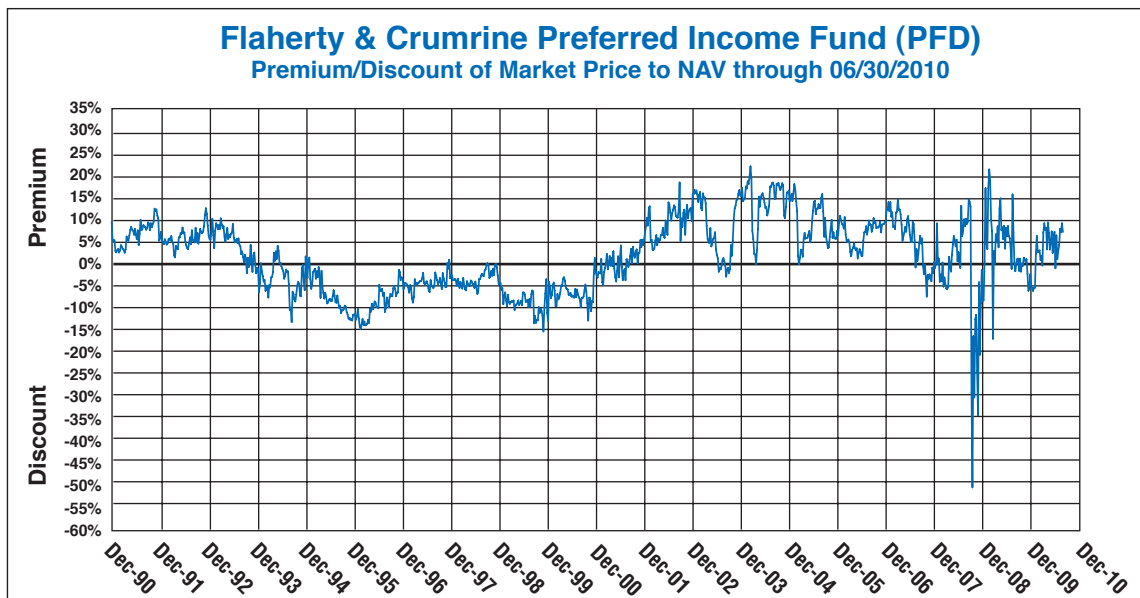
\* The Bank of America Merrill Lynch 8% Capped DRD Preferred Stock Index<sup>SM</sup> includes investment grade preferred securities issued by both corporations and government agencies that qualify for the corporate dividend received deduction with issuer concentration capped at a maximum of 8%. The Bank of America 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 Bank of America 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 Bank of America Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index<sup>SM</sup> includes adjustable rate preferred securities issued by U.S. 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.

The Fund's NAV performance (bottom line of the first table) demonstrates continued success of the strategy of using a moderate amount of leverage to enhance return on the Fund's portfolio sufficiently to cover its expenses and permit the NAV of the Fund to still outperform the unleveraged preferred market indices.

### 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 market price of Fund shares. Even following very strong results during the prior fiscal year, the market price continued to recover during the current fiscal year-to-date, producing a total return of +21.9% on the market price of Fund shares over the past six months.

In a perfect world, the market price of Fund shares would closely track the Fund's net asset value. As can be seen from the graph below, this often is not the case. While for most of the past ten years the Fund's market price has been above its NAV (in market parlance, "trading at a premium"), the market price dropped well below the underlying value of each Fund share during the depths of the financial crisis 1½ years ago. More recently, the market price has traded much more in line with the underlying value of its shares, and as of June 30, 2010 traded at a premium to NAV.



Based on a closing price of \$11.30 on June 30<sup>th</sup>, the current distribution rate on market price of the Fund's shares (assuming the current monthly distribution of \$0.0825 does not change) is 8.8%. In our opinion, this distribution rate is very competitive with comparable alternative investment opportunities.

### Preferred Market Conditions

Conditions in the preferred securities market have improved markedly since the depth of the financial crisis in March 2009. And despite the uncertainties discussed elsewhere in this report, the preferred market is alive and well. Along the path to improvement, however, there have been some bone-rattling bumps. The preferred market began and ended this past quarter in pretty good shape, but in-between we experienced (and survived!)

a pretty significant jolt. We expect that this pattern of generally rising preferred prices, punctuated by sharp setbacks and above-average volatility, will be the hallmark of the preferred market in 2010.

We judge the health of the market by two primary measures: relative price performance (compared to other segments of credit markets), and overall liquidity (how easy is it to buy and sell securities without impacting prices).

In our opinion, preferred securities continue to offer investors attractive levels of income and potential for price appreciation when compared to other types of fixed-income investments. During the darkest days of the market collapse (late 2008 to early 2009) preferred prices were weaker than every other fixed-income product except junk bonds. The gap has narrowed appreciably over the past year, but preferred securities still offer good relative value to investors.

Not only do preferreds look attractive versus broader credit markets, but the broader credit markets also appear undervalued versus other types of investments. Measures of cash flows into and out of mutual funds indicate demand for higher yielding fixed-income products is strong. This is no surprise. With high levels of volatility and uncertainty about the stock market, huge deficits faced by state and local municipalities, and money-market fund yields hovering around zero, many investors have turned to corporate bonds and preferred securities.

Liquidity, the other measure of market health, is also relatively good at present, but some explanation is required. The preferred securities market is never highly liquid, at least by the standards of most other securities markets. A large-cap, exchange-traded common stock may trade hundreds or thousands of times each day, with tiny bid-offer spreads; in the preferred universe, most trades require greater effort. But relative to historical measures of liquidity, the preferred market has been reasonably active recently.

Things were not quite as rosy during the first couple weeks of May. Preferred securities traded down significantly, as fears over the potential for a European debt crisis intensified. Prices fell despite surprisingly strong economic data in the United States, where the bulk of preferred issuers are domiciled. As discussed below, the European Union took dramatic steps to stem the crisis, and the market heaved a sigh of relief. Debt burdens remain high throughout developed markets, however, leaving conditions ripe for renewed market turbulence at some point down the road.

Preferred market participants are also scratching their collective heads as legislators and regulators address the role of certain types of preferred securities in the capital structure of financial institutions. The outcome could have far-reaching implications for the market, and our thoughts are discussed more fully below. Despite the uncertainty, we view the range of outcomes to be mostly positive for investors in preferred securities. Just be prepared for more bumps in the road.

## **Financial Regulation**

The Senate is poised to vote on financial regulatory reform legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). While the vote in the Senate is likely to be very close, the House has already approved it and we expect that Dodd-Frank will be enacted. The legislation will make significant changes to both the operations and capitalization of financial companies. Below we discuss the key features and implications of the bill for preferred investors.

First, Dodd-Frank will set capital standards for financial institutions. The bill largely leaves decisions about capital up to the relevant regulators, with the important constraint that capital requirements be set *no lower* than they are today. In addition, capital requirements will apply to average rather than period-end

assets. At most financial institutions, average assets tend to be higher than end-of-period assets. Thus, Dodd-Frank will raise effective capital requirements for most financial companies and make it more difficult to lower them in the future. For preferred investors, this is good news.

Second, Dodd-Frank contains a provision that will make trust preferred securities (TruPS) ineligible as Tier 1 capital. (Tier 1 capital is one of the primary measures of capital for a financial company; it includes common equity, retained earnings, qualifying preferred capital, and certain regulatory assets.) For banks with less than \$15 billion in assets as of December 31, 2009, TruPS issued before May 19, 2010 will retain Tier 1 capital eligibility permanently. For banks over that size, their TruPS will remain Tier 1 eligible until January 1, 2013; Tier 1 eligibility will phase out over the following three years (presumably, 75% eligibility in 2013, 50% in 2014, and 25% in 2015), with no Tier 1 credit by January 1, 2016. All TruPS issued on or after May 19, 2010 will not receive Tier 1 capital treatment, regardless of the size of the issuing bank. (There has been no public issuance of TruPS since that date.) This is mixed news for preferred investors. Banks are more likely to call TruPS that are no longer eligible as Tier 1 capital, and most TruPS allow issuers to call them at par if they no longer qualify as Tier 1 capital. That's potentially good news for TruPS that trade below par, but it's bad news for the small number of issues that trade at a premium. The provision may also be negative for traditional non-cumulative preferred stock, which will continue to count as Tier 1 capital, since supply might increase substantially if financial companies decide to replace TruPS with traditional preferreds.

Third, Dodd-Frank will restrict the activities of financial institutions in a number of ways. For preferred investors, two of the most important are (1) the "Volker Rule" limiting proprietary trading and investments in hedge funds and private equity and (2) the requirements for derivatives activities. Without getting into specifics, we see these provisions as reducing both the risks that financial institutions can take and the profits they can generate. The former is good for preferred investors, while the latter could be negative if it cuts deeply enough into profitability – since preferred investors ultimately are paid out of earnings. At this point, it appears that the bill takes moderate ground on both of these provisions, although we can't say definitively until regulators write the rules enforcing the provisions. On balance, we think these limitations on bank activities will benefit preferred investors.

Overall, we think Dodd-Frank will force banks to hold more capital, take less risk, or both. When we combine that with regulators' desire for banks to hold a higher proportion of high-quality capital (i.e., common equity), we see it as decidedly good news for preferred investors. We may need to reassess that conclusion when regulators turn the legislation into final rules. However, for now we are cautiously optimistic about the impact of Dodd-Frank on preferreds.

### **Changes to Capital Standards**

While the U.S. Congress is moving to pass Dodd-Frank, regulators here and abroad are formulating new capital standards for banks. These new rules, Basel III, will replace current Basel II guidelines that, in retrospect, permitted banks to operate with inadequate capital as markets became stressed. While the new rules are still being negotiated, two things are clear. First, banks will need to hold higher levels of capital than under Basel II, partly because certain asset classes will carry higher "risk weights" and partly because required capital ratios have increased or will increase.

Second, the "quality" of capital will improve, with a particular emphasis on the strongest form of capital, common equity. As preferred investors, we have always paid a great deal of attention to the composition of capital at the companies in which we invest, and we are happy to see regulators do the same. Over time, this should result in banks with higher common equity ratios and less reliance on preferred and hybrid securities

(in percentage terms). That no doubt will prompt changes to the preferred market, with shrinkage in some areas, expansion in others, and eventually emergence of some new forms of hybrid capital. While these changes may generate some volatility in the preferred market, we expect they will offer plenty of opportunities as well.

## **Eurozone Debt Problems**

One of the major challenges facing credit markets today is the sovereign debt situation in Europe. The global recession caused government budget deficits to swell almost everywhere. Portugal, Ireland, Italy, Greece, and Spain (the so-called PIIGS countries) each ran high budget deficits in 2009 (over 9% of GDP, except for Italy, which posted a deficit of 5.3% of GDP), with the prospect of still-sizeable deficits for years to come. Markets became worried about these countries' ability to repay their debt, resulting in sharply higher long-term interest rates in those countries (especially Greece), which only intensified the problems they face in bringing their debt under control.

Normally, a country has three "levers" it can pull to help address its fiscal imbalance: the exchange rate, monetary policy, and fiscal policy. As members of the European Monetary Union (EMU), however, individual countries don't control the first two. That leaves fiscal policy as the only real tool for reestablishing fiscal balance – and markets came to doubt that the PIIGS could move quickly enough to right the ship.

With Greece on the verge of a liquidity crisis – it had debt coming due without the cash to repay it or market access to refinance it – the EMU and International Monetary Fund (IMF) combined to offer a €110 billion assistance package to Greece in exchange for commitments from Greece to sharply reduce its deficit. This averted an immediate crisis, but markets quickly turned on the other high-deficit countries. Within days, European officials launched a more comprehensive set of proposals to address the widening crisis. In addition to the €110 billion assistance package for Greece, officials announced a massive increase in the debt stabilization fund for EU nations. The €750 billion plan consists of €440 billion in loans from Euro-zone governments, €60 billion from an EU emergency fund, and €250 billion from the IMF. In addition, the European Central Bank has begun purchasing EU government debt in order to provide liquidity to the markets, and the U.S. Federal Reserve reinstated foreign exchange swap lines to give foreign central banks access to U.S. dollars.

All of these concerns about Europe have weighed on the preferred securities market for two broad reasons. First, investors worry about the direct exposure that companies may have to these countries. On that score, the Fund has no direct exposure to foreign sovereign debt, and we cannot identify any investments with material exposure to Greece, the weakest of the EMU sovereigns. However, some of the companies in the Fund's portfolio do have material exposure to Spain, Italy, and (to a lesser extent) Portugal – although we still would characterize the Fund's exposure to those issuers as modest.

The second broad concern facing investors is the possibility that sovereign debt problems could lead to a breakup of the EMU and the Euro. Given the interconnectedness of the global financial system, breakup of the EMU would be highly disruptive to say the least, and there is no doubt it would negatively affect the preferred market. While we think this is an extremely low probability scenario, until markets have concluded it's a "no chance" scenario, we have to keep our eye on it. The creation of the debt stabilization fund and renewed budget restraint in high-deficit countries gives us comfort that sovereign risks are moving in the right direction.