

## FLAHERTY & CRUMRINE PREFERRED INCOME OPPORTUNITY FUND

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

There can be no mincing words. The preferred market had an awful year. As the table demonstrates, the environment has been extremely difficult for PFO, which must invest most of its assets in preferred securities and which utilizes leverage to achieve its goal of producing a high level of current income. The most positive thing we can say about these numbers stems from our fervent belief that, at present, preferred securities prices have simply fallen too much, and, over time, will recover.

### TOTAL RETURN ON NET ASSET VALUE<sup>(1)</sup> FOR PERIODS ENDED NOVEMBER 30, 2008

	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 . . . . .	-33.9%	-43.2%	-48.5%	-21.1%	-11.3%	-1.8%	3.6%
Lipper Domestic Investment Grade Funds <sup>(3)</sup> . . . . .	-15.2%	-17.1%	-17.6%	-2.8%	0.2%	3.4%	5.2%

(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 elsewhere in this report.

(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.

We encourage you to read the "Discussion Topics" that follow for a more thorough analysis of the Fund's investment performance. We've also included the performance of several preferred market indices for further comparison.

Once more we struggle to find appropriate words to describe events in the financial markets. Although evidence of market troubles first appeared in mid-2007, there can be little doubt that in recent months we have witnessed the worst fallout from the financial crisis. Over a ten day period in September, the government placed Fannie Mae and Freddie Mac into conservatorship, Lehman Brothers filed for bankruptcy and AIG required the first of two massive doses of government assistance. Like a financial earthquake, these events sent tremors throughout the financial system, with the preferred market situated near the epicenter.

In response, the Federal Reserve has flooded the system with liquidity, and numerous new government programs designed to stabilize the financial system have been created. The critical objective of each program is to restore confidence in the system, and to that end no amount of effort (or money) has been spared. Many of these efforts appear to be taking hold, and while we are clearly in the midst of a severe economic slowdown, the foundation for recovery is being established.

Of these government programs, the Capital Purchase Program (“CPP”) launched in mid-October had the greatest significance for the Fund. Through this program, the government injected almost \$350 billion of capital into qualifying banks and finance companies by purchasing newly issued preferred securities. The preferred market got a boost when it was disclosed that *existing* preferred securities of companies that participate in the program will typically *rank equal or senior* to those held by the government.

Most of the new government programs are aimed at shoring up the financial industry (commercial banks, investment banks and insurance companies). Despite having disproportionately less exposure to financials when compared to the overall preferred universe<sup>1</sup>, the Fund’s performance has been hurt badly by the industry downturn. At their lowest levels, prices on some financial issues had fallen by over 75%. Once the lifeline of government aid reaches a particular company, prices on its securities tend to rebound, but they remain well below earlier levels. Of the 21 bank and finance companies owned in the Fund, 15 have received government assistance or have been acquired by stronger institutions.

Much of the price decline can be attributed to concerns about credit quality, but as we’ve discussed in the past, technical factors like the ongoing massive, economy-wide deleveraging and a dramatic decline in market liquidity have hurt valuations as well. Issues of utility and energy companies, which comprise most of the non-financial portion of the portfolio, also experienced substantial price declines during the period. While concerns about credit quality may have contributed to these price declines, technical factors have played a major role.

Market conditions have made it necessary to reduce the amount of leverage employed by the Fund. As the value of the Fund’s investment portfolio declined, the ratio of assets to liabilities fell below required levels. The only remedy has been to redeem a portion of the leverage. To date the Fund has retired 29.1%, or \$20.4 million, of the leverage in place at the beginning of the year. Leverage is critical for enabling the Fund to achieve its goal of providing high current income – we encourage you to carefully read the discussion topics that follow.

An unavoidable consequence of deleveraging has been a reduction in the amount of income available to shareholders in the form of monthly dividends. Simply put, the Fund sold assets in order to redeem leverage, and fewer assets mean less income generated. Since the beginning of fiscal 2008, market conditions have required us to reduce the monthly dividend several times, for a total reduction of 26.5%. Again, this important topic is addressed more fully in the discussion topics.

Under normal circumstances, PFO must have *less than 25%* of its portfolio invested in the banking sector. Recently, the bank portion has risen above this level, reaching 35.9% as of January 9, 2009. The increase is primarily the result of prices of the Fund’s bank investments increasing relative to the rest of the portfolio, banks acquiring finance companies and broker-dealers and the conversion of finance companies into bank holding companies.

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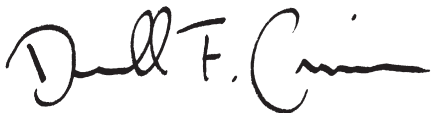
<sup>1</sup> According to the Flaherty & Crumrine website, [www.preferredstockguide.com](http://www.preferredstockguide.com), preferred securities issued by financial companies comprise 85% of the face value of the overall preferred market. As of November 30, 2008, 48% of the market value of PFO’s portfolio was in financials.

The unprecedented turbulence in financial markets also prompted the Fund to modify its interest-rate hedging strategy this year. As the credit crisis intensified in 2008, the normal relationship between the prices of preferred securities and the Fund's interest rate hedge positions (primarily options on Treasury bond futures and interest rate swaps) weakened or even reversed, so that the hedge could not be used effectively to help stabilize the Fund's NAV. At the same time, the yield curve steepened and option prices rose, increasing the cost of hedging. As these conditions developed, the Fund scaled back its interest rate hedge positions, removing them entirely by the end of 2008. We continue to review the effectiveness of the Fund's hedging strategies, and we anticipate using some hedging instruments when we believe it can accomplish its goals. For the most part, that means markets returning to more normal relationships. We don't know when that day will come, but we remain confident that it will.

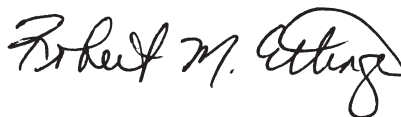
Where do we go from here? Just about any fixed-income investment that doesn't have "US Treasury" in its name has likely declined substantially in price over recent months, but the market for preferred securities has been particularly hard hit. Price declines of 50-75% on investment grade preferreds have not been unusual. We believe the preferred market is significantly undervalued at this time and that long-term investors will be rewarded handsomely for their patience. This conclusion is based upon our analysis described in the discussion topics and on the Fund's website.

Finally, we know this has been an extremely difficult year for shareholders, and while we might like to say we have been here before, we can't because we haven't. We believe that our fundamental approach to portfolio management has helped us avoid most of the credit casualties (the biggest exception being our exposure to Lehman Brothers Holdings). We also believe the current portfolio is comprised of survivors. The steps taken by the Fed and Treasury are starting to gain traction and will help. Economic downturns are always followed by recoveries and the incoming administration has indicated that stabilizing the economy is its highest priority. Although we cannot say exactly when the preferred market will recover, we look forward to a much happier 2009!

Sincerely,



Donald F. Crumrine  
Chairman of the Board



Robert M. Ettinger  
President

January 13, 2009

## DISCUSSION TOPICS

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

It's pretty safe to say the preferred securities market suffered its worst year in history in 2008. 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 and twelve month total returns of these indices:

#### Total Returns of Merrill Lynch Preferred Securities Indices\* for Periods Ended November 30, 2008

	<i>Six Months</i>	<i>One Year</i>
Merrill Lynch 8% Capped DRD Preferred Stock Index <sup>SM</sup> .....	-41.5%	-41.9%
Merrill Lynch 8% Capped Hybrid Preferred Securities Index <sup>SM</sup> .....	-25.7%	-21.9%
Merrill Lynch 8% Capped Corporate U.S. Capital Securities Index <sup>SM</sup> ....	-32.2%	-35.9%
Merrill Lynch Adjustable Preferred Stock, 7% Constrained Index <sup>SM</sup> .....	-51.4%	-54.4%

\* The Merrill Lynch 8% Capped DRD Preferred Index<sup>SM</sup> includes investment grade preferred securities issued by both corporations and government agencies that qualify for the corporate dividends received deduction with issuer concentration capped at a maximum of 8%. The Merrill Lynch 8% Capped Hybrid Preferred 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 7% Capped Adjustable Rate Preferred Securities 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.

While we realize it's only small consolation, as set forth in the table below, the Fund's total return on its securities portfolio before leverage exceeded most of these indices. Unfortunately, the Fund's strategy of using leverage to increase current income amplified its negative returns, and coupled with its expenses and hedging strategy, caused the NAV of the Fund to underperform most of the unleveraged indices.

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; and (c) issuing an 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 Periods Ended November 30, 2008**

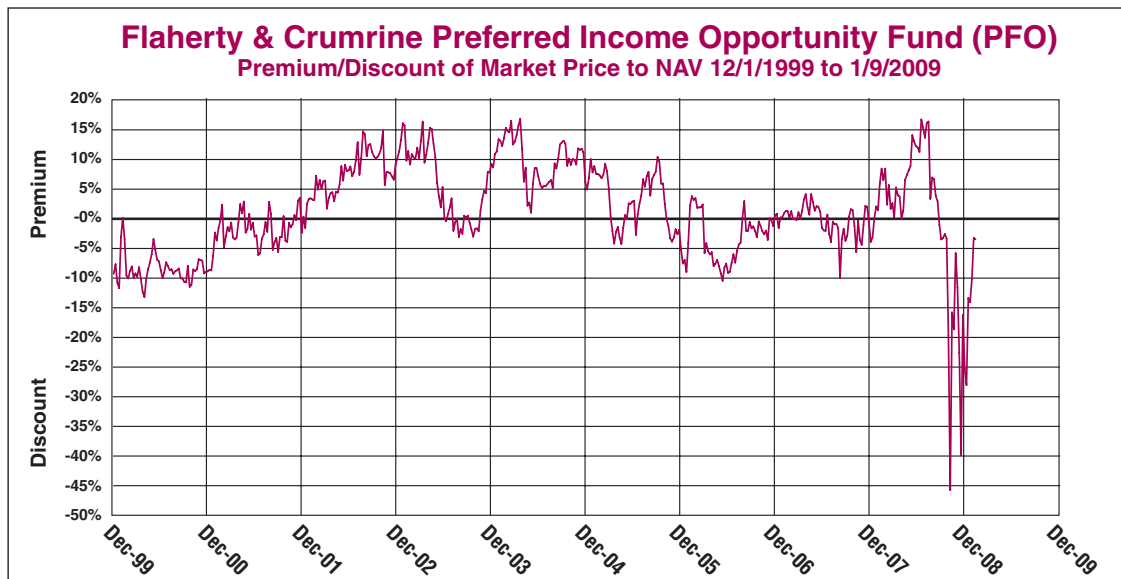
	<i>Six Months</i>	<i>One Year</i>
Total Return on Unleveraged Securities Portfolio (including principal and income) .....	-25.3%	-28.4%
Return from Interest Rate Hedging Strategy .....	-0.4%	-0.4%
Impact of Leverage .....	-16.5%	-17.6%
Expenses.....	-1.0%	-2.1%
<i>Total Return on NAV.....</i>	<i>-43.2%</i>	<i>-48.5%</i>

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

While our focus is primarily on managing the Fund's portfolio, an investor's actual return is comprised of monthly dividend payments plus changes in the Fund's market price. The loss-of-confidence factors that hurt prices of securities in the Fund's portfolio also caused selling of shares of the Fund itself that widened the Fund's market-price discount to NAV. This double negative resulted in a total return on market value for the year ended November 30, 2008 of -57.4%. During the fourth fiscal quarter alone, total return on *market value* was -43.5%.

Of course, the factors impacting prices of securities in the Fund's portfolio also drove down the price of the Fund. The market price hit a low of \$2.56 on October 10<sup>th</sup> and \$2.54 on November 20<sup>th</sup>. As of December 31<sup>st</sup>, subsequent to the Fund's fiscal year end the price had recovered some, closing the calendar year at \$4.60.

As can be seen from the chart below, the gap between the price of the Fund and the intrinsic value of the Fund (NAV) reached its widest level ever during October. No surprise, the record discount coincided with share price closing lows.



We have often observed year-end selling pressure in the Fund as investors attempt to realize gains or losses for tax purposes. Given the sharp decline in the Fund's price, this year appeared to be no different. We were heartened to see some price recovery in December, which probably means the Fund's high current yield on market price, 13.0% as of December 31<sup>st</sup>, has attracted new investors.

### **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. As a result, the monthly dividend rate changed several times this year. A portion of the distributions in calendar year 2008 were classified as a tax return of capital rather than ordinary income.

Since the beginning of fiscal 2008, the monthly dividend has been reduced from \$0.068 to \$0.050. Most of the dividend reduction in 2008 can be attributed to deleveraging. The reasons for deleveraging are discussed in detail below, but the impact on the Fund's monthly dividend is fairly obvious – in order to redeem or purchase a portion of its outstanding leverage, the Fund had to sell assets. As a result, the smaller portfolio generated less income; and while a smaller leverage balance helped reduce expenses, the net result was less income available to common shareholders.

### **The Fund's Leverage**

Let's start with, "Why does the Fund use leverage?" The answer is that the cost of leverage typically is lower than the yield on the Fund's portfolio and provides a valuable net addition to income for common shareholders. Since the Fund's inception, Auction Preferred Stock ("APS") has been the most effective form of leverage for a fund such as PFO, and an integral component of the Fund's income objective. However, earlier this year the auction process became a casualty of the liquidity crisis, and by February auctions were "failing". (This unfortunate terminology is used when there are not enough new investors to absorb the shares available for sale at or below the issue's maximum dividend rate. It should not be confused with a default by the issuer.)

Each issue of APS specifies how the rate will be determined when an auction fails. In the case of PFO, if an auction fails, the rate is set at the higher of the 60 day non-financial commercial paper index plus 2.5%, or that same index times 1.75. Since February, the rates paid by the Fund have been determined in this manner.

Fortunately, as Federal Reserve efforts to lower short-term interest rates (including the benchmark commercial paper index) have finally started to work, rates being paid by the Fund have dropped as well, and are now well below where they were a year ago.

Until recently, changes to the *amount* of leverage have been rare. However, during the last fiscal quarter the Fund redeemed \$20.4 million of its APS. As of November 30, 2008, PFO had \$49.6 million in auction preferred stock outstanding. The overall percent leverage represented by auction preferred stock to the Fund's total net assets available to common and preferred as of the same date was approximately 47.1%, reflecting the redemptions during the quarter (footnote 6 of the financial statements shows the details of these redemptions).

When the Fund was created, certain requirements designed to protect the interest of APS investors were established. Among these, the Fund must meet certain asset coverage requirements. Essentially, this calculation compares the Fund's asset values (discounted according to a specific set of rules) to the liquidation value of the APS plus the Fund's other liabilities. If this discounted asset value does not meet or exceed this amount, the Fund may not set aside, declare or pay dividends to common stock shareholders, and it must take steps to "cure" this coverage test. To do so, the Fund may adjust holdings (certain assets receive better asset coverage treatment than others) and sell assets to raise cash. Proceeds from asset sales may be invested in higher quality, lower yielding securities or held in cash, or in some cases used to reduce leverage, to restore the required level of asset coverage. If market values continue to decline, additional sales may be needed. If asset values move higher, the asset coverage will improve and additional asset sales will not be required.

If the Fund fails to meet this asset coverage test for ten business days, it is required to declare its intention to redeem at least enough shares of APS to once again pass the test (if you can't raise the bridge, you must lower the water). In addition, the Fund has the *option* of redeeming APS on any given auction date (which recur every 49 days) or purchasing shares directly from APS holders in private transactions.

In order to pay common stock dividends, the Fund must also meet certain requirements under the Investment Company Act of 1940. Among other things, the Act requires the Fund to have at least 200% asset coverage for its APS before it may declare a dividend to be paid to common stock shareholders. In other words, before declaring its dividend, a Fund has to have at least \$2 of assets for every \$1 of APS outstanding.

While we were able to make significant progress in meeting the asset coverage tests by changing the composition of the portfolio, the Fund was forced to conduct mandatory redemptions in November. In addition, the Board of Directors of the Fund determined to further de-leverage through optional redemptions and share repurchases.

We continue to explore alternatives to the APS, including debt financing. We want to be certain that any new type of leverage is consistent with the Fund's long term objectives. In the meantime, and importantly, the rates being paid on remaining APS have declined, along with other short-term interest rates, and still provide meaningful benefits to the dividend paid to common shareholders.

## **Preferred Market Conditions**

As we've mentioned, prices on almost all preferred securities are down in recent months, and in some instances the declines are hard to fathom. Traditional valuation techniques have not been very useful in this environment, but one tool that helps frame the discussion is called *default tolerance*.

We've posted a thorough discussion of our analysis on the Fund's website under the heading *Preferred Valuation After the TARP*, and we encourage shareholders to check it out. For our purposes here, a summary will suffice.

The objective of the analysis is to answer the question "*Given current valuations, what percentage of the portfolio would have to default to leave you worse off than buying a ten-year US Treasury note?*" As with any model, there are assumptions made, but even with conservative assumptions, over the ten years beginning December 31, 2008, 48% of the Fund's current portfolio would have to default in order for the Treasury note to produce a better return. This is an extraordinarily high default rate.

Looking rationally at preferred securities valuation leads us to the firm conclusion that preferreds are cheap. They are at historically wide spreads to benchmark fixed-income asset classes. They can tolerate

very high default rates and still generate positive returns, and the government's actions to limit the severity of the recession should substantially reduce the risk that defaults get that severe. At more-reasonable default rates, preferreds can provide common equity-like returns with lower risk. We believe that preferred securities remain extremely attractive for long-term investors.

However, we recognize that markets today are far from completely rational. Stung by losses, some leveraged preferred investors have been forced to exit the market, and many will not come back. Others see short-term risk that they feel outweighs preferreds' long-term potential, or they fear that new issue supply will prevent preferreds from recovering. Still others genuinely fear that the U.S. economy is headed for another Great Depression, despite all efforts to prevent it.

We do not know precisely how this recession will play itself out. We can only assess the factors that we think will affect preferred valuation and act accordingly. All investing entails taking risks. Intelligent long-term investing entails taking risks when the potential payoffs are high and the probability of poor outcomes is low. We believe that in the preferred market, now is such a time.

Although all companies have felt some strain from the recession and credit crunch, banks, finance companies, broker-dealers and, more recently, insurance companies have been most affected, given their direct and indirect exposure initially to the problems in housing and subsequently to financial markets. The pressure on preferred security valuations, especially those of financial issuers, intensified in early September with the federal government taking conservatorship of Fannie Mae and Freddie Mac (the GSEs), investing at a position senior to existing preferred holders and suspending the payment of preferred dividends. This proved a major catalyst for the collapse of preferred valuations (most dramatically for DRD eligible issues) beginning in September. These developments were closely followed by the bankruptcy of Lehman Brothers Holdings and the rescue of AIG. The surviving major broker-dealers reacted accordingly, with Merrill Lynch arranging a quick marriage with Bank of America and Goldman Sachs and Morgan Stanley converting to bank holding company registration, mandating a more conservative capital structure.

Beginning in mid-September, the federal government response to these developments has been significant. After some resistance, Congress approved the Treasury's Troubled Assets Relief Program (TARP). Although the funding was initially envisioned to support asset valuations, on October 14<sup>th</sup> the Treasury announced the Capital Purchase Program for banks and thrifts under the TARP, with clarification that the government's equity investment will rank equal with (and not rank senior to) existing DRD eligible preferred shareholders and junior to taxable preferred securities. This restored confidence in a preferred market that had been weakened significantly by the events beginning with the GSE conservatorship, and should facilitate the eventual restoration of private equity into these companies.

More recently, the Treasury announced a second round of preferred equity financing for Citigroup under the TARP, in addition to joining various other government agencies guaranteeing \$306 billion of this systemically important institution's troubled assets. In doing so, the Treasury returned to the original focus of the TARP – stabilizing asset valuations. Having committed the entire first tranche of TARP funding, the Treasury is now requesting the additional funds included in the initial legislation from Congress.

In consultation with Treasury, over the same period the Federal Reserve and the FDIC have established or announced a variety of funding facilities or guarantee programs to help stabilize financial markets, the magnitude of which dwarf the size of TARP. These include liquidity facilities for banks, primary dealers, money market funds (using banks as intermediaries), commercial paper issuers and, most recently, asset-backed commercial paper issuers. Recent guarantee programs support intermediate bank debt issuers and

money market funds. Announced for February 2009 are the Term Asset-backed Securities Loan Facility and the Government Sponsored Entities Purchase Program, to provide liquidity for consumer lending and to holders of GSE debt.

The speed and magnitude of the federal government's response to developments which climaxed in September have been unprecedented. While all issuers of preferred securities face a difficult operating environment over the next several years, this will be especially true for banks and other financial companies. However, the federal government's prompt recent actions provide some assurance that the financial system will continue to function.

### **Tax Advantages of 2008 Calendar Year Distributions**

In 2008, the Fund passed on a portion of its income to individuals in the form of qualified dividend income or QDI. QDI is taxed at a maximum 15% rate instead of an individual's ordinary income tax rate. In calendar year 2008, approximately 57.0% of distributions made by the Fund was eligible for QDI treatment. For an individual in the 28% tax bracket, this means that the Fund's total distributions will only be taxed at a blended 20.6% 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, an individual in the 28% tax bracket who held 100 shares of Common Stock of the Fund for the calendar year would have had to receive approximately \$84 in distributions from a traditional corporate bond fund to net the same after-tax amount as the \$77 in distributions paid by the Fund.

For detailed information about the tax treatment of the 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 52.0% of distributions that were eligible for the inter-corporate dividends received deduction or DRD.

It is important to remember that the composition of the portfolio and the income distributions can change from one year to the next, and that the QDI or DRD portions of next year's distributions may not be the same (or even similar) to this year's.

Pursuant to Rule 23c-1 under the Investment Company Act of 1940, the Fund is authorized to repurchase APS on the open market or through negotiated private transactions. Purchases of APS, if any, will be executed as market and business conditions warrant on the open market or in negotiated or block trades. The Fund is not obligated to repurchase any dollar amount or number of APS, and the timing and amount of any APS repurchased will depend on market conditions, share price, corporate and regulatory requirements, capital availability and other factors. Authorization to repurchase APS is at the discretion of the Fund's Board of Directors and may be limited or terminated at any time without prior notice.

## PORTFOLIO OVERVIEW

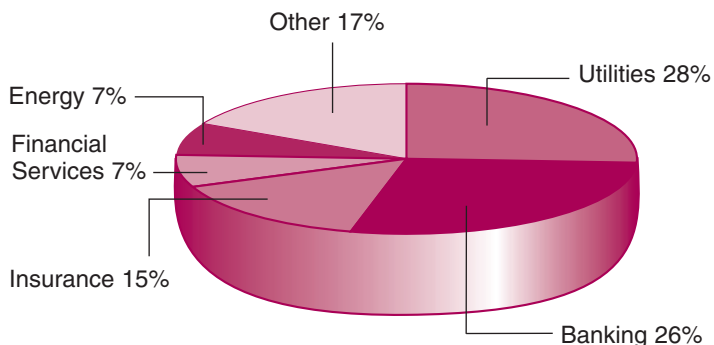
November 30, 2008 (Unaudited)

### Fund Statistics on 11/30/08

Net Asset Value	\$	4.71
Market Price	\$	3.93
Discount		16.56%
Yield on Market Price		16.79%
Common Stock Shares Outstanding		11,833,198

### Industry Categories

% of Portfolio



### Moody's Ratings % of Portfolio

AA	3.0%
A	10.1%
BBB	49.9%
BB	19.8%
Below "BB"	0.1%
Not Rated	4.6%
Below Investment Grade*	16.2%

\* Below investment grade by both Moody's and S&P.

### Top 10 Holdings by Issuer % of Portfolio

Southern California Edison	5.1%
Merrill Lynch	4.9%
Liberty Mutual Group	4.9%
Sovereign Bancorp	4.4%
Interstate Power & Light	3.7%
Banco Santander	3.0%
Ocean Spray	2.8%
Puget Energy	2.8%
Kinder Morgan	2.7%
Enbridge Energy Partners	2.5%

% of Portfolio\*\*

Holdings Generating Qualified Dividend Income (QDI) for Individuals	51%
Holdings Generating Income Eligible for the Corporate Dividends Received Deduction (DRD)	46%

\*\* This does not reflect year-end results or actual tax categorization of Fund distributions. These percentages can, and do, change, perhaps significantly, depending on market conditions. Investors should consult their tax advisor regarding their personal situation. See accompanying notes to the financial statements for the tax characterization of 2008 distributions.

**PORTFOLIO OF INVESTMENTS****November 30, 2008**

<u>Shares/\$ Par</u>		<u>Value</u>
<b>Preferred Securities — 84.8%</b>		
<b>Banking — 25.4%</b>		
\$ 3,000,000	Astoria Capital Trust I, 9.75% 11/01/29, Series B . . . . .	\$ 2,524,146
	Banco Santander:	
184,750	6.50% Pfd. . . . .	2,782,797 <sup>**</sup> (1)
22,750	6.80% Pfd. . . . .	359,734 <sup>**</sup> (1)
\$ 3,900,000	Capital One Capital III, 7.686% 08/15/36 . . . . .	1,804,062
\$ 4,500,000	CBG Florida REIT Corporation, 7.114%, 144A**** . . . . .	900,000
39,000	Citigroup, Inc., 8.125% Pfd., Series AA . . . . .	548,438*
45,000	Cobank, ACB, 7.00% Pfd., 144A**** . . . . .	1,201,950*
\$ 3,500,000	Comerica Capital Trust II, 6.576% 02/20/37 . . . . .	1,337,021
4,500	FBOP Corporation, Adj. Rate Pfd., 144A**** . . . . .	2,362,500*
\$ 2,250,000	First Hawaiian Capital I, 8.343% 07/01/27, Series B . . . . .	1,872,488 <sup>(1)</sup>
2,250	First Tennessee Bank, Adj. Rate Pfd., 144A**** . . . . .	1,153,125*
\$ 450,000	HBOS PLC, 6.657%, 144A**** . . . . .	209,730 <sup>**</sup> (1)
4,400	HSBC Series II, Variable Inverse Pfd., Pvt. . . . .	44*†
2,500	HSBC USA, Inc., \$2.8575 Pfd. . . . .	90,860*
3,600	JPMorgan Chase & Co., 6.15% Pfd., Series E . . . . .	136,125*
35,000	Keycorp Capital IX, 6.75% Pfd. 12/15/66 . . . . .	479,063
99,000	National City Corporation, 9.875% Pfd. . . . .	2,078,010*
28,000	PFGI Capital Corporation, 7.75% Pfd. . . . .	476,000
\$ 2,500,000	Regions Financing Trust II, 6.625% 05/15/47 . . . . .	1,106,253
3,200	Regions Financing Trust III, 8.875% Pfd. 06/15/78 . . . . .	64,480
212,700	Sovereign Bancorp, 7.30% Pfd., Series C . . . . .	2,871,450*
9,875	Sovereign Capital Trust V, 7.75% Pfd. 05/22/36 . . . . .	149,051
1,850	Sovereign REIT, 12.00% Pfd., Series A, 144A**** . . . . .	1,658,211
	U.S. Bancorp, Auction Pass-Through Trust, Cl. B:	
9	Series 2006-5, Variable Rate Pfd., 144A**** . . . . .	225*†
9	Series 2006-6, Variable Rate Pfd., 144A**** . . . . .	225*†
\$ 900,000	Washington Mutual Preferred Funding IV, 9.75%, 144A**** . . . . .	630††
\$ 1,400,000	Webster Capital Trust IV, 7.65% 06/15/37 . . . . .	589,802
		<u>26,756,420</u>
<b>Financial Services — 7.4%</b>		
	CIT Group, Inc.:	
10,000	5.189% Pfd., Series B . . . . .	249,500*
261,200	6.35% Pfd., Series A . . . . .	2,114,101*
890	First Republic Preferred Capital Corporation, 10.50% Pfd., 144A**** . . . . .	822,769

The accompanying notes are an integral part of the financial statements.

**PORTFOLIO OF INVESTMENTS (Continued)**

November 30, 2008

<u>Shares/\$ Par</u>		<u>Value</u>
<b>Preferred Securities — (continued)</b>		
<b>Financial Services — (continued)</b>		
22,500	First Republic Preferred Capital Corporation II, 8.75% Pfd., Series B, 144A**** . . .	\$ 420,750
	Goldman Sachs:	
24,680	Cabco Trust Capital I, Adj. Rate Pfd. 02/15/34 . . . . .	220,578
11	Pass-Through Certificates, Class B, 144A**** . . . . .	0*†
3,500	STRIPES Custodial Receipts, Pvt. . . . .	35*†
	Lehman Brothers Holdings, Inc.:	
45,800	5.67% Pfd., Series D . . . . .	11,794*††
9,500	5.94% Pfd., Series C . . . . .	2,484*††
25,000	6.50% Pfd., Series F . . . . .	1,638*††
13,400	7.95% Pfd. . . . .	29*††
	Merrill Lynch:	
112,000	Adj. Rate Pfd., Series 5 . . . . .	882,000*
3,000	Series II STRIPES Custodial Receipts, Pvt. . . . .	7,530*†
200,000	6.25% Pfd. . . . .	2,537,500*
30,000	8.625% Pfd., Series 8 . . . . .	538,125*
		<u>7,808,833</u>
<b>Insurance — 12.7%</b>		
\$ 3,250,000	AON Capital Trust A, 8.205% 01/01/27 . . . . .	1,655,108
	Arch Capital Group Ltd.:	
10,000	7.875% Pfd., Series B . . . . .	161,250** <sup>(1)</sup>
24,400	8.00% Pfd., Series A . . . . .	417,089** <sup>(1)</sup>
29,700	Axis Capital Holdings, 7.50% Pfd., Series B . . . . .	1,582,455 <sup>(1)</sup>
90,000	Delphi Financial Group, 7.376% Pfd. 05/15/37 . . . . .	863,442
\$ 3,250,000	Everest Re Holdings, 6.60% 05/15/37 . . . . .	1,355,689
	Liberty Mutual Group:	
\$ 4,500,000	7.80% 03/15/37, 144A**** . . . . .	2,305,278
\$ 250,000	10.75% 06/15/58, 144A**** . . . . .	132,238
\$ 1,500,000	MetLife Capital Trust X, 9.25% 04/08/38, 144A**** . . . . .	999,593
125,000	MetLife, Inc., 6.50% Pfd., Series B . . . . .	1,558,600*
\$ 200,000	PartnerRe Finance II, 6.44% 12/01/66 . . . . .	101,726 <sup>(1)</sup>
	Renaissancere Holdings Ltd.:	
42,050	6.08% Pfd., Series C . . . . .	520,579** <sup>(1)</sup>
56,700	6.60% Pfd., Series D . . . . .	793,800** <sup>(1)</sup>
115,500	Scottish Re Group Ltd., 7.25% Pfd. . . . .	66,124** <sup>(1)</sup> †
\$ 1,060,000	USF&G Capital, 8.312% 07/01/46, 144A**** . . . . .	896,300
		<u>13,409,271</u>

The accompanying notes are an integral part of the financial statements.

**PORTFOLIO OF INVESTMENTS (Continued)**

November 30, 2008

<u>Shares/\$ Par</u>		<u>Value</u>
<b>Preferred Securities — (continued)</b>		
<b>Utilities — 28.1%</b>		
	Alabama Power Company:	
4,980	4.60% Pfd. ....	\$ 360,751*
6,485	4.72% Pfd. ....	482,030*
868	4.92% Pfd. ....	67,253*
21,500	6.45% Pfd. ....	505,465*
1,579	Baltimore Gas & Electric Company, 6.70% Pfd., Series 1993 ....	149,058*
5,560	Central Vermont Public Service Corporation, 8.30% Sinking Fund Pfd., Pvt. ....	557,390*
2,050	Connecticut Light & Power Company, 4.50% Pfd., Series 1956 ....	69,618*
2,000	Consolidated Edison Company of New York, 4.65% Pfd., Series C ....	154,320*
\$ 1,750,000	Dominion Resources, Inc., 7.50% ....	893,540
15,030	Duquesne Light Company, 3.75% Pfd. ....	398,445*
4,400	Florida Power Company, 4.75% Pfd. ....	339,460*
	Georgia Power Company:	
5,655	6.125% Pfd. ....	139,078*
6,500	6.50% Pfd., Series 07-A ....	565,500*
2,000	Great Plains Energy, Inc., 4.35% Pfd. ....	135,950*
	Hawaiian Electric Company, Inc.:	
2,471	5.00% Pfd., Series D ....	51,196*
7,438	5.00% Pfd., Series E ....	154,106*
1,383	5.00% Pfd., Series I ....	28,654*
30,500	Indianapolis Power & Light Company, 5.65% Pfd. ....	2,448,540*
154,900	Interstate Power & Light Company, 8.375% Pfd., Series B ....	3,949,950*
	Pacific Enterprises:	
15,935	\$4.50 Pfd. ....	1,165,805*
8,935	\$4.75 Pfd., Series 53 ....	689,961*
\$ 1,500,000	PECO Energy Capital Trust III, 7.38% 04/06/28, Series D ....	1,331,531
14,020	Public Service Electric & Gas Company, 5.28% Pfd., Series E ....	1,167,305*
\$ 5,750,000	Puget Sound Energy, Inc., 6.974% 06/01/67 ....	2,911,225
	South Carolina Electric & Gas Company:	
13,711	5.125% Purchase Fund Pfd., Pvt. ....	762,247*
7,774	6.00% Purchase Fund Pfd., Pvt. ....	396,863*
	Southern California Edison:	
25,000	6.00% Pfd., Series C ....	2,186,250*
35,000	6.125% Pfd. ....	3,140,900*
\$ 1,780,000	Southern Union Company, 7.20% 11/01/66 ....	994,399
\$ 750,000	TXU Electric Capital V, 8.175% 01/30/37 ....	511,725

The accompanying notes are an integral part of the financial statements.

**PORTFOLIO OF INVESTMENTS (Continued)**

November 30, 2008

<u>Shares/\$ Par</u>	<u>Value</u>
<b>Preferred Securities — (continued)</b>	
<b>Utilities — (continued)</b>	
Union Electric Company:	
5,700 4.56% Pfd. ....	\$ 400,710*
10,156 \$7.64 Pfd. ....	1,042,260*
\$ 1,700,000 Wisconsin Energy Corporation, 6.25% 05/15/67 .....	851,136
6,000 Wisconsin Power & Light Company, 6.20% Pfd. ....	536,632*
	<u>29,539,253</u>
<b>Energy — 7.4%</b>	
\$ 4,000,000 Enbridge Energy Partners LP, 8.05% 10/01/37 .....	2,656,596
\$ 2,500,000 Enterprise Products Partners, 7.034% 01/15/68 .....	1,301,753
3,000 Kinder Morgan GP, Inc., 8.33% Pfd., 144A**** .....	2,897,010*
10,000 Lasmo America Limited, 8.15% Pfd., 144A**** .....	943,200*(1)
	<u>7,798,559</u>
<b>Miscellaneous Industries — 3.8%</b>	
13,600 E.I. Du Pont de Nemours and Company, \$4.50 Pfd., Series B .....	1,025,526*
35,000 Ocean Spray Cranberries, Inc., 6.25% Pfd., 144A**** .....	3,000,900*
	<u>4,026,426</u>
<b>Total Preferred Securities</b>	
(Cost \$149,755,280) .....	<u>89,338,762</u>
<b>Corporate Debt Securities — 2.6%</b>	
<b>Insurance — 2.6%</b>	
\$ 4,417,000 Liberty Mutual Insurance, 7.697% 10/15/97, 144A**** .....	2,768,721
	<u>2,768,721</u>
<b>Total Corporate Debt Securities</b>	
(Cost \$4,328,822) .....	<u>2,768,721</u>
<b>Money Market Fund — 12.1%</b>	
12,735,271 BlackRock Provident Institutional, T-Fund .....	12,735,271
	<u>12,735,271</u>
<b>Total Money Market Fund</b>	
(Cost \$12,735,271) .....	<u>12,735,271</u>

The accompanying notes are an integral part of the financial statements.

**PORTFOLIO OF INVESTMENTS (Continued)**

**November 30, 2008**

<b>Total Investments</b> (Cost \$166,819,373 <sup>***</sup> ) .....	99.5%	\$ 104,842,754
<b>Other Assets And Liabilities</b> (Net) .....	0.5%	<u>504,629</u>
<b>Total Net Assets Available to Common and Preferred Stock</b> .....	100.0%‡	<u>\$ 105,347,383</u>
<b>Auction Preferred Stock (APS) Redemption Value</b> .....		<u>(49,600,000)</u>
<b>Total Net Assets Available To Common Stock</b> .....		<u><u>\$ 55,747,383</u></u>

- \* Securities eligible for the Dividends Received Deduction and distributing Qualified Dividend Income.  
 \*\* Securities distributing Qualified Dividend Income only.  
 \*\*\* Aggregate cost of securities held.  
 \*\*\*\* Securities exempt from registration under Rule 144A of the Securities Act of 1933. These securities may be resold in transactions exempt from registration to qualified institutional buyers. These securities have been determined to be liquid under the guidelines established by the Board of Directors.  
 (1) Foreign Issuer.  
 † Non-income producing.  
 †† The issuer has filed for bankruptcy protection. As a result, the Fund may not be able to recover the principal invested and also does not expect to receive income on this security going forward.  
 ‡ The percentage shown for each investment category is the total value of that category as a percentage of net assets available to Common and Preferred Stock.

**ABBREVIATIONS:**

- Cabco** — Corporate Asset Backed Corporation  
**Pfd.** — Preferred Securities  
**Pvt.** — Private Placement Securities  
**STRIPES** — Structured Residual Interest Preferred Enhanced Securities

## STATEMENT OF ASSETS AND LIABILITIES

November 30, 2008

### ASSETS:

Investments, at value (Cost \$166,819,373) .....	\$ 104,842,754
Dividends and interest receivable .....	1,499,203
Prepaid expenses .....	67,853
	<u>          </u>
Total Assets .....	106,409,810

### LIABILITIES:

Dividends payable to Common Stock Shareholders .....	\$ 65,947	
Investment advisory fee payable .....	55,465	
Administration, Transfer Agent and Custodian fees payable .....	19,654	
Audit fees payable .....	56,200	
Legal fees payable .....	18,926	
Directors' fees payable .....	895	
Accrued expenses and other payables .....	47,611	
Accumulated undeclared distributions to Auction Preferred Stock Shareholders .....	<u>797,729</u>	
Total Liabilities .....		<u>1,062,427</u>

### Auction Preferred Stock (496 shares outstanding)

redemption value .....	<u>49,600,000</u>
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**NET ASSETS AVAILABLE TO COMMON STOCK** ..... \$ 55,747,383

### NET ASSETS AVAILABLE TO COMMON STOCK consist of:

Distributions in excess of net investment income .....	\$ (990,701)
Accumulated net realized loss on investments sold .....	(19,323,684)
Unrealized depreciation of investments .....	(61,976,619)
Par value of Common Stock .....	118,332
Paid-in capital in excess of par value of Common Stock .....	<u>137,920,055</u>
Total Net Assets Available to Common Stock .....	<u><u>\$ 55,747,383</u></u>

### NET ASSET VALUE PER SHARE OF COMMON STOCK:

Common Stock (11,833,198 shares outstanding) .....	<u><u>\$ 4.71</u></u>
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## STATEMENT OF OPERATIONS

For the Year Ended November 30, 2008

**INVESTMENT INCOME:**

Dividends† . . . . .		\$ 9,358,713
Interest . . . . .		<u>4,341,667</u>
Total Investment Income . . . . .		13,700,380

**EXPENSES:**

Investment advisory fee . . . . .	\$ 940,741	
Administrator's fee . . . . .	170,008	
Auction Preferred Stock broker commissions and auction agent fees	177,900	
Audit fees . . . . .	68,700	
Legal fees . . . . .	133,530	
Insurance expense . . . . .	123,207	
Transfer Agent fees . . . . .	72,664	
Directors' fees . . . . .	75,190	
Custodian fees . . . . .	22,471	
Compliance fees . . . . .	37,719	
Other . . . . .	<u>115,906</u>	
Total Expenses . . . . .		<u>1,938,036</u>

**NET INVESTMENT INCOME** . . . . . 11,762,344

**REALIZED AND UNREALIZED GAIN/(LOSS) ON INVESTMENTS**

Net realized loss on investments sold during the year . . . . .		(15,071,115)
Net realized loss from written options during the year . . . . .		(57,579)
Change in net unrealized appreciation/depreciation of investments .		<u>(49,297,762)</u>

**NET REALIZED AND UNREALIZED LOSS ON INVESTMENTS** . . . . . (64,426,456)

**DISTRIBUTIONS TO AUCTION PREFERRED STOCK SHAREHOLDERS:**

From net investment income (including changes in accumulated undeclared distributions) . . . . .		<u>(3,854,239)</u>
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**NET DECREASE IN NET ASSETS TO COMMON STOCK**

**RESULTING FROM OPERATIONS** . . . . . \$(56,518,351)

† For Federal income tax purposes, a significant portion of this amount may not qualify for the inter-corporate dividends received deduction ("DRD") or as qualified dividend income ("QDI") for individuals.

## STATEMENTS OF CHANGES IN NET ASSETS AVAILABLE TO COMMON STOCK

	<u>Year Ended November 30, 2008</u>	<u>Year Ended November 30, 2007</u>
<b>OPERATIONS:</b>		
Net investment income . . . . .	\$ 11,762,344	\$ 12,431,906
Net realized loss on investments sold during the year . . . . .	(15,128,694)	(1,720,220)
Change in net unrealized depreciation of investments . . . . .	(49,297,762)	(26,931,948)
Distributions to APS* Shareholders from net investment income, including changes in accumulated undeclared distributions . . . . .	<u>(3,854,239)</u>	<u>(3,357,998)</u>
<b>Net decrease in net assets resulting from operations . . . . .</b>	<b><u>(56,518,351)</u></b>	<b><u>(19,578,260)</u></b>
<b>DISTRIBUTIONS:</b>		
Dividends paid from net investment income to Common Stock Shareholders <sup>(1)</sup> . . . . .	(8,888,100)	(9,284,238)
Tax return of capital to Common Stock Shareholders . . . . .	<u>(352,939)</u>	<u>—</u>
<b>Total Distributions to Common Stock Shareholders . . . . .</b>	<b><u>(9,241,039)</u></b>	<b><u>(9,284,238)</u></b>
<b>FUND SHARE TRANSACTIONS:</b>		
Increase from shares issued under the Dividend Reinvestment and Cash Purchase Plan . . . . .	820,340	591,605
Gain on repurchase of Auction Preferred Stock <sup>(2)</sup> . . . . .	<u>1,600,000</u>	<u>—</u>
<b>Net increase in net assets available to Common Stock resulting from Fund share transactions . . . . .</b>	<b><u>2,420,340</u></b>	<b><u>591,605</u></b>
<b>NET DECREASE IN NET ASSETS AVAILABLE TO COMMON STOCK FOR THE YEAR . . . . .</b>	<b><u>\$ (63,339,050)</u></b>	<b><u>\$ (28,270,893)</u></b>
<b>NET ASSETS AVAILABLE TO COMMON STOCK:</b>		
Beginning of year . . . . .	\$119,086,433	\$147,357,326
Net decrease in net assets during the year . . . . .	<u>(63,339,050)</u>	<u>(28,270,893)</u>
End of year (including distributions in excess of net investment income \$(990,701) and \$(339,917), respectively) . . . . .	<u>\$ 55,747,383</u>	<u>\$119,086,433</u>

\* Auction Preferred Stock (formerly known as Money Market Cumulative Preferred™ Stock).

(1) May include income earned, but not paid out, in prior fiscal year.

(2) See Note 6.

**FINANCIAL HIGHLIGHTS****For a Common Stock share outstanding throughout each year.**

Contained below is per share operating performance data, total investment returns, ratios to average net assets and other supplemental data. This information has been derived from information provided in the financial statements and market price data for the Fund's shares.

	<b>Year Ended November 30,</b>				
	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>
<b>PER SHARE OPERATING PERFORMANCE:</b>					
Net asset value, beginning of year .....	\$ 10.14	\$ 12.60	\$ 12.14	\$ 12.27	\$ 12.59
<b>INVESTMENT OPERATIONS:</b>					
Net investment income .....	1.00	1.06	1.02	0.96	0.98
Net realized and unrealized gain/(loss) on investments .....	(5.46)	(2.44)	0.49	(0.01)	(0.27)
<b>DISTRIBUTIONS TO APS* SHAREHOLDERS:</b>					
From net investment income .....	(0.33)	(0.29)	(0.25)	(0.17)	(0.09)
Total from investment operations .....	(4.79)	(1.67)	1.26	0.78	0.62
<b>DISTRIBUTIONS TO COMMON STOCK SHAREHOLDERS:</b>					
From net investment income .....	(0.75)	(0.79)	(0.80)	(0.91)	(0.94)
From return of capital .....	(0.03)	—	—	—	—
Total distributions to Common Stock Shareholders .....	(0.78)	(0.79)	(0.80)	(0.91)	(0.94)
Gain on repurchase of Auction Preferred Stock .....	0.14	—	—	—	—
Net asset value, end of year .....	<u>\$ 4.71</u>	<u>\$ 10.14</u>	<u>\$ 12.60</u>	<u>\$ 12.14</u>	<u>\$ 12.27</u>
Market value, end of year .....	\$ 3.93	\$ 10.30	\$ 12.42	\$ 11.53	\$ 13.53
Total investment return based on net asset value** .....	(48.12%)	(13.90%)	11.02%	6.36%	4.68%
Total investment return based on market value** .....	(57.38%)	(11.28%)	15.22%	(8.40%)	7.57%
<b>RATIOS TO AVERAGE NET ASSETS AVAILABLE TO COMMON STOCK SHAREHOLDERS:</b>					
Total net assets, end of year (in 000's) .....	\$ 55,747	\$119,086	\$147,357	\$141,717	\$142,145
Operating expenses .....	2.05%	1.56%	1.52%	1.53%	1.52%
Net investment income † .....	8.36%	6.53%	6.34%	6.30%	7.11%
<b>SUPPLEMENTAL DATA:††</b>					
Portfolio turnover rate .....	60%	60%	68%	57%	28%
Total net assets available to Common and Preferred Stock, end of period (in 000's) .....	\$105,347	\$189,086	\$217,357	\$211,717	\$212,145
Ratio of operating expenses to total average net assets available to Common and Preferred Stock .....	1.19%	1.04%	1.02%	1.03%	1.03%

\* Auction Preferred Stock (formerly known as Money Market Cumulative Preferred™ Stock).

\*\* Assumes reinvestment of distributions at the price obtained by the Fund's Dividend Reinvestment and Cash Purchase Plan.

† The net investment income ratios reflect income net of operating expenses and payments to APS Shareholders.

†† Information presented under heading Supplemental Data includes APS.

## FINANCIAL HIGHLIGHTS (Continued)

### Per Share of Common Stock

	Total Dividends Paid†	Net Asset Value	NYSE Closing Price	Dividend Reinvestment Price <sup>(1)</sup>
December 31, 2007 .....	\$0.0680	\$9.64	\$9.46	\$9.64
January 31, 2008 .....	0.0680	10.23	10.25	10.23
February 29, 2008 .....	0.0680	9.94	10.06	9.94
March 31, 2008 .....	0.0680	8.65	9.09	8.65
April 30, 2008 .....	0.0680	8.93	9.47	9.00
May 30, 2008 .....	0.0680	8.80	9.90	9.41
June 30, 2008 .....	0.0680	8.10	9.30	8.83
July 31, 2008 .....	0.0680	7.39	7.77	7.39
August 29, 2008 .....	0.0680	7.36	7.25	7.35
October 27, 2008 <sup>(2)</sup> .....	0.0610	5.31 <sup>(3)</sup>	4.15	4.60
November 12, 2008 .....	0.0550	5.16 <sup>(4)</sup>	3.81	3.97
November 28, 2008 .....	0.0550	4.71	3.93	3.73

† May include distributions classified as a tax return of capital.

<sup>(1)</sup> Whenever the net asset value per share of the Fund's Common Stock is less than or equal to the market price per share on the reinvestment date, new shares issued will be valued at the higher of net asset value or 95% of the then current market price. Otherwise, the reinvestment shares of Common Stock will be purchased in the open market.

<sup>(2)</sup> September 30, 2008 distribution delayed; paid on October 27, 2008.

<sup>(3)</sup> NAV as of October 24, 2008.

<sup>(4)</sup> NAV as of November 7, 2008.

**FINANCIAL HIGHLIGHTS (Continued)****Per Share of Common Stock**

The table below sets out information with respect to Auction Preferred Stock currently outstanding.

<u>Date</u>	<u>Total Shares Outstanding (1)</u>	<u>Asset Coverage Per Share (2)</u>	<u>Involuntary Liquidation Preference Per Share (3)</u>
11/30/08	496	\$214,002	\$100,000
11/30/07	700	270,894	100,000
11/30/06	700	310,819	100,000
11/30/05	700	302,788	100,000
11/30/04	700	303,137	100,000
11/30/03	700	306,301	100,000

(1) See note 6.

(2) Calculated by subtracting the Fund's total liabilities (excluding the APS and accumulated undeclared distributions to APS) from the Fund's total assets and dividing that amount by the number of APS shares outstanding.

(3) Excludes accumulated undeclared dividends.

## **NOTES TO FINANCIAL STATEMENTS**

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### **1. Organization**

Flaherty & Crumrine Preferred Income Opportunity Fund Incorporated (the “Fund”) was incorporated as a Maryland corporation on December 10, 1991, and commenced operations on February 13, 1992 as a diversified, closed-end management investment company under the Investment Company Act of 1940, as amended (the “1940 Act”). The Fund’s investment objective is to provide its common shareholders with high current income consistent with the preservation of capital.

### **2. Significant Accounting Policies**

The following is a summary of significant accounting policies consistently followed by the Fund in the preparation of its financial statements. The preparation of the financial statements is in conformity with U.S. generally accepted accounting principles (“US GAAP”) and requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities in the financial statements and the reported amounts of increases and decreases in net assets from operations during the reporting period. Actual results could differ from those estimates.

*Portfolio valuation:* The net asset value of the Fund’s Common Stock is determined by the Fund’s Administrator no less frequently than on the last business day of each week and month. It is determined in accordance with the policies and procedures approved by the Board of Directors of the Fund by dividing the value of the Fund’s net assets available to Common Stock by the number of shares of Common Stock outstanding. The value of the Fund’s net assets available to Common Stock is deemed to equal the value of the Fund’s total assets less (i) the Fund’s liabilities and (ii) the aggregate liquidation value of the outstanding Auction Preferred Stock (“APS”).

The Fund’s preferred and debt securities are valued on the basis of current market quotations provided by independent pricing services or dealers approved by the Board of Directors of the Fund. Each quotation is based on the mean of the bid and asked prices of a security. In determining the value of a particular preferred or debt security, a pricing service or dealer may use information with respect to transactions in such investments, quotations, market transactions in comparable investments, various relationships observed in the market between investments, and/or calculated yield measures based on valuation technology commonly employed in the market for such investments. Common stocks that are traded on stock exchanges are valued at the last sale price or official close price on the exchange, as of the close of business on the day the securities are being valued or, lacking any sales, at the last available mean price. Futures contracts and option contracts on futures contracts are valued on the basis of the settlement price for such contracts on the primary exchange on which they trade. Investments in over-the-counter derivative instruments, such as interest rate swaps and options thereon (“swaptions”), are valued using prices supplied by a pricing service, or if such prices are unavailable, prices provided by a single broker or dealer that is not the counterparty or, if no such prices are available, at a price at which the counterparty to the contract would repurchase the instrument or terminate the contract. Investments for which market quotations are not readily available or for which management determines that the prices are not reflective of current market conditions are valued at fair value as determined in good faith by or under the direction of the Board of Directors of the Fund, including reference to valuations of other securities which are comparable in quality, maturity and type.

**NOTES TO FINANCIAL STATEMENTS (Continued)**

Investments in money market instruments and all debt and preferred securities which mature in 60 days or less are valued at amortized cost. Investments in money market funds are valued at the net asset value of such funds.

In September 2006, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards No. 157 “Fair Value Measurements” (“SFAS 157”) effective for fiscal years beginning after November 15, 2007. This standard clarifies the definition of fair value for financial reporting, establishes a framework for measuring fair value and requires additional disclosures about the use of fair value measurements. The Fund has adopted SFAS 157 as of December 1, 2007. The three levels of the fair value hierarchy under SFAS 157 are described below:

- Level 1 – quoted prices in active markets for identical securities
- Level 2 – other significant observable inputs (including quoted prices for similar securities, interest rates, prepayment speeds, credit risk, etc.)
- Level 3 – significant unobservable inputs (including the Fund’s own assumptions in determining the fair value of investments)

The inputs or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in those securities. A summary of the inputs used to value the Fund’s net assets as of November 30, 2008 is as follows:

Valuation Inputs	Investments in Securities (Market Value)	Other Financial Instruments (Unrealized Appreciation/ Depreciation)*
Level 1 – Quoted Prices . . . . .	\$ 24,199,088	\$ —
Level 2 – Other Significant Observable Inputs . . . . .	80,643,666	—
Level 3 – Significant Unobservable Inputs . . . . .	—	—
<b>Total . . . . .</b>	<b>\$104,842,754</b>	<b>\$ —</b>

\* Other financial instruments are derivative instruments not reflected in the Portfolio of Investments, such as futures, forwards and swaps which are valued at the unrealized appreciation/depreciation on the investment. As of November 30, 2008 the Fund does not have any other financial instruments.

*Securities transactions and investment income:* Securities transactions are recorded as of the trade date. Realized gains and losses from securities sold are recorded on the specific identified cost basis. Dividend income is recorded on ex-dividend dates. Interest income is recorded on the accrual basis. The Fund also amortizes premiums and accretes discounts on fixed income securities using the effective yield method.

*Options:* Purchases of options are recorded as an investment, the value of which is marked-to-market at each valuation date. When the Fund enters into a closing sale transaction, the Fund will record a gain or loss depending on the difference between the purchase and sale price. The risks associated with purchasing options and the maximum loss the Fund would incur are limited to the purchase price originally paid.

## **NOTES TO FINANCIAL STATEMENTS (Continued)**

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When the Fund writes an option, an amount equal to the premium received by the Fund is recorded as a liability, the value of which is marked-to-market at each valuation date. When a written option expires, the Fund realizes a gain equal to the amount of the premium originally received. When the Fund enters into a closing purchase transaction, the Fund realizes a gain (or loss if the cost of the closing purchase transaction exceeds the premium received when the option was written) without regard to any unrealized gain or loss on the underlying security, and the liability related to such option is eliminated. When a call option is exercised, the Fund realizes a gain or loss from the sale of the underlying security and the proceeds from such sale are increased by the amount of the premium originally received. When a put option is exercised, the amount of the premium originally received will reduce the cost of the security which the Fund purchased upon exercise.

The risk in writing a call option is that the Fund may forego the opportunity for profit if the market price of the underlying security increases and the option is exercised. The risk in writing a put option is that the Fund may incur a loss if the market price of the underlying security decreases and the option is exercised.

*Repurchase agreements:* The Fund may engage in repurchase agreement transactions. The Fund's investment adviser reviews and approves the eligibility of the banks and dealers with which the Fund may enter into repurchase agreement transactions. The value of the collateral underlying such transactions is at least equal at all times to the total amount of the repurchase obligations, including interest. The Fund maintains possession of the collateral through its custodian and, in the event of counterparty default, the Fund has the right to use the collateral to offset losses incurred. There is the possibility of loss to the Fund in the event the Fund is delayed or prevented from exercising its rights to dispose of the collateral securities.

*Federal income taxes:* The Fund intends to continue to qualify as a regulated investment company by complying with the requirements under subchapter M of the Internal Revenue Code of 1986, as amended, applicable to regulated investment companies and intends to distribute substantially all of its taxable net investment income to its shareholders. Therefore, no federal income tax provision is required.

In June 2006, the FASB issued FASB Interpretation 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes." This standard defines the threshold for recognizing the benefits of tax-return positions in the financial statements as "more-likely-than-not" to be sustained upon challenge by the taxing authority and requires measurement of a tax position meeting the more-likely-than-not criterion, based on the largest benefit that is more than 50 percent likely to be realized. FIN 48 became effective as of the beginning of the first fiscal year beginning after December 15, 2006, with early application permitted if no interim financial statements have been issued. At adoption, companies must adjust their financial statements to reflect only those tax positions that are more likely-than-not to be sustained as of the adoption date. The tax periods open to examination by the Internal Revenue Service include the fiscal years ended November 30, 2008, 2007, 2006 and 2005. The Fund's major tax jurisdictions are federal and California. As of November 30, 2008, the Fund has evaluated the adoption of FIN 48 and determined that there is no material impact on the financial statements.

*Dividends and distributions to shareholders:* The Fund expects to declare dividends on a monthly basis to shareholders of Common Stock ("Shareholders"). Distributions to Shareholders are recorded on

**NOTES TO FINANCIAL STATEMENTS (Continued)**

the ex-dividend date. Any net realized short-term capital gains will be distributed to Shareholders at least annually. Any net realized long-term capital gains may be distributed to Shareholders at least annually or may be retained by the Fund as determined by the Fund's Board of Directors. Capital gains retained by the Fund are subject to tax at the capital gains corporate tax rate. Subject to the Fund qualifying as a regulated investment company, any taxes paid by the Fund on such net realized long-term capital gains may be used by the Fund's Shareholders as a credit against their own tax liabilities. The Fund may pay distributions in excess of the Fund's net investment company taxable income and this excess would be a tax-free return of capital distributed from the Fund's assets.

Income and capital gain distributions are determined and characterized in accordance with income tax regulations which may differ from US GAAP. These differences are primarily due to (1) differing treatments of income and gains on various investment securities held by the Fund, including timing differences, (2) the attribution of expenses against certain components of taxable investment income, and (3) federal regulations requiring proportionate allocation of income and gains to all classes of shareholders.

Distributions from net realized gains for book purposes may include short-term capital gains, which are included as ordinary income for tax purposes, and may exclude amortization of premium on certain fixed income securities, which are not reflected in ordinary income for tax purposes. The tax character of distributions paid, including changes in accumulated undeclared distributions to APS Shareholders, during 2008 and 2007 was as follows:

	<u>Distributions paid in fiscal year 2008</u>			<u>Distributions paid in fiscal year 2007</u>	
	<u>Ordinary Income</u>	<u>Long-Term Capital Gains</u>	<u>Return of Capital</u>	<u>Ordinary Income</u>	<u>Long-Term Capital Gains</u>
Common	\$8,888,100	\$0	\$352,939	\$9,284,238	\$0
Preferred	\$3,854,239	\$0	\$0	\$3,357,998	\$0

As of November 30, 2008, the components of distributable earnings (i.e., ordinary income and capital gain/loss) available to Common and Preferred Stock Shareholders, on a tax basis, were as follows:

<u>Capital (Loss) Carryforward</u>	<u>Undistributed Ordinary Income</u>	<u>Undistributed Long-Term Gain</u>	<u>Net Unrealized Appreciation/(Depreciation)</u>
\$(19,138,376)	\$0	\$0	\$(62,161,927)

At November 30, 2008, the composition of the Fund's \$19,138,376 accumulated realized capital losses was \$1,223,987, \$694,286, \$2,051,511 and \$15,168,592 incurred in 2002, 2004, 2007 and 2008, respectively. These losses may be carried forward and offset against any future capital gains through 2010, 2012, 2015 and 2016, respectively.

*Reclassification of accounts:* During the year ended November 30, 2008, reclassifications were made in the Fund's capital accounts to report these balances on a tax basis, excluding temporary differences, as of November 30, 2008. Additional adjustments may be required in subsequent reporting periods. These reclassifications have no impact on the net asset value of the Fund.

## NOTES TO FINANCIAL STATEMENTS (Continued)

The calculation of net investment income per share in the financial highlights excludes these adjustments. Below are the reclassifications:

<u>Paid-in Capital</u>	<u>Undistributed Net Investment Income</u>	<u>Accumulated Net Realized Gain on Investments</u>
\$8,684	\$329,211	\$(337,895)

*Excise tax:* The Internal Revenue Code of 1986, as amended, imposes a 4% nondeductible excise tax on the Fund to the extent the Fund does not distribute by the end of any calendar year at least (1) 98% of the sum of its net investment income for that year and its capital gains (both long-term and short-term) for its fiscal year and (2) certain undistributed amounts from previous years. The Fund paid \$17,142 of Federal excise taxes attributable to calendar year 2007 in March 2008.

*Additional Accounting Standards:* In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, "Disclosures about Derivative Instruments and Hedging Activities" ("SFAS 161"). SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. SFAS 161 requires enhanced disclosures about the Fund's derivative and hedging activities. Management is currently evaluating the impact the adoption of SFAS 161 will have on the Fund's financial statement disclosures.

### **3. Investment Advisory Fee, Administration Fee, Transfer Agent Fee, Custodian Fee, Directors' Fees and Chief Compliance Officer Fee**

Flaherty & Crumrine Incorporated (the "Adviser") serves as the Fund's investment adviser. Prior to May 22, 2008, the Fund paid the Adviser a monthly fee at an annual rate of 0.625% of the value of the Fund's average monthly total net assets available to Common and Preferred Stock up to \$100 million and 0.50% of the value of the Fund's average monthly total net assets available to Common and Preferred Stock in excess of \$100 million.

For purposes of calculating the fees payable to the Adviser, Administrator and Custodian, the Fund's average weekly total managed assets means the total assets of the Fund minus the sum of accrued liabilities. For purposes of determining total managed assets, the liquidation preference of any preferred shares issued by the Fund is not treated as a liability.

Effective as of May 22, 2008, the Fund pays the Adviser a monthly fee at an annual rate of 0.625% of the value of the Fund's average monthly total managed assets up to \$100 million and 0.50% of the Fund's average monthly total managed assets of \$100 million or more. For purposes of calculating the fees payable to the Adviser, Administrator and Custodian, the Fund's total managed assets means the total assets of the Fund (including any assets attributable to the Fund's auction preferred stock that may be outstanding or otherwise attributable to the use of leverage) minus the sum of accrued liabilities (other than debt, if any, representing financial leverage). For purposes of determining total managed assets, the liquidation preference of any preferred shares issued by the Fund is not treated as a liability.

## NOTES TO FINANCIAL STATEMENTS (Continued)

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PNC Global Investment Servicing (U.S.) Inc. ("PNC"), formerly known as PFPC Inc., serves as the Fund's Administrator. As Administrator, PNC calculates the net asset value of the Fund's shares attributable to Common Stock and generally assists in all aspects of the Fund's administration and operation. As compensation for PNC's services as Administrator, the Fund pays PNC a monthly fee at an annual rate of 0.10% of the first \$200 million of the Fund's average weekly total managed assets, 0.04% of the next \$300 million of the Fund's average weekly total managed assets, 0.03% of the next \$500 million of the Fund's average weekly total managed assets and 0.02% on the Fund's average weekly total managed assets above \$1 billion.

PNC also serves as the Fund's Common Stock dividend-paying agent and registrar (Transfer Agent). As compensation for PNC's services, the Fund pays PNC a fee at an annual rate of 0.02% of the first \$150 million of the Fund's average weekly net assets attributable to Common Stock, 0.0075% of the next \$350 million of the Fund's average weekly net assets attributable to Common Stock, and 0.0025% of the Fund's average weekly net assets attributable to Common Stock above \$500 million, plus certain out of pocket expenses. For the purpose of calculating such fee, the Fund's average weekly net assets attributable to Common Stock are deemed to be the average weekly value of the Fund's total assets minus the sum of the Fund's liabilities. For this calculation, the Fund's liabilities are deemed to include the aggregate liquidation preference of any outstanding Fund preferred shares.

PFPC Trust Company ("PFPC Trust") serves as the Fund's custodian. PFPC Trust is an indirect subsidiary of PNC Financial Services. As compensation for PFPC Trust's services as custodian, the Fund pays PFPC Trust a monthly fee at the annual rate of 0.010% of the first \$200 million of the Fund's average weekly total managed assets, 0.008% of the next \$300 million of the Fund's average weekly total managed assets, 0.006% of the next \$500 million of the Fund's average weekly total managed assets and 0.005% of the Fund's average weekly total managed assets above \$1 billion.

The Fund currently pays each Director who is not a director, officer or employee of the Adviser a fee of \$9,000 per annum, plus \$500 for each in-person meeting of the Board of Directors or any committee and \$150 for each telephone meeting. The Audit Committee Chairman receives an additional annual fee of \$2,500. The Fund also reimburses all Directors for travel and out-of-pocket expenses incurred in connection with such meetings.

The Fund currently pays the Adviser a fee of \$37,500 per annum for Chief Compliance Officer services and reimburses out-of-pocket expenses incurred in connection with providing services in this role.

#### **4. Purchases and Sales of Securities**

For the year ended November 30, 2008, the cost of purchases and proceeds from sales of securities excluding short-term investments, aggregated \$93,431,463 and \$125,085,425, respectively.

At November 30, 2008, the aggregate cost of securities for federal income tax purposes was \$167,004,681, the aggregate gross unrealized appreciation for all securities in which there is an excess of value over tax cost was \$1,868,989 and the aggregate gross unrealized depreciation for all securities in which there is an excess of tax cost over value was \$64,030,916.

**NOTES TO FINANCIAL STATEMENTS (Continued)**

Written option transactions during the year ended November 30, 2008, are summarized as follows:

	<u>Contract Amounts</u>	<u>Premiums Received</u>
Written options outstanding at beginning of year . . . .	0	\$0
Options Opened . . . . .	255	444,102
Options Exercised . . . . .	0	0
Options Expired . . . . .	0	0
Options Closed . . . . .	(255)	(444,102)
Written options outstanding at end of period . . . . .	0	\$0

**5. Common Stock**

At November 30, 2008, 240,000,000 shares of \$0.01 par value Common Stock were authorized.

Common Stock transactions were as follows:

	<u>Year Ended 11/30/08</u>		<u>Year Ended 11/30/07</u>	
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>
Shares issued under the Dividend Reinvestment and Cash Purchase Plan . . . . .	88,991	\$820,340	48,835	\$591,605

**6. Auction Preferred Stock (APS) (formerly known as Money Market Cumulative Preferred™ Stock)**

The Fund's Articles of Incorporation authorize the issuance of up to 10,000,000 shares of \$0.01 par value preferred stock. The APS is senior to the Common Stock and results in the financial leveraging of the Common Stock. Such leveraging tends to magnify both the risks and opportunities to Common Stock Shareholders. Dividends on shares of APS are cumulative.

The Fund is required to meet certain asset coverage tests with respect to the APS. If the Fund fails to meet these requirements and does not correct such failure, the Fund may be required to redeem, in part or in full, APS at a redemption price of \$100,000 per share plus an amount equal to the accumulated and unpaid dividends on such shares in order to meet these requirements. Additionally, failure to meet the foregoing asset requirements could restrict the Fund's ability to pay dividends to Common Stock Shareholders and could lead to sales of portfolio securities at inopportune times.

If the Fund allocates any net gains or income ineligible for the dividends received deduction to shares of the APS, the Fund is required to make additional distributions to APS Shareholders or to pay a higher dividend rate in amounts needed to provide a return, net of tax, equal to the return had such originally paid distributions been eligible for the dividends received deduction.

An auction of the APS is generally held every 49 days. Existing APS Shareholders may submit an order to hold, bid or sell such shares at par value on each auction date. APS Shareholders may also trade shares in the secondary market, if any, between auction dates. Since mid-February 2008, the normal

**NOTES TO FINANCIAL STATEMENTS (Continued)**

functioning of the market for auction preferred stock of U.S. closed-end funds, including the Fund, has been disrupted, and the Fund's APS holders have not been able to sell their shares through the auction process.

The Fund announced the redemption of APS shares as noted in the table below. Mandatory redemptions are required under certain circumstances, as discussed above. Shares were redeemed at a redemption price equal to the liquidation preference of \$100,000 per share, plus the amount of accumulated but unpaid dividends for each redemption date, respectively.

Description	\$ Amount of APS	Announce Date	Payment Date
Optional Redemption	\$10,000,000	October 1, 2008	October 14, 2008
Mandatory Redemption	\$2,400,000	October 21, 2008	November 20, 2008*

\* Shares were redeemed on the date reflected; however, from the Fund's perspective, the November 20 mandatory redemption was effective as of October 24, 2008. The earlier effective date was due to the unconditional deposit of funds with the paying agent.

The Fund repurchased APS shares in negotiated private transactions as noted in the table below. The purchases were made at a price of \$80,000 per share. The difference between the purchase price and the liquidation preference of \$100,000 per share is included on the Statement of Changes to Net Assets Available to Common Stock in this report as "Gain on repurchase of Auction Preferred Stock". The gain resulting from both purchases was \$1.6 million.

Description	\$ Amount of APS	Trade Date	Settlement Date
Share Repurchase	\$4,500,000	November 10, 2008	November 14, 2008
Share Repurchase	\$3,500,000	November 10, 2008	November 18, 2008

At November 30, 2008, 496 shares of APS were outstanding at the annualized rate of 4.32%. The dividend rate, as set by the auction process, is generally expected to vary with short-term interest rates. As a result of ongoing disruptions in the auction market, the Fund is paying a dividend rate equal to the maximum rate, as defined in the Fund's Articles Supplementary. The maximum rate is equal to the greater of (i) 175% of the reference rate and (ii) 2.50% plus the reference rate. "Reference Rate" means the applicable "AA" Non-Financial Composite Commercial Paper Rate. These rates may vary in a manner unrelated to the income received on the Fund's assets, which could have either a beneficial or detrimental impact on net investment income and gains available to Common Stock Shareholders. While the Fund expects to structure its portfolio holdings and hedging transactions to lessen such risks to Common Stock Shareholders, there can be no assurance that such results will be attained.

## **7. Portfolio Investments, Concentration and Investment Quality**

The Fund invests primarily in a diversified portfolio of preferred securities. This includes traditional preferred stocks eligible for the inter-corporate dividends received deduction ("DRD") and fully taxable preferred securities. Under normal market conditions, at least 80% of the value of the Fund's net assets will be invested in preferred securities. Also, under normal market conditions, the Fund invests at

## **NOTES TO FINANCIAL STATEMENTS (Continued)**

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least 25% of its total assets in securities issued by companies in the utilities industry and a significant percentage, but no more than 25% of its total assets, in securities issued by companies in the banking industry. The Fund's portfolio may therefore be subject to greater risk and market fluctuation than a portfolio of securities representing a broader range of investment alternatives.

The Fund may invest up to 25% of its assets at the time of purchase in securities rated below investment grade. These securities must be rated at least either "Ba3" by Moody's Investors Service, Inc. or "BB-" by Standard & Poor's or, if unrated, judged to be comparable in quality by the Adviser, in any case, at the time of purchase. However, these securities must be issued by an issuer having a class of senior debt rated investment grade outstanding.

The Fund may invest up to 15% of its assets in common stocks and, under normal market conditions, up to 20% of its assets in debt securities. Certain of its investments in hybrid, i.e., fully taxable, preferred securities will be subject to the foregoing 20% limitation to the extent that, in the opinion of the Adviser, such investments are deemed to be debt-like in key characteristics. Typically, a security will not be considered debt-like (a) if an issuer can defer payment of income for eighteen months or more without triggering an event of default and (b) if such issue is a junior and fully subordinated liability of an issuer or its ultimate guarantor.

In addition to foreign money market securities, the Fund may invest up to 30% of its total assets in the securities of companies organized or having their principal place of business outside the United States. All foreign securities held by the Fund will be denominated in U.S. dollars.

### **8. Special Investment Techniques**

The Fund may employ certain investment techniques in accordance with its fundamental investment policies. These may include the use of when-issued and delayed delivery transactions. Securities purchased or sold on a when-issued or delayed delivery basis may be settled within 45 days after the date of the transaction. Such transactions may expose the Fund to credit and market valuation risk greater than that associated with regular trade settlement procedures. The Fund may also enter into transactions, in accordance with its investment policies, involving any or all of the following: short sales of securities, purchases of securities on margin, futures contracts, interest rate swaps, swap futures, options on futures contracts, options on securities, swaptions and certain credit derivative transactions, including, but not limited to, the purchase and sale of credit protection. As in the case of when-issued securities, the use of over-the-counter derivatives, such as interest rate swaps, swaptions, and credit default swaps may expose the Fund to greater credit, operations, liquidity, and valuation risk than is the case with regulated, exchange traded futures and options. These transactions are used for hedging or other appropriate risk-management purposes, or, under certain other circumstances, to increase return. No assurance can be given that such transactions will achieve their desired purposes or will result in an overall reduction of risk to the Fund.

**NOTES TO FINANCIAL STATEMENTS (Continued)**

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**9. Securities Lending**

The Fund may lend up to 15% of its total assets (including the value of the loan collateral) to certain qualified brokers in order to earn additional income. The Fund receives compensation in the form of fees or interest earned on the investment of any cash collateral received. The Fund also continues to receive interest and dividends on the securities loaned. The Fund receives collateral in the form of cash or securities with a market value at least equal to the market value of the securities on loan, including accrued interest. In the event of default or bankruptcy by the borrower, the Fund could experience delays and costs in recovering the loaned securities or in gaining access to the collateral. The Fund has the right under the lending agreement to recover the securities from the borrower on demand. As of November 30, 2008, there were no securities on loan by the Fund. Income from securities lending for the year ended November 30, 2008 was \$31,152 and is included in interest income on the Statement of Operations.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders  
Flaherty & Crumrine Preferred Income Opportunity Fund Incorporated:

We have audited the accompanying statement of assets and liabilities of Flaherty & Crumrine Preferred Income Opportunity Fund Incorporated, including the portfolio of investments, as of November 30, 2008, and the related statement of operations for the year then ended, the statements of changes in net assets for each of the years in the two-year period then ended, and the financial highlights for each of the years in the five-year period then ended. These financial statements and financial highlights are the responsibility of management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of November 30, 2008 by correspondence with the custodian. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of Flaherty & Crumrine Preferred Income Opportunity Fund Incorporated as of November 30, 2008, and the results of its operations for the year then ended, the changes in its net assets for each of the years in the two-year period then ended, and the financial highlights for each of the years in the five-year period then ended, in conformity with U.S. generally accepted accounting principles.

**KPMG LLP**

Boston, Massachusetts  
January 23, 2009

**SUPPLEMENTARY TAX INFORMATION (Unaudited)**

Distributions to Common Stock and Auction Preferred Stock (APS) Shareholders are characterized as follows for purposes of Federal income taxes (as a percentage of total distributions, including any tax return of capital):

**Fiscal Year 2008**

	<u>Individual Shareholder</u>			<u>Corporate Shareholder</u>		
	<u>QDI</u>	<u>Ordinary Income</u>	<u>Tax Return of Capital</u>	<u>DRD</u>	<u>Ordinary Income</u>	<u>Tax Return of Capital</u>
APS	60.85%	39.15%	0.00%	54.57%	45.43%	0.00%
Common Stock	58.31%	37.53%	4.16%	52.30%	43.54%	4.16%

**Calendar Year 2008**

	<u>Individual Shareholder</u>			<u>Corporate Shareholder</u>		
	<u>QDI</u>	<u>Ordinary Income</u>	<u>Tax Return of Capital</u>	<u>DRD</u>	<u>Ordinary Income</u>	<u>Tax Return of Capital</u>
APS	58.87%	41.13%	0.00%	53.62%	46.38%	0.00%
Common Stock	57.00%	39.09%	3.91%	51.99%	44.10%	3.91%

Qualified Dividend Income ("QDI") distributions are taxable at a maximum 15% personal tax rate.

**Section 19 Notices**

Section 19 of the 1940 Act requires registered investment companies to include a notice with the payment of a dividend if a portion of that dividend may come from sources other than undistributed net income (other sources could include realized gains from the sale of securities and non-taxable return of capital). Copies of the Section 19 notices for the Fund are available on the website at [www.preferredincome.com](http://www.preferredincome.com).

Form 1099-DIV will be sent to shareholders in January 2009 reporting the amount and tax characterization of distributions for the 2008 calendar year.

## **ADDITIONAL INFORMATION (Unaudited)**

### **Dividend Reinvestment and Cash Purchase Plan**

Under the Fund's Dividend Reinvestment and Cash Purchase Plan (the "Plan"), a shareholder whose Common Stock is registered in his or her own name will have all distributions reinvested automatically by PNC as agent under the Plan, unless the shareholder elects to receive cash. Distributions with respect to shares registered in the name of a broker-dealer or other nominee (that is, in "street name") may be reinvested by the broker or nominee in additional shares under the Plan, but only if the service is provided by the broker or nominee, unless the shareholder elects to receive distributions in cash. A shareholder who holds Common Stock registered in the name of a broker or other nominee may not be able to transfer the Common Stock to another broker or nominee and continue to participate in the Plan. Investors who own Common Stock registered in street name should consult their broker or nominee for details regarding reinvestment.

The number of shares of Common Stock distributed to participants in the Plan in lieu of a cash dividend is determined in the following manner. Whenever the market price per share of the Fund's Common Stock is equal to or exceeds the net asset value per share on the valuation date, participants in the Plan will be issued new shares valued at the higher of net asset value or 95% of the then current market value. Otherwise, PNC will buy shares of the Fund's Common Stock in the open market, on the New York Stock Exchange ("NYSE") or elsewhere, on or shortly after the payment date of the dividend or distribution and continuing until the ex-dividend date of the Fund's next distribution to holders of the Common Stock or until it has expended for such purchases all of the cash that would otherwise be payable to the participants. The number of purchased shares that will then be credited to the participants' accounts will be based on the average per share purchase price of the shares so purchased, including brokerage commissions. If PNC commences purchases in the open market and the then current market price of the shares (plus any estimated brokerage commissions) subsequently exceeds their net asset value most recently determined before the completion of the purchases, PNC will attempt to terminate purchases in the open market and cause the Fund to issue the remaining dividend or distribution in shares. In this case, the number of shares received by the participant will be based on the weighted average of prices paid for shares purchased in the open market and the price at which the Fund issues the remaining shares. These remaining shares will be issued by the Fund at the higher of net asset value or 95% of the then current market value.

Plan participants are not subject to any charge for reinvesting dividends or capital gains distributions. Each Plan participant will, however, bear a proportionate share of brokerage commissions incurred with respect to PNC's open market purchases in connection with the reinvestment of dividends or capital gains distributions. For the year ended November 30, 2008, \$1,848 in brokerage commissions were incurred.

The automatic reinvestment of dividends and capital gains distributions will not relieve Plan participants of any income tax that may be payable on the dividends or capital gains distributions. A participant in the Plan will be treated for Federal income tax purposes as having received, on the dividend payment date, a dividend or distribution in an amount equal to the cash that the participant could have received instead of shares.

## **ADDITIONAL INFORMATION (Unaudited) (Continued)**

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In addition to acquiring shares of Common Stock through the reinvestment of cash dividends and distributions, a shareholder may invest any further amounts from \$100 to \$3,000 semi-annually at the then current market price in shares purchased through the Plan. Such semi-annual investments are subject to any brokerage commission charges incurred by PNC under the Plan.

A shareholder whose Common Stock is registered in his or her own name may terminate participation in the Plan at any time by notifying PNC in writing, by completing the form on the back of the Plan account statement and forwarding it to PNC, or by calling PNC directly. A termination will be effective immediately if notice is received by PNC not less than 10 days before any dividend or distribution record date. Otherwise, the termination will be effective, and only with respect to any subsequent dividends or distributions, on the first day after the dividend or distribution has been credited to the participant's account in additional shares of the Fund. Upon termination and according to a participant's instructions, PNC will either (a) issue certificates for the whole shares credited to the shareholder's Plan account and a check representing any fractional shares or (b) sell the shares in the market. Shareholders who hold Common Stock registered in the name of a broker or other nominee should consult their broker or nominee to terminate participation.

The Plan is described in more detail in the Fund's Plan brochure. Information concerning the Plan may be obtained from PNC at 1-800-331-1710.

### **Proxy Voting Policies and Proxy Voting Record on Form N-PX**

The Fund files Form N-PX with its complete proxy voting record for the 12 months ended June 30<sup>th</sup> no later than August 31<sup>st</sup> of each year. The Fund filed its latest Form N-PX with the Securities and Exchange Commission ("SEC") on August 7, 2008. This filing, as well as the Fund's proxy voting policies and procedures, are available (i) without charge, upon request, by calling the Fund's transfer agent at 1-800-331-1710 and (ii) on the SEC's website at [www.sec.gov](http://www.sec.gov). In addition, the Fund's proxy voting policies and procedures are available on the Fund's website at [www.preferredincome.com](http://www.preferredincome.com).

### **Portfolio Schedule on Form N-Q**

The Fund files a complete schedule of portfolio holdings with the SEC for the first and third fiscal quarters on Form N-Q, the latest of which was filed for the quarter ended August 31, 2008. The Fund's Form N-Q is available on the SEC's website at [www.sec.gov](http://www.sec.gov) or may be viewed and obtained from the SEC's Public Reference Room in Washington D.C. Information on the operation of the Public Reference Section may be obtained by calling 1-800-SEC-0330.

### **Portfolio Management Team**

In managing the day-to-day operations of the Fund, the Adviser relies on the expertise of its team of money management professionals, consisting of Messrs. Crumrine, Ettinger, Stone and Chadwick. The professional backgrounds of each member of the management team are included in the "Information about Fund Directors and Officers" section of this report.

**ADDITIONAL INFORMATION (Unaudited) (Continued)**

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**Certifications**

Included in the Annual Written Affirmation submitted to the NYSE, Donald F. Crumrine, as the Fund's Chief Executive Officer, has certified that, as of May 16, 2008, he was not aware of any violation by the Fund of applicable NYSE corporate governance listing standards. The Fund's reports to the SEC on Forms N-CSR and N-Q contain certifications by the Fund's principal executive officer and principal financial officer that relate to the Fund's disclosure in such reports and that are required by Rule 30a-2(a) under the 1940 Act.

**ADDITIONAL INFORMATION (Unaudited) (Continued)****Information about Fund Directors and Officers**

The business and affairs of the Fund are managed under the direction of the Fund's Board of Directors. Information pertaining to the Directors and officers of the Fund is set forth below.

<b>Name, Address, and Age</b>	<b>Position(s) Held with Fund</b>	<b>Term of Office and Length of Time Served*</b>	<b>Principal Occupation(s) During Past Five Years</b>	<b>Number of Funds In Fund Complex Overseen By Director</b>	<b>Other Directorships Held By Director**</b>
<b>NON-INTERESTED DIRECTORS:</b>					
<b>David Gale</b> Delta Dividend Group, Inc 220 Montgomery Street Suite 1920 San Francisco, CA 94104 Age: 59	Director	Class I Director since January 1997	President of Delta Dividend Group, Inc. (investments)	4	
<b>Morgan Gust</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 61	Director	Class III Director since February 1992	Owner and operator of various entities engaged in agriculture and real estate; Former President of Giant Industries, Inc. (petroleum refining and marketing) from March 2002 through June 2007	4	CoBiz, Financial, Inc. (financial services)
<b>Karen H. Hogan†</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 47	Director	Class III Director since April 2005	Active Committee Member and Volunteer to several non-profit organizations; from September 1985 to January 1997, Senior Vice President of Preferred Stock Origination at Lehman Brothers and Previously, Vice President of New Product Development	4	

\* The Fund's Board of Directors is divided into three classes, each class having a term of three years. Each year the term of office of one class expires and the successor or successors elected to such class serve for a three year term. The three year term for each class expires as follows:

**Class I Director** – three year term expires at the Fund's 2009 Annual Meeting of Shareholders; director may continue in office until his successor is duly elected and qualified.

**Class II Directors** – three year term expires at the Fund's 2010 Annual Meeting of Shareholders; directors may continue in office until their successors are duly elected and qualified.

**Class III Directors** – three year term expires at the Fund's 2011 Annual Meeting of Shareholders; directors may continue in office until their successors are duly elected and qualified.

\*\* Each Director also serves as a Director for Flaherty & Crumrine Preferred Income Fund, Flaherty & Crumrine/Claymore Preferred Securities Income Fund, and Flaherty & Crumrine/Claymore Total Return Fund.

† As a Director, represents holders of shares of the Fund's Auction Preferred Stock.

## ADDITIONAL INFORMATION (Unaudited) (Continued)

<u>Name, Address, and Age</u>	<u>Position(s) Held with Fund</u>	<u>Term of Office and Length of Time Served*</u>	<u>Principal Occupation(s) During Past Five Years</u>	<u>Number of Funds In Fund Complex Overseen By Director</u>	<u>Other Directorships Held By Director**</u>
<b>NON-INTERESTED DIRECTORS:</b>					
<b>Robert F. Wulf</b> P.O. Box 753 Neskowin, OR 97149 Age: 71	Director and Audit Committee Chairman	Class II Director since February 1992	Financial Consultant; Trustee, University of Oregon Foundation; Trustee, San Francisco Theological Seminary	4	
<b>INTERESTED DIRECTOR:</b>					
<b>Donald F. Crumrine†, ††</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 61	Director, Chairman of the Board and Chief Executive Officer	Class II Director since February 1992	Chairman of the Board and Director of Flaherty & Crumrine Incorporated	4	

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† As a Director, represents holders of shares of the Fund's Auction Preferred Stock.

†† "Interested person" of the Fund as defined in the 1940 Act. Mr. Crumrine is considered an "interested person" because of his affiliation with Flaherty & Crumrine Incorporated, which acts as the Fund's investment adviser.

**ADDITIONAL INFORMATION (Unaudited) (Continued)**

<b>Name, Address, and Age</b>	<b>Position(s) Held with Fund</b>	<b>Term of Office and Length of Time Served</b>	<b>Principal Occupation(s) During Past Five Years</b>
<b>OFFICERS:</b>			
<b>Robert M. Ettinger</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 50	President	Since October 2002	President and Director of Flaherty & Crumrine Incorporated
<b>R. Eric Chadwick</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 33	Chief Financial Officer, Vice President and Treasurer	Since July 2004	Director of Flaherty & Crumrine Incorporated since June 2006; Vice President of Flaherty & Crumrine Incorporated
<b>Chad C. Conwell</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 36	Chief Compliance Officer, Vice President and Secretary	Since July 2005	Chief Compliance Officer of Flaherty & Crumrine Incorporated since September 2005; Vice President of Flaherty & Crumrine Incorporated since July 2005; Attorney with Paul, Hastings, Janofsky & Walker LLP from September 1998 to June 2005
<b>Bradford S. Stone</b> 392 Springfield Avenue Mezzanine Suite Summit, NJ 07901 Age: 49	Vice President and Assistant Treasurer	Since July 2003	Director of Flaherty & Crumrine Incorporated since June 2006; Vice President of Flaherty & Crumrine Incorporated
<b>Laurie C. Lodolo</b> 301 E. Colorado Boulevard Suite 720 Pasadena, CA 91101 Age: 45	Assistant Compliance Officer, Assistant Treasurer and Assistant Secretary	Since July 2004	Assistant Compliance Officer of Flaherty & Crumrine Incorporated since August 2004; Secretary of Flaherty & Crumrine Incorporated since February 2004; Account Administrator of Flaherty & Crumrine Incorporated

## Directors

Donald F. Crumrine, CFA  
Chairman of the Board  
David Gale  
Morgan Gust  
Karen H. Hogan  
Robert F. Wulf, CFA

## Officers

Donald F. Crumrine, CFA  
Chief Executive Officer  
Robert M. Ettinger, CFA  
President  
R. Eric Chadwick, CFA  
Chief Financial Officer,  
Vice President and Treasurer  
Chad C. Conwell  
Chief Compliance Officer,  
Vice President and Secretary  
Bradford S. Stone  
Vice President and  
Assistant Treasurer  
Laurie C. Lodolo  
Assistant Compliance Officer,  
Assistant Treasurer and  
Assistant Secretary

## Investment Adviser

Flaherty & Crumrine Incorporated  
e-mail: [flaherty@pfdincome.com](mailto:flaherty@pfdincome.com)

## Questions concerning your shares of Flaherty & Crumrine Preferred Income Opportunity Fund?

- If your shares are held in a Brokerage Account, contact your Broker.
- If you have physical possession of your shares in certificate form, contact the Fund's Transfer Agent & Shareholder Servicing Agent —  
PNC Global Investment Servicing  
(U.S.) Inc.  
P.O. Box 43027  
Providence, RI 02940-3027  
1-800-331-1710

**This report is sent to shareholders of Flaherty & Crumrine Preferred Income Opportunity Fund Incorporated for their information. It is not a Prospectus, circular or representation intended for use in the purchase or sale of shares of the Fund or of any securities mentioned in this report.**



Flaherty & Crumrine  
PREFERRED INCOME  
OPPORTUNITY FUND

# Annual Report

November 30, 2008

[www.preferredincome.com](http://www.preferredincome.com)