

## FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Fund:

The fiscal year ended on a positive note, posting solid returns for the third consecutive quarter. As can be seen in the table below, the eye-popping performance of recent periods tells only part of the story, but one we are happy to report!

### TOTAL RETURN ON NET ASSET VALUE FOR PERIODS ENDED NOVEMBER 30, 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 <sup>(1)</sup>	14.8%	42.8%	82.5%	-6.4%	-0.8%	4.5%	8.5%
Barclays Capital U.S. Aggregate Index <sup>(3)</sup>	2.9%	6.2%	11.6%	6.4%	5.5%	6.4%	7.0%
S&P 500 Index <sup>(4)</sup>	7.9%	20.5%	25.2%	-5.8%	0.7%	-0.6%	8.6%

- (1) In prior periods, the Fund included the performance of funds in Lipper's Domestic Investment-Grade funds category, which reflected the equally-weighted average performance returns of all closed-end funds in the category in each month during the period. The category last included closed-end funds in the U.S. Mortgage and Corporate Debt BBB Rated sub-categories and has included other sub-categories in prior periods. With Lipper no longer publishing these results in a comparable format, the Fund will no longer include these results. For the period ended November 30, 2009, this category returned 5.8%, 15.4%, 31.0%, 3.9%, 4.5%, 6.2% and 7.0% (for the three month, six month, one year, three year, five year, ten year and since inception periods).
- (2) Since inception on January 31, 1991.
- (3) 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.
- (4) 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.

The financial crisis of the past two years claimed countless casualties and caused greater market volatility in the preferred market than any time in memory. A double digit return, up or down, was unusual before the crisis, yet such numbers have recently become more common.<sup>1</sup>

For all of fiscal 2009, the NAV *increased* 82.5% as the market for preferred securities came back to life. Although recent performance is impressive, it has not been enough to offset the decline of 48.4% in fiscal 2008. Unfortunately, it takes a lot more positive percentage returns to overcome a given amount of negative return. And if that's not enough to induce some head scratching, the analysis is further complicated by changes in the amount of leverage used by the Fund. We delve more deeply into these numbers, as well as returns on the market price of Fund shares, in the discussion section.

<sup>1</sup> The Fund's interest rate hedging strategy generally helps dampen volatility of returns, but the decision to temporarily suspend such hedging late last year has had little impact on performance (more on this later).

To help readers put the Fund's performance in context, we've included returns for broader fixed-income and equity markets. Other performance comparisons are discussed more thoroughly in the discussion section which follows.

Conditions in the preferred securities market have improved dramatically. Efforts by various government agencies, especially the Federal Reserve, have clearly helped stabilize the financial sector; prices of securities issued by commercial banks and insurance companies have recovered much of their lost value. Another factor contributing to the rebound in the preferred market is the absence of alternative investments such as asset-backed securities, collateralized debt obligations and commercial mortgage-backed securities. Investors have returned to more traditional investments like preferred securities, as the supply of "alternative" products has virtually disappeared.

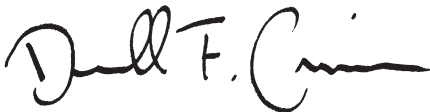
Although risks remain, the outlook for the preferred securities market seems bright. Market liquidity has improved and new securities are being issued. Confidence in the banking sector has improved, as banks have repaid more than 70% of the TARP preferreds issued during the height of the financial crisis. There are also indications that increased standardization of preferred security structures may be coming down the road, something investors would welcome.

The fact that the government used preferred stock investments to provide capital to distressed companies is an indication of how important these securities are in the world of finance. Without preferred securities, the number of companies that failed during the financial crisis would likely have been far greater.

In another sign of better times, the Fund announced an increase in the monthly distribution to \$0.072 from \$0.063 beginning with the December 2009 dividend. Several factors contributed to the increase, including changes to the Fund's leverage. The impact of leverage, investment income and Fund expenses on the amount of the dividend can get confusing, but it is important for shareholders to understand how the distributions are determined. We attempt to clarify things a bit in the discussion section.

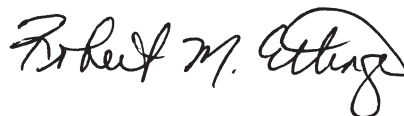
More information is always available on the Fund's website, including expanded discussion of many of the topics in this letter. In addition, our thoughts on the economic outlook are published quarterly and posted to the site. We encourage you to visit the website at [www.preferredincome.com](http://www.preferredincome.com).

Sincerely,



Donald F. Crumrine  
Chairman of the Board

January 21, 2010



Robert M. Ettinger  
President

## DISCUSSION TOPICS

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

The table below reflects the performance of each investment technique available for use 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 (see the following discussion on interest rate hedging); 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 the total return on NAV.

#### Components of PFD's Total Return on NAV for the Fiscal Year Ended November 30, 2009

	<i>Six Months*</i>	<i>One Year</i>
Total Return on Unleveraged Securities Portfolio (including principal and income).....	+27.7%	+51.7%
Return from Interest Rate Hedging Strategy .....	0.0%	0.0%
Impact of Leverage (including leverage expense) .....	+16.0%	+32.8%
Expenses (excluding leverage expense) .....	-0.9%	-2.0%
<i>Total Return on NAV</i>	<b>+42.8%</b>	<b>+82.5%</b>

\* Actual, not annualized.

By the end of the Fund's fiscal year ended November 30<sup>th</sup>, the preferred market had recovered dramatically from the lows it reached in 2008 and early 2009. More importantly, as can be seen by comparing the total return on the securities portfolio (the first row of the above table) to the index results in the following table, the Fund's portfolio outperformed the three largest segments of the market. The fourth segment of the market, adjustable rate preferred securities, constitutes roughly 3% of the entire preferred market as well as of the Fund's portfolio.

#### Total Returns of Bank of America Merrill Lynch Preferred Securities Indices\* for Periods Ended November 30, 2009

	<i>Six Months</i>	<i>One Year</i>
BofA Merrill Lynch 8% Capped DRD Preferred Stock Index <sup>SM</sup> .....	+20.5%	+25.1%
BofA Merrill Lynch 8% Capped Hybrid Preferred Securities Index <sup>SM</sup> .....	+13.9%	+27.8%
BofA Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index <sup>SM</sup> ..	+26.8%	+49.2%
BofA Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index <sup>SM</sup> ....	+43.0%	+87.9%

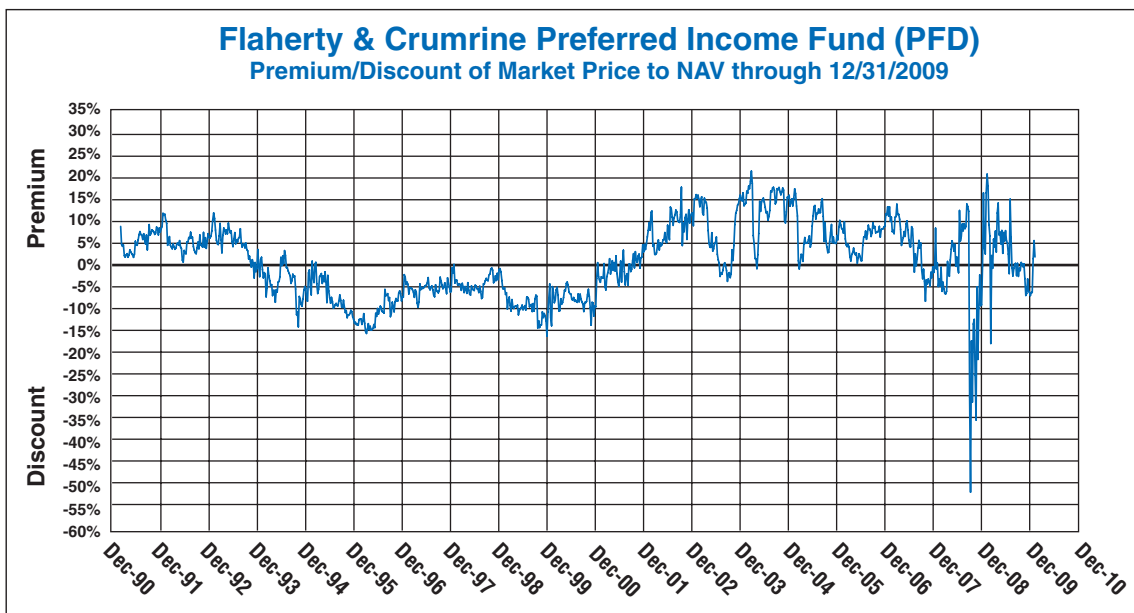
\* The Bank of America Merrill Lynch 8% Capped DRD Preferred Stock Index<sup>SM</sup> includes investment grade preferred securities issued by both corporations and government agencies that qualify for the corporate dividend received deduction with issuer concentration capped at a maximum of 8%. The 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 bottom line of the Fund's performance (as well as the bottom line of the first table) demonstrates how leverage benefited common stock shareholders during the past year. In contrast to the experience during fiscal 2008, the strategy of using leverage to increase current income magnified the positive returns over the Fund's fiscal 2009, and, even net of its expenses, caused the NAV of the Fund (with the added benefit of leverage) to significantly outperform the three largest 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 Fund's *market price*. After hitting lows in late 2008, the Funds' market price improved dramatically in 2009, and for the twelve months ending November 30, 2009, the total return on market price of Fund shares was +78.8%.

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. For most of the past year the market price has been below the NAV (in market parlance, "trading at a discount"). Recently, the discount narrowed and the market price is more in line with the underlying value of each Fund share.



Based on a closing price of \$10.47 on December 31<sup>st</sup>, the current distribution rate on the market price of the Fund's shares (assuming the current monthly distribution of \$0.072 does not change) is 8.3%. In our opinion, this distribution rate measures up favorably with most comparable investment opportunities.

### Preferred Market Conditions

Conditions in the preferred securities market have improved markedly since the very dark days of last winter. By late February 2009, prices on preferred securities had fallen to such a degree that the market seemed to be predicting few companies would survive. And while the severe economic downturn did claim its victims, the vast majority of companies appear to be well on the way to full recovery.

By most measures, key aspects of the preferred market are returning to normal levels. Trading has improved; there has been a steady supply of new issues; market participation appears widespread; and valuation metrics appear more consistent with other market segments. Of course, the most important measure of whether the preferred market has returned to normal levels is price. In our opinion, prices on much of the universe of preferred securities remain attractive, especially when compared to pre-crisis levels.

Since March, there have been almost thirty new preferred issues, totaling over \$16 billion. Although some of the new issues have been in exchange for older preferred securities, there has been new supply, and investors appear to have an appetite for more.

Perceptions of credit quality have also improved recently. Bolstered by banks returning bailout funds to the government (discussed below), investor confidence is coming back. The market reacted positively to each announcement of the Troubled Asset Relief Program (TARP) repayment, especially those of Bank of America and Citigroup. In addition to paying back the government, a number of banks raised new capital (common and preferred) in a sign that traditional financing sources are opening up again.

Though banks have the most preferred securities outstanding, preferred securities of insurance companies and public utilities constitute the other large sectors of the preferred securities universe. The insurance industry has generally benefited from improved investment performance and very few natural catastrophes. A number of insurance companies repurchased a portion of their outstanding preferred securities in recent months; in turn, the market prices of their remaining securities have risen substantially. Utilities, largely unaffected by the financial crisis, have continued to perform well, as investors seek perceived safety and diversification.

From time to time, the national credit rating agencies, primarily Moody's, Standard & Poor's, and Fitch, have revised the methodology they use to rate preferred securities. We rely primarily on our own research to evaluate credit quality, but the impact of public ratings can't be ignored. So when the agencies recently announced changes (once again!) to the methodology they employ in rating preferred securities, we were a bit dismayed. However, the market took it in stride, and despite a number of downgrades, prices changed little, if at all.

In December, a little known, but extremely important international committee based in Basel, Switzerland, proposed stricter guidelines for the way banks account for capital raised by issuing preferred securities. From our initial read of the guidelines, it appears that, after a transition period, in order for banks to receive the most favorable regulatory treatment from preferred capital, the issues will have to look more like old fashioned perpetual preferred stock. In addition, the U.S. Congress is considering new regulations for financial institutions that will affect many of the issuers in the Fund's portfolio. Of course, we'll monitor these developments closely and keep you informed, but we are optimistic that these changes will be beneficial to the Fund.

The preferred securities market, much like the broader stock and bond markets, took some severe hits during the financial crisis, and we still expect some bumps in the road to complete recovery in our markets. That being said, we aren't surprised by the extent of the ongoing recovery, even if the speed at which it has occurred has been faster than we imagined.

### **Bank Repayment of TARP Preferred and Impact on Preferred Investors**

In aggregate, U.S. banks have repaid about \$188 billion of the roughly \$264 billion in preferred capital purchased from them by the TARP. Focusing on the 19 largest banks that were subject to the Supervisory

Capital Assessment Program (SCAP), 18 of these banks received approximately \$221 billion in TARP capital and 12 of them have repaid about \$182 billion as of December 18, 2009.<sup>2</sup> This has turned out to be a significantly faster timetable for repayment than most market participants expected, and it highlights that (1) policies implemented to protect the financial system were largely effective and (2) the health of the banking system is improving rapidly.

All of the money-center banks and most of the major trust banks have repaid their TARP capital. These institutions have viewed repayment as important to their business. They believe that customers have a higher degree of confidence doing business – particularly when it involves counterparty risk – with a bank that has repaid the Treasury.

On the other hand, most regional and community banks have not yet repaid their TARP capital. This is not a bad thing for preferred investors. Although our assessment of their ability to repay TARP capital varies among regional and community banks, we believe that it is prudent for them to hold on to the capital at this time. While economic and financial conditions have improved, aggregate loan losses are still increasing. We expect them to peak in 2010, but some geographic regions and loan categories (e.g., commercial real estate) are likely to turn around more slowly. Regional and community banks, particularly smaller ones, tend to have more geographic, and often more loan-category, concentration than larger money-center banks, which makes them more exposed to those uncertainties. As a result, we do not fault these banks for holding on to their TARP capital for a while longer. If the economic recovery proceeds as expected and loan losses begin to trend down, we expect that most of the remaining banks will repay their TARP capital in 2010. However, banks with tough geographic footprints or concentrations of problem loans may not repay their TARP capital for several more years, and some will not survive at all.

As preferred investors, we care more about the quality of a bank's loan book, its business prospects, and the quantity and composition of its capital than whether or not it has repaid the TARP. We generally are happy to see banks repay the Treasury as long as they issue a meaningful amount of common equity to fund the repayment – something nearly all of the banks that have repaid the TARP have done.

### **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. This meant that hedging interest rates using put options on Treasury futures as had been done historically added risk to the Fund, which emphatically is not the objective of the hedging program. Second, the cost of hedging rose dramatically as the yield curve steepened and options

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<sup>2</sup> Citigroup received a total of \$45 billion in TARP capital and issued \$7.1 billion in additional preferreds to the U.S. Treasury as payment for insurance on \$301 billion of troubled assets. Treasury later exchanged \$25 billion of TARP preferred for common equity. (We include this amount as "repaid," since it is no longer a Citigroup obligation.) As part of the repayment plan announced on December 14, 2009, Citigroup will repay the balance of \$20 billion in TARP preferred, but \$5.3 billion of the "additional preferreds" will remain outstanding. The other banks that have repaid their TARP capital are: American Express, Bank of America, BB&T Bank, Bank of New York Mellon, Capital One Financial, Goldman Sachs, JP Morgan Chase, Morgan Stanley, State Street Bank & Trust, U.S. Bancorp, and Wells Fargo.

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 the market conditions at the time. (For a more detailed explanation, see “Update on Hedging Strategy,” July 6, 2009 on the Fund’s web site.)

Looking at the hedging strategy currently, we conclude that it remains too early to reinstate the hedging program. Although some preferred securities are starting to move in concert with the general level of long-term Treasury rates, most are not. For the preferred market as a whole, correlations between movements in prices of preferreds and the hedge instruments we use are increasing, but they remain well below their historical levels. While hedging today probably would not add to risk as it did during the height of the crisis, it still would not do much to reduce it. Meanwhile, the cost of hedging remains high, and preferreds remain attractively priced.

However, it does appear that the preferred market is gradually moving back toward a stronger relationship with swaps and Treasuries, even if that progress is insufficient to persuade us to reestablish the hedging program at this time. As the financial system heals, preferred securities are likely to reconnect with long-term benchmark Treasury rates. When they do, we will consider hedging again.

## **The Fund’s Leverage**

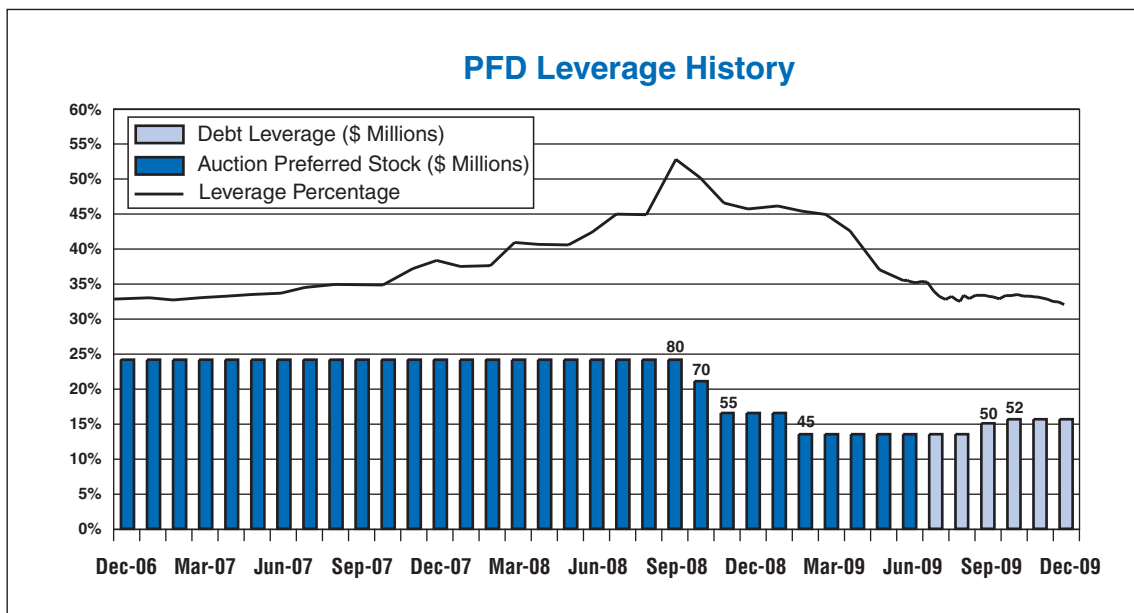
As we have discussed in the past, there have been important changes in the Fund’s leverage since the beginning of the credit crisis. Most notably, during the past year, the Fund redeemed all of its remaining outstanding auction preferred stock, and instead began using debt for leverage. Equally important, the amount of leverage in the Fund in dollars and as a percent of total assets has changed.

Leverage is an important part of the Fund’s strategy to produce high current income. Over time, the cost of leverage is typically lower than the yield on the Fund’s portfolio. The difference between what the Fund earns on its investments and pays on the money it borrows increases the income available to common shareholders.

The Fund began a process of transitioning from auction preferred leverage to bank debt leverage in early 2008. When it worked as intended, auction preferred stock was a very efficient form of leverage. However the breakdown of the auction process in late 2007 prompted us to seek alternative leverage. We determined that a borrowing facility was the best available option.

In addition to economic considerations there is a set of rules that govern leverage (most importantly, the terms and conditions of the leverage agreement, and all relevant securities laws). We take all of these factors into consideration as we manage the leverage *and* the assets of the Fund.

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.



When the leverage was comprised entirely of auction preferred stock, the *amount* of leverage rarely changed. As a result, the *percentage* of the Fund's leverage to total net assets varied as the value of the portfolio moved up or down. As can be seen in the chart, the leverage percentage climbed steadily as the financial crisis unfolded and the value of the Fund's investment portfolio fell.

As the leverage ratio rose to unsustainable levels, the Fund sold assets and used the proceeds to reduce leverage. While this meant that monthly distributions to shareholders had to be cut, it also served to reduce the NAV and market price risk to the Fund's common shareholders.

With debt leverage, it has been easier and less expensive to *increase* the amount borrowed by the Fund (within certain limits!). This is important because the dramatic recovery in asset prices meant the Fund could comfortably borrow more and use the money to purchase additional securities.

The "right" amount of leverage is never a simple matter to determine. Type of borrowing, the cost of funds and market conditions will all be factors to consider. At present, we are comfortable with the amount of the leverage. We continuously monitor these factors and try to use leverage in a manner most consistent with the Fund's objectives.

### 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, including the cost of leverage. 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 a few Fund portfolio holdings that are not currently making dividend or interest payments (noted as "non-

income producing” in the portfolio listing that follows). This obviously has a direct impact on our forecasted income.

Historically, the Fund’s use of auction preferred stock as leverage encouraged it to invest in tax-advantaged (DRD-eligible) securities. As the Fund has transitioned away from auction preferred stock, its portfolio has also shifted to much greater percentages of fully-taxable securities. On a pre-tax basis, this has had a positive impact on the amount of income earned by the Fund, since fully-taxable securities typically yield more than tax-advantaged ones. Of course, as detailed in the Supplementary Tax Information below, the amount of income eligible for the corporate dividends received deduction (DRD) has accordingly decreased.

The primary variables on the expense forecast are the cost and amount of leverage employed by the Fund. During the year, we saw two different trends. Late in 2008, the reduction in the *amount* of leverage (and the amount of additional incremental income it provided) dwarfed the benefit the Fund would have seen from its declining *cost* of leverage. As a result, the Fund began its fiscal year with a dividend cut. In the second half of 2009, the Fund saw both variables trend positive: the cost of leverage continued to drop and the amount of leverage was increased. As we discussed in the shareholder letter, the additional income provided by that additional leverage consequently allowed the Fund to increase its dividend.

### **Impact of the Federal Reserve Raising Short-Term Rates**

With the federal funds rate hovering near zero percent, it’s fair to ask what will happen to the Fund when the Fed inevitably raises short-term rates. We have to start with the caveat that there is no comprehensive answer, since the Fund’s performance depends on a lot more than the fed funds rate, which is the only interest rate that the Fed controls directly. Having said that, we believe there are several likely repercussions of Fed tightening.

Higher short-term rates are likely to reduce income available to the Fund’s common stock shareholders. The Fund’s cost of leverage would go up, whereas most of the Fund’s assets pay fixed dividends or interest. The Fund could hedge this risk by fixing the cost of leverage for some period of time, but doing so would certainly increase the cost of leverage today in exchange for possibly lowering it in the future. Because the yield curve currently is steep, the market expects short rates will rise significantly and soon. As of December 31, 2009, the market was pricing-in 25-50 basis points (bp) of tightening by the Fed by June 2010, 100-125 bp of tightening by the end of 2010, and more than 250 bp of tightening by the end of 2011. Hedging the cost of leverage locks in those expected rate increases. Short-term interest rates may rise by more than that, but we currently think the economic outlook favors low rates for a longer period than the market expects. Nonetheless, when short-term rates eventually do rise, it probably will strain the Fund’s dividend.

While the impact of higher short-term rates on income is fairly clear, their impact on preferred securities’ prices is ambiguous. Higher short-term rates normally are associated with higher long-term rates and lower preferred prices. However, we don’t think these are normal times! The Fed is not likely to raise short-term rates until the economy is stronger, which in turn should be positive for the credit outlook. With preferred valuations still being driven more by credit developments than by the general level of interest rates, Fed tightening – at least in moderate amounts – might actually be good news for preferred prices. In addition, if the Fed tightens by less than the market expects, long-term rates could fall, just as they did when the Fed tightened in 2004-05. In short, it’s not obvious that long-term interest rates are set to rise, even though higher short-term rates are inevitable at some point – and it’s even less clear that tighter monetary policy would be bad news for preferreds. (This is another reason why the Fund’s hedging program is on hold.)

Implicit in this analysis is the view that the Fed will not have to raise short-term rates dramatically, which probably would push all rates higher. The only reason we could anticipate such high short-term rates is a breakout of inflation. Given soaring budget deficits and accommodative monetary policy, sharply higher inflation down the road cannot be ruled out. However, as we have discussed in recent Economic Updates, we do not think inflation will gain a foothold over the near to medium term. If we are right about that, we think the main impact of moderately tighter monetary policy on the Fund is likely to be somewhat reduced income.

### **Federal Tax Advantages of 2009 Calendar Year Distributions**

In 2009, the Fund passed on a portion of its income to individuals in the form of qualified dividend income or QDI. Under federal law, QDI is taxed at a maximum 15% rate instead of an individual's ordinary income tax rate. In calendar year 2009, approximately 54.0% of distributions made by the Fund was eligible for QDI treatment. For an individual in the 28% tax bracket, this means that the Fund's total distributions will only be taxed at a blended 21.0% rate versus the 28% rate which would apply to distributions by a fund containing traditional corporate bonds. This tax advantage means that, all other things being equal, an individual in the 28% tax bracket who held 100 shares of Common Stock of the Fund for the calendar year would have had to receive approximately \$84 in distributions from a traditional corporate bond fund to net the same after-tax amount as the \$77 in distributions paid by the Fund.

For detailed information about the tax treatment of the particular distributions received from the Fund, please see the Form 1099 you receive from either the Fund or your broker.

Corporate shareholders also receive a federal tax benefit from the 37.4% of distributions that were eligible for the inter-corporate dividends received deduction or DRD.

It is important to remember that the composition of the portfolio and the income distributions can change from one year to the next, and that the QDI or DRD portions of 2010's distributions may not be the same (or even similar) to 2009.

***As previously discussed, the Fund redeemed all of its outstanding auction preferred stock during the past year and began using debt for leverage. The following describes risks associated with leveraging the Fund through the use of borrowing, which do not materially differ from the risks the Fund formerly faced through leveraging using auction preferred stock.***

Because the investment risk associated with investment assets purchased with funds obtained through leveraging is borne solely by each Fund's Common Stock shareholders, adverse movements in the price of the Fund's portfolio holdings would have a more severe effect on the Fund's net asset value than if the Fund were not leveraged. Leverage creates risks for the Fund's Common Stock shareholders, including the likelihood of greater volatility of the Fund's net asset value and the market price of its shares, and the risk that fluctuations in interest rates on borrowings may affect the return to Common Stock shareholders. If income from the securities purchased with such funds is not sufficient to cover the cost of leverage, net income of the Fund would be less than if leverage had not been used, and therefore the amount available for distribution to Common Stock shareholders as dividends will be reduced. In such an event, the Fund may nevertheless determine to maintain its leveraged position in order to avoid capital losses on securities purchased with the leverage. Further, all expenses associated with borrowing, such as interest expenses and transaction costs, will be borne solely by the Fund's Common Stock shareholders.

If the asset coverage for borrowing declines below the limits specified in the Investment Company Act of 1940 (the "1940 Act") or in the terms of the financing arrangement, the Fund might be required to sell a

portion of its investments when it is not advantageous to do so. In the extreme, sales of investments required to meet asset coverage tests imposed by the 1940 Act could also cause a Fund to lose its status as a regulated investment company under the Internal Revenue Code of 1986, as amended (the "Code"). If a Fund were unable to make adequate distributions to shareholders because of asset coverage or other restrictions, it could fail to qualify as a regulated investment company for federal income tax purposes, and, even if it did not fail to so qualify, it could become liable for income and excise tax on the portion of its earnings which are not distributed on a timely basis in accordance with applicable provisions of the Code.

## PORTFOLIO OVERVIEW

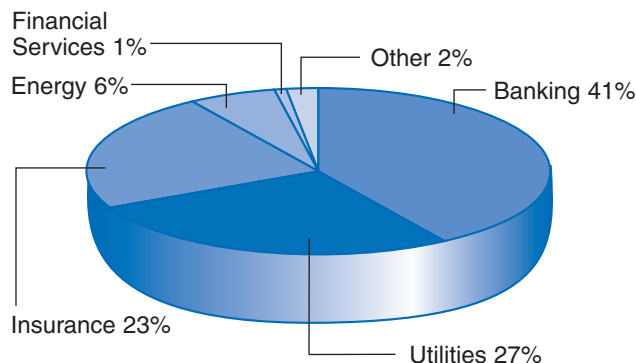
November 30, 2009 (Unaudited)

### Fund Statistics on 11/30/09

Net Asset Value	\$	9.82
Market Price	\$	9.12
Discount		7.13%
Yield on Market Price		8.29%
Common Stock Shares Outstanding		10,671,285

### Industry Categories

% of Net Assets†



### Moody's Ratings % of Net Assets†

AA	0.3%
A	20.9%
BBB	56.9%
BB	18.5%
Below "BB"	0.6%
Not Rated	1.2%

Below Investment Grade\* 14.9%

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

### Top 10 Holdings by Issuer

% of Net Assets†

Banco Santander	7.3%
PNC Financial Services	6.4%
Goldman Sachs	4.6%
Liberty Mutual Group	4.4%
Metlife	4.0%
Dominion Resources	3.8%
Comerica	3.4%
Capital One Financial	3.4%
Interstate Power & Light	3.0%
Enbridge Energy Partners	2.9%

% of Net Assets\*\*†

Holdings Generating Qualified Dividend Income (QDI) for Individuals 46%

Holdings Generating Income Eligible for the Corporate Dividends Received Deduction (DRD) 31%

\*\* 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. See accompanying notes to financial statements for the tax characterization of 2009 distributions.

† Net Assets include assets attributable to the use of leverage.

**PORTFOLIO OF INVESTMENTS****November 30, 2009**

<u>Shares/\$ Par</u>		<u>Value</u>
<b>Preferred Securities — 95.7%</b>		
<b>Banking — 40.8%</b>		
\$ 2,750,000	Astoria Capital Trust I, 9.75% 11/01/29, Series B . . . . .	\$ 2,574,918 <sup>(1)</sup>
417,300	Banco Santander, 10.50% Pfd., Series 10 . . . . .	11,501,831 <sup>** (1) (2)</sup>
48,700	Bank of America Corporation, 6.70% Pfd. . . . .	885,366 <sup>* (1)</sup>
	Barclays Bank PLC:	
\$ 2,400,000	6.278% . . . . .	1,794,000 <sup>** (1) (2)</sup>
40,000	6.625% Pfd., Series 2 . . . . .	768,400 <sup>** (2)</sup>
20,000	8.125% Pfd., Series 5 . . . . .	469,400 <sup>** (2)</sup>
75,000	BB&T Capital Trust VI, 9.60% Pfd. . . . .	2,036,250 <sup>(1)</sup>
\$ 5,500,000	Capital One Capital III, 7.686% 08/15/36 . . . . .	4,730,000 <sup>(1)</sup>
\$ 600,000	Capital One Capital VI, 8.875% 05/15/40 . . . . .	597,757
	CIT Group, Inc.:	
32,500	5.189% Pfd., Series B . . . . .	54,844 <sup>* ††</sup>
\$ 905,000	6.10% 03/15/67 . . . . .	85,975 <sup>††</sup>
64,455	6.35% Pfd., Series A . . . . .	22,720 <sup>* ††</sup>
\$ 5,210,000	Colonial BancGroup, 7.114%, 144A <sup>****</sup> . . . . .	15,630 <sup>††</sup>
\$ 7,100,000	Comerica Capital Trust II, 6.576% 02/20/37 . . . . .	5,360,500 <sup>(1)</sup>
9,000	FBOP Corporation, Adj. Rate Pfd., 144A <sup>****</sup> . . . . .	49,500 <sup>* ††</sup>
1,250	First Republic Preferred Capital Corporation, 10.50% Pfd., 144A <sup>****</sup> . . . . .	1,131,250 <sup>(1)</sup>
22,500	First Republic Preferred Capital Corporation II, 8.75% Pfd., Series B, 144A <sup>****</sup> . . . . .	485,156 <sup>(1)</sup>
3,250	First Tennessee Bank, Adj. Rate Pfd., 144A <sup>****</sup> . . . . .	1,715,391 <sup>* (1)</sup>
\$ 600,000	First Tennessee Capital I, 8.07% 01/06/27, Series A . . . . .	505,102
\$ 500,000	First Tennessee Capital II, 6.30% 04/15/34, Series B . . . . .	282,725
\$ 1,500,000	First Union Capital II, 7.95% 11/15/29 . . . . .	1,496,181 <sup>(1)</sup>
	Goldman Sachs:	
132,000	Adj. Rate Pfd., Series D . . . . .	2,705,010 <sup>*</sup>
\$ 4,501,000	Capital II, 5.793% . . . . .	3,330,740 <sup>(1)</sup>
2,500	STRIPES Custodial Receipts, Pvt. . . . .	1,165,000 <sup>*</sup>
\$ 500,000	HSBC USA Capital Trust II, 8.38% 05/15/27, 144A <sup>****</sup> . . . . .	495,897
	HSBC USA, Inc.:	
43,900	Adj. Rate Pfd., Series D . . . . .	924,644 <sup>* (1)</sup>
113,700	6.50% Pfd., Series H . . . . .	2,500,547 <sup>* (1)</sup>
2,500	\$2.8575 Pfd. . . . .	102,500 <sup>* (1)</sup>
\$ 950,000	JPMorgan Chase Capital XXVII, 7.00% 11/01/39, Series AA . . . . .	962,515
15,000	Keycorp Capital VIII, 7.00% Pfd. 06/15/66 . . . . .	289,838 <sup>(1)</sup>
23,500	Keycorp Capital X, 8.00% Pfd. . . . .	505,250 <sup>(1)</sup>
\$ 550,000	Lloyds Banking Group PLC, 6.657%, 144A <sup>****</sup> . . . . .	292,086 <sup>** (2) †</sup>
31,500	PFGI Capital Corporation, 7.75% Pfd. . . . .	700,875 <sup>(1)</sup>

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

**PORTFOLIO OF INVESTMENTS (Continued)**

November 30, 2009

<u>Shares/\$ Par</u>		<u>Value</u>
<b>Preferred Securities — (continued)</b>		
<b>Banking — (continued)</b>		
274,200	PNC Financial Services, 9.875% Pfd., Series F .....	\$ 7,776,998 <sup>*(1)</sup>
\$ 1,600,000	PNC Preferred Funding Trust III, 8.70%, 144A**** .....	1,574,342 <sup>(1)</sup>
20,100	Sovereign Capital Trust V, 7.75% Pfd. 05/22/36 .....	496,922 <sup>(1)</sup>
1,750	Sovereign REIT, 12.00% Pfd., Series A, 144A**** .....	1,938,125
\$ 1,000,000	Washington Mutual, 9.75%, 144A**** .....	10,000 <sup>††</sup>
\$ 1,600,000	Webster Capital Trust IV, 7.65% 06/15/37 .....	1,000,000 <sup>(1)</sup>
\$ 450,000	Wells Fargo Capital XV, 9.75% 09/26/13 .....	479,250
		<u>63,813,435</u>
<b>Financial Services — 0.4%</b>		
\$ 500,000	General Electric Capital Corporation, 6.375% 11/15/67 .....	411,855 <sup>(1)</sup>
11,300	HSBC Finance Corporation, 6.36% Pfd. ....	217,440*
	Lehman Brothers Holdings, Inc.:	
15,000	5.67% Pfd., Series D .....	6,750* <sup>††</sup>
19,500	5.94% Pfd., Series C .....	7,800* <sup>††</sup>
25,000	6.50% Pfd., Series F .....	4,063* <sup>††</sup>
27,500	7.95% Pfd. ....	2,778* <sup>††</sup>
		<u>650,686</u>
<b>Insurance — 20.2%</b>		
\$ 1,000,000	Ace Capital Trust II, 9.70% 04/01/30 .....	1,147,542 <sup>(1)(2)</sup>
	Arch Capital Group Ltd.:	
4,700	7.875% Pfd., Series B .....	112,389 <sup>** (2)</sup>
22,800	8.00% Pfd., Series A .....	554,325 <sup>** (1)(2)</sup>
	AXA SA:	
\$ 1,500,000	6.379%, 144A**** .....	1,226,250 <sup>** (1)(2)</sup>
\$ 4,000,000	6.463%, 144A**** .....	3,105,000 <sup>** (1)(2)</sup>
35,900	Axis Capital Holdings, 7.50% Pfd., Series B .....	2,764,300 <sup>(1)(2)</sup>
90,600	Delphi Financial Group, 7.376% Pfd. 05/15/37 .....	1,582,103 <sup>(1)</sup>
\$ 3,540,000	Everest Re Holdings, 6.60% 05/15/37 .....	2,708,100 <sup>(1)</sup>
	Liberty Mutual Group:	
\$ 300,000	7.80% 03/15/37, 144A**** .....	240,000 <sup>(1)</sup>
\$ 4,500,000	10.75% 06/15/58, 144A**** .....	4,747,500 <sup>(1)</sup>
\$ 500,000	MetLife Capital Trust IV, 7.875% 12/15/37, 144A**** .....	480,000 <sup>(1)</sup>
\$ 2,000,000	MetLife Capital Trust X, 9.25% 04/08/38, 144A**** .....	2,100,000 <sup>(1)</sup>

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

**PORTFOLIO OF INVESTMENTS (Continued)**

November 30, 2009

<u>Shares/\$ Par</u>		<u>Value</u>
<b>Preferred Securities — (continued)</b>		
<b>Insurance — (continued)</b>		
	MetLife, Inc.:	
100,000	6.50% Pfd., Series B .....	\$ 2,221,250*
\$ 1,250,000	10.75% 08/01/39 .....	1,503,657 <sup>(1)</sup>
	Principal Financial Group:	
5,000	5.563% Pfd., Series A .....	346,719*
100,000	6.518% Pfd., Series B .....	1,926,250 <sup>(1)</sup>
	Renaissancere Holdings Ltd.:	
122,250	6.08% Pfd., Series C .....	2,314,193 <sup>** (1) (2)</sup>
10,700	7.30% Pfd., Series B .....	248,909 <sup>** (2)</sup>
119,500	Scottish Re Group Ltd., 7.25% Pfd. ....	515,344 <sup>** (2) †</sup>
\$ 750,000	USF&G Capital, 8.312% 07/01/46, 144A**** .....	719,934 <sup>(1)</sup>
\$ 1,500,000	XL Capital Ltd., 6.50%, Series E .....	1,102,500 <sup>(1) (2)</sup>
		<u>31,666,265</u>
<b>Utilities — 26.2%</b>		
10,000	Baltimore Gas & Electric Company, 6.70% Pfd., Series 1993 .....	946,250 <sup>(1)</sup>
2,780	Central Vermont Public Service Corporation, 8.30% Sinking Fund Pfd., Pvt. ....	279,529*
\$ 2,491,000	COMED Financing III, 6.35% 03/15/33 .....	1,943,979 <sup>(1)</sup>
	Dominion Resources, Inc.:	
\$ 3,500,000	7.50% .....	3,451,903 <sup>(1)</sup>
90,000	8.375% Pfd., Series A .....	2,490,300 <sup>(1)</sup>
40,000	Entergy Arkansas, Inc., 6.45% Pfd. ....	848,752 <sup>(1)</sup>
	Georgia Power Company:	
12,600	6.125% Pfd. ....	317,048 <sup>(1)</sup>
12,500	6.50% Pfd., Series 2007A .....	1,256,641 <sup>(1)</sup>
3,000	Gulf Power Company, 6.45% Pfd., Series 2007A .....	294,569 <sup>(1)</sup>
32,650	Indianapolis Power & Light Company, 5.65% Pfd. ....	2,739,541*
170,900	Interstate Power & Light Company, 8.375% Pfd., Series B .....	4,744,611 <sup>(1)</sup>
	Pacific Enterprises:	
22,430	\$4.50 Pfd. ....	1,742,531 <sup>(1)</sup>
10,000	\$4.75 Pfd., Series 53 .....	813,125 <sup>(1)</sup>
\$ 500,000	PECO Energy Capital Trust III, 7.38% 04/06/28, Series D .....	424,860 <sup>(1)</sup>
\$ 4,400,000	Puget Sound Energy, Inc., 6.974% 06/01/67 .....	3,888,016 <sup>(1)</sup>
60,000	Scana Corporation, 7.70% Pfd. ....	1,512,000
	Southern California Edison:	
35,000	6.00% Pfd., Series C .....	3,159,846 <sup>(1)</sup>
11,500	6.125% Pfd. ....	1,060,875 <sup>(1)</sup>

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

**PORTFOLIO OF INVESTMENTS (Continued)**

November 30, 2009

<u>Shares/\$ Par</u>	<u>Value</u>	
<b>Preferred Securities — (continued)</b>		
<b>Utilities — (continued)</b>		
\$ 3,000,000	Southern Union Company, 7.20% 11/01/66 .....	\$ 2,505,000 <sup>(1)</sup>
\$ 750,000	TXU Electric Capital V, 8.175% 01/30/37 .....	226,875
18,800	Union Electric Company, \$7.64 Pfd. ....	1,879,413 <sup>(1)</sup>
\$ 3,900,000	Wisconsin Energy Corporation, 6.25% 05/15/67 .....	3,446,687 <sup>(1)</sup>
14,750	Xcel Energy, Inc., \$4.08 Pfd., Series B .....	1,045,775*
		41,018,126
<b>Energy — 6.4%</b>		
\$ 4,700,000	Enbridge Energy Partners LP, 8.05% 10/01/37 .....	4,471,312 <sup>(1)</sup>
	Enterprise Products Partners:	
\$ 750,000	7.00% 06/01/67 .....	665,838
\$ 1,500,000	8.375% 08/01/66, Series A .....	1,462,450 <sup>(1)</sup>
3,500	Kinder Morgan GP, Inc., 8.33% Pfd., 144A**** .....	3,430,219*
		10,029,819
<b>Miscellaneous Industries — 1.7%</b>		
40,000	Ocean Spray Cranberries, Inc., 6.25% Pfd., 144A**** .....	2,611,252 <sup>(1)</sup>
		2,611,252
<b>Total Preferred Securities</b>		
	(Cost \$160,096,758) .....	149,789,583
<b>Corporate Debt Securities — 2.8%</b>		
<b>Financial Services — 0.2%</b>		
10,000	Ameriprise Financial, Inc., 7.75% 06/15/39 .....	247,825 <sup>(1)</sup>
		247,825
<b>Insurance — 2.3%</b>		
\$ 2,200,000	Liberty Mutual Insurance, 7.697% 10/15/97, 144A**** .....	1,845,367 <sup>(1)</sup>
\$ 2,000,000	UnumProvident Corporation, 7.25% 03/15/28, Senior Notes .....	1,724,340 <sup>(1)</sup>
		3,569,707

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

**PORTFOLIO OF INVESTMENTS (Continued)**

November 30, 2009

<u>Shares/\$ Par</u>	<u>Value</u>
<b>Corporate Debt Securities — (continued)</b>	
<b>Utilities — 0.3%</b>	
20,000 Entergy Texas, Inc., 7.875% 06/01/39 .....	\$ 534,200
	<u>534,200</u>
<b>Total Corporate Debt Securities</b> (Cost \$3,941,492) .....	<u>4,351,732</u>
<b>Money Market Fund — 0.3%</b>	
526,348 BlackRock Provident Institutional, T-Fund .....	526,348
<b>Total Money Market Fund</b> (Cost \$526,348) .....	<u>526,348</u>
<b>Total Investments</b> (Cost \$164,564,598 <sup>***</sup> ) .....	98.8% 154,667,663
<b>Other Assets And Liabilities</b> (Net) .....	<u>1.2%</u> <u>1,896,458</u>
<b>Net Assets before loan</b> .....	<u>100.0%†</u> \$ <u>156,564,121</u>
<b>Loan Principle Balance</b> .....	<u>(51,800,000)</u>
<b>Total Net Assets Available To Common Stock</b> .....	<u>\$ 104,764,121</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 November 30, 2009, these securities amounted to \$28,212,899 or 18.0% of net assets. These securities have been determined to be liquid under the guidelines established by the Board of Directors.

(1) All or a portion of this security has been pledged as collateral for the Fund's loan. The total value of such securities was \$117,899,596 at November 30, 2009.

(2) 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 before the loan.

**ABBREVIATIONS:**

**Pfd.** — Preferred Securities

**Pvt.** — Private Placement Securities

**REIT** — Real Estate Investment Trust

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

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

## STATEMENT OF ASSETS AND LIABILITIES

November 30, 2009

### ASSETS:

Investments, at value (Cost \$164,564,598) . . . . .	\$ 154,667,663
Dividends and interest receivable . . . . .	2,058,506
Prepaid expenses. . . . .	<u>224,688</u>
Total Assets. . . . .	156,950,857

### LIABILITIES:

Loan Payable . . . . .	\$51,800,000	
Dividends payable to Common Stock Shareholders . . . . .	61,705	
Investment advisory fees payable . . . . .	74,367	
Administration, Transfer Agent and Custodian fees payable . . . . .	23,101	
Audit fees payable . . . . .	52,100	
Legal fees payable . . . . .	18,382	
Directors' fees payable . . . . .	1,342	
Accrued expenses and other payables . . . . .	23,449	
Accumulated undeclared distributions to Auction Preferred Stock Shareholders . . . . .	<u>132,290</u>	
Total Liabilities. . . . .		<u>52,186,736</u>

**NET ASSETS AVAILABLE TO COMMON STOCK** . . . . . \$ 104,764,121

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

Undistributed net investment income . . . . .	\$ 31,856
Accumulated net realized loss on investments sold. . . . .	(37,616,281)
Unrealized depreciation of investments . . . . .	(9,896,935)
Par value of Common Stock. . . . .	106,713
Paid-in capital in excess of par value of Common Stock. . . . .	<u>152,138,768</u>
Total Net Assets Available to Common Stock. . . . .	<u>\$ 104,764,121</u>

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

Common Stock (10,671,285 shares outstanding) . . . . .	<u>\$ 9.82</u>
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## STATEMENT OF OPERATIONS

For the Year Ended November 30, 2009

**INVESTMENT INCOME:**

Dividends† . . . . .	\$ 5,968,116
Interest . . . . .	<u>5,659,759</u>
Total Investment Income . . . . .	11,627,875

**EXPENSES:**

Investment advisory fees . . . . .	\$ 754,419
Administrator's fees . . . . .	130,496
Auction Preferred Stock broker commissions and auction agent fees . . . . .	81,535
Audit fees . . . . .	60,900
Legal fees . . . . .	98,917
Insurance expenses . . . . .	126,471
Transfer Agent fees . . . . .	52,038
Directors' fees . . . . .	65,886
Custodian fees . . . . .	25,280
Compliance fees . . . . .	37,785
Interest expense . . . . .	310,069
Other . . . . .	<u>149,690</u>
Total Expenses . . . . .	<u>1,893,486</u>

**NET INVESTMENT INCOME** . . . . . 9,734,389

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

Net realized loss on investments sold during the year . . . . .	(15,921,276)
Change in net unrealized appreciation/depreciation of investments . . . . .	<u>56,189,433</u>

**NET REALIZED AND UNREALIZED GAIN ON INVESTMENTS** . . . . . 40,268,157

**DISTRIBUTIONS TO AUCTION PREFERRED STOCK SHAREHOLDERS:**

From net investment income (including changes in accumulated undeclared distributions) . . . . .	<u>(1,041,660)</u>
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**NET INCREASE IN NET ASSETS TO COMMON STOCK**

**RESULTING FROM OPERATIONS** . . . . . \$ 48,960,886

† 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

	<u>Year Ended</u> <u>November 30, 2009</u>	<u>Year Ended</u> <u>November 30, 2008</u>
<b>OPERATIONS:</b>		
Net investment income . . . . .	\$ 9,734,389	\$ 13,492,692
Net realized loss on investments sold during the year . . . . .	(15,921,276)	(18,269,870)
Change in net unrealized appreciation/depreciation of investments . .	56,189,433	(53,709,204)
Distributions to APS* Shareholders from net investment income, including changes in accumulated undeclared distributions . . . . .	<u>(1,041,660)</u>	<u>(4,493,991)</u>
<b>Net increase/(decrease) in net assets resulting from operations . . . . .</b>	<b>48,960,886</b>	<b>(62,980,373)</b>
<b>DISTRIBUTIONS:</b>		
Dividends paid from net investment income to Common Stock Shareholders <sup>(1)</sup> . . . . .	(8,040,825)	(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>(8,040,825)</b>	<b>(9,712,016)</b>
<b>FUND SHARE TRANSACTIONS:</b>		
Increase from shares issued under the Dividend Reinvestment and Cash Purchase Plan . . . . .	<u>566,685</u>	<u>415,249</u>
<b>Net increase in net assets available to Common Stock resulting from Fund share transactions . . . . .</b>	<b>566,685</b>	<b>415,249</b>
<b>NET INCREASE/(DECREASE) IN NET ASSETS AVAILABLE TO COMMON STOCK FOR THE YEAR . . . . .</b>	<b><u>\$ 41,486,746</u></b>	<b><u>\$ (72,277,140)</u></b>
<b>NET ASSETS AVAILABLE TO COMMON STOCK:</b>		
Beginning of year . . . . .	\$ 63,277,375	\$ 135,554,515
Net increase/(decrease) in net assets during the year . . . . .	<u>41,486,746</u>	<u>(72,277,140)</u>
End of year (including undistributed net investment income of \$31,856 and distributions in excess of net investment income of \$(882,350), respectively) . . . . .	<u>\$104,764,121</u>	<u>\$ 63,277,375</u>

\* Auction Preferred Stock.

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

## STATEMENT OF CASH FLOWS

For the Year Ended November 30, 2009

**INCREASE/(DECREASE) IN CASH****CASH FLOWS FROM OPERATING ACTIVITIES:**

Net increase in net assets resulting from operations . . . . .	\$ 48,960,886
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**ADJUSTMENTS TO RECONCILE NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS TO NET CASH USED IN OPERATING ACTIVITIES:**

Purchase of investment securities . . . . .	(77,492,564)
Proceeds from disposition of investment securities . . . . .	66,546,567
Sale of short-term investment securities, net . . . . .	10,934,424
Return of capital received from investments in preferred stock . . . . .	667,231
Cash received from bankruptcy claim . . . . .	1,750,466
Increase in dividends and interest receivable . . . . .	(467,664)
Decrease in receivable for investments sold . . . . .	807,400
Increase in prepaid expenses . . . . .	(154,753)
Net amortization/(accretion) of premium/(discount) . . . . .	(228,357)
Decrease in accrued expenses and other liabilities . . . . .	(18,721)
Unrealized appreciation on securities . . . . .	(56,189,433)
Net realized loss from investments . . . . .	<u>15,921,276</u>

Net cash provided in operating activities . . . . .	<u>11,036,758</u>
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**CASH FLOWS FROM FINANCING ACTIVITIES:**

Proceeds from loan . . . . .	51,800,000
Proceeds from shares reinvested . . . . .	566,685
Redemption of Auction Preferred Stock (APS) . . . . .	(54,800,000)
Decrease in payable for APS . . . . .	(551,120)
Decrease in dividend payable to common stock shareholders . . . . .	(11,498)
Distributions to common stock shareholders from net investment income . . . . .	<u>(8,040,825)</u>

Net cash used by financing activities . . . . .	<u>(11,036,758)</u>
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Net increase/(decrease) in cash . . . . .	—
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**CASH:**

Beginning of the year . . . . .	<u>—</u>
End of the year . . . . .	<u>\$ —</u>

**SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:**

Interest paid during the year . . . . .	<u>302,107</u>
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## FINANCIAL HIGHLIGHTS

For a Common Stock share outstanding throughout each year.

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.

	Year Ended November 30,				
	2009	2008	2007	2006	2005
<b>PER SHARE OPERATING PERFORMANCE:</b>					
Net asset value, beginning of year	\$ 5.98	\$ 12.85	\$ 15.80	\$ 15.26	\$ 15.49
<b>INVESTMENT OPERATIONS:</b>					
Net investment income	0.92	1.27	1.35	1.29	1.22
Net realized and unrealized gain/(loss) on investments	3.78	(6.80)	(2.90)	0.62	(0.07)
<b>DISTRIBUTIONS TO APS* SHAREHOLDERS:</b>					
From net investment income	(0.10)	(0.42)	(0.37)	(0.32)	(0.21)
Total from investment operations	4.60	(5.95)	(1.92)	1.59	0.94
<b>DISTRIBUTIONS TO COMMON STOCK SHAREHOLDERS:</b>					
From net investment income	(0.76)	(0.87)	(1.03)	(1.05)	(1.17)
From return of capital	—	(0.05)	—	—	—
Total distributions to Common Stock Shareholders	(0.76)	(0.92)	(1.03)	(1.05)	(1.17)
Net asset value, end of year	\$ 9.82	\$ 5.98	\$ 12.85	\$ 15.80	\$ 15.26
Market value, end of year	\$ 9.12	\$ 5.67	\$ 12.41	\$ 16.98	\$ 16.44
Total investment return based on net asset value**	82.53%	(48.39%)	(12.90%)	10.74%	5.78%
Total investment return based on market value**	78.78%	(49.34%)	(21.73%)	10.47%	1.33%
<b>RATIOS TO AVERAGE NET ASSETS AVAILABLE TO COMMON STOCK SHAREHOLDERS:</b>					
Total net assets, end of year (in 000's)	\$ 104,764	\$ 63,277	\$135,555	\$165,475	\$158,277
Operating expenses including interest expense <sup>(1)</sup>	2.44%	—	—	—	—
Operating expenses excluding interest expense	2.04%	1.99%	1.49%	1.49%	1.48%
Net investment income †	12.55%	—	—	—	—
Net investment income, including payments to APS Shareholders †	11.21%	8.38%	6.57%	6.39%	6.38%
<b>SUPPLEMENTAL DATA: ††</b>					
Portfolio turnover rate	56%	67%	59%	71%	54%
Net assets before loan, end of year (in 000's)	\$ 156,564	\$118,077	\$215,555	\$245,475	\$238,277
Ratio of operating expenses including interest expense <sup>(1)(2)</sup> to net assets before loan and APS	1.50%	—	—	—	—
Ratio of operating expenses excluding interest expense <sup>(2)</sup> to net assets before loan and APS	1.25%	1.15%	0.99%	0.99%	0.99%

\* Auction Preferred Stock.

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

† The net investment income ratios reflect income net of operating expenses, including interest expense.

†† Information presented under heading Supplemental Data includes APS and loan principal balance.

<sup>(1)</sup> See Note 7.

<sup>(2)</sup> Does not include distributions to APS shareholders.

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	\$6.54
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
June 30, 2009 .....	0.0630	7.64	8.00	7.64
July 31, 2009 .....	0.0630	8.18	8.11	8.20
August 31, 2009 .....	0.0630	8.73	8.50	8.60
September 30, 2009 .....	0.0630	9.37	9.40	9.37
October 30, 2009 .....	0.0630	9.72	9.03	9.24
November 30, 2009 .....	0.0630	9.82	9.12	9.40

<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.

**FINANCIAL HIGHLIGHTS (Continued)**

The table below sets out information with respect to Auction Preferred Stock 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>
11/30/09	—	N/A	N/A
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

(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.

## **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 any outstanding preferred stock.

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 (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.

*Fair Value Measurement:* The inputs and valuation techniques used to measure fair value of the Fund's investments are summarized into three levels as described in the hierarchy 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 investments as of November 30, 2009 is as follows:

	<u>Total Value at November 30, 2009</u>	<u>Level 1 Quoted Price</u>	<u>Level 2 Significant Observable Inputs</u>	<u>Level 3 Significant Unobservable Inputs</u>
Preferred Securities				
Banking	\$63,813,435	\$42,628,999	\$21,134,936	\$49,500
Financial Services	650,686	629,295	21,391	—
Insurance	31,666,265	13,558,420	18,107,845	—
Utilities	41,018,126	12,515,862	28,502,264	—
Energy	10,029,819	—	10,029,819	—
Miscellaneous Industries	2,611,252	—	2,611,252	—
Corporate Debt Securities	4,351,732	782,025	3,569,707	—
Money Market Fund	526,348	526,348	—	—
Total Investments	<u>\$154,667,663</u>	<u>\$70,640,949</u>	<u>\$83,977,214</u>	<u>\$49,500</u>

**NOTES TO FINANCIAL STATEMENTS (Continued)**

Following is a reconciliation of Level 3 investments for which significant unobservable inputs were used to determine fair value:

	<u>Preferred Securities</u>	
	Total Investments	Banking
<b>Balance as of 11/30/08</b> . . . . .	\$ —	\$ —
Accrued discounts/premiums . . . . .	—	—
Realized gain/(loss) . . . . .	—	—
Change in unrealized appreciation/(depreciation) .	(4,675,500)	(4,675,500)
Net purchases/(sales) . . . . .	—	—
Transfers in and/or out of Level 3 . . . . .	4,725,000	4,725,000
<b>Balance as of 11/30/09</b> . . . . .	\$ 49,500	\$ 49,500

For the year ended November 30, 2009, total change in unrealized gain/(loss) on Level 3 securities still held at year end and included in the change in net assets was \$(4,675,500). Total unrealized gain/(loss) for all securities (including Level 1 and Level 2) can be found on the accompanying Statement of Operations.

*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.

*Options:* In the normal course of pursuing its investment objectives, the Fund is subject to interest rate risk and may purchase or write options to hedge against this risk. 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.

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

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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. There were no purchased or written options for the year ended November 30, 2009.

*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.

Management has analyzed the Fund's tax positions taken on Federal income tax returns for all open tax years (November 30, 2009, 2008, 2007 and 2006), and has concluded that no provision for federal income tax is required in the Fund's financial statements. The Fund's major tax jurisdictions are federal and California. The Fund's federal and state income and federal excise tax returns for tax years for which the applicable statutes of limitations have not expired are subject to examination by the Internal Revenue Service and state departments of revenue.

*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.

**NOTES TO FINANCIAL STATEMENTS (Continued)**

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	\$8,040,825	\$0	\$9,155,620	\$0	\$556,396
Preferred	\$1,041,660	\$0	\$4,493,991	\$0	\$0

As of November 30, 2009, 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>
\$(37,653,508)	\$436,155	\$0	\$(9,894,364)

At November 30, 2009, the composition of the Fund's \$37,653,508 accumulated realized capital losses was \$778,250, \$2,761,487, \$18,185,622 and \$15,928,149 incurred in 2004, 2007, 2008 and 2009, respectively. These losses may be carried forward and offset against any future capital gains through 2012, 2015, 2016 and 2017, respectively.

*Reclassification of accounts:* During the year ended November 30, 2009, reclassifications were made in the Fund's capital accounts to report these balances on a tax basis, excluding temporary differences, as of November 30, 2009. Additional adjustments may be required in subsequent reporting periods. These reclassifications have no impact on the net asset value of the Fund.

The calculation of net investment income per share in the financial highlights excludes these adjustments. Below are the reclassifications:

<u>Paid-in Capital</u>	<u>Undistributed Net Investment Income</u>	<u>Accumulated Net Realized Gain on Investments</u>
\$(501,074)	\$262,302	\$238,772

*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.

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

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### **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 (including any assets attributable to the Fund's 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 outstanding 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 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 0.01% 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.

**NOTES TO FINANCIAL STATEMENTS (Continued)**

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.

**4. Purchases and Sales of Securities**

For the year ended November 30, 2009, the cost of purchases and proceeds from sales of securities excluding short-term investments, aggregated \$77,492,564 and \$66,546,567, respectively.

At November 30, 2009, the aggregate cost of securities for federal income tax purposes was \$164,562,027, the aggregate gross unrealized appreciation for all securities in which there is an excess of value over tax cost was \$17,445,510 and the aggregate gross unrealized depreciation for all securities in which there is an excess of tax cost over value was \$27,339,874.

**5. Common Stock**

At November 30, 2009, 240,000,000 shares of \$0.01 par value Common Stock were authorized.

Common Stock transactions were as follows:

	Year Ended 11/30/09		Year Ended 11/30/08	
	Shares	Amount	Shares	Amount
Shares issued under the Dividend Reinvestment and Cash Purchase Plan . . . . .	85,637	\$566,685	39,898	\$415,249

**6. Auction Preferred Stock (APS)**

The Fund's Articles of Incorporation authorize the issuance of up to 10,000,000 shares of \$0.01 par value preferred stock. Prior to July 14, 2009, the Fund had preferred stock issued in the form of APS. The APS was senior to the Common Stock and resulted in the financial leveraging of the Common Stock. As of July 14, 2009, the Fund redeemed and cancelled the last remaining shares of APS and does not currently have any issued and outstanding shares of preferred stock.

The Fund redeemed APS shares as detailed in the table below. 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. The Fund utilized proceeds from its debt facility (See Note 7) for the last redemption. After these redemptions, borrowings from its debt facility were the Fund's sole source of leverage.

Redemption Date	\$ Amount of APS
November 12, 2008	\$15,000,000*
November 12, 2008	8,100,000*
November 20, 2008	2,100,000*
April 7, 2009	10,000,000*
July 14, 2009	44,800,000

\* Shares were redeemed on the dates reflected; however, from the Fund's perspective, the November 12<sup>th</sup> (\$8,100,000) and November 20<sup>th</sup> redemptions were effective as of October 24, 2008, the November 12<sup>th</sup> (\$15,000,000) redemption was effective as of November 7, 2008 and the April 7<sup>th</sup> 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.

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

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### **7. Committed Financing Agreement**

The Fund entered into a committed financing agreement (“Financing Agreement”) on June 26, 2009 which allowed the Fund to borrow up to an initial limit of \$44.8 million on a secured basis. The primary use of the initial proceeds was to redeem the outstanding shares of APS (See Note 6), although the Fund will use the borrowing facility in the normal course of business as financial leverage. Such leveraging tends to magnify both the risks and opportunities to Shareholders. On August 28, 2009, the Financing Agreement was amended to allow for changes in the committed amount. As of November 30, 2009, the committed amount, and amount borrowed under the Financing Agreement was \$51.8 million.

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. For the period beginning on July 14, 2009 (initial use of the facility) and ending on November 30, 2009, the daily weighted average annualized interest rate on the drawn balance was 1.564% and the average daily loan balance was \$48,061,538. The Fund paid the lender an 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 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 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

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**NOTES TO FINANCIAL STATEMENTS (Continued)**

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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.

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

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

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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 November 30, 2009, there were no securities on loan by the Fund.

### **11. Subsequent Events**

Management has evaluated the impact of all subsequent events on the Fund through January 21, 2010, the date the financial statements were issued, and has determined that there were no subsequent events requiring recognition or disclosure in the financial statements.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders  
Flaherty & Crumrine Preferred Income Fund Incorporated

We have audited the accompanying statement of assets and liabilities of Flaherty & Crumrine Preferred Income Fund Incorporated, including the portfolio of investments, as of November 30, 2009, and the related statement of operations for the year then ended, the statements of changes in net assets for each of the years in the two-year period then ended, the statement of cash flows for the year then ended, and the financial highlights for each of the years in the five-year period then ended. These financial statements and financial highlights are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of November 30, 2009 by correspondence with the custodian. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of Flaherty & Crumrine Preferred Income Fund Incorporated as of November 30, 2009, the results of its operations and its cash flows for the year then ended, the changes in its net assets for each of the years in the two-year period then ended, and the financial highlights for each of the years in the five-year period then ended, in conformity with U.S. generally accepted accounting principles.

**KPMG LLP**

Boston, Massachusetts  
January 21, 2010

## **SUPPLEMENTARY TAX INFORMATION (Unaudited)**

Distributions to Common Stock and Auction Preferred Stock (APS) shareholders are characterized as follows for purposes of Federal income taxes (as a percentage of total distributions):

### **Fiscal Year 2009**

	<b><u>Individual Shareholder</u></b>		<b><u>Corporate Shareholder</u></b>	
	<b><u>QDI</u></b>	<b><u>Ordinary Income</u></b>	<b><u>DRD</u></b>	<b><u>Ordinary Income</u></b>
APS and Common Stock	55.65%	44.35%	40.39%	59.61%

### **Calendar Year 2009**

	<b><u>Individual Shareholder</u></b>		<b><u>Corporate Shareholder</u></b>	
	<b><u>QDI</u></b>	<b><u>Ordinary Income</u></b>	<b><u>DRD</u></b>	<b><u>Ordinary Income</u></b>
APS	55.65%	44.35%	40.39%	59.61%
Common Stock	53.96%	46.04%	37.41%	62.59%

Qualified Dividend Income ("QDI") distributions are taxable at a maximum 15% personal tax rate.

### **Section 19 Notices**

Section 19 of the 1940 Act 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).

Form 1099-DIV will be sent to shareholders in January 2010 reporting the amount and tax characterization of distributions for the 2009 calendar year.

## **ADDITIONAL INFORMATION (Unaudited)**

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### **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 year ended November 30, 2009, \$1,019 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)**

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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 21, 2009. 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 August 31, 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)**

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**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.

## 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: 62	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:

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\*\* 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: 51	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: 37	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> 47 Maple Street Suite 403 Summit, NJ 07901 Age: 50	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: 46	Assistant Compliance Officer, Assistant Treasurer and Assistant Secretary	Since July 2004	Assistant Compliance Officer and Secretary of Flaherty & Crumrine Incorporated

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## 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

## 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  

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PREFERRED INCOME FUND

# Annual Report

November 30, 2009

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