

## FLAHERTY & CRUMRINE PREFERRED INCOME OPPORTUNITY FUND

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

As can be seen in the table below, the net asset value of the Fund rose substantially during the most recent fiscal quarter. A variety of factors contributed to the strength and, despite a dramatic recovery in the prices of preferred securities, we believe the sector remains undervalued relative to other market segments.

### TOTAL RETURN ON NET ASSET VALUE<sup>(1)</sup> FOR PERIODS ENDED MAY 31, 2009

	Actual Returns			Average Annualized Returns			
	Three Months	Six Months	One Year	Three Years	Five Years	Ten Years	Life of Fund <sup>(2)</sup>
Flaherty & Crumrine Preferred Income Opportunity Fund . . . . .	39.7%	29.6%	-26.4%	-14.6%	-6.8%	0.6%	5.1%
Lipper Domestic Investment Grade Funds <sup>(3)</sup> . . . . .	10.9%	13.5%	-5.9%	1.1%	2.6%	4.7%	5.8%

(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 in the footnotes to the financial statements.

(2) Since inception on February 13, 1992.

(3) Reflects the equally-weighted average performance returns of all closed-end funds in Lipper's Domestic Investment-Grade funds category in each month during the period. The category currently includes closed-end funds in the U.S. Mortgage and Corporate Debt BBB Rated sub-categories and has included other sub-categories in prior periods. 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.

After several quarters of sharply declining prices, the preferred market was poised for a rebound. But even with eye-popping appreciation over the past few months, prices on the vast majority of preferred securities remain well below the highs of last year.

The state of the market appeared to hit rock bottom in early March, when the financial system was rumored to be on the brink of collapse. Since that time cooler heads have prevailed and the rumors appear to have been greatly exaggerated. Many financial companies have taken steps to strengthen their balance sheets and a few have already returned funds received from the government for emergency assistance.

We have recently watched with fascination the stunning reversal of a long-term trend. Over the past decade, large and mid-sized financial companies in need of new capital often chose to issue preferred and hybrid securities rather than sell common stock. This strategy seemed to satisfy both their common shareholders and regulators; investors, including PFO, became quite comfortable purchasing these securities. Hundreds of billions of dollars of this "senior equity" has been issued. Recently (and dramatically), the emphasis has flip-flopped, and many financial companies have been taking steps to replace preferred securities with common stock, or have simply sold additional common stock.

These steps are very beneficial to owners of preferred securities and have been the main driver of the recent recovery in preferred prices. Prices have improved as issuers typically pay above-market levels in order to exchange a sufficient amount of preferred securities for common stock. The credit quality of preferred securities that remain outstanding improves because common stock ranks junior to preferred securities, so the more common stock a company has outstanding (relative to preferred), the greater the protection against adversity. This trend is important to the Fund, so we've posted a more detailed discussion in the "Discussion Topics" below.

The Fund's holdings in financial issuers (mostly banks and insurance companies) were responsible for much of its poor performance over the past year, and they were the primary contributors to its positive performance over this past quarter. The extraordinary steps taken by the various federal government entities appear to be helping, but the ultimate recovery of the financial sector will hinge on a broad economic recovery. We discuss the economic outlook on the Fund's website, [www.preferredincome.com](http://www.preferredincome.com).

We don't want to neglect the non-financial portion of the portfolio, but for most of these holdings things have been blissfully uneventful for some time. The Fund is required to maintain at least 25% of the portfolio in the utility industry, but since the industry comprises only 5% of the entire preferred universe, we tend to have greater concentrations in certain credits. By overweighting utilities, the Fund outperformed the broader preferred market when financials were collapsing, but it also meant the Fund underperformed during the past quarter. All things considered, however, utilities have been a good thing to own.

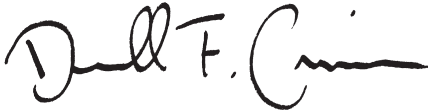
Unfortunately, the Fund does have a few investments in companies that have stopped making dividend or interest payments on their securities. These positions are identified in the portfolio listing as "non-income producing". The prices of these securities have declined to reflect the market consensus on the outlook for the issuers, and thus are fully reflected in the net asset value of the Fund. In addition, as discussed below, we take these situations into consideration when determining the amount of the Fund's monthly distribution to shareholders.

The Fund is undergoing an important change unrelated to the preferred markets just discussed – after months of hard work and negotiations, the Fund has secured new financing which is being used to redeem all remaining shares of its auction preferred stock (APS). As discussed previously, the auction market ceased functioning early last year and ever since we have been working to secure a suitable replacement. With the demise of the auction market, we determined the most efficient alternative is a committed financing agreement with a bank (a fancy term for a loan), but before we could proceed there were obstacles which had to be overcome. In recent days, the last of these were addressed and the new loan was secured.

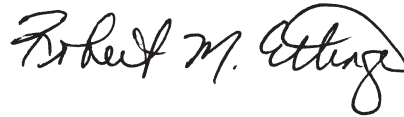
Replacing APS with bank debt should benefit the Fund in several ways. Initially, and we expect over the long run, the bank loan will be less expensive than the APS. This will especially be true if (and when) short term interest rates increase. In addition, we should have greater flexibility managing assets of the Fund, and while we don't envision doing anything differently from the way we do things now, there are likely to be instances when the additional flexibility will be important.

More information is always available on the Fund's website, including discussion of many of the topics in this letter. This calendar year, we have written about preferred securities valuations, the Citicorp exchange offer, the U.S. government's Capital Assistance Plan, the results of the "stress tests" of key financial institutions and, most recently, our interest rate hedging strategy. We encourage you to visit the website at [www.preferredincome.com](http://www.preferredincome.com).

Sincerely,

A handwritten signature in black ink, appearing to read "Donald F. Crumrine". The signature is fluid and cursive, with a large initial "D" and a long, sweeping tail.

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 initial "R" and a circular flourish at the end.

Robert M. Ettinger  
President

July 20, 2009

## DISCUSSION TOPICS

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

As the table below demonstrates, the preferred market performed very well during the first six months of the Fund's fiscal year ending May 31<sup>st</sup>, although the recovery didn't actually begin until early March. While no index comprehensively reflects the preferred market, Merrill Lynch publishes four 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 8% Capped Hybrid Preferred Securities Index (which includes fully-taxable, exchange-traded preferred securities); the Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index (which includes fully-taxable capital 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 total returns for these indices:

#### Total Returns of Merrill Lynch Preferred Securities Indices\* for the Six Months Ended May 31, 2009

Merrill Lynch 8% Capped DRD Preferred Stock Index <sup>SM</sup> .....	+3.8%
Merrill Lynch 8% Capped Hybrid Preferred Securities Index <sup>SM</sup> .....	+12.3%
Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index <sup>SM</sup> .....	+17.7%
Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index <sup>SM</sup> .....	+31.3%

\* The Merrill Lynch 8% Capped DRD Preferred Stock Index<sup>SM</sup> 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 Merrill Lynch 8% Capped Hybrid Preferred Securities Index<sup>SM</sup> 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 Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index<sup>SM</sup> 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%. The Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index<sup>SM</sup> 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, are unmanaged and do not reflect any expenses.

As the following table demonstrates, the Fund's total return on its securities portfolio (before leverage) outperformed these indices, with the exception of the Merrill index measuring adjustable rate preferreds. However, adjustable rate preferred securities constitute only approximately 3% of the entire preferred market, about the same weighting as these securities are held in the Fund. In contrast to the experience last year, the strategy of using leverage to increase current income has magnified the positive returns over the Fund's fiscal year-to-date, and, even net of its expenses, caused the NAV of the Fund to outperform these unleveraged indices (except for adjustable rate preferreds).

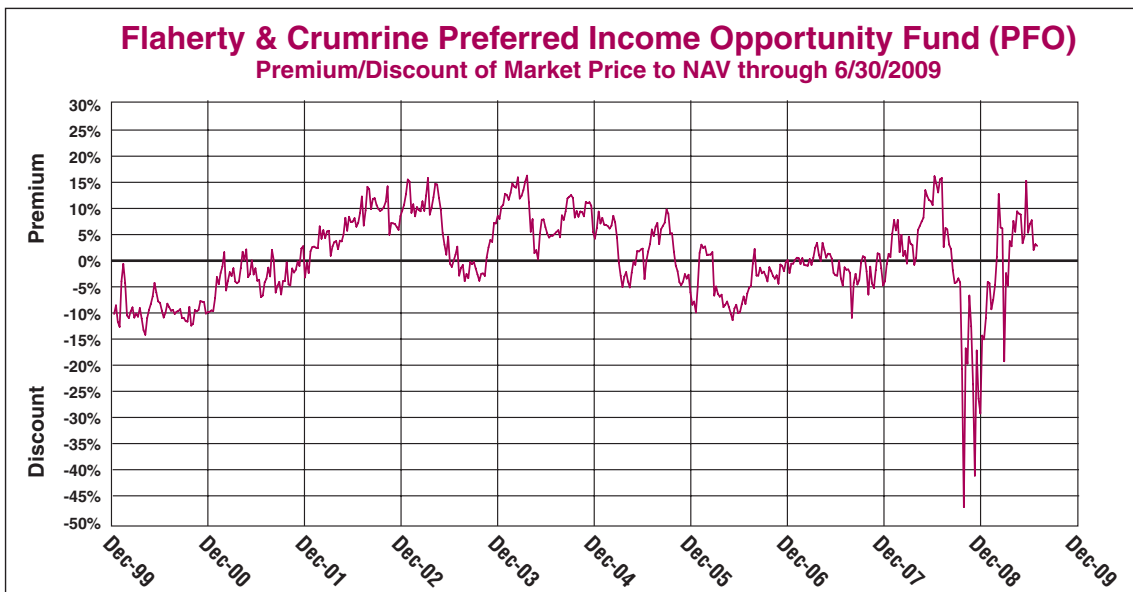
The table below reflects performance of each investment tool used by the Fund to achieve its objective, namely: (a) investing in a portfolio of securities; (b) hedging that portfolio of securities against significant increases in long-term interest rates (although no hedges were in place over the Fund's fiscal year-to-date (see the following discussion on interest rate hedging)); and (c) issuing auction-rate preferred stock to leverage and enhance returns to Common Stock shareholders. The table then adjusts for the impact of the Fund's operating expenses to arrive at a total return on NAV (which factors in all of these items).

**Components of PFO's Total Return on NAV  
for the Six Months Ended May 31, 2009**

Total Return on Unleveraged Securities Portfolio (including principal and income).....	+20.1%
Return from Interest Rate Hedging Strategy .....	0.0%
Impact of Leverage .....	+10.9%
Expenses .....	-1.4%
<i>Total Return on NAV</i>	
	+29.6%

**Total Return on Market Price of Fund Shares**

While our focus is primarily on managing the Fund's investment portfolio, an investor's actual return is comprised of monthly dividend payments plus changes in the Fund's market price. The improvement in investor psychology impacting valuation of the Fund's securities has also favorably affected the relationship between the intrinsic value of the Fund (its NAV) and its market price. Over the Fund's fiscal year-to-date through May 31<sup>st</sup>, the excellent return on NAV plus the market price discount to NAV transitioning to a premium combined to produce a total return on *market value* of +63.7%. During the 2<sup>nd</sup> fiscal quarter alone, total return on *market value* was +38.4%.



Even following the recovery over the past several months in both the Fund's NAV and market price, as of June 30<sup>th</sup> the Fund still returns a high current yield based on market price of 9.5%.

## **Monthly Distributions to Fund Shareholders**

The monthly distribution paid to shareholders is intended to reflect current market conditions, but we also must make assumptions about the future. We begin with an estimate of the sustainable income generated from the investment portfolio, and end with a forecast of expenses. While it sounds simple, in periods of rapid change, forecasting income and expenses becomes more art than science. There are always a lot of moving parts when the Fund sets the monthly distribution, and the present is no different.

With regard to income earned by the Fund, the financial crisis has claimed many victims and there are now a few holdings in the Fund's portfolio that are not presently making dividend or interest payments. These are identified as "non-income producing" in the portfolio listing that follows. If these companies are not able to resolve their present difficulties, they are unlikely to resume making distributions. We are monitoring these situations very closely and will make adjustments as necessary. Because these non-income producing holdings have already fallen in price to nominal values, the risk to NAV from holding them is minimal.

In addition, some distributions received by the Fund may be classified as "return of capital". This is an accounting concept that results when an issuer has sufficient funds to make dividend payments, but its retained earnings balance is less than the amount distributed. In such instances, the Fund receives payment, but it must be treated differently from other distributions by both the Fund and Fund shareholders.

On the plus side, we expect the steps being taken to replace auction preferred stock with a bank loan will reduce the expense incurred by the Fund on its leverage. Following is a discussion of the Fund's leverage. Terms of the bank loan are described in footnote 7 of the financial statements.

## **The Fund's Leverage**

As we've discussed in prior reports, collapse of the auction preferred stock market in February 2008 caused the Fund's outstanding auction preferred stock (APS) to reset at relatively high "maximum rates." As a result, the Fund has since sought reasonable alternatives to its use of auction preferred stock for leverage. Only recently has the Fund been able to overcome two significant hurdles to refinancing all its outstanding APS.

The Investment Company Act of 1940 presented the first hurdle for the Fund. The Investment Company Act only requires the Fund to have 200% asset coverage for its outstanding preferred stock. In other words, the Fund must have \$2 in assets for every \$1 of APS outstanding. For much of the Fund's history, it comfortably had preferred asset coverage well in excess of 200%. For debt, however, the Fund must have 300% asset coverage – \$3 in assets for every \$1 borrowed.

Unprecedented market conditions in the past year made it very difficult to maintain even 200% asset coverage, let alone the 300% for borrowed money. As a result, in October 2008, the Fund applied for exemptive relief from the Securities and Exchange Commission to allow it to use debt to refinance its then-outstanding APS that would only be subject to a 200% asset coverage requirement. After several revisions to the Fund's application, on June 1<sup>st</sup> the Fund finally received SEC exemptive relief that allows 200% asset coverage on this refinancing debt. Importantly, though, this relief only lasts until October 31, 2010. By that date, the Fund must have 300% asset coverage whenever it borrows money.

The other hurdle, of course, came from finding a loan on terms sufficiently reasonable to make sense for the Fund's common stock shareholders. Like any other borrower during the financial crisis, it took a little bit of time to obtain this financing. Happily, with the exemptive relief now in hand, on June 26<sup>th</sup>, the Fund was able to announce that it had secured this funding and that it could now redeem all outstanding APS.

The recent recovery in the Fund's portfolio has helped the Fund significantly improve its asset coverage. As of June 30<sup>th</sup>, the Fund's leverage had asset coverage of 299%. It is important to note that refinancing the Fund's source of leverage does not affect the dollar amount of leverage used by the Fund. In other words, leverage will continue to provide a similar impact (whether positive or negative) to the Fund's common shareholders as it has in prior periods.

## **Preferred Market Conditions**

The preferred securities market has recovered significantly over the past several months, as the financial market's concern about broad nationalization of the U.S. banking system has abated and the pace of economic deterioration has moderated. With preferred securities priced in early March for a much worse experience than existed during the Great Depression, even a difficult recession looked pretty good.

A critical factor in the preferred market's improvement has been a meaningful shift in the role of preferred stock and hybrid securities in the capital structure of banks and financial companies. We anticipate these changes will have a long-term positive impact on the preferred market, even though we may encounter further uncertainty before it all plays out.

Falling between debt and equity on a company's balance sheet, preferred securities have long been used as an effective way for companies to get some of the benefits of common equity without diluting the interests of their common stock shareholders. In the years leading up to the financial crisis, the portion of overall capital comprised of preferred securities increased substantially, often as a means to finance common stock repurchases. Compared to ten years ago, the balance sheet of a typical bank, insurance or finance company has become more skewed toward preferred securities and less toward common stock. This emphasis on preferred over common was supported by regulators and rating agencies alike. Preferred capital increased still further when the federal government decided to inject capital into troubled banks and insurance companies. (Although, while it did so through investment in preferred securities, these securities rank at a level *junior* to existing taxable preferreds and *pari passu* (or equal to) existing traditional preferred stocks.)

As we have discussed in recent letters, three factors – excess supply, deleveraging and credit deterioration – were primarily responsible for the steep drop in prices of preferred securities. But many preferred prices became so distressed that companies realized if they issued common stock and used the proceeds to *purchase* their own preferred securities at deep discounts to par, they could simultaneously reduce their dividend expense and increase their common equity ratio.

Some companies executed this recapitalization formally via public offers to exchange preferred shares into common stock, which directly adds to common equity. Other companies simply purchased preferred shares in the open market; the discount to par is booked as a gain, which adds to earnings and thus to common equity. In either event, these efforts were done at substantial premiums to the previously existing market prices for their preferreds, giving a major boost to the preferred market. In addition, by adding to common equity and reducing preferreds on the balance sheet, these companies improved the creditworthiness of their remaining preferred securities, which has aided investor confidence tremendously. As confidence has re-emerged, other investors have waded back in, reinforcing these higher preferred prices.

In another sign of life in the preferred market, a few new issues have been brought to market in recent weeks. The new deals have been structured to attract non-institutional investors (\$25 par value and listed on the NYSE), and have been met with healthy demand.

We still expect some bumps in the road. The economy remains weak and there are plenty of troubled loans to work out. In addition, although the preferred exchanges and buybacks have been beneficial for the market, virtually all of them have been done at discounts to par value. However, we think the crisis phase of the market has passed, and investors should begin to refocus on individual credits rather than worry about the solvency of the financial system as a whole.

### **Impact on the Fund of Rating Agency Downgrades of Preferred Securities**

As the financial crisis intensified, the three primary credit rating agencies – Moody's Investors Service, Standard and Poor's, and Fitch Ratings – downgraded many preferred securities, with some falling from investment grade to below investment grade. Not surprisingly, these downgrades have been concentrated among financial issuers, but utilities and other industries also have seen downgrades. Upgrades have been few and far between. In most cases, we agreed with the direction of the rating actions early in the crisis. Financial institutions faced unprecedented risks as the financial crisis unfolded, and those risks needed to be reflected in issuers' ratings, although we think preferred ratings were sometimes reduced to levels that were inconsistent with their senior and subordinated debt ratings. We have been more baffled by some recent downgrades, however, given brightening economic prospects, much improved money and credit markets, and strengthened capital positions at many (though not all) financial institutions.

Regardless of our own views, the rating agencies still matter in the management of the Fund, so it's worth taking a moment to understand how these rating actions affect it. First, and perhaps most obviously, the price of a preferred tends to fall, if only temporarily, when it is downgraded. This affects NAV, of course, but it also affects the Fund's leverage ratio. If many of the Fund's holdings decline in value, the Fund may (and at several points over the past nine months, did) need to sell securities in order to reduce leverage, typically resulting in a loss. Even if preferred prices subsequently recover, lower leverage means that NAV will not recover to the same extent.

Second, the Fund is required to meet certain asset coverage tests, and ratings determine how much of a security's market value may be used to cover fund liabilities. If a security is downgraded, especially if it is downgraded from investment grade to below investment grade, its coverage value generally decreases (even if its price does not). At a minimum, this reduces the "excess" coverage of the Fund. If enough securities are downgraded, the Fund may have to reduce borrowings, or sell lower-rated securities and buy higher-rated ones; both probably mean lower levels of income for the Fund. Of course, we try to manage the Fund to avoid that outcome, but downgrades definitely make it more difficult.

Finally, the Fund has an investment policy that limits holdings of securities without an investment grade rating by at least one agency to 25% of total assets. The Fund is not required to sell assets if downgrades push holdings above the limit, but it cannot add to such holdings until they are again below the limit. Historically, this has not been a significant constraint on the management of the Fund. Our focus is on investment-grade issuers, and most preferreds from these issuers were rated investment grade. Recent ratings actions have pushed many preferreds below investment grade at one or more rating agencies, even when the issuer's senior debt remains solidly investment grade. For example, Moody's rates Wells Fargo senior unsecured debt A1 but its preferred stock only Ba3, fully 8 notches lower. (This is one of those situations where we think the ratings are inconsistent: either Ba3 is too low for the preferreds or A1 is too high



for the senior debt.) If the rating agencies continue to downgrade preferreds, the limit on below investment grade holdings could prevent the Fund from buying securities that it believes are attractive, which could reduce income or total return going forward.

Although ratings actions have been overwhelmingly negative in recent quarters – and overdone in our view for many preferreds – we think the outlook is starting to improve, especially for financial institutions. As noted elsewhere in this letter, banks and insurance companies have raised a substantial amount of common equity capital over the past several months, both from common stock offerings and through preferred-to-common stock exchanges. Looking ahead, banks are going to hold thicker common equity cushions than they have historically. All of these things are positive for preferreds longer-term. While the Fund has a bit less maneuvering room than normal due to rating agency downgrades, we do not think those actions will have a substantial impact on the ability of the Fund to meet its objectives.

### **Change in Concentration Policy**

On April 21<sup>st</sup>, the Fund's shareholders approved a change in its concentration policy so that it will invest at least 25% of its total assets in each of the utilities industry and the financial services sector under normal market conditions. Formerly, the Fund invested more than 25% of its total assets in the utilities industry under normal market conditions and limited its investments in any other industry to 25%.

The new “financial services” concentration policy requires the Fund to invest, under normal market conditions, more than 25% of its assets in companies principally engaged in financial services. For purposes of this policy, a company is “principally engaged” in financial services if it derives at least 50% of its revenue from providing financial services. Companies in the financial services sector include: commercial banks, industrial banks, savings institutions, finance companies, diversified financial services companies, investment banking firms, securities brokerage houses, investment advisory companies, leasing companies, insurance companies and companies providing similar services.

The Fund now has the flexibility to go above or below 25% in any one type of financial services company as long as at least 25% is invested in financial services companies in the aggregate. For example, the Fund may 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 assets invested in financial services companies.

### ***THE FOLLOWING DESCRIBES RISKS ASSOCIATED WITH INVESTING IN THE FINANCIAL SERVICES SECTOR.***

U.S. and foreign laws and regulations require commercial banks and bank holding companies to maintain minimum levels of capital and liquidity and to establish loan loss reserves. A bank's failure to maintain specified capital ratios may trigger dividend restrictions, suspensions on payments on subordinated debt, and limitations on growth. Bank regulators have broad authority in these instances and can ultimately impose sanctions, including conservatorship or receivership, on such non-complying banks even when these banks continue to be solvent, thereby possibly resulting in the elimination of stockholders' equity. Unless a bank holding company has subsidiaries other than banks that generate substantial revenues, the holding company's cash flow and ability to declare dividends may be impaired severely by restrictions on the ability of its bank subsidiaries to declare dividends.

Similarly, U.S. and foreign laws and regulations require insurance companies to maintain minimum levels of capital and liquidity. An insurance company's failure to maintain these capital ratios may also trigger dividend restrictions, suspensions on payments of subordinated debt, and limitations on growth. Insurance regulators (at the state-level in the United States) have broad authority in these instances and can ultimately impose sanctions, including conservatorship or receivership, on such non-complying insurance companies even when these companies continue to be solvent, thereby possibly resulting in the elimination of shareholders' equity. In addition, insurance regulators have extensive authority in some categories of insurance of approving premium levels and setting required levels of underwriting.

Governmental fiscal and monetary policies and general economic and political conditions can affect the availability and cost of funds to financial services companies, loan demand and asset quality and thereby impact the earnings and financial condition of financial services companies. In addition, the enactment of new legislation and regulation, as well as changes in the interpretation and enforcement of existing laws and regulations, may directly affect the manner of operations and profitability of participants in the financial services sector. Downturns in a national, regional or local economy or in the general business cycle or depressed conditions in an industry, for example, may adversely affect the quality or volume of a bank's loan portfolio or an insurance company's investment portfolio, particularly if the portfolio is concentrated in the affected region, industry or market sector. From time to time, general economic conditions have adversely affected financial institutions' energy, agricultural, commercial and/or residential real estate, less-developed country, venture capital, technology, telecommunications, and highly-leveraged loan portfolios.

Since September 2008, the financial services sector has experienced unprecedented turbulence. The U.S. economy's current recession, led by the downturn in the housing industry, adversely affected the quality of most financial services companies' loan and securities portfolios. Loan charge-offs and mark-to-market losses have caused the capital ratios and overall financial condition of most financial services companies to deteriorate. In response, U.S. and foreign governments purchased significant equity capital positions in many banks and some insurance companies. Governments now hold a greater amount of preferred stock in some issuers than the total outstanding public preferred stock of that issuer. The full impact of government actions and deteriorating economic conditions is still unknown and could continue to adversely affect financial services companies. The impact of a deteriorating economy or industry upon institutions depends, in part, on the size of the institutions, the extent to which they are involved in the type of lending or market affected, the duration of the softening in the affected area and the managerial and capital resources of the financial institutions. The turbulence has also created calls for additional government regulation and oversight of many financial service providers which, if enacted, may also impact financial institutions. In addition, changes in accounting rules applicable to loans and investment securities also may adversely impact the financial condition of these institutions.