

## FLAHERTY & CRUMRINE PREFERRED INCOME OPPORTUNITY FUND

To the Shareholders of Flaherty & Crumrine Preferred Income Opportunity Fund:

Fiscal 2012 concluded with positive returns—total return on net asset value<sup>1</sup> for the final fiscal quarter<sup>2</sup> was +5.7%. Over the full fiscal year, return on NAV was +29.7%. Since the Fund's inception almost 21 years ago, the average annual return is +9.4%. The table below puts these numbers in context, comparing the Fund to two broad indices, one for equities and one for bonds. In the discussion section below, we dig deeper into performance; hopefully, investors will come away with a clear understanding of the factors underlying the numbers as well as our outlook for the months ahead.

### TOTAL RETURN ON NET ASSET VALUE FOR PERIODS ENDED NOVEMBER 30, 2012

	Actual Returns			Average Annualized Returns			
	Three Months	Six Months	One Year	Three Years	Five Years	Ten Years	Life of Fund <sup>(1)</sup>
Flaherty & Crumrine Preferred Income Opportunity Fund . . . . .	5.7%	13.7%	29.7%	22.1%	12.2%	9.1%	9.4%
Barclays Capital U.S. Aggregate Index <sup>(2)</sup> . . .	0.5%	2.0%	5.5%	5.7%	6.0%	5.4%	6.5%
S&P 500 Index <sup>(3)</sup> . . . . .	1.3%	9.3%	16.1%	11.2%	1.3%	6.4%	8.2%

(1) Since inception on February 13, 1992.

(2) The Barclays Capital 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 the 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.*

We encourage shareholders with long-term investment horizons to focus on performance on net asset value; we also realize performance based on the market price of Fund shares is important. During the fiscal quarter the return based on income plus change in the Fund's market price was -1.4%. For the fiscal year, this measure was +19.5%.

On December 10, 2012 the Fund announced it would make a special year-end distribution of \$0.1165 per share (in addition to the regular December dividend). The special year-end dividend results from the Fund earning slightly more than we anticipated during the past year.

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

<sup>2</sup> September 1, 2012—November 30, 2012

At the same time, the Fund announced a small decrease in the monthly distribution to be paid to shareholders. The new rate, \$0.073 per share, is 3.3% lower than the previous amount. As readers may recall, we have cautioned that a decline in the dividend was inevitable as some of the higher-yielding securities in the Fund's portfolio are redeemed and replaced with lower-yielding securities. The relatively small reduction is evidence that so far, we have been able to manage the redemption trend with some success. A more comprehensive discussion about the Fund's dividends can be found in the section following this letter.

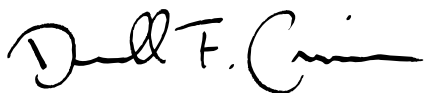
At this time last year, we were writing with a measure of concern over the outlook for financial markets and world economies. Since then, European economies have been mired in recession, and the United States has marched steadfastly toward its own fiscal cliff. Political leaders around the world have yet to deal decisively with their economic problems, but they have made some progress. We also witnessed several natural catastrophes, most notably super storm Sandy.

Despite this ominous backdrop, the market for preferred securities is in fine shape. The financial condition of the U.S. banking industry has improved significantly; in most instances, banks now have more capital and greater transparency than at any time we can recall. Property and casualty insurance companies easily withstood the impact of major catastrophes thanks to disciplined underwriting and conservative capital levels. Even life insurance companies, under pressure from low interest rates, have generally managed to produce consistently good earnings.

Demand for preferred securities is strong as evidenced by a gradual decline in coupon rates on new issues. The pace of issuance has been steady, and the variety of issuers and structures have kept us on our toes. We anticipate issuers will continue to raise new preferred capital for the foreseeable future. Much new issuance has been to replace older and more expensive issues. Conversely, some issuers have redeemed preferred securities without issuing replacements. As a result, the size of the preferred market has shrunk modestly.

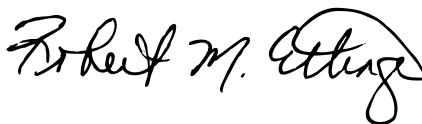
It's not in our nature to be cheerful, so despite a very cheery 2012, we plan to approach the new year as we always do—with healthy levels of vigilance and skepticism. In the section below, we dig deeper into topics mentioned here as well as others important to shareholders. In addition, we encourage you to visit the Fund's website, [www.preferredincome.com](http://www.preferredincome.com) for timely and important information.

Sincerely,



Donald F. Crumrine  
Chairman

December 31, 2012



Robert M. Ettinger  
President

## DISCUSSION TOPICS

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

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

#### Components of PFO's Total Return on NAV for the Fiscal Year Ended November 30, 2012

	<i>Six Months*</i>	<i>One Year</i>
Total Return on Unleveraged Securities Portfolio (including principal change and income) . . . . .	9.8%	20.9%
Return from Interest Rate Hedging Strategy . . . . .	N/A	N/A
Impact of Leverage (including leverage expense) . . . . .	4.7%	10.2%
Expenses (excluding leverage expense) . . . . .	-0.7%	-1.4%
<i>Total Return on NAV</i>	<b>13.8%</b>	<b>29.7%</b>

\* Actual, not annualized.

For comparison, the following table displays returns over the same time periods on three indices compiled by Bank of America Merrill Lynch, reflecting various segments of the preferred market. Because the 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 Periods Ended November 30, 2012

	<i>Six Months</i>	<i>One Year</i>
BofA Merrill Lynch 8% Capped DRD Preferred Stock Index <sup>SM</sup> . . . . .	5.7%	12.5%
BofA Merrill Lynch 8% Capped Hybrid Preferred Securities Index <sup>SM</sup> . . . . .	4.7%	12.4%
BofA Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index <sup>SM</sup> . . . . .	10.1%	19.4%

\* The Bank of America Merrill Lynch 8% Capped DRD Preferred Stock 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 8% Capped Hybrid Preferred Securities 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 8% Capped Corporate U.S. Capital Securities 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.

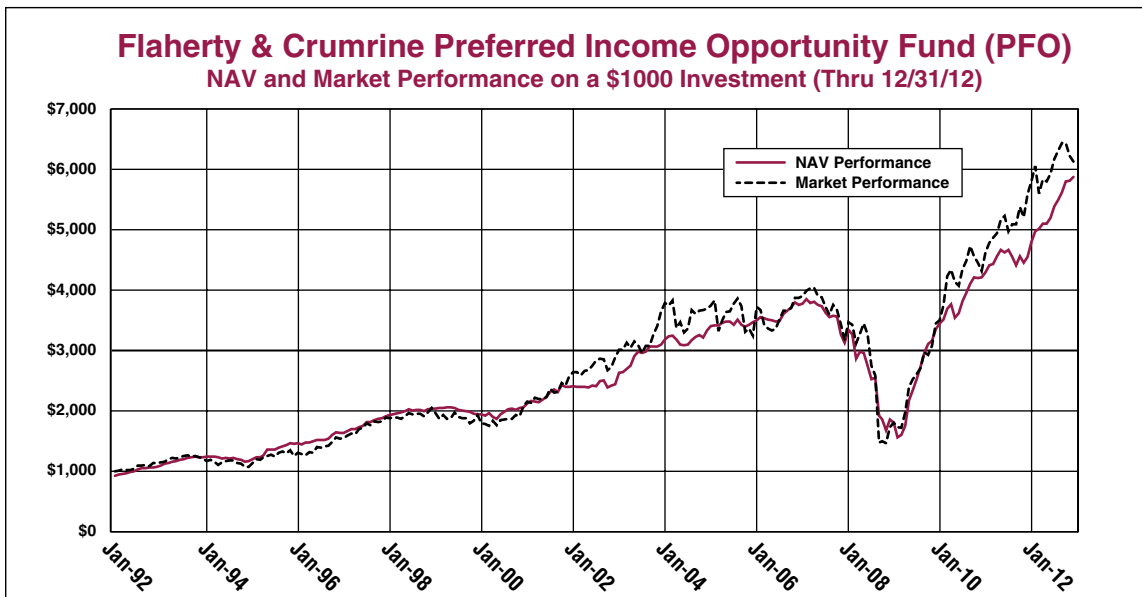
Over the past six-month and one-year time periods, the Fund's (unleveraged) securities portfolio has either beaten or modestly underperformed each of the three indices shown above.

During fiscal 2012, the Fund's total return on NAV significantly exceeded the returns on the indices, aided by the Fund's use of leverage. While leverage can reduce returns during periods of adverse market conditions, during the recent fiscal year the Fund's use of leverage enhanced both income distributed by the Fund and its total return over the period.

## 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 its *market price*. During the twelve month period ending November 30, 2012, total return on market price of Fund shares was +19.5%.

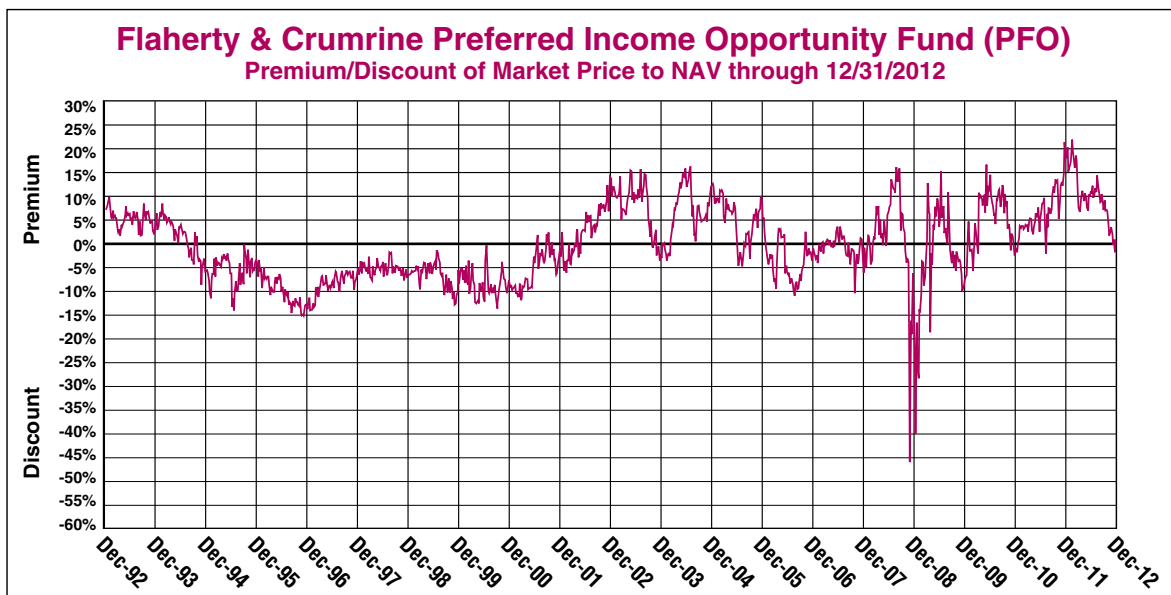
Historically, the preferred securities market has experienced price volatility consistent with those of fixed income securities. However, since mid-2007 it has become clear that preferred security valuations, including both Fund NAV and market price of its shares, can move dramatically when there is volatility in stock prices. The chart below contrasts the relative stability of the Fund's earlier period with the more recent decline and recovery in both its NAV and market price, during and following the "Great Recession."



The decline and recovery in their valuations over this period was not unique to preferred securities. Virtually all fixed-income asset classes, excluding U.S. Treasury securities, experienced some volatility during this period. However, both the market price and NAV of the Fund have recovered sufficiently that long-term shareholders have experienced returns consistent with those received prior to 2007.

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, the resulting premium or discount of the Fund, calculated as the difference between these two inputs and expressed as a percentage, would remain relatively close to zero. However, as can be seen from the chart on page 5, over the life of the Fund this often has not been the case, and since 2010 the market price of Fund shares has typically traded at a premium to NAV. The Fund began fiscal 2012 with its market price at a significant premium to NAV. By the end of fiscal 2012 this premium had contracted considerably, and, as a result, the total return earned on market price, while still impressive, trailed the total return on NAV shown in the table on page 3.

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 over time.



Based on a closing price of \$11.22 on December 31<sup>st</sup>, the current annualized yield on market price of Fund shares (assuming its new current monthly distribution of \$0.073 does not change) is 7.81%.

### Monthly Distributions to Fund Shareholders

The Fund makes monthly distributions of income to shareholders consistent with its primary objective of providing high current income. The Fund earns its income both by investing its shareholder capital in income-producing securities, such as preferred securities, and employing leverage by borrowing additional money to invest in more income-producing securities.

This use of leverage is important in the Fund's strategy for producing high current income. Over time, the cost of leverage tends to be lower than the yield on the Fund's portfolio. The difference between what the Fund earns on its investments and pays on the borrowed money increases income available to common shareholders.

A lot of good things happened in 2012 that added to the success of this strategy and resulted in extra income being available for common shareholders at year end. For calendar year 2012, total distributions to shareholders (including the special distribution in December) were 12.6% higher than the sum of ordinary monthly distributions during the year. Although interest rates across the entire yield curve have declined in recent years, the Fund has held securities with coupons above current market levels. Income the Fund was earning continued to benefit from those higher-coupon securities. At the same time, the Fund's cost of leverage continued to move lower (1.09% as of this writing), as it is tied to the level of 3-Month LIBOR. We have also had an opportunity over the past couple of years to adjust the terms of the leverage to be more

favorable in both cost and flexibility. Lastly, the Fund received income from a bankruptcy settlement late in the year that added to December's special distribution.

We have written over the past year about the impact of changes in the regulatory environment (e.g., Dodd-Frank, Basel III), sustained low levels of interest rates, and the transition in the preferred securities market to more traditional preferred stock (versus trust preferred securities). The Fund has already completed much of the reinvestment related to Dodd-Frank redemptions of bank trust preferreds, with only about 3.5% of the portfolio remaining in bank trust preferreds that are still subject to early redemption. We do expect issuers to continue to refinance higher-coupon securities, even beyond bank trust preferreds, given the low absolute level of interest rates.

In determining the new monthly dividend announced in December, we have looked out over the next year and anticipated necessary reinvestment. We expect that leverage costs will remain low, given our outlook for the economy and guidance from the Federal Reserve. As such, we hope that current monthly dividends can be sustained through the fiscal year, consistent with our belief that shareholders are better served by stable monthly distributions than by distributions that change from month-to-month. As we have cautioned before, however, it is important not to confuse "stable dividend" with "constant dividend." When it comes to distributions, there is no such thing as "forever."

The two primary factors that could alter this course are greater-than-expected declines in top-line portfolio income, and increases in the cost of leverage from these historically-low levels. Both are probably inevitable, but we believe they are not likely to happen at exactly the same time and, in both cases, the pace should be gradual. We also believe preferred securities offer attractive total returns currently and that the Fund will continue to offer a competitive distribution rate.

### **Preferred Market Conditions**

Conditions in the market for preferred securities<sup>1</sup> are very positive. In our view the market is healthier than any time in recent memory. Slow economic growth in the U.S., uncertainty about the fiscal cliff, and the ongoing debt problems in Europe, have steered more investors to preferred securities. The sector offers some of the highest yields in the fixed income universe, and recently prices have been much less volatile than for common stocks.

Two important trends, *refinancing of high cost issues* and *par redemptions of bank trust preferred securities* continue to impact the market. These have been in motion for several years and we have discussed them often in the past.

Briefly, by *refinancing*, issuers take advantage of the current low interest-rate environment to redeem outstanding preferred securities, replacing them with less expensive new issues. Of course, for investors the impact is a decline in investment income.

The pace of *par redemptions of bank trust preferred securities* is winding down. Made possible by provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, these redemptions have resulted in a meaningful reduction in the size of the market.

In 2012, we saw \$68 billion of preferred securities redeemed<sup>2</sup> by issuers (this does not include purchases made by issuers in the open market, a harder number to calculate). Of this amount, \$44 billion or 64% is attributable to regulatory change. The balance (\$24 billion or 36%) were calls made to remove higher coupon issues and may or may not have been replaced.

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<sup>1</sup> For our purposes, the market is defined to include deeply subordinated debt and preferred stock denominated in US dollars.

<sup>2</sup> A portion of these were announced in 2012 to be redeemed in 2013.

Investors eagerly bought most new issues throughout the year. A total of \$57 billion from 127 issuers was added to the market in 2012. The numbers breakdown as follows:

Bank .....	31%	Retail .....	71%
Insurance .....	22%	Institutional .....	29%
REIT .....	20%		
Finance .....	14%	Domestic .....	85%
Miscellaneous .....	5%	Foreign .....	15%
Utility .....	5%		
Communications .....	2%	QDI Eligible .....	45%
Energy .....	1%	Fully Taxable .....	55%

A vibrant market for new issues helps overall market liquidity, a key barometer of market health. The number of market participants, including market makers and end-users, appears to be growing. We expect the level of activity in preferred markets to remain strong in 2013 to the benefit of almost everyone in the space.

### **Preferreds' Performance in Periods of Market Stress**

After taking a shellacking during the financial crisis, preferred securities have posted stellar returns over the past three years, pushing yields on most new issues down to a 5-6% range. What should investors expect going forward?

Investors need to remember that preferred securities have characteristics of both equity and debt securities. In times of economic or financial stress, preferreds' equity-like characteristics come to the fore. Issuers can defer—or for noncumulative issues, skip—dividends. In addition, prices of preferred securities can drop sharply, reflecting higher probability of issuer default or regulatory seizure during a period of stress. Regulatory changes have made preferred securities more explicitly loss-absorbing and equity-like. In short, investors should expect that in the future preferred securities will absorb losses if and when issuing companies come under significant financial strain. At the same time, preferred securities pay fixed- or floating-rate dividends that do not increase as an issuer's earnings or capital rise (although they improve prospects that an issuer will make full and timely payment of those dividends). This means that, when held to redemption, investors earn, at most, the dividend yield on that security, plus or minus the difference between the purchase and redemption price of the issue; upside is limited. Of course, active management of preferred securities can add (or subtract) return over time, but when the market is trading near par value, as it is now, dividend yield is the primary driver of prospective returns.

Applying those notions to preferred securities in today's market, we anticipate "dividend plus a bit" returns over the next year or two. The U.S. economy is growing moderately, inflation is low, and monetary policy is accommodative; interest rates are likely to remain low. Credit quality continues to improve; problem loans are falling, housing is recovering, and household balance sheets are improving. Europe is making tentative progress toward resolving its sovereign debt crisis. Banking regulation is driving higher common equity capital and lower risk. Add it up, and we foresee low risk of a sharp, widespread drop in preferred securities' prices. Meanwhile, preferred securities' yields remain attractive relative to other fixed-income alternatives, and there is reason for their prices to move modestly higher. We do not anticipate a repeat of recent double-digit returns, simply because starting yields are lower and the market is no longer trading at a discount to par.

In a low-return world, investors should welcome the yields offered by preferred securities today. But investors need to understand the downside risks presented by preferreds' equity-like features, even if those risks appear remote for now.

### **Changes to Fund Industry Concentration Policy**

On April 19, 2012 Fund shareholders approved a change in Fund concentration policy so that under normal market conditions it will invest at least 25% of its total assets in the financial sector. Formerly, under normal conditions the Fund invested at least 25% of its total assets in the utilities industry and at least 25% of its total assets in the banking industry. The change was recommended because utility issues now comprise a much smaller part of the preferred universe, and financials a much larger part, than when the Fund was formed.

The new concentration policy requires the Fund to invest, under normal market conditions, at least 25% of its total assets in the financial sector, which for this purpose is comprised of the banking, thrifts & mortgage finance, diversified financial services, finance, consumer finance, capital markets, asset management & custody, investment banking & brokerage, insurance, insurance brokers and real estate investment trust (REIT) industries. From time to time, the Fund may have 25% or more of its total assets invested in any one of these industries.

The Fund now has flexibility to go above or below 25% in any one type of company in the financial sector as long as at least 25% of its total assets is invested in the financial sector in aggregate. For example, the Fund could have more than 25% of its total assets in insurance companies, while at other times it could have that portion invested in banks. At all times, though, the Fund would have at least 25% of its total assets invested in the financial sector.

### **Status of the Fund's Hedging Strategy**

The Fund suspended its interest rate hedging program as the financial crisis intensified in the autumn of 2008. There were three principal reasons why the Fund stopped hedging the long-term interest-rate risk of its portfolio. First, the relationship between preferred securities' prices and Fund hedging instruments (Treasury bond futures, interest rate swaps, or options on both) broke down during the financial crisis, and hedging lost its effectiveness. Second, the cost of hedging rose dramatically, as the yield curve steepened, volatility increased, and options prices rose. Finally, preferred securities became exceptionally cheaper and were likely to offer attractive returns to shareholders even if long-term Treasury yields increased. We believed hedging simply would not work under these market conditions.

Today, the correlation between preferred securities and our hedge instruments has improved, but it remains both weaker and significantly less stable than historic norms. We will continue to evaluate market conditions and the composition of the Fund's portfolio, and we may reinstate the hedge if we judge that conditions warrant it.

### **Federal Tax Advantages of 2012 Calendar Year Distributions**

In 2012, the Fund passed on a portion of its income to individuals in the form of qualified dividend income, or QDI. Under federal law for 2012, QDI was taxed at a minimum of 0% and a maximum 15% rate instead of an individual's ordinary income tax rate.

In calendar year 2012, approximately 49.4% of distributions made by the Fund was eligible for QDI treatment. For an individual in the 28% marginal tax bracket, this means that the Fund's total distributions will only be taxed at a blended 21.7% 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, such an individual who held 100 shares of Common Stock of the Fund for the calendar year would have had to receive approximately \$98.32 in distributions from a fully-taxable bond fund to net the same after-tax amount as the \$90.35 distributions paid by the Fund.

For detailed information about tax treatment of 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 20.7% distributions that were eligible for the inter-corporate dividends received deduction, or DRD.

It is important to remember that composition of the portfolio and income distributions can change from one year to the next, and that the QDI or DRD portions of 2013's distributions may not be the same (or even similar) to 2012. In addition, the maximum QDI tax rate is increasing in 2013 from 15% to 20% for certain high-income individuals.