

FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Fund:

The combination of falling interest rates and ongoing demand for preferred securities helped the Fund produce excellent returns during its third fiscal period ending August 31, 2010. For the three month period, total return on net asset value was +12.1%. Total return using market price of Fund shares was +18.5% during the period.

It has been quite an eventful summer in the preferred securities market. We'll hit the highlights here, and readers willing to do a little extra-credit homework will find more detailed discussions on the Fund's website.

In addition to strong performance of the Fund's investment portfolio, the monthly dividend paid to shareholders was increased to \$0.089 per share from \$0.0825, commencing with the August distribution. This 7.9% increase reflects the ongoing favorable environment of relatively high yields on Fund investments and the low cost of Fund borrowings.

We expect the level of economic growth to remain tepid over the coming quarters and then to show gradual improvement. We anticipate the Fund's cost of borrowing will follow a similar path, remaining low for a period, then increasing gradually. Of course, unless income from the Fund's investments also increases, a rise in the cost of borrowing would negatively impact the distribution to shareholders.

Although economic activity has slowed recently, we do not expect the economy to fall back into recession. In fact, we see some healthy signs, such as a substantial increase in personal savings and steady levels of business investment aimed at improving productivity. As individuals save more, some of these dollars are likely to find their way into the preferred market. As companies become more efficient, their financial condition generally improves. These trends, along with declining interest rates, have helped boost the Fund's investment performance.

In the aftermath of the financial meltdown, Congress and various bank regulators set out to establish new rules to hopefully prevent a repeat of the crisis. We are now getting a better sense of how new regulations will impact the market. With passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July, along with increasing clarification from international bank regulators, the fog is beginning to lift on the future role of preferred securities as a source of capital for the banking industry¹.

Since our last letter, rule makers have indicated which security structures they don't like, but have yet to decide what will be okay. It is now clear that trust preferred securities, which are favored by banks as a form of capital, will not meet the new standards. As a result, not only will there be no new issues of this type, issuers will want to redeem or replace outstanding trust preferreds sooner than was previously expected. In response, prices of many bank trust preferred securities have moved higher—contributing to the Fund's strong performance.

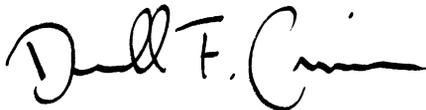
It is less clear what types of securities banks will be allowed to issue to meet future capital requirements. We are monitoring the debate closely and throwing in our two cents whenever appropriate. At this time, we believe the parties are moving toward a sensible conclusion and will ultimately induce banks to issue preferred securities suitable for the Fund's portfolio. Of course, we will stay on top of this and report important developments in these letters or on the Fund's website.

¹ The treatment of preferred securities issued by *non-banks* has not changed in any meaningful way.

As of this writing, roughly 23% of the Fund's portfolio is invested in trust preferred securities issued by U.S. banks. In light of the new rules, we think it is likely that many of these issues will be redeemed, beginning in 2013. We'll have our work cut out for us trying to replace the income on these securities, but until we have a better idea how the banks will replace these issues, it is difficult to predict the impact on the Fund.

As always, we encourage you to visit www.pfdincome.com to read our Quarterly Economic Update as well as a more detailed discussion of factors affecting the wonderful world of preferred securities.

Sincerely,

A handwritten signature in black ink, appearing to read "Donald F. Crumrine". The signature is fluid and cursive, with a large initial "D" and a long, sweeping underline.

Donald F. Crumrine
Chairman

October 15, 2010

A handwritten signature in black ink, appearing to read "Robert M. Ettinger". The signature is cursive and somewhat stylized, with a large initial "R" and a prominent loop at the end.

Robert M. Ettinger
President