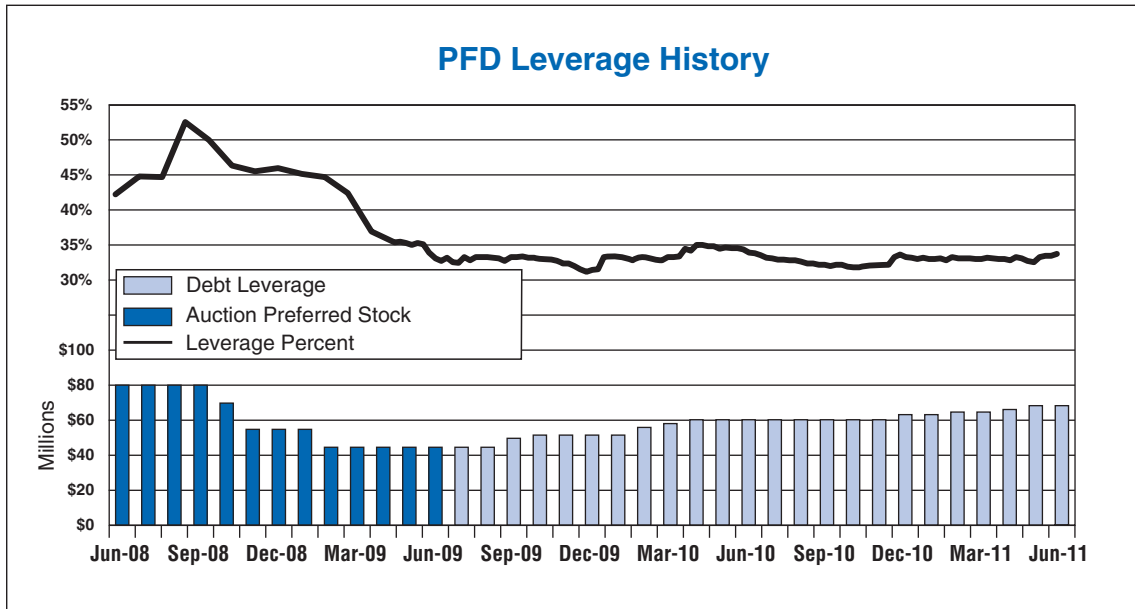


# Flaherty & Crumrine Preferred Income Fund Incorporated

## Correction to Semi-Annual Report for the Six Months Ended May 31, 2011

Please note that the semi-annual report mailed by the Fund in late July 2011 contained a chart on page 7 with incorrect data. The corrected chart is shown below.



## FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Fund:

During the three month period ending May 31, 2011, the Fund's total return on net asset value was +5.6%. Over the first half of fiscal 2011 the return on NAV was +11.0%. The table below presents these and other performance measures of interest to investors.

### TOTAL RETURN ON NET ASSET VALUE FOR PERIODS ENDED MAY 31, 2011

	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 . . . . .	5.6%	11.0%	31.3%	15.0%	5.3%	7.4%	9.9%
Barclays Capital U.S. Aggregate Index <sup>(2)</sup> . . . . .	2.6%	1.9%	5.8%	6.5%	6.6%	5.8%	6.9%
S&P 500 Index <sup>(3)</sup> . . . . .	1.8%	15.0%	26.0%	0.9%	3.3%	2.6%	9.1%

(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 common stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

*Current performance may be lower or higher than the quoted past performance, which cannot guarantee future results. In addition, NAV performance will vary from market price performance, and you may have a taxable gain or loss when you sell your shares.*

At the risk of sounding like a broken record, we reprise our caution of the past few letters: returns of this magnitude are unlikely to be repeated. The market for preferred securities has had a nice run recovering from the depths of the financial crisis in early 2009. Prices on many securities are now at or above levels of three years ago, and we view the overall preferred market as fairly priced relative to other broad asset classes.

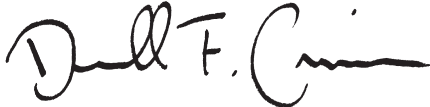
Of course, this does not mean all individual securities are perfectly valued. Pricing inefficiencies are an endearing part of the preferred market, and it is unlikely this will change. Part of our job is to identify and take advantage of opportunities as they present themselves. Our credit analysis and security selection, as well as effective management of leverage, have been at the heart of the Fund's excellent performance.

Financial markets are still facing some major uncertainties. First and foremost, the economic outlook is as cloudy as ever. European leaders are dealing with the Greek debt crisis, and other sovereign credit problems are lurking in the background. Private sector debt shrunk during the financial crisis; now it's the public sector's turn, and it is far from clear how that will play out. Effects of the Japanese earthquake and tsunami are still being felt and likely will take years to resolve fully. The housing market remains an albatross around the neck of the U.S. economy (among others). And worldwide, financial regulators have yet to fully articulate a new set of rules for bank capital and regulation.

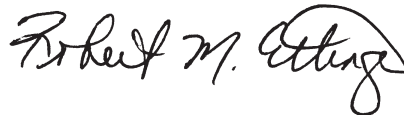
We see both risk and opportunity in these uncertainties. As always, we will do our best to minimize the risk and capitalize on the opportunities.

In the discussion topics that follow, we present a more detailed review of the Fund's performance, as well as further discussion on several topics mentioned above. As always, we encourage you to visit [www.preferredincome.com](http://www.preferredincome.com) to read our Quarterly Economic Update, as well as more detailed discussion of the wonderful world of preferred securities.

Sincerely,



Donald F. Crumrine  
Chairman



Robert M. Ettinger  
President

July 8, 2011

## DISCUSSION TOPICS

### The Fund's Portfolio Results and Components of Total Return on Net Asset Value (NAV)

The table below reflects performance of each investment technique available for use by the Fund to achieve its objective, namely: (a) investing in a portfolio of securities; (b) possibly hedging that portfolio of securities against significant increases in long-term interest rates (see the following discussion on the status of the Fund's interest-rate hedging strategy); and (c) utilizing leverage to enhance returns to shareholders. Next, we compute the impact of the Fund's operating expenses. All of the parts are summed to determine total return on the Fund's NAV.

#### Components of PFD's Total Return on NAV for the Six Months Ended May 31, 2011

	<i>Six Months*</i>
Total Return on Unleveraged Securities Portfolio (including principal and income) .....	+8.0%
Return from Interest Rate Hedging Strategy.....	N/A
Impact of Leverage (including leverage expense) .....	+3.7%
Expenses (excluding leverage expense) .....	-0.7%
	<b><i>Total Return on NAV</i> +11.0%</b>

\* Actual, not annualized.

Over the first half of fiscal 2011, the Fund's investment portfolio has continued to perform well, both absolutely and relative to various sectors of the preferred market as measured by the various Bank of America Merrill Lynch preferred market indices shown in the table below. During this recent six month period, only the Bank of America Merrill Lynch adjustable-rate preferred index, reflecting just 2 % of the total preferred market, earned a comparable return to that of the Fund's portfolio (the first row of the above table).

#### Total Returns of Bank of America Merrill Lynch Preferred Securities Indices\* for the Six Months Ended May 31, 2011

	<i>Six Months</i>
BofA Merrill Lynch 8% Capped DRD Preferred Stock Index <sup>SM</sup> .....	+6.0%
BofA Merrill Lynch 8% Capped Hybrid Preferred Securities Index <sup>SM</sup> .....	+5.1%
BofA Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index <sup>SM</sup> .....	+6.2%
BofA Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index <sup>SM</sup> .....	+8.1%

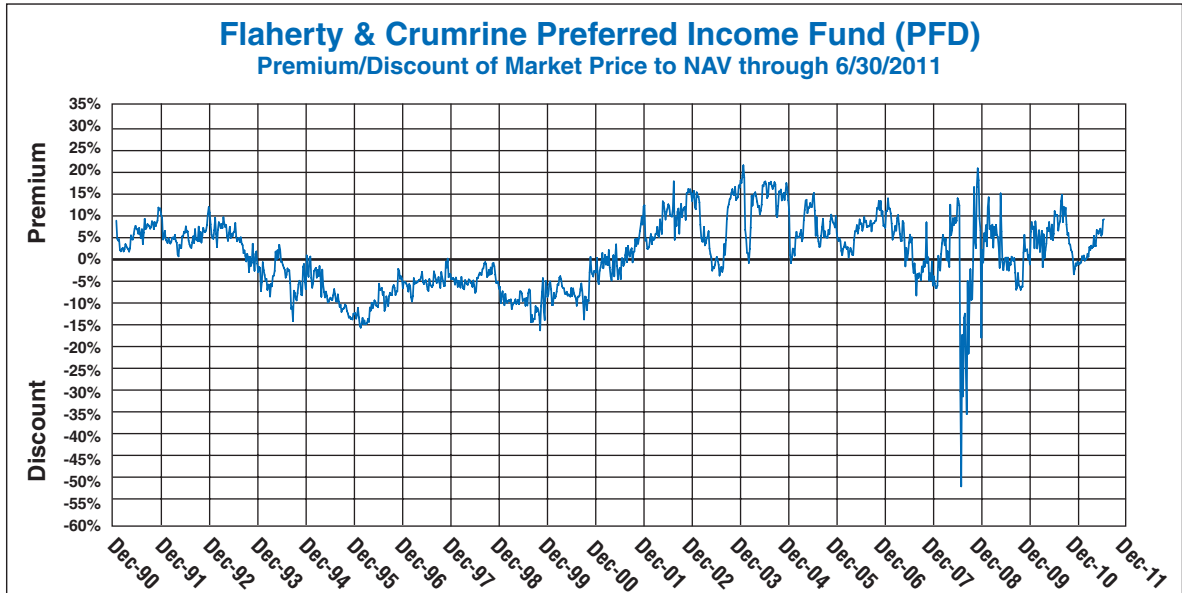
\* The Bank of America Merrill Lynch 8% Capped DRD Preferred Stock Index<sup>SM</sup> includes investment grade preferred securities issued by both corporations and government agencies that qualify for the corporate dividend received deduction with issuer concentration capped at a maximum of 8%. The 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 six-month NAV performance (positive 11.0%) demonstrates continued success of the strategy of using leverage to enhance return on the Fund's portfolio sufficiently to absorb its expenses and permit the NAV of the Fund to still outperform all of the unleveraged preferred market indices.

### Total Return on Market Price of Fund Shares

While our focus continues to be 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 the strong results over recent years, the market price of Fund shares continued to perform well during the current fiscal year-to-date, producing a total return of +16.2% through May 31<sup>st</sup>.

In a perfect world, the market price of Fund shares would track the Fund's NAV. 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 generally 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 recent financial crisis. However, more recently the market price has traded more in line with the underlying value of the Fund's shares, and currently is trading at a premium to NAV. Because the Fund's premium to NAV expanded slightly over the current fiscal year-to-date, the total return earned on its market price exceeded the total return on NAV.



Based on a closing price of \$13.45 on June 30<sup>th</sup> and the Fund's current monthly dividend of \$0.09, the current distribution rate on market price of the Fund's shares is 8.0%. Because of the leverage employed by the Fund and other factors, this distribution rate compares very favorably with those available on other strategies investing in preferred securities, including ETFs and open-end funds.

## Preferred Market Conditions

Conditions in the market remain positive, although an uncertain economic environment and unresolved regulatory issues are impacting activity. The best barometers for market conditions are trading volume, bid-offer spreads, and new issue activity. At present, all three measures are off from last quarter, but still indicate healthy conditions.

Market activity often slows during the summer, so we don't read anything meaningful in the decline. We are more focused on the impact of new regulations (discussed below) and how financial institutions transition to the new rules. Of particular interest are securities which under certain circumstances may be called by the issuer to the detriment of investors. In May, Fifth Third Bancorp exercised such a call and the market was certainly caught by surprise. As a result, other issues with similar features declined in price to reflect the risk of early redemption. Having been aware of this risk for some time, the Fund's portfolio had limited exposure to these issues.

There were 26 new issues during the quarter, totaling just under \$10 billion. The bulk of the issuance was from REITs and insurance companies. And, reflecting ongoing demand from retail investors, most of these new issues came in a format favored by individual investors—\$25 par, exchange listed and five years of call protection.

During the quarter, issuers redeemed 28 issues with a market value of just under \$8.8 billion. The fact that the number and amount approximate those of new issues is mostly coincidental; however, some companies did take advantage of market conditions to refinance high-cost preferred securities with new, less-expensive securities. Of course, as issuers reduce interest expense, investor income falls as well. We try to minimize the impact of these transactions, but over time, if interest rates remain low, income earned by the Fund is likely to decline.

Finally, we observe with a sense of irony the likely shift back to days of old when “traditional” preferred stock was the only security (other than common stock) that banks could treat as capital (discussed more fully in the discussion of bank regulation below). The market appears well positioned to handle a transition in which hybrid and trust preferred issues get replaced with non-cumulative, perpetual preferred stock. This change is likely to have a significant impact on the Fund's portfolio, although it is too early to know the overall effect of the change. We believe bank credit quality will improve; however, income earned on the Fund's portfolio may fall if new issues come to market at lower yields.

## Update on Regulatory and Capital Reform for Banks

June saw further clarification on new “Basel III” international banking regulations being developed by the Basel Committee on Banking Supervision. The Committee announced that it had determined that globally-systemically important financial institutions should hold up to an additional 2.5% of *common* equity above and beyond that required of smaller banks. The idea is to reduce the likelihood of a failure of a large global bank, which could put the entire financial system at risk because of the bank's size, interconnectedness, lack of substitutability, global activity and complexity.

As we've discussed previously, international and national banking regulators have responded to the 2008-2009 financial crisis with new regulation and stiffer capital requirements. As a refresher, we'll briefly summarize the key features of bank regulatory reform from the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), and bank capital requirements of the Basel III framework – both from the perspective of preferred investors.

Of primary importance to investors in preferred securities are the regulations surrounding bank capital requirements: in other words, (1) *how much and what types of capital will banks be required to hold*, and (2) *what features will securities need in order to qualify as a particular form of capital?* We expect national regulators to offer preliminary rules on capital later this summer or early fall, followed by a comment period of several months. That should put the market on track for final U.S. bank capital rules late this year or early next year.

*How much capital?* Under Basel III, banks will be required to maintain much higher levels of capital than in the past, particularly at the common equity level. Minimum common equity capital will rise from the current 2.5% of risk-weighted assets (RWA) to 7%, including a “capital conservation buffer” when fully implemented in 2019.

Basel III still leaves a role for preferred securities in a bank’s capital structure, as it requires total Tier 1 capital of 8.5%, with the additional 1.5% comprised of common and/or preferred equity. Further, total capital must be 10.5%, with the additional 2.0% above Tier 1 consisting of both Tier 1 and other capital.

In addition, all banks will be subject to a “countercyclical” capital buffer ranging from 0% to 2.5%, as determined by national regulators; and large global banks will be subject to the 1% to 2.5% “systemically important financial institution” capital buffer.

While individual countries still need to adopt these standards, we expect that the great majority will do so. In fact, Switzerland has already announced that its two systemically important banks, UBS and Credit Suisse, will be required to hold total capital of at least 19% of RWA, including a Tier 1 common equity ratio of 10% – well in excess of the Basel III standard.

*What type of preferred security qualifies as Tier 1 capital?* Basel III also introduces loss absorbency rules for preferred securities. The theory is that all Tier 1 capital should be able to absorb losses on both a “gone concern” basis and on a “going concern” basis. Historically, preferred securities have provided substantial loss absorbency upon failure of a firm, since all preferred claims are subordinate to claims of depositors and senior creditors. However, preferreds are – strictly by their contractual terms – only moderately loss absorbing on a going concern basis, because the issuer can defer dividend payments but not eliminate the preferred liability outright in times of strain. Basel III provides that regulators must have the ability to force the conversion of preferreds to common stock, or lower or write off the preferred liability if they believe the bank is no longer viable.

Preferred securities, however, don’t need to incorporate such terms explicitly. If a country’s bank resolution regime incorporates a system for allocating losses to capital providers prior to the injection of state funding, then the loss provision language is not required. While we won’t know for sure until final rules are written for the United States, it appears that Dodd-Frank gives U.S. bank regulators just such authority. As a result, it is likely that perpetual, noncumulative U.S. bank preferreds eligible for the dividends received deduction will remain qualifying Tier 1 capital under the new rules. Other countries are likely to adopt similar resolution regimes as well.

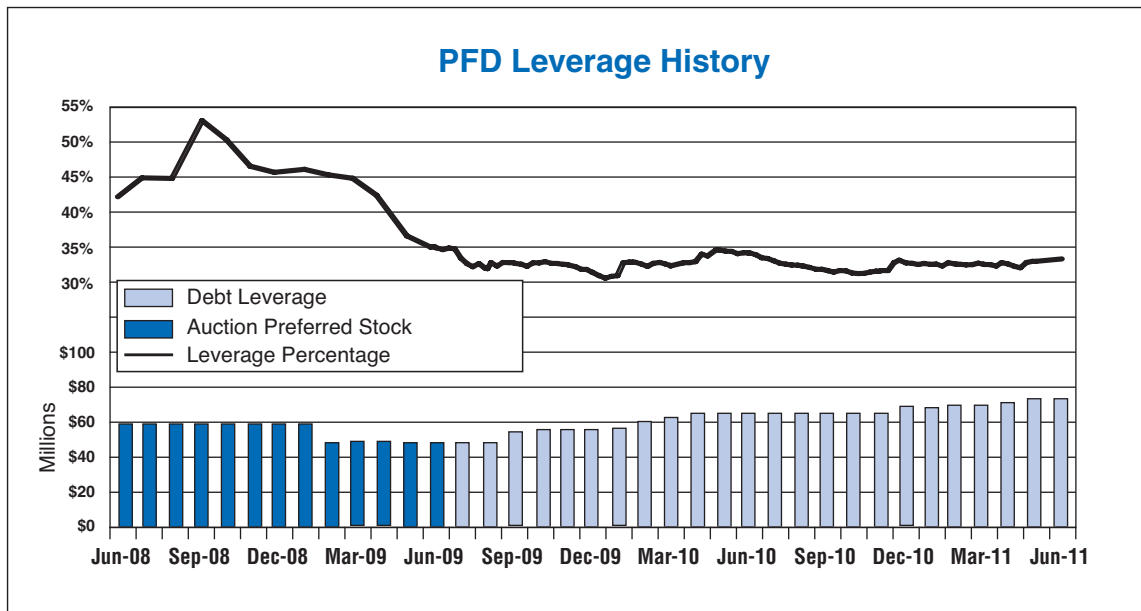
Dodd-Frank also makes significant changes to U.S. banks’ operations and capital requirements. Most importantly for preferred investors, it eliminates trust preferred securities (TruPS) from Tier 1 capital for most banks the Fund invests in. The new rules phase in starting from 2013 through 2015. This change in regulatory treatment for TruPS makes it likely that most, though not all, TruPS will be called between 2013 and 2016, as banks replace those instruments with qualifying forms of Tier 1 capital. As of May 31, approximately 19% of the Fund’s portfolio was invested in TruPS issued by U.S. banks.

We continue to believe that the Dodd-Frank and Basel III regulatory changes will be positive for investors in preferred securities. Banks will need to hold significantly more common equity capital than they have in the past. In fact, they already do. This will give banks much more capacity to absorb losses before preferred investments are in danger of impairment. While all these regulatory changes create uncertainty in the market, we believe they will be beneficial for preferreds.

## The Fund's Leverage

Leverage is an important part of the Fund's strategy for producing high current income. The cost of leverage typically is lower than the yield on the Fund's portfolio. The difference between what the Fund earns on its investments and pays on borrowed money increases income available to common shareholders. Over the past six months, the Fund has paid an average annualized interest rate of 1.3% on its borrowed money. Given the much higher current yields generated by the Fund's portfolio, this use of leverage has had a meaningful positive impact on the Fund's dividends to common shareholders.

There are two useful measures of how much leverage the Fund has in place. The first is simply the total dollar amount of leverage. The other measure is the ratio of the Fund's assets financed by that leverage (in other words, the amount of leverage divided by total assets). The chart below presents both measures of leverage over the past three years.



As reflected by the table, the dramatic recovery in asset prices has meant the Fund has been able to comfortably increase borrowings and use the money to purchase additional securities. During the first six months of this fiscal year, the Fund has continued to increase its leverage balances, while not significantly increasing the leverage ratio.

The "right" percentage of leverage in a fund is never simple to determine. Type of borrowing, cost of funds and market conditions all will be factors to consider. At present, we are comfortable with the leverage percentage used by the Fund, and we will consider increasing or decreasing the amount of borrowing based on future market conditions.

## **Status of the Fund's Hedging Strategy**

The Fund suspended its interest rate hedging program as the financial crisis intensified in the autumn of 2008. There were three principal reasons why we suspended the program at the time. First, the relationship between preferred securities' prices and the Fund's hedging instruments (Treasury bond futures, interest rate swaps, and options on both) was turned on its head during the financial crisis. Historically, preferred prices had tended to rise (fall) in periods of falling (rising) long-term Treasury rates, but as the financial crisis unfolded, the opposite occurred: preferred prices plunged while Treasury and swap rates fell, as investors sold risky assets and raced into Treasuries. Therefore, hedging lost its effectiveness. Second, the cost of hedging rose dramatically, as the yield curve steepened and options prices rose sharply. Finally, preferred securities became exceptionally cheap and were likely to offer high returns to shareholders even if Treasury yields increased moderately. Add them up, and we believed that hedging simply would not work under market conditions at the time.

Re-examining those three factors today, we believe that conditions have moved us closer to reinstating the Fund's hedging strategy, but we are not there yet. First, the correlation between preferred securities and our hedging instruments has improved, but it remains both weaker and significantly less stable than historical norms. Second, owing largely to the steepness of the yield curve, options continue to be very expensive. The third factor, preferred securities' valuation, currently sits within the range we would consider "normal," but by itself that does not persuade us to hedge the Fund's portfolio exposure just yet. We will continue to evaluate market conditions and may reinstate the Fund's hedging strategy if we judge that conditions warrant it.

## INVESTMENT POLICY MODIFICATION

On February 3, 2011, the Fund announced the following changes to its investment policies. These changes were effective on April 4, 2011.

**Old Policy:** At time of purchase, at least 75% of the securities that the Fund will acquire will be rated investment grade by either Moody's Investors Services, Inc. ("Moody's") or Standard & Poor's Corporation ("S&P"), or, if unrated, judged to be comparable in quality. In addition, the Fund may invest up to 25% of its assets at the time of purchase in securities rated below investment grade by both Moody's and S&P, if (a) such securities are rated at least "Ba3" by Moody's or "BB-" by S&P and (b) such securities are issued by an issuer having an outstanding class of senior debt rated investment grade at the time of purchase. Thus, the Fund may not invest in securities rated below "Ba3" by Moody's and below "BB-" by S&P.

**New Policy:** At time of purchase, at least 75% of the securities that the Fund will acquire will be rated investment grade by any one of Moody's, S&P or Fitch Ratings Group ("Fitch"). In addition, the Fund may invest up to 25% of its assets at the time of purchase in securities rated below investment grade by all of Moody's, S&P and Fitch, provided that (a) such securities are rated at least "Ba3" by Moody's, "BB-" by S&P, or "BB-" by Fitch or (b) such securities are issued by an issuer having an outstanding class of senior debt rated investment grade by any one of Moody's, S&P, or Fitch at the time of purchase. Thus, the Fund may invest in securities rated below "Ba3" by Moody's, "BB-" by S&P and "BB-" by Fitch if the issuer has investment grade senior debt outstanding.

### Impact of Changes:

- (1) Fitch is now one of the approved ratings agencies for determining whether a security meets the definition of "investment grade" for purposes of the Fund's policy of investing at least 75% of its assets in securities rated investment grade at the time of purchase or in securities of equivalent quality;
- (2) The Fund may now purchase securities rated below Ba3/BB-/BB- by each of Moody's, S&P and Fitch, respectively, as long as the senior debt of the same issuer is rated investment grade by any one of Moody's, S&P or Fitch at the time of purchase; and
- (3) If the senior debt of an issuer is unrated or it has no outstanding senior debt, the Fund may now purchase its preferred securities if they are rated at least Ba3/BB-/BB- by any one of Moody's, S&P or Fitch, respectively.

As a result of these changes, a security would be counted as investment grade if it had an investment grade rating by any one of Moody's, S&P or Fitch, even if the other two rating agencies rated it below investment grade. The effect of this change would be to reduce the Fund's holdings deemed below investment grade purchases, as of January 31, 2011, from 15.9% to 12.4%. In addition, the Fund would be authorized to purchase below Ba or BB securities of investment grade issuers, subject to an overall 25% limit on purchasing below investment grade securities. While this change would permit the Fund to acquire securities rated B and below, the Fund's adviser has no current intention of doing so.

As before, the Fund will apply the ratings criteria at the time of purchase and the Fund will not be required to dispose of securities if, after purchase, they are downgraded, although the adviser may take this into account in determining whether to retain the security. As a result, more than 25% of the Fund's holdings at any time may be rated below investment grade or in equivalent securities. In addition, as before, the Fund may invest in unrated securities that the Fund's investment adviser deems to be comparable in quality to rated issues in which the Fund is authorized to invest.

## **Risks of Investing in Securities Rated Below Ba3/BB-**

The Fund can purchase below-investment grade securities with ratings of at least Ba3 by Moody's and BB- by S&P and Fitch; such ratings generally indicate an issuer that is less vulnerable to non-payment of its obligations than other speculative issuers. The issuer, however, faces major ongoing uncertainty or exposure to adverse business, financial or economic conditions that could lead to inadequate capacity to meet its financial commitments. Under the Fund's new investment policy with respect to the investment grade rating of securities, the Fund may invest in securities with ratings below Ba3/BB- so long as the issuer of such securities has an outstanding class of senior debt rated investment grade by any one of Moody's, S&P or Fitch. Although a company's senior debt rating may be investment grade, an underlying security issued by such company in which the Fund may invest may have a lower than investment grade rating. A security with a rating below Ba3/BB- generally indicates the issuer of such security has a high degree of vulnerability of not paying its financial obligations. A security rated B1 to B3 by Moody's, or B+ to B- by S&P or Fitch, for example, indicates an issuer that is more vulnerable to not paying its obligations than a Ba3 or BB- issuer; the issuer, however, currently has the capacity to meet its financial commitments, although adverse business, financial, or economic conditions will likely impair the issuer's capacity or willingness to meet its financial commitments. Securities rated Caa by Moody's or CCC by S&P or Fitch indicate an issuer that is highly speculative and likely to be in, or very near default with some prospects of recovery of principal and interest, although the issuer is dependent upon favorable business, financial, and economic conditions to meet its financial commitments. Securities rated below Caa or CCC generally indicate an issuer that is highly vulnerable to not paying its obligations or that has defaulted on an obligation.