

FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Fund:

The Fund delivered a second consecutive quarter of double-digit returns as financial markets continued to recover from lows hit earlier this year. During the three-month period ended August 31st, total return on net asset value was +24.4%, and total return on market value of Fund shares was +18.4%.

As the worst of the financial crisis appears to be behind us, prices on most securities in the Fund's portfolio rose during the quarter. Although the credit outlook for some issuers remains speculative and the prices of their securities remain depressed, many securities that suffered the biggest declines earlier in the year staged the most dramatic recoveries. That being said, while prices in general are much higher than just three months ago, they remain well below the highs reached in recent years. There should be further recovery if the markets continue to normalize as we expect.

The strong performance over the past two quarters occurred despite the negative impact of our investments in a few troubled companies. During the past quarter, Colonial Bank was shut down by regulators. At this point, we are assuming there will be no additional income earned and minimal principal recovery on our investment in its parent, Colonial BancGroup, Inc. Two additional credits, FBOP Bancorp and CIT Group, suspended distributions on the securities owned by the Fund. Both companies are currently exploring strategies to improve their financial condition.

One year ago, the world's financial system was on the brink of collapse. In the blink of an eye, we went from a world in which anyone with a pulse could get a loan to a virtual shutdown of the capital markets. Investors, large and small, appeared ready to stuff money in a mattress rather than hand it over to a bank or money market fund. Access to short-term liquidity, the life blood of business, largely disappeared, and long-term financing was virtually unobtainable. Banks simply stopped lending (not only to long-time customers, but even more troublesome, to other banks), and capital market investors were in no mood to provide new financing.

When compared to broader credit markets, the preferred market has a much greater concentration in financial companies. In addition, the majority of preferred issues are long-term and consequently tend to have more volatile prices than other fixed-income instruments. As a result, the performance of the preferred market (and the Fund) was dismal throughout the early part of the financial crisis.

After one year, and massive amounts of government intervention, we see signs of recovery and perhaps a greater sense of rationality in the markets. On more than one occasion we've expressed our opinion that market volatility was exacerbated by excessive amounts of leverage. We underestimated the extent to which price declines could trigger selling by over-leveraged investors, producing an accelerating downward price spiral. We learned some valuable lessons during this financial chaos. We improved our analytic tools (and hopefully developed a more refined sense of smell) to help us discern changes in fundamental value from a leverage-fed frenzy. We further refined our credit criteria to help us identify riskier issuers earlier in the credit cycle. And, as leveraged investors ourselves, we have a keener appreciation for liquidity in the Fund's portfolio.

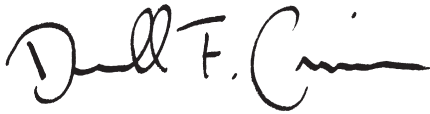
We believe these lessons will improve ongoing management of the Fund. Don't expect wholesale changes, but we would not be doing our job if we did not adapt to this new, more turbulent environment. For instance, the Fund suspended its hedging strategy last year, not because we no longer believe in hedging but because we did not think it would work in a crisis environment. At some point in the future, we anticipate reinstating the Fund's hedging strategy. Similarly, we have increased the portfolio's emphasis on liquid issues and issuers. By doing so, the Fund may give up some current income, but we believe this provides greater flexibility in managing the portfolio and its leverage for the benefit of shareholders.

In our last letter we indicated that the Fund was in the process of replacing all remaining shares of Auction Preferred Stock with bank debt. The switch is complete and the Fund's leverage is now comprised entirely of debt. While the breakdown in the auction preferred stock market made the change necessary, the Fund already is realizing some benefits from the new leverage. Foremost among these benefits are lower borrowing expense and greater flexibility in managing the portfolio.

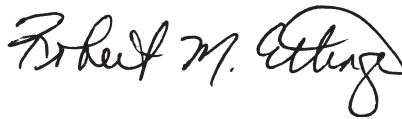
All markets have endured tremendous upheaval over the past year. More change is on the horizon, as the financial system moves from crisis to recovery. The Fund will continue to assess and adapt to this new market environment. We take that responsibility seriously, and we appreciate the support that shareholders have given us.

More information is always available on the Fund's website, including discussion of many of the topics in this letter. In addition, our thoughts on the economic outlook are published quarterly and posted to the site. We encourage you to visit the website at www.preferredincome.com.

Sincerely,



Donald F. Crumrine
Chairman of the Board



Robert M. Ettinger
President

October 15, 2009