

## *FLAHERTY & CRUMRINE PREFERRED INCOME OPPORTUNITY FUND*

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

Fiscal 2017 has been a very good year for preferred securities, and the third fiscal quarter<sup>1</sup> continued in stride. Total return<sup>2</sup> on net asset value (“NAV”) was 3.1% for the quarter, bringing total return for the first nine months of fiscal 2017 to 15.7%. Total return on market price over the same periods was -0.9% and 19.4%, respectively.

Credit conditions continue to provide a supportive backdrop for yields and spreads, as most issuers of preferreds maintain strong balance sheets. Bank payout ratios (common stock dividends plus share buybacks) are now averaging at or above 100% of current earnings, which means, as a group, banks are no longer adding to their common equity layer of capital. Normally, this could be cause for concern – but given years of balance-sheet strengthening since the financial crisis, these payout ratios are comfortably supported.

Political headlines of all flavors remain omnipresent, including topics such as healthcare reform, tax reform, immigration, and North Korea. Equity and fixed-income markets, however, have largely ignored a lack of near-term progress on these issues and focused on potential for positive economic developments – notably lower taxes and regulatory reform. There are winners and losers in all policy decisions, but markets are pricing in some upside from lower tax rates and reduced regulatory burdens.

Away from these headlines, we have been living in a low-volatility financial environment for quite some time, which has been positive for spreads of most fixed-income products. Mid- to longer-term interest rates generally fell during the quarter, although rates have remained relatively range-bound in recent years. For example, the constant-maturity 10-year Treasury yield, currently around 2.3%, has been within about 0.75% of today’s rate since mid-2011. The economy continues to expand moderately with few signs of higher inflation. As a result, the Federal Reserve is moving very deliberately in removing accommodative monetary policy. The Fed last hiked the federal funds rate in June and has another 0.25% hike penciled in for December. In October, it will begin scaling back reinvestment of Treasury and mortgage-backed securities acquired in the wake of the financial crisis. Although we expect markets will take unwinding of “quantitative easing” in stride, the Fed will be the first major central bank to shrink its balance sheet, and this is a new source of market uncertainty.

Financial regulators in the United Kingdom announced that London banks will no longer be required to submit quotes for LIBOR (London interbank offered rate) after December 31, 2021. Since LIBOR is a reference rate for trillions of dollars of financial instruments – including many floating and fixed-to-floating rate preferred securities – it will be critical to find an alternative benchmark reference rate for instruments continuing past 2021. The Federal Reserve assigned the Alternative Reference Rate Committee (ARRC) to work on a transition from U.S. Dollar LIBOR to a new benchmark reference rate, and they have already identified viable alternatives. Once an alternative is finalized, transition to a new benchmark reference rate will be complicated by the sheer number of instruments involved and mechanics of a change. This process will take time, but we believe market participants have a large incentive to get it right.

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<sup>1</sup> June 1, 2017—August 31, 2017

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

One of the best places to find total return this quarter was in the primary market. New issue supply has been limited all year, and redemptions of higher-coupon preferred securities have continued at a healthy pace. Many offerings were met with strong demand that exceeded deal size, which in turn pushed prices up. This robust primary market also boosted secondary markets, as prices adjusted to reflect new-issue clearing levels.

During the quarter, a modest drop in interest rates helped lower-coupon securities outperform higher-coupon securities at the margin. Like last quarter, it is difficult to identify laggards in the portfolio this year. Performance lag has been relative return – not absolute negative return – in most cases – typically a result of call (redemption) features embedded in most preferreds. As a security moves above its call price, the call option limits further upside potential as rates or spread move lower. Investors continue to earn coupons, many of which are tax-advantaged, but price increases become more limited.

Looking forward, returns should come mostly from the coupons on securities as the pace of price gains tapers off or even reverses. Compared to fixed-income alternatives, however, preferred securities continue to offer value. Market volatility could increase, and economic or credit conditions could change – which may cause spreads to widen – but we believe preferreds' combination of credit quality and yield will be difficult to replace in other fixed-income asset classes.

As always, we encourage you to visit the Fund's website, [www.preferredincome.com](http://www.preferredincome.com), for important information.

Sincerely,

The Flaherty & Crumrine Portfolio Management Team

September 30, 2017