

## FLAHERTY & CRUMRINE PREFERRED INCOME OPPORTUNITY FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Opportunity Fund (“PFO”):

PFO continued to perform well, delivering +6.6% total return on net asset value<sup>1</sup> in the second fiscal quarter.<sup>2</sup> During the first half of fiscal 2014, total return on NAV was +11.8%. As shown below, longer period returns have been excellent. The table includes performance of two indices, Barclays U.S. Aggregate and S&P 500 as proxies for bond and stock markets, respectively. While neither is a benchmark for Fund performance, they provide useful context for broad alternative-asset categories.

### TOTAL RETURN ON NET ASSET VALUE FOR PERIODS ENDED MAY 31, 2014

	Actual Returns			Average Annualized Returns			
	Three Months	Six Months	One Year	Three Years	Five Years	Ten Years	Life of Fund <sup>(1)</sup>
<b>Flaherty &amp; Crumrine Preferred Income Opportunity Fund</b> .....	<b>6.6%</b>	<b>11.8%</b>	<b>9.5%</b>	<b>13.3%</b>	<b>25.5%</b>	<b>8.2%</b>	<b>9.5%</b>
Barclays U.S. Aggregate Index <sup>(2)</sup> .....	1.8%	3.3%	2.7%	3.5%	5.0%	5.0%	6.2%
S&P 500 Index <sup>(3)</sup> .....	4.0%	7.6%	20.4%	15.1%	18.4%	7.8%	9.3%

(1) Since inception on February 13, 1992.

(2) The Barclays U.S. Aggregate Index is an unmanaged index considered representative of the U.S. investment grade, fixed-rate bond market.

(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.

*Current performance may be lower or higher than quoted past performance, which cannot guarantee future results. In addition, NAV performance will vary from market price performance, and you may have a taxable gain or loss when you sell your shares.*

The market price of Fund shares outpaced NAV, and, as a result, total return on market price was +9.7% in the quarter and +21.0% over the first half of fiscal 2014.

The Federal Reserve has steadily slowed the pace of bond purchases related to its quantitative easing program. Concern this “taper” would lead to market volatility has thus far been unfounded. Intermediate and long term interest rates actually declined during the past three months and preferred securities responded very favorably. From peak (early March) to trough (late May), yields on 10-year and 30-year U.S. Treasury bonds fell 36 and 43 basis points, respectively.

Our economic outlook for the U.S. remains intact—sluggish growth in 2014, accelerating modestly in 2015 and 2016. Recent economic data serve to reinforce this view. We expect short-term interest rates will remain low through mid-2015, while intermediate and long-term rates will drift higher. Most important, credit trends in domestic companies held by the Fund will remain stable to positive.

<sup>1</sup> Following methodology required by the SEC, total return assumes dividend reinvestment and includes income and principal change, plus the impact of leverage and expenses.

<sup>2</sup> March 1, 2014—May 31, 2014

Geopolitical risks have increased in several regions around the globe. The Fund has no direct exposure to companies based in Russia, former Soviet Union countries, the Middle East, or Argentina. Of course, the Fund owns credits which may do business in these regions, but in no instance do we consider those risks to be unmanageable.

On a positive note, the European sovereign debt crisis appears to have stabilized, and economic growth is returning. Although they still face challenges, European credits held in the Fund are on much improved footing. The financial crisis, “Great Recession,” and Euro-zone sovereign debt crisis certainly caused some sleepless nights, but patience and hard work are paying off. Shareholders can take comfort: our investment process has worked well for over 30 years.

In the section below, we dig deeper into topics mentioned here, as well as others of interest to shareholders. In addition, we encourage you to visit the Fund’s website, [www.preferredincome.com](http://www.preferredincome.com) for timely and important information.

Sincerely,

The Flaherty & Crumrine Portfolio Management Team:

R. Eric Chadwick  
Donald F. Crumrine  
Robert M. Ettinger  
Bradford S. Stone

June 30, 2014

## DISCUSSION TOPICS (Unaudited)

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

The table below reflects performance over the recent six months of each element comprising total return for the Fund, namely: (a) investing in a portfolio of securities; (b) possibly hedging that portfolio of securities against significant increases in long-term interest rates; and (c) utilizing leverage to enhance returns to shareholders. Next, we compute the impact of the Fund's operating expenses. All parts are summed to determine total return on NAV.

#### Components of PFO's Total Return on NAV for the Six Months Ended May 31, 2014\*

Total Return on Unleveraged Securities Portfolio (including principal change and income) .....	8.3%
Return from Interest Rate Hedging Strategy .....	N/A
Impact of Leverage (including leverage expense) .....	4.2%
Expenses (excluding leverage expense) .....	0.7%

\* Actual, not annualized.

*Total Return on NAV*    **11.8%**

For comparison, the following table displays returns over the same time period on three indices compiled by Bank of America Merrill Lynch, reflecting various segments of the preferred securities market. Because these index returns exclude all expenses and the impact of leverage, they compare most directly to the top line in the Fund's performance table above (Total Return on Unleveraged Securities Portfolio).

#### Total Returns of Bank of America Merrill Lynch Preferred Securities Indices\* for the Six Months Ended May 31, 2014

BofA Merrill Lynch 8% Constrained DRD Eligible Preferred Securities Index <sup>SM</sup> .....	9.8%
BofA Merrill Lynch Hybrid Preferred Securities 8% Constrained Index <sup>SM</sup> .....	9.2%
BofA Merrill Lynch US Capital Securities US Issuers 8% Constrained Index <sup>SM</sup> .....	8.2%

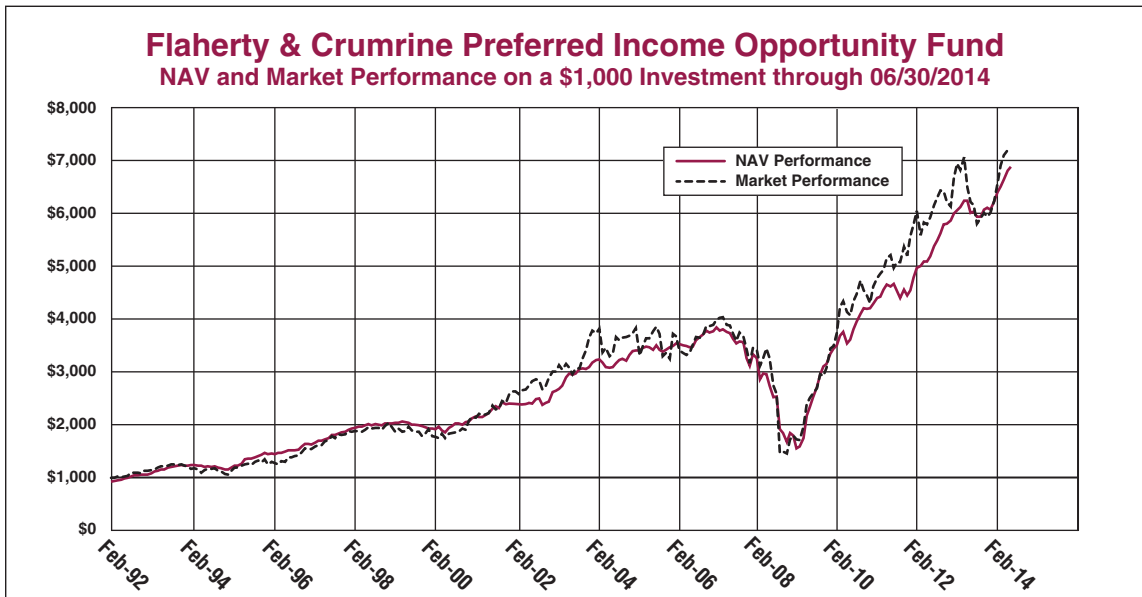
\* The Bank of America Merrill Lynch 8% Constrained DRD Eligible Preferred Securities Index<sup>SM</sup> (P8D0) includes investment grade preferred securities issued by both corporations and government agencies that qualify for the corporate dividend received deduction with issuer concentration capped at a maximum of 8%. The Bank of America Merrill Lynch Hybrid Preferred Securities 8% Constrained Index<sup>SM</sup> (P8HO) 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 US Capital Securities US Issuers 8% Constrained Index<sup>SM</sup> (C8CT) 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%. All index returns include interest and dividend income, and, unlike the Fund's returns, are unmanaged and do not reflect any expenses.

Over the past six-months, returns on the Fund's (unleveraged) securities portfolio trailed two out of the three preferred market indices shown above and slightly outperformed the other. However, during its fiscal year-to-date, the Fund's total return on NAV significantly exceeded returns on the indices because of the Fund's use of leverage. While leverage can reduce returns during periods of adverse market conditions, over the past six-months of positive conditions, it enhanced price returns and its low cost increased income available to be distributed by the Fund.

## Total Return on Market Price of Fund Shares

While our focus is primarily on managing the Fund's investment portfolio, our shareholders' actual return is comprised of the Fund's monthly dividend payments *plus* changes in the *market price* of Fund shares. During the six-month period ending May 31, 2014, total return on market price of Fund shares was 21.0%.

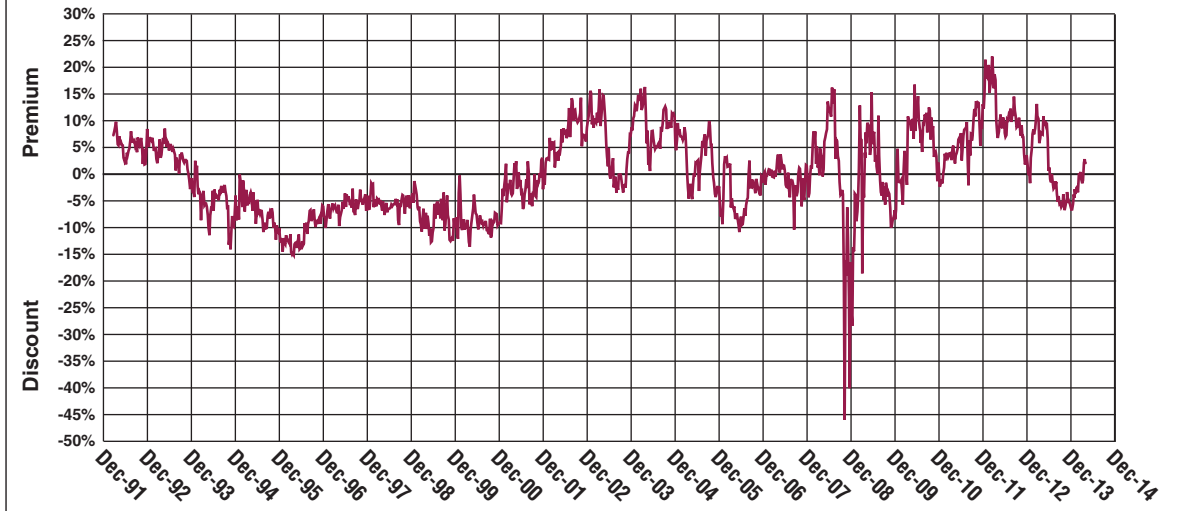
Historically, the preferred securities market has experienced price volatility consistent with those of other fixed-income securities. However, since mid-2007 it has become clear that preferred-security valuations, including both the Fund's NAV and the market price of its shares, can move dramatically when there is volatility in financial markets. The chart below contrasts the relative stability of the Fund's earlier period with the more recent volatility in both its NAV and market price. Virtually all fixed-income asset classes experienced increased volatility over this period.



In a more perfect world, the market price of Fund shares and its NAV, as shown in the above chart, would track more closely. If so, any premium or discount, calculated as the difference between these two inputs and expressed as a percentage, would remain relatively close to zero. However, as can be seen in the chart below, this often has not been the case. The Fund began fiscal 2014 with its market price at a discount to NAV, but by May 31<sup>st</sup> the Fund was trading at a premium. As a result, the total return earned on market price was greater than the total return on NAV shown in the table above.

Although divergence between NAV and market price of a closed-end fund is generally driven by supply/demand imbalances affecting its market price, we can only speculate about why the relationship between the Fund's market price and NAV hasn't been closer.

## Flaherty & Crumrine Preferred Income Opportunity Fund (PFO) Premium/Discount of Market Price to NAV through 6/30/2014



Based on a closing price of \$11.61 on June 30<sup>th</sup>, the current annualized yield on market price of Fund shares assuming its current monthly distribution of \$0.073 does not change is 7.55%. In our opinion, this distribution rate measures up favorably with most comparable fixed-income investment opportunities. Of course, there can be no guarantee that the Fund's dividend will not change based on market conditions.

### Preferred Market Conditions

It would be difficult to argue that the performance of preferreds over the first six months of the year has been less than fantastic. In most cases, market prices are back to, or above, levels of a year ago—prior to the selloff that began with hints of Fed “taper” and a sharp rise in rates that was compounded by tax-loss selling and other technical factors late in 2013. Much of the recovery may have been expected as year-end selling subsided, but strong fundamental and technical conditions have contributed to a sustained rally.

Credit quality continues to improve for most issuers of preferreds. Regulation of financial companies is still evolving, but national regulators generally are adhering to standards established under Basel III as they roll out their specific rules. To meet these new requirements, financial companies are holding much more common equity capital than in the past, which is credit enhancing for preferreds.

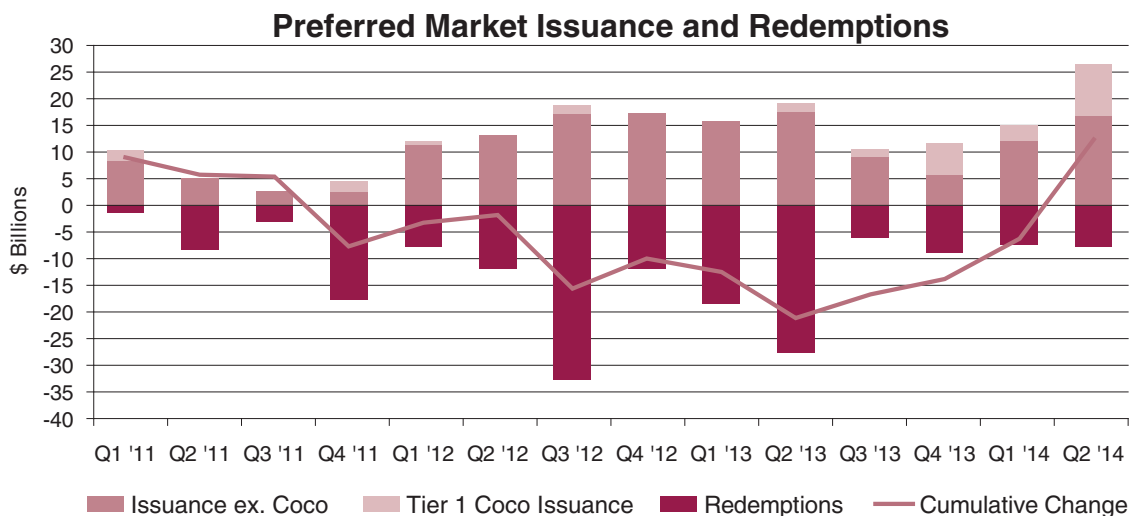
Bank stress tests completed earlier this year confirmed that progress has been made. Most large U.S. banks now have excess common equity capital, even under new, stricter guidelines. As a result, banks are beginning to return more capital to shareholders. This is a healthy development that should not harm the position of preferred holders in the near future, as overall capital levels should be maintained at reasonable levels.

Broader economic improvement, while not as robust as many hoped, continues to support the outlook for credit improvement for corporations and households alike. Loan losses at banks are well off their highs, and are reverting to more “normal” levels consistent with slow improvement in consumer balance sheets.

The market's technical backdrop also deserves a good deal of credit for preferreds' performance this year. Interest rates have retreated from their recent highs, perhaps even more than most would have predicted. Monetary policy remains accommodative, and options for fixed-income investors to find yield are limited. Preferreds are currently the highest-yielding domestic asset class by most measures, and their yields have attracted buyers from many areas of fixed-income markets.

As you know, the preferred market is dwarfed in size by the corporate bond market—the traditional staple in a fixed-income portfolio. So when investors look outside the corporate bond market for yield and turn their sights to preferreds, the amount of money interested in this market can be overwhelming. This has been the pattern of late, which has created strong demand for preferreds.

As you can see from the chart below, issuance of preferreds has finally turned the corner and has been increasing in recent months. Much of this is driven by regulatory requirements and lower all-in yields available to issuers, and it has been fairly concentrated in the banking industry. Supply has been easily absorbed by the market, and we expect future supply to be very manageable, as banks continue to be patient in meeting their regulatory goals for additional Tier 1 capital.



Source: Flaherty & Crumrine Incorporated

Many of these fundamental and technical factors are likely to persist at least over the near term. Higher interest rates could certainly reduce some enthusiasm for preferreds, but the economic backdrop should cause rates to remain in a reasonable range over the near-term. It is doubtful prices will continue to increase at their recent feverish pace, but we do expect the preferred market to continue to produce good total returns for investors. Preferreds remain one of the few pockets of yield and good credit quality available today.

### Economic Conditions

After weather-induced weakness in the first quarter, when real gross domestic product (GDP) fell by 2.9%, the U.S. economy returned to growth in the second quarter. Economists expect roughly 3.3% real GDP growth over the balance of 2014 but, owing to first quarter weakness, only about 1.7% growth in 2014 overall, much weaker than earlier forecasts. Private domestic final sales, defined as personal

consumption expenditures (PCE) plus business and residential investment, expanded by 2.6% over the 12 months ending in March. Although more-rapid PCE growth is likely to be limited, business and residential investment should rebound from their winter slowdowns. We expect this core segment of the economy to accelerate gradually over the next several years.

Inventories and trade, which were major drags on growth in the first quarter, should either add to or, at a minimum, subtract less from growth over coming quarters. Likewise, government consumption should begin adding to GDP growth by the fourth quarter. Credit conditions continue to improve overall. Importantly, this moderate-growth and low-inflation economic environment remains favorable for preferred securities.

Looking further ahead, assuming private domestic final sales expand at 2.5% or so, as other sectors start adding to growth in 2015 and 2016, real GDP could accelerate to 2.5-3.0%. That pace of growth should gradually shrink the U.S. “output gap” (the difference between actual GDP and potential GDP assuming full employment), which economists estimate is about 3% currently. However, it should take some time before inflation pressures emerge. While monetary policy should remain relatively accommodative, we expect the Fed will begin raising rates cautiously in the second half of 2015. Longer-term Treasury rates already reflect higher short-term rates (that’s why the yield curve is so steep), and we believe additional long-term rate increases, while likely, will be modest. We discuss interest rate risk in more detail below.

### **Interest-Rate Risk and Hedging**

As we discussed in the last quarterly shareholder letter, there are three reasons why we remain sanguine about prospective returns on preferred securities, even if long-term interest rates increase modestly. First, yields on preferred securities are not perfectly correlated with Treasury yields, and yield spreads on preferred securities may provide some cushion against rising Treasury rates. Second, relatively high dividend income on preferred securities can turn modest principal losses into positive total returns over time.

Third, the Fund has increased its allocation to “fixed-to-floating rate” preferred securities over the past year. These issues pay a fixed-rate dividend initially and then reset at a margin over an index rate such as 3-month LIBOR. They typically yield a little less than pure fixed-rate issues, but they generally have much less interest-rate risk. That decision actually hurt the Fund’s performance in the first half of 2014, as interest rates fell, but we think it will pay off over coming years. As of May 31, 2014, the Fund’s allocation to fixed-to-floating rate preferred securities was 45.0%.

We continue to monitor and evaluate interest-rate-hedging strategies, but a steep yield curve makes them very expensive currently—whether hedging the cost of short-term leverage or long-term preferred securities. For hedging to be profitable, interest rates need to rise by more than what is priced into the market, and that is a high hurdle currently. That is not to say that rates cannot increase by more than the market currently expects, but it does mean that rates have to rise a lot just to avoid losing money on a hedge. For now, we see better alternatives for managing the Fund’s interest-rate risk through selection of portfolio holdings of preferred securities.

### **U.S. Bank Credit Quality**

Spurred by regulatory requirements enacted in the wake of the financial crisis, U.S. banks have dramatically improved their capital structures and risk profiles. They have simplified their businesses and reduced business risk. They are more liquid. And, they have sharply increased common equity capital. As a group, the ten largest U.S. commercial and investment banks by asset size have increased their average

ratio of tangible common equity to tangible assets to 8.0%, an increase of 75%.<sup>3</sup> While this is just one capital ratio, it's an important one for investors in preferred securities, since common equity is the only form of capital *junior* to preferred. We think higher levels of common equity capital and other efforts to improve bank safety and soundness offset most new regulatory risks faced by preferred securities.

You wouldn't know that, however, by looking at agency ratings of preferred securities issued by these banks. From December 31, 2007 to May 31, 2014, the average preferred security rating of those ten large banks has fallen from A+ to BBB-, a five-notch decline. Many of these banks' preferred stock, including Citigroup, Bank of America, Goldman Sachs, Morgan Stanley and Capital One, are rated below investment grade by each of the three major rating agencies.

Why have rating agencies imposed such large downgrades on these banks' preferred securities? We think, in part, they were rated too high prior to the financial crisis and needed to come down. In addition, regulators today have resolution powers that they either did not have or were reluctant to use in the past; preferred ratings needed to reflect this increased risk of loss. However, it appears that the agencies are unimpressed by improvements in capital and business risk at these companies. We think the agencies have over-penalized these now much-stronger institutions. Flaherty & Crumrine's internal ratings on these issuers were, on average, lower than the agencies' prior to the crisis, and they are higher now. While the average agency rating on Fund portfolio holdings has declined since the financial crisis, we believe its true credit quality has improved.

### **Contingent-Convertible Securities (CoCos)—Europe's Version of Bank Preferred Stock**

In addition to preferred stock issued by U.S. banks, we also invest in other types of preferred securities issued by foreign banks (subject to the Fund's 30% limit on all types of foreign securities). Over the past several years, banks in the United States and Europe have issued different types of preferred capital in response to changes in regulation since the financial crisis. While we haven't yet purchased any of these newer forms of European preferreds, they are designed to provide similar capital support as U.S. preferred stock. As a result, we consider them to be part of a continuing evolution of the preferred market and ultimately could be suitable investments for the Fund.

In simple terms, bank holding companies have three primary forms of capital: common equity is most junior and absorbs losses first, debt is most senior and absorbs losses last, and preferred stock is in between. As investors in preferred securities, we know we are near the bottom of the capital stack and near the front of the line when it comes to absorbing losses. That's why we are so focused on creditworthiness and common equity capital.

Under current U.S. bank capital regulations, non-common-equity Tier 1 capital, or "Additional Tier 1" (AT1) capital, is principally comprised of traditional, noncumulative perpetual preferred stock. In Europe (including the United Kingdom and Switzerland), AT1 capital comes in a different flavor: contingent convertible securities, or "CoCos." These securities can convert to common equity, or in some cases be written off entirely, if an issuing bank falls below certain regulatory capital thresholds.

Although there are important differences among these securities, they perform the same role in the capital structures of issuing companies: absorbing losses, especially at the point when a bank faces failure—the so-called "point of non-viability." CoCos get their name from the fact that they can be converted

---

<sup>3</sup> The banks sampled are: Bank of America Corp., BB&T Corp., Capital One Financial Corp., Citigroup Inc., Goldman Sachs Group Inc., JPMorgan Chase & Co., Morgan Stanley, PNC Financial Services Group, U.S. Bancorp and Wells Fargo & Company.



to equity under certain contingencies. A key trigger for conversion would be if a bank's common equity Tier 1 capital (CET1) falls below a specified threshold. Each CoCo's prospectus lays out what happens if a trigger is breached. They can be very complex, but generally fall into one of three types: (1) convert to common equity at a pre-specified price; (2) write-down with recovery rights; and (3) permanent write-down with no recovery rights.

If its conversion trigger were set high enough, a CoCo could provide a bank with "going-concern" capital; that is, it could convert to equity at a point when an issuer needs some incremental capital to remain healthy but is not at risk of failure. Most CoCos issued to date, however, have triggers (generally 5.125% CET1) that are at or below regulatory minimums for those institutions. As "gone concern" capital, they are designed to absorb losses at a bank's point of non-viability (i.e., when regulators would step in to liquidate the bank holding company), not to help it get back on its feet.

U.S. bank preferred stock performs a practically identical loss-absorption role as CoCos, and we see more similarities than differences in these securities. They both provide a little bit of *going-concern* loss-absorption in that dividends can be skipped. And they both provide a lot of *gone-concern* loss-absorption through equity conversion or cancellation—at a point when prospects for recovery are dim. These are risks we already evaluate when investing in U.S. bank preferred securities. CoCos add some new bells and whistles, but they are still preferreds to us.

At least for now, it is worth noting that U.S. banks are much closer to meeting fully phased-in CET1 requirements than most foreign banks. This means that currently there is more common equity supporting U.S. banks' preferred stock than European banks' CoCos. This is especially true when compared on a non-risk-weighted basis (so-called leverage ratio). Some might argue capital strength doesn't matter at this favorable point in the credit cycle, but we think that would be a short-sighted approach to evaluating *perpetual* capital instruments.

The Fund currently has no investments in CoCos but we think of them as an extension of the preferred market and an eligible investment for the Fund. There are still many open questions on bank resolution authority and how regulators will exercise it. As we gain a better understanding of both foreign and U.S. bank resolution regimes and conversion/write-down terms and conditions, we may determine CoCos are suitable investments for the portfolio. One thing is certain: CoCos will be a growing part of the preferred securities market over coming years as European banks refinance older non-compliant issues and raise additional capital.