

## PREFERRED INCOME FUND INCORPORATED

Dear Shareholder:

The Preferred Income Fund has been “hanging in there” in these troubled times. Total return on the net asset value (“NAV”) of the shares was 3.5% for the third fiscal quarter, which brought the return for the last twelve months up to 5.4%.

In the last quarter, the securities markets were all over the map reflecting a struggling economy, jitters over terrorists and Iraq, rumored and actual corporate misdeeds, and the upcoming congressional election. Weak common stock prices produced a “flight to quality” and a strong rally in the Treasury bond market. However, corporate bonds and preferreds did not fully participate in the prosperity of Treasuries. Credit concerns, reinforced by a rash of bankruptcies, particularly pressured lower-rated corporate issues.

The Fund’s hedges were an “artistic success”, even though they lost money in the quarter. A flight to quality that causes Treasuries to outperform preferreds can make hedging a losing game. Fortunately, we anticipated this possibility and limited our exposure to hedge losses. In technical terms, the Fund held put options on Treasury bond futures that were further out-of-the-money than usual.

The Fund’s hedges are similar to an insurance policy that is subject to a deductible. Currently, our position is equivalent to having a big deductible, which is great for holding down the cost of hedging. However, it also provides less protection against rising interest rates, which is the basic purpose of the hedge. These are unusual times, and we think this approach is appropriate now.

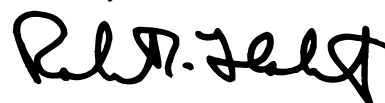
The two main sectors of the preferred market have been “out of sync” so far in fiscal 2002. Earlier this year, hybrid preferreds outperformed traditional preferreds, which offer special tax advantages to corporate investors. In the latest quarter, the roles were reversed with traditional preferreds leading the way. Having one sector zig each time the other zagged actually helped smooth out some of the market’s volatility.

Despite their better performance recently, we still see attractive opportunities among traditional preferreds. During the last quarter, we added slightly to our holdings of traditional issues, reducing hybrid preferreds in the process. At the end of the quarter, hybrids accounted for just under 25% of the Fund’s portfolio, the lowest position in over four years.

Credit risk is widespread today. Otherwise healthy enterprises can be turned into basket cases as lenders and investors boycott companies in need of cash. Distressed sellers of perfectly good assets far outnumber the willing buyers with ready cash. On the positive side, corporate managers are rapidly realizing that it is time to clean up their acts and their balance sheets.

The Fund’s portfolio holds preferreds of two issuers, Conseco Inc. and Farmland Industries Inc., that are undergoing financial restructurings. Those two preferreds represented only about 0.2% of the Fund’s portfolio on August 31<sup>st</sup>.

Sincerely,



Robert T. Flaherty  
*Chairman of the Board*

September 18, 2002

Preferred Income Fund Incorporated  
**SUMMARY OF INVESTMENTS**  
**August 31, 2002 (Unaudited)**

	<u>Value (000's)</u>	<u>Percent of Total Net Assets</u>
<b>Adjustable Rate Preferred Securities</b>		
Banking .....	\$ 27,900	12.5%
Financial Services .....	469	0.2
Total Adjustable Rate .....	<u>28,369</u>	<u>12.7</u>
<b>Fixed Rate Preferred Securities</b>		
Utilities .....	73,777	33.2
Banking .....	40,127	18.0
Financial Services .....	30,680	13.8
Insurance .....	22,308	10.0
Oil and Gas .....	7,039	3.2
Miscellaneous Industries .....	5,800	2.6
Total Fixed Rate .....	<u>179,731</u>	<u>80.8</u>
Inverse Floating Rate Preferred Securities .....	1,544	0.7
<b>Total Preferred Stocks and Securities</b> .....	209,644	94.2
<b>Debt Securities</b> .....	2,133	1.0
<b>Common Stocks</b> .....	6,041	2.7
<b>Purchased Put Options</b> .....	890	0.4
<b>Money Market Funds</b> .....	901	0.4
<b>Total Investments</b> .....	219,609	98.7
<b>Other Assets and Liabilities (Net)</b> .....	2,882	1.3
<b>Total Net Assets</b> .....	<u>\$222,491</u>	<u>100.0%</u>

**FINANCIAL DATA**

**Per Share of Common Stock (Unaudited)**

	<u>Dividend Paid</u>	<u>Net Asset Value</u>	<u>NYSE Closing Price</u>	<u>Dividend Reinvestment Price (1)</u>
December 31, 2001 .....	<b>\$0.1640</b>	\$14.46	\$14.70	\$14.46
January 31, 2002 .....	0.0820	14.40	15.20	14.77
February 28, 2002 .....	0.0820	14.24	15.50	15.20
March 31, 2002 .....	0.0820	14.14	14.44	14.14
April 30, 2002 .....	0.0820	14.11	14.52	14.11
May 31, 2002 .....	0.0820	13.99	14.75	13.99
June 30, 2002 .....	0.0880	14.03	15.25	14.61
July 31, 2002 .....	0.0880	13.85	15.55	14.77
August 31, 2002 .....	0.0880	14.23	15.95	15.15

(1) 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 payment 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.

**STATEMENT OF CHANGES IN NET ASSETS AVAILABLE TO COMMON STOCK<sup>(1)</sup>**  
**Nine Months Ended August 31, 2002 (Unaudited)**

	<u>Value</u> <u>(000's)</u>
<b>OPERATIONS:</b>	
Net investment income . . . . .	\$ 9,594
Net realized loss on investments sold during the period . . . . .	(1,615)
Net unrealized depreciation of investments during the period . . . . .	(2,133)
Distributions to Money Market Cumulative Preferred™ Stock Shareholders from net investment income, including changes in accumulated undeclared distributions . . . . .	(850)
Net increase in net assets from operations . . . . .	<u>4,996</u>
<b>DISTRIBUTIONS:</b>	
Dividends paid from net investment income to Common Stock Shareholders (2) . . . . .	(8,338)
Distributions paid from net realized capital gains to Common Stock Shareholders . . . . .	<u>—</u>
Total Distributions . . . . .	<u>(8,338)</u>
<b>FUND SHARES TRANSACTIONS:</b>	
Increase from Common Stock Transactions . . . . .	1,474
Decrease due to Money Market Cumulative Preferred™ Stock transactions . . . . .	<u>(491)</u>
<b>NET DECREASE IN NET ASSETS AVAILABLE TO COMMON STOCK FOR THE PERIOD . . . . .</b>	<b>(2,359)</b>
<b>NET ASSETS AVAILABLE TO COMMON STOCK:</b>	
Beginning of period . . . . .	144,649
End of period . . . . .	<u>\$ 142,290</u>

**FINANCIAL HIGHLIGHTS<sup>(1)</sup>**  
**Nine Months Ended August 31, 2002 (Unaudited)**  
**For a Common share outstanding throughout the period.**

<b>OPERATING PERFORMANCE:</b>	
Net asset value, beginning of period . . . . .	\$ 14.62
<b>INVESTMENT OPERATIONS:</b>	
Net investment income . . . . .	0.96
Net realized loss and unrealized depreciation on investments . . . . .	(0.38)
<b>DISTRIBUTIONS TO MMP* SHAREHOLDERS:</b>	
From net investment income (including change in accumulated undeclared dividends on MMP) . . . . .	(0.08)
From net realized capital gains . . . . .	<u>0.00</u>
Total from investment operations . . . . .	<u>0.50</u>
Cost of Issurance of Additional MMP* . . . . .	(0.05)
<b>DISTRIBUTIONS TO COMMON SHAREHOLDERS:</b>	
From net investment income . . . . .	(0.84)
From net realized capital gains . . . . .	<u>0.00</u>
Total distributions to Common Shareholders . . . . .	<u>(0.84)</u>
Net asset value, end of period . . . . .	<u>\$ 14.23</u>
Market value, end of period . . . . .	<u>\$ 15.95</u>
Common shares outstanding, end of period . . . . .	<u>9,998,668</u>
<b>RATIOS TO AVERAGE NET ASSETS AVAILABLE TO COMMON STOCK SHAREHOLDERS:</b>	
Net investment income . . . . .	8.26%**
Operating expenses . . . . .	1.44%**
<b>SUPPLEMENTAL DATA:††</b>	
Portfolio turnover rate fiscal year to date . . . . .	20%
Net assets, end of period (in 000's) . . . . .	\$ 222,491
Ratio of operating expenses to total average net assets including MMP* . . . . .	0.99%**

(1) These tables summarize the nine months ended August 31, 2002 and should be read in conjunction with the Fund's audited financial statements, including footnotes, in its Annual Report dated November 30, 2001, and in conjunction with the Fund's unaudited financial statements, including footnotes, in its Semi-Annual report dated May 31, 2002.

(2) Includes income earned, but not paid out, in prior fiscal year.

\* Money Market Cumulative Preferred™ Stock.

\*\* Annualized.

†† Information presented under heading Supplemental Data includes MMP\*.

**Directors**

Martin Brody  
Donald F. Crumrine, CFA  
Robert T. Flaherty, CFA  
David Gale  
Morgan Gust  
Robert F. Wulf, CFA

**Officers**

Robert T. Flaherty, CFA  
Chairman of the Board  
and President  
Donald F. Crumrine, CFA  
Vice President  
and Secretary  
Robert M. Ettinger, CFA  
Vice President  
Peter C. Stimes, CFA  
Vice President  
and Treasurer

**Investment Adviser**

Flaherty & Crumrine Incorporated  
e-mail: flaherty@fin-mail.com

**Questions concerning your shares of 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 —  
PFPC Inc.  
P.O. Box 43027  
Providence, RI 02940-3027  
1-800-331-1710

**This report is sent to shareholders of 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.**



## Quarterly Report

August 31, 2002

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