

FLAHERTY & CRUMRINE PREFERRED INCOME FUND

To the Shareholders of the Flaherty & Crumrine Preferred Income Fund (“PFID” or the “Fund”):

During the second half of 2007, conditions in U.S. preferred securities markets deteriorated dramatically, resulting in significant negative performance for the Fund. While some companies in the Fund’s portfolio have challenges to manage, we believe those companies and the Fund’s other holdings will continue to deliver high current income to the Fund’s shareholders. No one knows when the preferred and overall credit markets will stabilize, but eventually they will. The road to stabilization is likely to be bumpy for some time, so we will continue to navigate diligently with our disciplined, credit-focused investment strategy.

The following table summarizes the Fund’s performance in its most recent fiscal quarter and over longer time periods, compared with the average return of a group of closed-end funds that invest in other types of securities than preferred securities (as outlined in footnote (3) below):

TOTAL RETURN ON NET ASSET VALUE⁽¹⁾ FOR PERIODS ENDED NOVEMBER 30, 2007

	Actual Returns			Average Annualized Returns			
	Three Months	Six Months	One Year	Three Years	Five Years	Ten Years	Life of Fund ⁽²⁾
Flaherty & Crumrine Preferred Income Fund	-7.7%	-12.2%	-12.8%	0.8%	6.4%	5.7%	9.9%
Lipper Domestic Investment Grade Funds ⁽³⁾	2.2%	2.0%	3.9%	5.0%	6.1%	6.2%	7.4%

(1) Based on monthly data provided by Lipper Inc. in each calendar month during the relevant period. Distributions are assumed to be reinvested at NAV in accordance with Lipper’s practice, which differs from the methodology used elsewhere in this report.

(2) Since inception on January 31, 1991.

(3) Includes all closed-end funds in Lipper’s U.S. Government, U.S. Mortgage and Corporate Debt BBB Rated categories in each month during the period. Although the investment strategies used by the Fund differ significantly from the strategies used by these other fixed-income funds, the Fund seeks to accomplish a similar objective.

As the table reflects, the Fund’s relative performance over all time periods was dramatically impacted by the last six months of the fiscal year. Since July 2007, U.S. markets have suffered from a severe credit crunch. Sparked by the problems in the subprime mortgage market, the credit crunch expanded into a complete re-evaluation by investors and lenders of prices associated with the extension of credit and liquidity, in other words, the “risk premium.” Rationally or irrationally, lenders and investors became afraid of the greater risk that their borrowers might default, and demanded significantly higher risk premiums for making loans or owning preferred or debt securities. Many investors fled to the safest credit instrument they knew – U.S. Treasury securities.

Widening risk premiums played out in a number of market sectors. For consumers, mortgage rates jumped significantly in the first few months of the crunch and banks tightened lending standards. For institutions, credit fears became so widespread that banks even worried about lending to other banks; the cost of interbank borrowing surged. For the Fund, leverage became more expensive and yields on preferred securities increased dramatically, driving down the value of the Fund's portfolio.

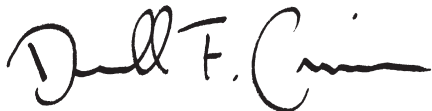
In some asset classes, lenders and investors simply retreated from extending credit to borrowers at any risk premium. Left unchecked, this credit contraction could have had severe negative repercussions on both asset values and the economy. In response, the Federal Reserve cut the fed funds rate by one percentage point and the discount rate by one and a half percentage points, with the likelihood of further cuts to come. In addition, the Fed and other major global central banks flooded markets with liquidity through repurchase operations. Preferred securities and other credit-market instruments, which were falling sharply in price prior to the Fed's actions, have since stabilized somewhat. Although we cannot say that prices of credit-market instruments have reached a bottom, the Fed's actions have clearly helped provide liquidity to the market. In the discussion topics that follow this letter, we write further about our thoughts on the future of the current credit crunch, the outlook for the U.S. economy and the possible response by the Fed. It's likely that the behavior of the preferred securities market these past months will one day be the subject of business school dissertations. From our vantage point, we'd observe that the market was impacted by, among other things, issues of liquidity, a flood of supply from financial issuers desperate to replenish their capital and concerns over the creditworthiness of the financial institutions that constitute a large part of the preferred securities market.

Early on, losses by investors in mortgage securities prompted liquidation of their holdings in preferred securities to meet their funding needs. Too many willing sellers, and too few buyers, then had an adverse impact on valuations throughout the secondary preferred securities market. Subsequently, companies directly impacted by credit-related losses – especially banks, broker-dealers and the government-sponsored housing lenders, Fannie Mae and Freddie Mac – turned largely to the preferred market to raise much-needed capital to offset their losses. The pricing of these new issues came at substantial discounts to outstanding preferred securities, which further drove down prices in the secondary preferred market (including for preferred securities of non-financial companies).


Although many types of companies have experienced some strain from the current credit crunch, those most affected include banks, financial services companies and broker-dealers – the industries with direct and indirect exposures to problems in the housing market. Preferred securities issued by these types of companies have consequently suffered the greatest declines in value. In the more detailed discussion that follows this letter, we talk about credit fundamentals of the financial services companies we own. In short, we believe that current market values of most securities we own are more reflective of the credit crunch and associated fears and illiquidity than the overall creditworthiness of these issuers. Consequently, we remain cautiously optimistic that a more normal market will bring about positive returns for our preferred-securities investments this year. On a longer-term horizon, we are all but certain of it.

Following this letter is discussion on a variety of subjects, including: an attribution of total returns on net asset value; the Fund's market price performance; the economy and our views on monetary policy; credit fundamentals of financial services companies; and tax treatment of the Fund's dividends. The Questions and Answers on the Fund's website at www.preferredincome.com have additional comments on a number of topics that may interest you. We believe an informed shareholder can be one of the strongest assets of any company, and we encourage you to read the remainder of this report and explore the website for a wide range of additional information about your Fund.

Sincerely,

A handwritten signature in black ink, appearing to read "Donald F. Crumrine". The signature is fluid and cursive, with a large, sweeping flourish at the end.

Donald F. Crumrine
Chairman of the Board

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

Robert M. Ettinger
President

January 18, 2008

DISCUSSION TOPICS

The Fund's Preferred Securities Portfolio and Components of Total Return on NAV

The preferred securities market has suffered one of its worst years in modern U.S. financial history. While no index comprehensively reflects the investment universe for the Fund, Merrill Lynch publishes three different indices which attempt to measure performance of some sectors of the investment-grade preferred securities market: the Merrill Lynch 8% Capped DRD Preferred Stock Index (which includes traditional tax-advantaged preferred stocks); the Merrill Lynch Hybrid Preferred Securities Index (which includes fully-taxable, exchange-traded preferred securities) and the Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index (which includes both tax-advantaged and taxable preferred securities with adjustable dividends). Set forth below are the six month and twelve month total returns of these indices:

Total Returns of Merrill Lynch Preferred Securities Indices*
for Periods Ended November 30, 2007

	Six Months	One Year
Merrill Lynch 8% Capped DRD Preferred Stock Index SM	(8.7)%	(6.9)%
Merrill Lynch Hybrid Preferred Securities Index SM	(9.2)%	(7.8)%
Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index SM	(15.6)%	(13.7)%

* The 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 Merrill Lynch Hybrid Preferred Securities IndexSM includes taxable, fixed-rate, U.S. dollar-denominated investment-grade, preferred securities listed on a U.S. exchange. The Merrill Lynch Adjustable Preferred Stock, 7% Constrained IndexSM includes adjustable rate preferred securities issued by US 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 on net asset value, are unmanaged and do not reflect any expenses.

While we realize it's only small consolation, as set forth in the table below, the Fund's total return on its securities portfolio was better than these indices. Unfortunately, as one might expect, the Fund's strategy of using leverage amplified its negative returns and, coupled with its expenses and hedging strategy, caused the NAV of the Fund to perform worse than two of the indices.

The table below reflects the performance of each investment tool used 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; and (c) issuing an auction-rate preferred stock to leverage and enhance returns to Common Stock shareholders. The table then adjusts for the impact of the Fund's expenses to arrive at a total return on NAV (which factors in all of these items).

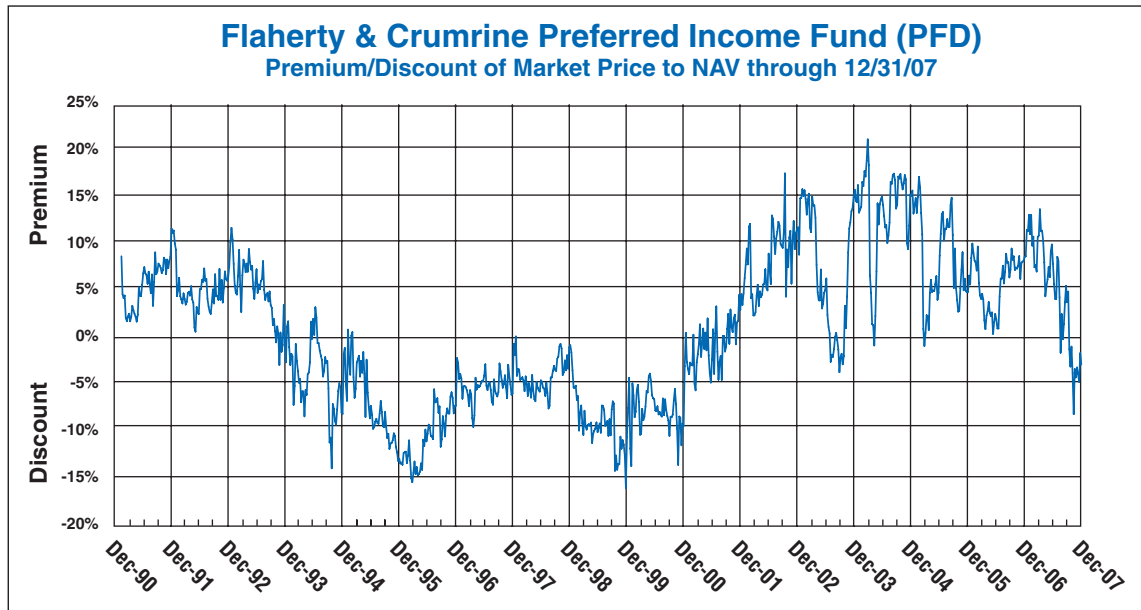
Components of PFD's Total Return on NAV
for Periods Ended November 30, 2007

	Six Months	One Year
Total Return on Unleveraged Securities Portfolio (including principal and income)	(6.2)%	(5.3)%
Return from Interest Rate Hedging Strategy.....	(0.6)%	(0.8)%
Impact of Leverage	(4.6)%	(5.2)%
Expenses.....	(0.7)%	(1.5)%
<i>Total Return on NAV</i>	(12.2)%	(12.8)%

Market Total Return

While our focus is primarily on managing the Fund's portfolio, an investor's actual return is comprised of monthly dividend payments plus changes in the Fund's market price. For the year ended November 30, 2007, the total return on *market value* for the Fund's common shares was -21.7%. During the fourth quarter alone, total return on *market value* was -10.5%.

We've often said that in a perfect world, market prices would closely track net asset values; however, as seen in the chart below, in the real world deviations can be large. Over the past year, shareholders saw some significant deterioration in the relationship between net asset value and market price.



Over the past six months, investors have been indiscriminately selling many types of corporate securities, including closed-end funds. The discounts of closed-end funds of all stripes, including the Fund's, widened materially. Toward the end of the year, the Fund's decline in market price was further compounded by tax-loss selling pressure. Throughout the period, the market price of the Fund's shares has almost traded without apparent relation to their underlying net asset value (NAV), and we have seen near-historic discounts in the Fund's market prices to their NAVs.

As discussed in greater detail on the Fund's website, fundamentally, the market prices of the Fund's shares are subject to the laws of supply and demand, which became substantially imbalanced. We believe that the fundamentals of PFD continue to be strong and that this supply/demand imbalance is unjustified when one considers the Fund's current dividend levels and the quality of its portfolio.

The U.S. Economy and Federal Reserve Monetary Policy

The U.S. economy has performed remarkably well to date in the face of significant deterioration in housing and credit markets. Real gross domestic product grew by 4.9% at an annual rate in the third quarter,

the fastest quarterly growth pace in four years. However, prospects for future growth have clearly dimmed. Today, the key question for the economy – and for investors – is to what extent housing and credit headwinds affect economic growth over coming quarters. On one hand, if the impact is only modest, then the economy probably can regain its footing after a couple quarters of slow (sub-2%) growth. On the other hand, if the housing downturn becomes even worse than expected, generating further sizable losses in the financial sector, then credit contraction in combination with already-slowing consumer spending could result in recession.

Without repeating the detailed analysis we present in our Quarterly Economic Update (which is available on the Fund's website), we continue to think that the economy will narrowly avoid recession. However, we now believe that additional monetary easing will be needed, and the downside risks have increased as credit market strains have intensified.

The housing market remains the weakest part of the economy, and we expect it to weaken through 2008 as a large inventory of unsold homes continues to weigh on both prices and construction activity. Many mortgage borrowers with little home equity will default, others will struggle with higher mortgage payments as their rates reset, and fewer and fewer homeowners will be able to extract home equity to finance current consumption. The result will be slower growth in consumer spending, although we think that steady, if unspectacular, gains in employment will prevent consumption from falling outright.

Falling home prices and poor loan underwriting have resulted in surging delinquency and default rates and rising loss severity. Mortgage investors must anticipate how many loans will default and how much of the loan value will be recovered in foreclosure. Thus, mortgage prices need to reflect not only current losses, but also expectations of all future losses. As a result, the price of many mortgage-backed securities, particularly those backed by subprime loans, have fallen dramatically – even in cases where securities have suffered no defaults on principal or interest to date. In turn, prices of securities issued by companies with exposure to mortgage securities also have fallen sharply.

The distinction between current and expected losses is an important one for investors. First, because prices have fallen on many securities, financial institutions who hold them have taken sizable mark-to-market losses that have reduced earnings and capital. But these write downs already incorporate expected future losses. In the case of subprime mortgages (and many other assets), market prices incorporate quite dire loss estimates. Although it's possible that losses ultimately will exceed market expectations, it's also possible that losses will be less. If in fact losses are less than current market prices reflect, then holders of those securities ultimately will report gains from current (depressed) prices. Thus, investors in these securities may well avoid further losses (or even have gains) even as defaults increase, as long as defaults and losses arising from those defaults are less than what is baked into current prices. Second, although market prices reflect severe loss expectations on mortgages, the vast majority of those losses have not yet occurred. Normally, changes in wealth (in this case, mark-to-market losses) have a significantly smaller economic impact than realized losses (actual defaults). As a result, the economic impact of defaults will probably take some time to play out. That offers the possibility that the economy can avoid recession, despite the magnitude of the losses that ultimately may be incurred in the mortgage market. At the same time, it also means growth may be sluggish for more than just a couple of quarters. Right now, we just can't say which way the economy is likely to turn: toward recession, an extended period of sluggish growth, or a two-quarter pause before resuming normal growth. However, even the best of those three scenarios points to slow growth in early 2008, so our economic outlook remains cautious.

In response to the gloomier economic outlook and the credit crunch, the Federal Reserve cut the fed funds rate by a total of one percentage point from September through December 2007. However, just as it increased the rate further than normal due to declining risk premiums from 2004-06, the Fed may now have to lower the fed funds rate by more than normal due to elevated risk premiums. The credit crunch, which has raised risk premiums, has reduced the stimulative effect of the Fed's rate cuts. Although recent coordinated actions by major central banks to provide term financing are starting to improve the pass-through of lower official rates to market rates, it is clear that whatever set of market rates needed to keep the economy out of recession is likely to be associated with a lower-than-normal fed funds rate.

In addition to the cost of credit, the Fed needs to be concerned about the availability of credit. Securitization markets are essentially shut down for mortgages other than U.S. government agency-eligible conforming loans; ditto for many other forms of collateral. This is forcing borrowers to turn to banks and finance companies for funds, expanding their balance sheets at a time when capital is being squeezed due to mark-to-market losses and higher charge-offs on existing loans. Thus, financial institutions are tightening lending standards and raising loan rates, which likely will constrain economic growth in the absence of easier monetary policy.

With the bulk of the economic impact of rising loan defaults yet to be felt, we believe that the Fed will err on the side of additional rate cuts, at least until market rates come down meaningfully.

Fundamental Credit Trends for Financial Services Companies

Although the economic outlook is uncertain, we believe that the credit outlook is positive overall. The corporate nonfinancial sector remains healthy, with low leverage, strong interest coverage, and good liquidity. However, the corporate financial sector, which constitutes the largest sector of the preferred market and where consequently the Fund has significant holdings, is both more strained and more variable. Funding costs for all financial institutions have increased meaningfully, and many companies have taken large write-downs on subprime mortgages and other assets whose market prices have fallen substantially. Life insurance and property and casualty insurance companies have generally avoided most of the problems facing other financial companies, but banks, finance companies, financial guarantors and broker-dealers have been significantly affected because of their direct and indirect exposure to problems in housing markets. These companies all face a difficult operating environment over the next several years, especially if the economy slips into recession.

Recognizing these risks, we remain confident about the overall creditworthiness of the Fund's holdings of financial issuers. Overall, we believe that the issuers (a) are well capitalized, (b) have strong business franchises, (c) are well managed, and (d) have access to additional capital, if needed. We believe that they have the ability to absorb sizable losses and still navigate a difficult credit landscape. Because most of these financial companies operate in a mark-to-market environment, their write downs already reflect both current and expected future losses. Although we admit that we worry about a few holdings more than others, we believe that overall credit quality of the portfolio remains sound. Put simply, we think that current preferred securities prices more accurately reflect the fear and illiquidity of today's credit markets than the fundamental creditworthiness of the issuers. It may take some time, but we are confident that preferred securities prices will reflect more of their creditworthiness eventually.

Tax Advantages of 2007 Calendar Year Distributions

In 2007, the Fund passed on a portion of its income to individuals in the form of qualified dividend income or QDI. QDI is taxed at a maximum 15% rate instead of an individual's ordinary income tax rate. In calendar year 2007, approximately 69.1% 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 19.0% 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 \$116 in distributions from a traditional corporate bond fund to net the same after-tax amount as the \$103 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 59.0% 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 the QDI or DRD portions of next year's distributions may not be the same (or even similar) to this year's.