

FLAHERTY & CRUMRINE PREFERRED INCOME OPPORTUNITY FUND

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

The preferred market didn’t miss a beat in the third fiscal quarter¹, continuing where it left off second quarter with additional positive returns. Total return² on net asset value (“NAV”) was 6.0% for the quarter, bringing the total return for the first nine months of fiscal 2016 to 10.7%. Total return on market price over the same periods was 4.6% and 20.7%, respectively.

Tailwinds described earlier in the year continued unabated during the most recent quarter. Monetary policy globally was very accommodative; supply of new preferred securities was subdued; “legacy” (those losing regulatory-capital treatment) and higher-coupon preferred securities were redeemed at a healthy pace; and credit quality remained strong. Preferred securities offered yield to investors struggling to find it in other places, which resulted in strong demand and higher prices for the asset class.

There is a direct inverse relationship in fixed-income securities (including preferreds) between price and yield, and higher prices this year have led to much lower coupons for newly-issued preferred securities. Many new issues during the quarter yield in the range of 4.5%—5.5%, which in many cases is lower than early-2016 levels by almost 1.0%. These lower yields on preferreds were the result of lower overall interest rates (Treasuries and Swap Rates) and tighter spreads. Many issuers have taken advantage of persistently-low rates and positive market sentiment to refinance higher-coupon securities.

Although U.S. interest rates remain very low, the short end of the curve (notably T-bills and LIBOR) has moved higher in recent months as investors begin to factor in additional rate hikes by the Federal Reserve. The Federal Open Market Committee passed on a rate hike at its meeting on September 21, however, so markets continue to wrestle with predicting a future path of increases. Higher levels of 3-month LIBOR have resulted in higher leverage costs for the Fund, and future changes in this reference rate will be highly correlated to Federal Reserve rate changes. Although leverage still adds substantial incremental net income for the Fund, we expect that to decline modestly over time as borrowing costs rise.

We continue to see value in preferred securities, although security selection has become more challenging as yields have moved lower and older, higher-coupon issues have been refinanced. Flows into the preferred market (via mutual funds, exchange-traded funds (ETFs), asset managers, and retail investors) have been very strong for many years. If anything gives us pause, it is more this level of inflow than current valuations. ETFs that invest in preferreds have become very large relative to their target market segment (\$25-par listed securities), and it isn’t clear where the outer limits are located. We know ETFs have been a source of volatility in the past (or opportunity, depending on one’s viewpoint), and we expect they could be again in the future. Preferreds should benefit from continued strong credit quality, reliably earning coupons—many of them tax-advantaged—over time. However, at current levels they are potentially more sensitive to changes in market sentiment than they were six months ago.

¹ June 1, 2016—August 31, 2016

² Following the methodology required by the Securities and Exchange Commission, total return assumes dividend reinvestment.

As always, we encourage you to visit the Fund's website, www.preferredincome.com for timely and important information.

Sincerely,

The Flaherty & Crumrine Portfolio Management Team

September 30, 2016