

FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Fund:

We begin with good news about distributions on your shares of PFD—the Fund finished fiscal 2010 with a bit of extra income, so shareholders of record on December 23, 2010 received an additional \$0.03 per share. In addition, the regular monthly distribution was increased to \$0.09 from \$0.089 per share beginning with the December dividend¹.

During the Fund's final fiscal quarter, the portfolio once again turned in solid performance. For the three-month period ending November 30, 2010, the Fund's return on net asset value was +5.5%. Over the entire fiscal year, the return on NAV was +31.5%. The table below presents these and other performance measures of interest to investors.

TOTAL RETURN ON NET ASSET VALUE FOR PERIODS ENDED NOVEMBER 30, 2010

	Actual Returns			Average Annualized Returns			
	Three Months	Six Months	One Year	Three Years	Five Years	Ten Years	Life of Fund ⁽¹⁾
Flaherty & Crumrine Preferred Income Fund	5.5%	18.3%	31.5%	7.4%	3.6%	7.0%	9.5%
Barclays Capital U.S. Aggregate Index ⁽²⁾	-0.1%	3.9%	6.0%	6.4%	6.2%	6.2%	6.9%
S&P 500 Index ⁽³⁾	13.1%	9.5%	9.9%	-5.2%	1.0%	0.8%	8.6%

(1) Since inception on January 31, 1991.

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

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

The Fund's strong performance during the quarter was accomplished despite a weak market for US Treasury bonds and continued uncertainty about changes in regulation of the banking industry.

Conditions in the market for preferred securities are still positive. Demand is broad based and steady, while most participants expect the size of the market to decline (at least over the near-term). The market has also been boosted by steady improvement in the financial strength of many issuers as, corporate profitability has steadily improved.

¹ A more in-depth discussion of the dividend and other important topics can be found in the section which follows our letter.

Short-term interest rates remain near zero as economic activity remains positive but stubbornly slow. Unemployment rates are high, and the impact of fiscal and monetary actions has been more muted than desired. We anticipate short-term interest rates (and hence the cost of the Fund's leverage) will remain low over the near-term; however, eventually they will go up. Our view is detailed in the Quarterly Economic Outlook available on the Fund's website.

Yields on *long-term* U.S. Treasury bonds increased almost 60 basis points during the period; prices fell roughly 10%. Clearly, concerns about a pick-up in economic activity, inflation, or both, have become more widespread. In the past, a move of this magnitude typically caused some corresponding drop in the prices of preferred securities. Obviously, the recent period was not typical—most preferred prices actually went up in the face of falling bond prices. The correlation between prices of preferred securities and treasury bonds used to be reliably high, but this has not been the case for much of the past three years (a major reason the Fund suspended its hedging strategy in autumn 2008).

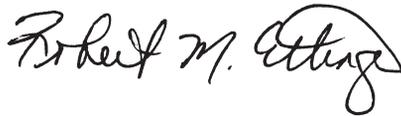
As discussed previously, the financial crisis brought to light a need to rethink the role of capital in the banking industry. Regulators and policy makers are debating the amount and composition of capital necessary to prevent a repeat of the crisis. Preferred securities play a very important part in the debate. This is a complex matter and there are a lot of chefs in the kitchen; it will likely take many more months before the process is complete. However, some change is certain and we are managing the portfolio to reflect things we know and some we anticipate. We remain optimistic the ultimate outcome will be beneficial over the long term.

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

Sincerely,



Donald F. Crumrine
Chairman



Robert M. Ettinger
President

January 10, 2011

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 the status of the Fund's interest rate hedging strategy); and (c) utilizing leverage to enhance returns to shareholders. Next, we compute the impact of the Fund's operating expenses. All of the parts are summed to determine total return on NAV.

Components of PFD's Total Return on NAV for the Fiscal Year Ended November 30, 2010

	<i>Six Months*</i>	<i>One Year</i>
Total Return on Unleveraged Securities Portfolio (including principal and income)	+12.9%	+22.4%
Return from Interest Rate Hedging Strategy	N/A	N/A
Impact of Leverage (including leverage expense)	+6.2%	+10.7%
Expenses (excluding leverage expense)	-0.8%	-1.6%%
<i>Total Return on NAV</i>	+18.3%	+31.5%

* Actual, not annualized.

The following table displays returns for the various segments of the preferred securities market as measured by BofA Merrill preferred indices, over both the past six months and the Fund's fiscal year ended November 30th. During these periods, the preferred market continued the price recovery that began in early 2009, but at a somewhat slower pace. As can be seen by comparing the total return on the Fund's securities portfolio (the first row of the above table) to the index results below, the Fund's portfolio outperformed all segments of the preferred market over its fiscal year ending November 30th, even excluding the impact of leverage. During the past six months, the Fund's (unleveraged) securities portfolio outperformed all segments of the preferred market except adjustable rate preferred securities, which constitute only about 2.5% of the entire preferred market and just 2.3% of the Fund's portfolio.

Total Returns of Bank of America Merrill Lynch Preferred Securities Indices* for the Periods Ended November 30, 2010

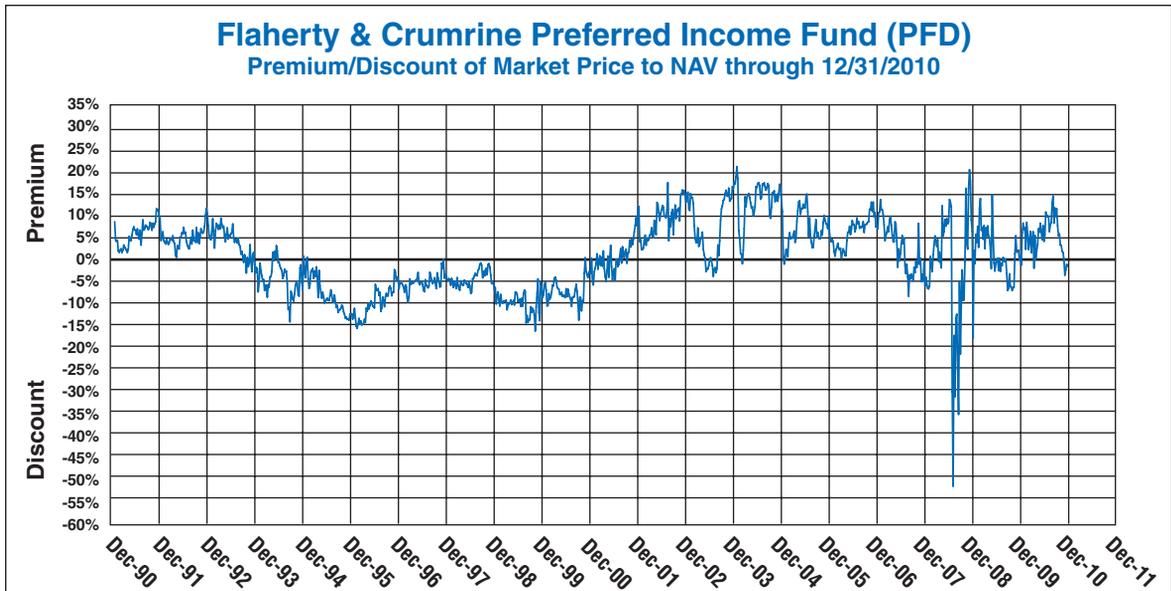
	<i>Six Months</i>	<i>One Year</i>
BofA Merrill Lynch 8% Capped DRD Preferred Stock Index SM	+8.2%	+16.9%
BofA Merrill Lynch 8% Capped Hybrid Preferred Securities Index SM	+10.8%	+18.8%
BofA Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index SM ..	+10.8%	+19.7%
BofA Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index SM	+13.5%	+16.3%

* The Bank of America Merrill Lynch 8% Capped DRD Preferred Stock IndexSM includes investment grade preferred securities issued by both corporations and government agencies that qualify for the corporate dividends received deduction with issuer concentration capped at a maximum of 8%. The Bank of America Merrill Lynch 8% Capped Hybrid Preferred Securities IndexSM 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 IndexSM 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 IndexSM 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.

As shown in the first table, the Fund’s performance demonstrates how leverage again benefited common stock shareholders over the past year – increasing current income and magnifying the positive returns over the Fund’s fiscal 2010. Although leverage can adversely impact Fund results in unfavorable market environments, during the recent fiscal year leverage assisted the Fund’s NAV in significantly outperforming returns available in the preferred securities market, as measured by the various BofA Merrill preferred 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*. During the twelve months ending November 30, 2010, the total return on market price of Fund shares was +43.6%.



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 above, this often is not the case. For most of the past year the *market price* has been above the NAV (in market parlance, “trading at a premium”). Because the Fund began fiscal 2010 with its market price below NAV (“trading at a discount”) and ended the fiscal year above, the total return earned on market price exceeded the total return on NAV.

Based on a closing price of \$11.62 on December 31st, the current annualized yield on the market price of the Fund’s shares (assuming the current monthly distribution of \$0.09 does not change) is 9.29%. In our opinion, this distribution rate measures up favorably with most comparable investment opportunities.

Preferred Market Conditions

By most measures, preferred market trading conditions are back to pre-crisis levels. Trading volumes and bid/offer spreads, though never robust compared to other major market segments, have returned to more customary levels. In our opinion, preferred securities remain attractively valued relative to other fixed income securities; plus, we are still finding opportunities to add value through credit research and security selection.

Credit conditions continue to improve. The economy is growing fast enough for profits to rebound nicely, but not fast enough to generate much demand for new capital spending by corporations. Households are paying down debt, driving investors who had previously purchased mortgage and credit card debt into other asset classes. Corporations are showing strong cash flow, improved interest coverage, and growing liquidity. Loan quality is improving, with delinquencies and charge-offs falling in almost all loan categories—though commercial real estate remains an important exception. Overall, credit default rates continue to trend lower. The result is good demand for preferred securities, little new issuance, and tighter spreads. We think these factors will continue to benefit the markets for some time to come.

Trading activity in the “retail” segment of the market² has been boosted by the rapid growth of exchange traded funds. ETF’s that invest primarily in preferred securities are “rules based” in that there is limited discretion about how a fund is managed—the objective is to closely track a specific index. We sometimes scratch our heads as to the appeal of these funds, but they do provide a healthy dose of liquidity, and they have attracted a lot of new investors to the preferred market.

In the aftermath of the financial crisis, new legislation (much of which has yet to be implemented) has resulted in wide ranging changes to the banking industry. Since preferred securities issued by banks comprise over sixty percent of the overall market, we watch this legislation with great interest. In the topic which follows, we discuss the most relevant regulatory changes; here, we’ll focus on market impact.

One thing we know for sure—certain types of preferred securities will eventually become obsolete. It is now clear that regulatory changes will diminish the benefits of some securities to the banks that issued them, and as a result, it is widely assumed many preferred securities will be retired at the earliest practical opportunity. The prospects of issuer redemptions have provided a boost to the market.

Of course, this wouldn’t be the preferred market without a fair share of hazards. In some cases, buried deep in the documentation of a security, there is language which permits the issuer to exercise an early redemption, at par, if certain events occur. Without such a provision, the issuer would either have to pay a premium to call the issue, or may not be permitted to call it at all until some future date. Such events, which seemed remote just a couple years ago, have in fact occurred in response to changes in financial regulation.

Market participants appear to have adjusted expectations about early redemption of *non-bank* preferred securities as well, though for different reasons. Recall that companies choose to issue preferred securities in part because it can improve the ratings on its debt, which in turn can reduce the all-in cost of its capital (since preferred is ranked “junior” to debt, the debt is viewed to be more secure). The major rating agencies have become less inclined to look favorably on certain types of preferred securities, hence non-bank issuers may also be inclined to retire certain preferred issues sooner than expected. The redemption terms of these non-bank issues haven’t changed, but the market now perceives the likelihood of issuer redemption to be higher and as a result, prices adjust to reflect the perception.

While it has become clear that certain types of preferred securities are destined to become a footnote in financial textbooks, a viable replacement has yet to emerge. A lot of smart people are hard at work to build a better preferred, and we’re optimistic they will succeed (though it may take a few iterations). You can bet we will be involved!

² In general, rules for ETF’s that invest primarily in preferred securities require the funds to invest only in securities listed on a national stock exchange; such issues comprise roughly half of the preferred market.

All of this leads to one unavoidable conclusion: *during the next few years, market participants, including the Fund, will need to find replacements for a significant number of high yielding securities.* At this juncture, of course, we cannot tell how the Fund will weather this reinvestment risk.

Update on Regulatory and Capital Reform for Banks

As we discussed in detail in the Fund's semiannual report from May 2010, banks face significant new regulation and stiffer capital requirements. We will quickly summarize the key features of bank regulatory reform from the Dodd-Frank bill and bank capital requirements from the Basel Committee on Bank Supervision—both from the perspective of preferred investors.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) makes significant changes to banks' operations and capital requirements. Most importantly for preferred investors, it eliminates trust preferred securities (TruPS) from Tier 1 capital for most banks the Funds would invest in. (Tier 1 capital is one of the primary measures of capital for a financial company; it includes common equity, retained earnings, qualifying preferred capital, and regulatory assets). The new rules phase in starting from 2013 through 2015. This change in regulatory treatment for TruPS makes it likely that most, though not all, TruPS will be called between 2013 and 2016, as banks replace those instruments with qualifying forms of Tier 1 capital. As of this writing, roughly 23% of the Fund's portfolio is invested in trust preferred securities issued by U.S. banks.

Along with changes made by lawmakers in the U.S., the Basel Committee on Banking Supervision in recent months has released its Basel III framework on bank capital. (This committee sets international banking standards that are subsequently adopted by national regulators, including the U.S.). These new rules will sharply increase the amount of common equity capital held by banks, while leaving an important role for preferred securities.

Currently, banks must hold at least 2.5% of risk-weighted assets (RWA) in the form of common equity. (The U.S. minimum is 4% common equity, and most banks carry substantially more than the minimum.) When Basel III is fully phased in, minimum common equity will rise to 4.5% of RWA. Coupled with some additionally required "capital buffers," we suspect that U.S. banks typically will hold 8-10% common equity and at least 10-12% Tier 1 capital, two to four percentage points higher than before the financial crisis. That's a lot more common equity providing credit support to preferred securities, which will comprise much of the difference between total Tier 1 and Tier 1 common equity.

Another likely, but still undecided, feature of the Basel III rules is a provision to impose "loss absorbency" on any non-common Tier 1 capital instruments. The theory is that all Tier 1 capital should be able to absorb losses on both a "gone concern" basis (i.e., in bankruptcy or receivership) *and* on a "going-concern" basis. Historically, preferred securities have provided substantial loss absorbency upon failure of a firm, since all preferred claims are subordinate to claims of depositors and senior creditors. However, preferreds are—strictly by their contractual terms—only moderately loss absorbing on a going concern basis, because the issuer can defer dividend payments but not eliminate the preferred liability outright in times of strain. The Basel Committee wants to give regulators the ability to either convert preferreds to common stock or write off the preferred liability if they believe the bank is no longer viable.

We have written a lengthy comment letter to the Basel Committee on loss absorbency. Interested readers will find it on the Fund's website or at the Basel Committee website at <http://www.bis.org/publ/bcbs174/fac.pdf>. Suffice to say that we think the proposed loss absorption provision for bank preferreds is unnecessary in the United States, and perhaps elsewhere. Nonetheless, if regulators

insist on it, we think a properly designed mechanism to convert preferred into common stock would be acceptable to preferred investors, while a write-off mechanism would not. We await the Committee’s decision on this sometime in 2011.

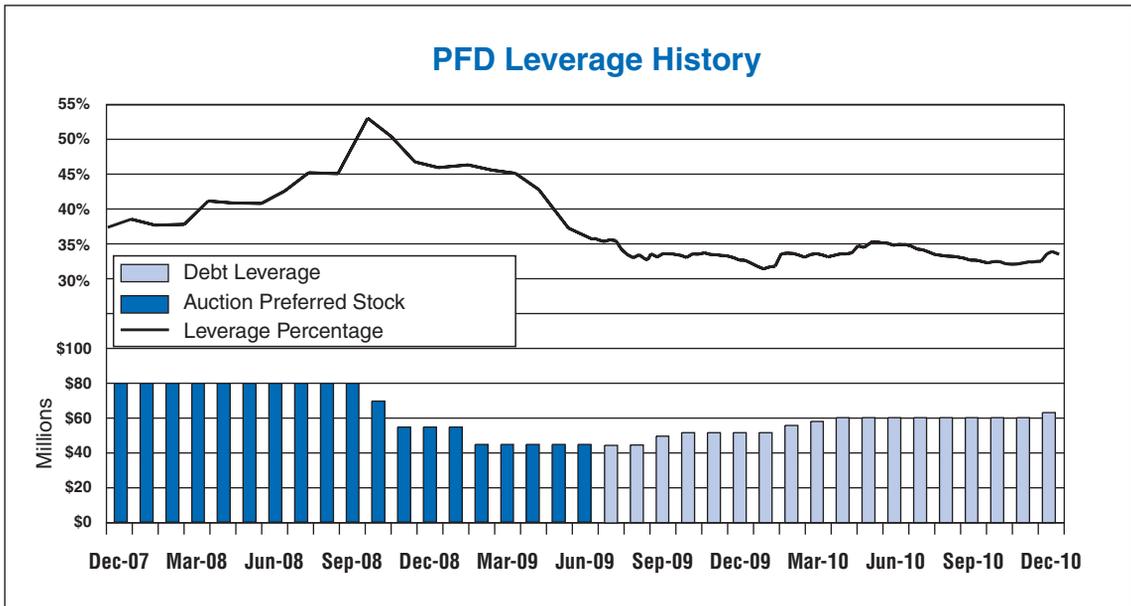
Overall, the new regulatory framework being imposed on banks by Dodd-Frank and Basel III will force banks to hold more capital or take less risk, or both. With respect to bank capital, regulators are requiring substantially more common equity capital than before, while retaining a meaningful role for preferred securities. These developments are broadly supportive for bank preferreds, though they do increase regulatory risk. As the new rules get implemented over the next several years, there will be numerous changes and opportunities awaiting preferred investors.

The Fund’s Leverage

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. Over the past fiscal year, the Fund has paid an average interest rate of 1.443% on its borrowed money. Given the much higher current yields generated by the Fund’s portfolio, this use of leverage had a meaningful positive impact on the Fund’s dividends to common shareholders.

In addition to economic considerations, there is a set of rules that govern leverage (most importantly, the terms and conditions of the Fund’s leverage agreement with its lender, 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 the portfolio moved up or down. As can be seen in the chart, the leverage percentage climbed steadily as the financial crisis unfolded from 2007 through early 2009 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, the Fund now has the ability 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. Throughout 2010, the Fund continued to increase its leverage balances. These increases, at very favorable interest rates, allowed the Fund to increase its monthly dividend three times since December 2009, for a total of 25% in cumulative increases.

The "right" percentage of leverage in a fund is never a simple matter to determine. Type of borrowing, the cost of funds and market conditions all will be factors to consider. At present, we are comfortable with the leverage percentage used by the Fund, and we will consider increasing or decreasing the amount of borrowing based on future market conditions. Of course, we continuously monitor our leverage balances and try to use leverage in a manner consistent with the Fund's objective.

Monthly Distributions to Fund Shareholders

The Fund makes monthly distributions of income to shareholders consistent with the objective of the Fund to provide high current income. The Fund is a regulated investment company, and as such, there are a number of tax laws that require the Fund to distribute almost all of its net investment income to shareholders each year. If the Fund were to not satisfy the minimum distribution requirements, it could risk its pass-through status and perhaps face financial penalties.

Even though these rules are well-defined, we still believe that there is a bit of art involved in setting dividend policy. One approach to distributions would be for the Fund to simply pay out its net earnings each month. Because of the uneven nature of the Fund's income and expenses, this would likely result in distribution rates that would change every month. This approach has never seemed terribly appealing to us.

We believe our shareholders are better served by a more stable level of monthly distributions. In striving for more stability and to reflect the inherent uncertainty in predicting future net earnings, in any particular month the Fund may pay out less than the amount earned for the same month; in other months the distribution may be comprised of current month's earnings *plus* income from prior months.

The rules mentioned above also impose a specific time-frame on the decisions about distributions, as they require true-up over each fiscal year. If the Fund has excess income at the end of this annual period, the Fund must make decisions that balance the goal of income stability and the requirements imposed by law. The Fund has always met the legal distribution requirements, but many times in the past the Fund has decided to not exceed the minimum requirements with the intent of "carrying over" a bit of income to the next fiscal-year period. Given that the minimum requirements are quite high, the carryover can never be more than a modest amount (less than one-month's dividend). There is an economic cost associated with this decision in the form of an excise tax on portions of the undistributed amounts, but we believe this cost is minimal and more than offset by the benefits of a more stable distribution rate over time. Details on the amount of undistributed net investment income and the incurrence of any related excise tax, if applicable, are available in the Notes to the financial statements.

As mentioned above, we believe this is more art than science, but the goal of high current income that is sustainable over a reasonable period of time seems to us consistent with trying to maximize value over the long-run for shareholders.

Federal Tax Advantages of 2010 Calendar Year Distributions

In 2010, 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. As a result of recent changes to the Internal Revenue Code, it is expected that this favorable tax rate for QDI will continue through 2012.

In calendar year 2010, approximately 52% of distributions made by the Fund was eligible for QDI treatment. For an individual in the 28% marginal tax bracket, this means that the Fund's total distributions will only be taxed at a blended 21.3% 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, such an individual who held 100 shares of Common Stock of the Fund for the calendar year would have had to receive approximately \$111 in distributions from a traditional corporate bond fund to net the same after-tax amount as the \$101 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 20.8% 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 2011's distributions may not be the same (or even similar) to 2010.

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. Hedging lost its effectiveness. Second, the cost of hedging rose dramatically as the yield curve steepened and options prices rose sharply. Finally, preferred securities became exceptionally cheap and were likely to offer high returns to shareholders even if Treasury yields increased moderately. Add them up, and we believed that hedging simply would not work under market conditions at the time.

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, many are not. For the preferred market as a whole, correlations between movements in prices of preferreds and the hedge instruments we use are increasing. However, they are too unstable to convince us that portfolio hedging would be reliably effective. Meanwhile, the cost of hedging is high, and preferreds continue to be attractively priced. At some point we expect that these circumstances will change. When they do, we will consider hedging again and may implement hedges prior to being able to communicate such a change to shareholders in our regular quarterly reporting.