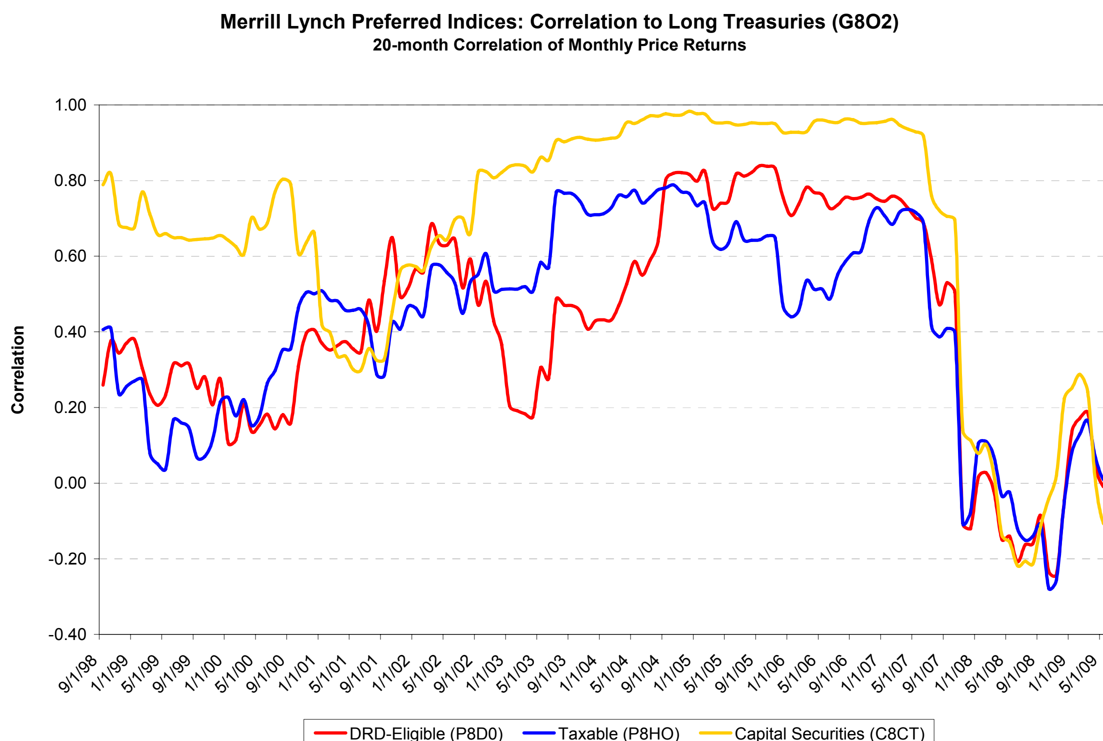
Update on Hedging Strategy

Historically, each Flaherty & Crumrine Fund[1] has employed what we called a "safety net" hedging strategy involving the purchase of out-of-the-money (OTM) put options of Treasury bond futures or interest rate swaps (swaptions). The goal of the hedging strategy is to limit the decline in the net asset value (NAV) of each Fund that is due to a rise in the general level of long-term interest rates. For most of the Funds' lives, the relationship between price changes in Treasuries or swaps and preferreds was reasonably consistent. As shown in the graph below, although the correlation between Treasury or swap prices and preferred securities prices was not perfect, it was reasonably good and generally had the proper sign – when Treasury bond prices rose (fell), preferred prices tended to rise (fall) as well.



As the credit crisis began to unfold in August 2007, this relationship started to break down. Around that time, each Fund began to scale back the hedge (buying further OTM options and/or reducing the number of options purchased) in recognition of the looser correlation between preferreds and Treasuries. In the autumn of 2008, as the financial crisis intensified with the conservatorship of Fannie Mae and Freddie Mac, the rescues of AIG and Citigroup and the bankruptcy of Lehman Brothers Holdings, the correlation between preferreds and each Fund's interest rate hedging instruments reversed. Preferred prices plunged as Treasury and interest rate swap prices soared. Simultaneously, in this uncertain and fearful environment, market volatility hit historical highs, which pushed option prices up dramatically. Thus, each Fund was faced with

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[1] The four Flaherty & Crumrine Funds are Flaherty & Crumrine Preferred Income Fund (NYSE: PFD), Flaherty & Crumrine Preferred Income Opportunity Fund (NYSE: PFO), Flaherty & Crumrine/Claymore Preferred Securities Income Fund (NYSE: FFC) and Flaherty & Crumrine/Claymore Total Return Fund (NYSE: FLC).

a situation where its hedging strategy would be both extremely expensive and unlikely to protect NAV. As a result, each Fund suspended its interest rate hedging program in November 2008.

Looking forward, we are starting to see some normalization in preferred securities markets, but we do not think it is time yet to reinstate the Safety Net hedging strategy. Although the correlation between preferred prices and Treasury or interest rate swap prices has increased, it's still only around zero. This reflects the fact that preferred securities prices are moving mainly on credit news, not on changes in the general level of interest rates. Moreover, while we believe that the worst of the financial crisis has past, the economy is still weak and market fears could intensify again, prompting another wave of Treasury bond buying and preferred securities selling. This would reduce the market value of the hedge at the same time preferred prices were falling, adding to the decline in NAV. (Put options on Treasuries or swaps gain value as Treasury or swap prices fall and lose value as they rise.)

Alternatively, if the economy gradually improves and financial markets continue to heal, then it's likely that Treasury bond prices would fall while preferred prices rise. In this case, both preferreds and the hedge instruments rise in value. Either way, we believe that hedging in such a market would *add* risk to the Funds, not reduce it. That's not what we are trying to accomplish with the hedge.

We also need to consider the cost of the hedge in deciding when to reinstate it. Even if we conclude that hedging likely would reduce risk, the cost of the hedge needs to be reasonable in relation to the amount of risk reduction. Currently, we think options are still too expensive for the risk reduction they can deliver. Implied price volatility (a measure of the cost of option protection) on Treasury bond futures options is now around 15% annualized. That is well below its peak of nearly 25% from last autumn, but it's still about double what it was prior to the crisis. In addition, the yield curve is very steep, which further increases the cost of hedging.

Add it up, and we do not think it is wise to spend Fund assets on interest rate options at the present time, especially when there are still plenty of attractively priced preferreds to buy. At some point, we are likely to conclude that preferred markets have returned to "normal," at which point we should again expect our hedge instruments to reduce portfolio risk rather than add to it. Option prices also are bound to decline as the crisis passes, which should reduce the cost of hedging. When those days return, we will consider reinstating the Safety Net hedge.

July 6, 2009

Notes to Indices

All index returns do not reflect any expenses. They are presented on a pre-tax basis and are calculated on a month-end basis. In addition, index returns are unmanaged and do not necessarily represent any Flaherty & Crumrine Fund.

The Merrill Lynch 8% Capped DRD-Eligible Preferred Stock Index (P8D0), Merrill Lynch 8% Capped Hybrid Preferred Securities Index (P8HO), and Merrill Lynch 8% Capped Corporate US Capital Securities Index (C8CT) are referenced in this report. P8HO is a subset of the Merrill Lynch Fixed Rate Preferred Securities Index that contains all listed, subordinated constituents of the fixed rate index with a payment deferral feature. The fixed rate index includes investment grade DRD eligible and non-DRD eligible preferred stock and senior debt. P8D0 is a subset of the fixed rate index that contains fixed rate preferred securities which qualify for the corporate dividends received deduction and are issued by U.S. corporations and government agencies. C8CT is a subset of the Merrill Lynch Corporate All Capital Securities Index that contains 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. All three indices have the issuers capped at 8%.

The Merrill Lynch Long US Treasury Bond Index (G8O2) is referenced in this report. G8O2 is an index of all publicly-held U.S. Treasury bonds with maturity of 15-years or longer as of the index date.