Mutual fund investing involves risks, including possible loss of principal. Unless otherwise specified, all information is shown as of December 31, 2016. Past performance information quoted below does not guarantee future results. The investment return and principal value of an investment in The Fairholme Fund, The Fairholme Focused Income Fund ("The Income Fund"), and The Fairholme Allocation Fund ("The Allocation Fund"), (each being a "Fund" and collectively, the "Funds"), will fluctuate so that the value of an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance information quoted below. Performance figures reflect the deduction of expenses and assume reinvestment of dividends and capital gains but do not reflect a 2.00% redemption fee imposed by The Fairholme Fund and The Allocation Fund on shares redeemed or exchanged within 60 calendar days of their purchase. Most recent month-end performance and answers to any questions you may have can be obtained by calling Shareholder Services at (866) 202-2263. Each Fund maintains a focused portfolio of investments in a limited number of issuers and does not seek to diversify its investments. This exposes each Fund to the risk of unanticipated industry conditions and risks particular to a single company or the securities of a single company within its respective portfolio. The S&P 500 Index (the "S&P 500") is a widely recognized, unmanaged index of 500 of the largest companies in the United States as measured by market capitalization and the performance of the S&P 500 assumes the reinvestment of all dividends and distributions. The Bloomberg Barclays U.S. Aggregate Bond Index (the "Bloomberg Barclays Bond Index") is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, and includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency). The S&P 500 and the Bloomberg Barclays Bond Index are used for comparative purposes only, and are not meant to be indicative of a Fund's performance, asset composition, or volatility. A Fund's performance may differ markedly from the performance of the S&P 500 or the Bloomberg Barclays Bond Index in either up or down market trends. Because indices cannot be invested in directly, these index returns do not reflect a deduction for fees, expenses, or taxes. The expense ratios for The Fairholme Fund, The Income Fund, and The Allocation Fund reflected in the current prospectus dated March 29, 2016, are 1.04%, 1.01%, and 1.01%, respectively, and may differ from the actual expenses incurred by the Funds for the period covered by the Funds' Annual Report. The expense ratio includes any acquired fund fees and expenses which are incurred indirectly by each Fund as a result of investments in securities issued by one or more investment companies.

January 30, 2017

To the Shareholders and Directors of Fairholme Funds, Inc.:

Since Fairholme's inception, we have pursued a value-oriented investment approach that avoids popular securities in favor of companies that are both unloved and undervalued. Although the world has become more uncertain and the recognition of value is taking longer, we remain optimistic. Business cycles exist. History continues to rhyme. Investors march to the drums of both greed and fear. Markets move with asset values, but not always. Since 2000, our letters have tried to explain how we assay fundamental values and assess the differences between such values and their market prices. Our goal remains to buy dollars for fifty cents or less.

Technological disintermediation and regulatory overreach have increasingly affected investment conditions, including the supply of and demand for human and capital resources. Fairholme's investment checklist has necessarily adapted to these and other evolving dynamics. Continuous review of risks and returns resulted in transitioning the Fairholme mutual funds (collectively, the "Funds") from common equities toward shorter term, higher yielding, and more senior debt obligations and reduced exposure to financials that may lose more than can be gained amid higher interest rates over the coming years. Our investments have significantly less correlation with equity market indices. We believe that the Funds have the wherewithal for outsized rewards while protecting against the inevitable headwinds caused by rising interest rates and high valuation levels.

Exchange-traded index funds ("ETFs") are all the rage these days for their straightforward, low-cost replication of broad indexes. While it is a good idea to efficiently go long America, ETFs occasionally swing to illogical extremes when popularity leads to overpriced and overweighted constituents. When bubbles burst, it may take a decade or longer to recover what may be lost in a few months. Given the choice, we strongly prefer to focus on the unpopular, underpriced, and underweighted. We recall Charlie Munger's advice:

> *Students learn corporate finance at business schools. They are taught that the whole secret is diversification. But the rule is exactly the opposite. The 'know-nothing' investor should practice diversification, but it is crazy if you are an expert. The goal of investment is to find situations where it is safe not to diversify. If you only put 20% into the opportunity of a lifetime, you are not being rational. Very seldom do we get to buy as much of any good idea as we would like to.*

Fannie Mae and Freddie Mac

Odds favor Fannie Mae or Freddie Mac helped your parents and you obtain a first home, and that the same will be true for your children and grandchildren. Fannie Mae and Freddie Mac guarantee the timely payment of principal and interest demanded by lenders. Investors just like you own and fund their operations. Yet, we fight an expropriation of our principal by the government. Here's where we stand: prosperity exists in a capitalist society only when contracts are honored. The rule of law must be respected and cannot be eliminated by fiat. If you disagree, just see the despair in Venezuela. We look forward to a decision from the United States Court of Appeals for the District of Columbia Circuit that protects and preserves our investments in Fannie Mae and Freddie Mac. Signs indicate that we are nearing the end of our "Alice in Washington" journey.

Our three appellate court judges (Janice Brown, Doug Ginsburg, and Patricia Millett) published a separate decision (*Heartland Plymouth Court MI, LLC v. National Labor Relations Board*) that we believe is instructive to their eventual ruling in our case. Writing for the majority, Judge Brown stated:

> *As this case shows, what the [National Labor Relations Board ("NLRB")] proffers as a sophisticated tool towards national uniformity can just as easily be an instrument of oppression, allowing the government to tell its citizens: "We don't care what the law says, if you want to beat us, you will have to fight us" … We recognize the [NLRB's] unimpeded access to the public fisc means these modest fees can be dismissed as chump change. But money does not explain the Board's bad faith; "the pleasure of being above the rest" does. See C.S. Lewis, MERE CHRISTIANITY 122 (Harper Collins 2001). Let the word go forth: for however much the judiciary has emboldened the administrative state, we "say what the law is." Marbury, 5 U.S. (1 Cranch) at 177. In other words, administrative hubris does not get the last word under our Constitution. And citizens can count on it.*[1]

In another decision (*DirecTV, Inc. v. National Labor Relations Board*), Judge Brown was even more direct about the perils of unchecked executive action when she noted that: "Judicial review should mean more than batting cleanup for the administrative state."[2] If applied in equal measure, these sentiments bode well for our case.

Finding no clear reason in favor of extraordinary secrecy, U.S. Court of Federal Claims Judge Margaret Sweeney (*Fairholme Funds v. United States,* No. 1:13-cv-00465-MMS) recognized that the government's attempt to hide thousands of documents is unjustifiable, for the work of our government must withstand public scrutiny. Judge Sweeney issued a court order directing the Obama Administration to produce scores of documents that were improperly withheld based on assertions of deliberative process privilege, bank examiner privilege, and presidential communications privilege. Her decision was largely upheld upon review by the U.S. Court of Appeals for the Federal Circuit. In due course, we expect further proof that Obama Administration officials violated laws established by our founding fathers to prevent such unfettered discretion. Alexander Hamilton said it best:

> *The nature of the contract in its origin is, that the public will pay the sum expected in the security, to the first holder, or his assignee. The intent, in making the security assignable, is, that the proprietor may be able to make use of his property, by selling it for as much as it may be worth in the market, and that the buyer may be safe in the purchase. Every buyer therefore stands exactly in the place of the seller, has the same right with him to the identical sum expressed in the security and having acquired the right, by fair purchase, and in conformity to the original agreement and intention of the government, his claim cannot be disputed, without manifest injustice.*[3]

We are frequently asked (i) why we own the preferred stock of Fannie Mae and Freddie Mac instead of common shares, and (ii) how this story ends. Our answers are simple: the provisions of the preferred stock contracts that we own provide us with greater security and certainty than the common stock and, as you know, we are not speculators. In this instance, we have invested in two superb insurance companies with unparalleled brand recognition, talented human capital, proprietary information technology infrastructure, and robust industry relationships. Fannie Mae and Freddie Mac are quintessential examples of what Warren Buffett would describe as "economic castles protected by unbreachable moats." As interest rates rise, Fannie Mae's and Freddie Mac's portfolios become even more valuable – and we anticipate that Q4 2016 results will reflect this positive impact. Allow me to emphasize a few points that you may have heard before:

Any intellectually honest observer would proffer that the rational steps for resolution are: (i) halt the payment of any further monies to the United States Treasury; (ii) permit the companies to retain capital in order to protect taxpayers; (iii) transform the companies into low-risk, public utilities with regulated rates of return, just like your local electric company; and (iv) eventually release them from the shackles of a perpetual conservatorship so they can help more low- and moderate-income families move up the economic ladder. Only the disingenuous would assert that recapitalization of these companies would take decades and come at taxpayers' expense, as if retaining earnings precluded the ability of each company to raise equity from private investors. Only those beholden to special interests would ignore the substantial reforms implemented at Fannie Mae and Freddie Mac over the last eight years and pretend the companies are somehow doomed to repeat the past upon release from conservatorship. And only those who oppose the dream of homeownership for America's middle class would attempt to dismantle two publicly traded, shareholder-owned companies that have singlehandedly provided over $7 trillion in liquidity to support our mortgage market since 2009. We are optimistic that the indispensability of Fannie Mae and Freddie Mac to affordable homeownership eventually overpowers the taboo imposed upon them by the previous Washington establishment.

Sears Holdings Corporation

Focusing on tangible assets has served us over many years, but most believe Sears to be the exception to the rule. Disruptive technologies; near-zero cost of capital; and few, if any, legacy obligations provide young competitors with great advantages over old-line operators. Today, Airbnb is the largest lodging company in the world without owning a single hotel room. Uber is the world's largest taxi company without owning a car (and perhaps soon without utilizing a single driver). Intuit's Rocket Mortgage lends only via the net. Amazon crushes competition without a physical retail footprint. Mega-tech companies are now trusted in all aspects of personal and corporate life. I'm reminded of this every day by my Fairholme team, our clients, fellow directors at Sears, and friends.

Bottom line: Sears has degraded net asset values, but there is still much left and the company is fixing its cash drain. Recent corporate announcements – including (i) the proposed sale of Craftsman to Stanley Black and Decker for a cumulative $775 million plus a 15-year royalty stream on all third-party Craftsman sales to new customers and the use of a perpetual license for the Craftsman brand by Sears (royalty free) for 15 years; (ii) shuttering 150 unprofitable stores in 2017 on top of the roughly 235 stores that were closed in 2016; and (iii) marketing certain properties within the company's real estate portfolio to further unlock value – reflect an acceleration in the company's transformation efforts consistent with Chairman Eddie Lampert's recent public comments:

> *[In late September 2016], we announced a partnership between Shop Your Way, Sears Auto Centers and Uber. This is another example of how we are transforming Sears Holdings to focus on serving our Shop Your Way members … Expect additional partnerships over time emphasizing our Shop Your Way business … Kmart continues to operate over 700 stores … a significant number of these stores are profitable … we are intent on improving the performance of our unprofitable stores and, if we cannot, we will close them … We are acting more aggressively and continuing to evaluate stores as leases expire and as other opportunities present themselves that improve the economics of Sears Holdings. Our significant asset base gives us the wherewithal to fund our business, but we don't intend to use our asset value to support losses.*[4]

Seritage Growth Properties

Fortune Magazine notes that "there is still a lot of life in that American mainstay, the suburban mall," but the tenant mix is shifting to accommodate new consumer preferences.[5] Indeed, growing demand for "very un-mall-like grocery stores, spin-class fitness shops, and entertainment centers" presents attractive opportunities for landlords such as Seritage, who can convert existing retail square footage to "non-retail spaces that people want."[6] In 18

[1] *Heartland Plymouth Court MI, LLC v. N.L.R.B.,* No. 15-1034 (D.C. Cir. Sept. 30, 2016).
[2] *DirecTV, Inc. v. N.L.R.B.,* No. 11-1273 (D.C. Cir. Sept. 16, 2016).
[3] Alexander Hamilton, *Writings* (The Library of America) 538.
[4] Eddie Lampert, "Committed to our Members, Kmart and our Transformation. http://blog.searsholdings.com/eddie-lampert/committed-to-our-members-kmart-and-our-transformation/

months, Seritage has re-leased 2.2 million square feet and commenced or completed 48 wholly owned redevelopment projects. Sears now represents 65% of signed lease revenue; down from 90%. Headlines overlook this renter diversification and ignore Seritage's acceleration with large mixed-use redevelopments in Santa Monica (California), Aventura (Florida), Hicksville (New York), and Redmond (Washington).

The St. Joe Company

To outperform in sports, you must go to where the ball will be – not where it already is. The same is true of investing and our investment in St. Joe. Northwest Florida Beaches International Airport, the newest U.S. international airport, is approaching 1,000,000 "travel legs" per year. Becca Hardin, President of the Bay Economic Development Alliance, which helps bring business to the airport and surrounding area, recently commented: "We've got a couple of really hot prospects that are looking at some sites in VentureCrossings … We think 2017 is going to be the year that some of these projects come into fruition and we will be able to announce them."[7] Joe is growing and has the assets and entitlements to meet multi-generational demand for affordable housing, commercial facilities, healthcare, education, and transportation. See for yourself at www.venturecrossings.com and www.watersound.com – you'll get the idea. As St. Joe's Chairman, I cordially invite you to visit the beginning of Florida's newest metropolis.

Imperial Metals Corporation

Depressed copper prices made for a challenging operating environment during much of 2016, and Imperial ended the year with a C$65 million equity offering to improve liquidity – diluting each share of common stock by approximately 15%. Nevertheless, Imperial managed to successfully launch Red Chris and mining operations are running at full capacity. On our most recent site visit, we observed large quantities of "rock" being moved to access concentrated mineralization and finish tailing dam embankments. We expect the company to spend 2017 fine tuning its recovery processes and widening the mining pit. Improved copper prices and higher recovery rates will enable profitable operations, a reduction of leverage, and execution of a plan to double or triple mining production at this world-class asset.

Chesapeake Energy Corporation

In early 2016, news on all things related to oil and natural gas devoted little coverage to how declining commodity prices were forcing energy companies to reduce supply, lower debt, and cut operating costs. Time and again, history shows that a commodity price forges its own anchor. Our credit investments in Chesapeake Energy performed exceptionally well in 2016 due to the combination of operational efficiencies driving down unit costs, higher natural gas prices, and success with debt buybacks and asset sales.

Atwood Oceanics, Inc.

Stressed energy markets led us to invest in senior bonds of offshore driller Atwood Oceanics. The bonds were purchased at attractive prices relative to the backlog of future cash flow from drilling operations and the value of Atwood's modernized fleet. Thus far, Atwood has weathered tough conditions as the industry slowly rebalances between rig supply and demand in a lower commodity price environment. Atwood's management has reduced cash operating costs by 25% while extending contracts with customers and suppliers. Atwood also reduced the outstanding senior bond class by over 30% through debt repurchases and raised liquidity through an equity offering. All actions combine to give us comfort that Atwood is positioned to capitalize on the eventual upcycle.

A New Administration

America's newly installed executive branch intends to rebuild a working class that forms the bedrock for economic and social progress. Reduced regulation and corporate tax cuts will lower hurdles and raise earnings. Fiscal stimulus will further advance both. We look forward to these initiatives, realize markets are not cheap, and understand that "a bird in the hand is worth two in the bush." Irrespective of whether purchasing bonds or stocks, Fairholme is constantly evaluating how to optimize investment returns and minimize chances of permanent loss. That's why we purchased securities of Fannie Mae, Freddie Mac, Sears, and others – after all, our job is to create sustainable wealth.

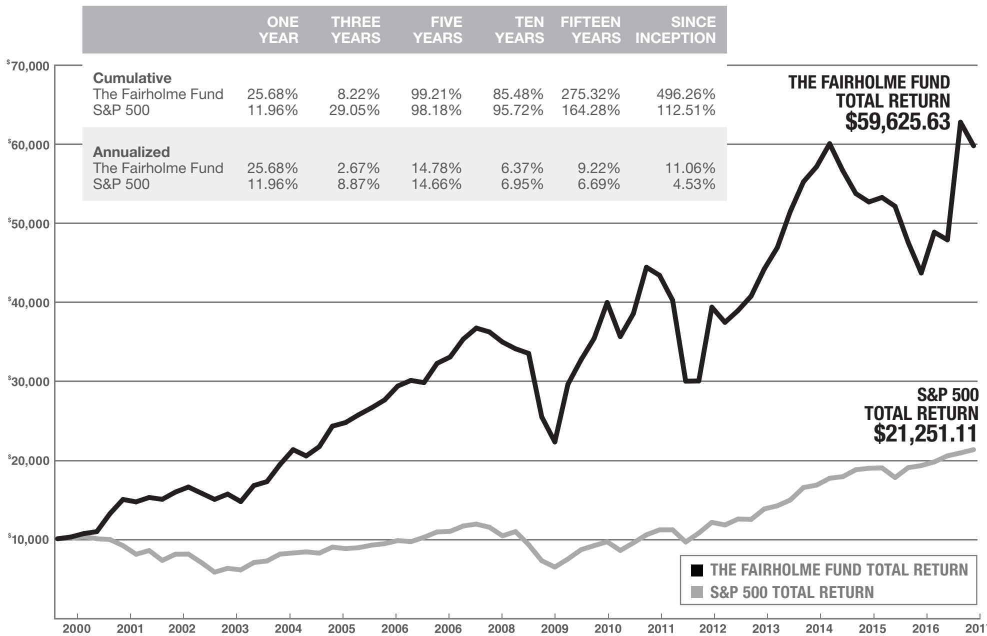
Fund composition and performance information is in the appendix to this letter. We expect to hold our next conference call in the second quarter. Details will be posted on the Funds website and emailed to our distribution list subscribers. To sign up, please visit www.fairholmefunds.com/subscribe.

Respectfully submitted,

Bruce R. Berkowitz
Chief Investment Officer

[5] Phil Wahba, "Simon Property Group Fights to Reinvent the Shopping Mall," *Fortune Magazine*, 2 December 2016.
[6] Ibid.
[7] Brauer, Carey, "Officials look to lure development to VentureCrossings," *Panama City News Herald,* 26 January 2017.

The Fairholme Fund



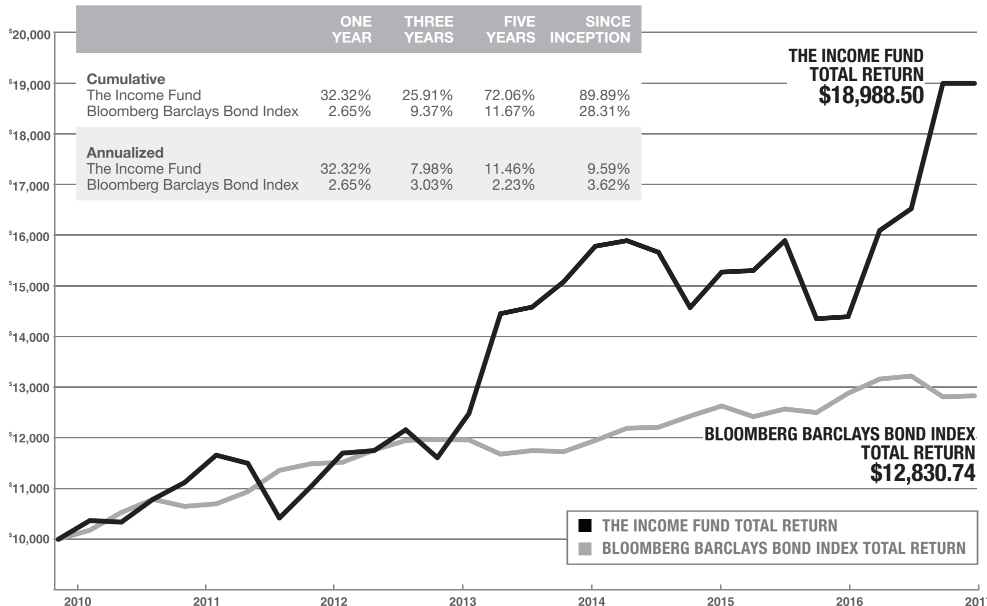
	ONE YEAR	THREE YEARS	FIVE YEARS	TEN YEARS	FIFTEEN YEARS	SINCE INCEPTION
Cumulative						
The Fairholme Fund	25.68%	8.22%	99.21%	85.48%	275.32%	496.26%
S&P 500	11.96%	29.05%	98.18%	95.72%	164.28%	112.51%
Annualized						
The Fairholme Fund	25.68%	2.67%	14.78%	6.37%	9.22%	11.06%
S&P 500	11.96%	8.87%	14.66%	6.95%	6.69%	4.53%

TOP 10 ISSUERS (% OF NET ASSETS)	
Federal National Mortgage Association	20.1%
Federal Home Loan Mortgage Corp.	16.9%
The St. Joe Co.	15.1%
Cash and Cash Equivalents*	14.4%
Sears Holdings Corp.	9.5%
Chesapeake Energy Corp.	6.7%
Imperial Metals Corp.	6.3%
Intelsat Jackson Holdings S.A.	3.3%
Seritage Growth Properties	3.1%
Atwood Oceanics, Inc.	2.4%

The chart on the left covers the period from inception of The Fairholme Fund (December 29, 1999) through December 31, 2016.

The Fairholme Fund increased 25.68% versus an 11.96% gain for the S&P 500 in 2016. The above graph and performance table compare The Fairholme Fund's unaudited performance (after expenses) with that of the S&P 500, with dividends and distributions reinvested, for various periods ending December 31, 2016. The value of a $10,000 investment in The Fairholme Fund at its inception was worth $59,626 (assumes reinvestment of distributions into additional Fairholme Fund shares) compared to $21,251 for the S&P 500 at year-end. Of the $59,626, the value of reinvested distributions was $37,926. The year-end net asset value of The Fairholme Fund is $2.9 billion, all of which is profit.

The Income Fund



	ONE YEAR	THREE YEARS	FIVE YEARS	SINCE INCEPTION
Cumulative				
The Income Fund	32.32%	25.91%	72.06%	89.89%
Bloomberg Barclays Bond Index	2.65%	9.37%	11.67%	28.31%
Annualized				
The Income Fund	32.32%	7.98%	11.46%	9.59%
Bloomberg Barclays Bond Index	2.65%	3.03%	2.23%	3.62%

TOP 10 ISSUERS (% OF NET ASSETS)	
Imperial Metals Corp.	18.7%
Cash and Cash Equivalents*	14.8%
Sears Holdings Corp.	10.3%
Federal National Mortgage Association	9.7%
Federal Home Loan Mortgage Corp.	9.0%
Seritage Growth Properties	6.6%
Atwood Oceanics, Inc.	5.3%
Chesapeake Energy Corp.	4.9%
GMAC Capital Trust I, Inc.	4.5%
Intelsat Jackson Holdings S.A.	3.7%

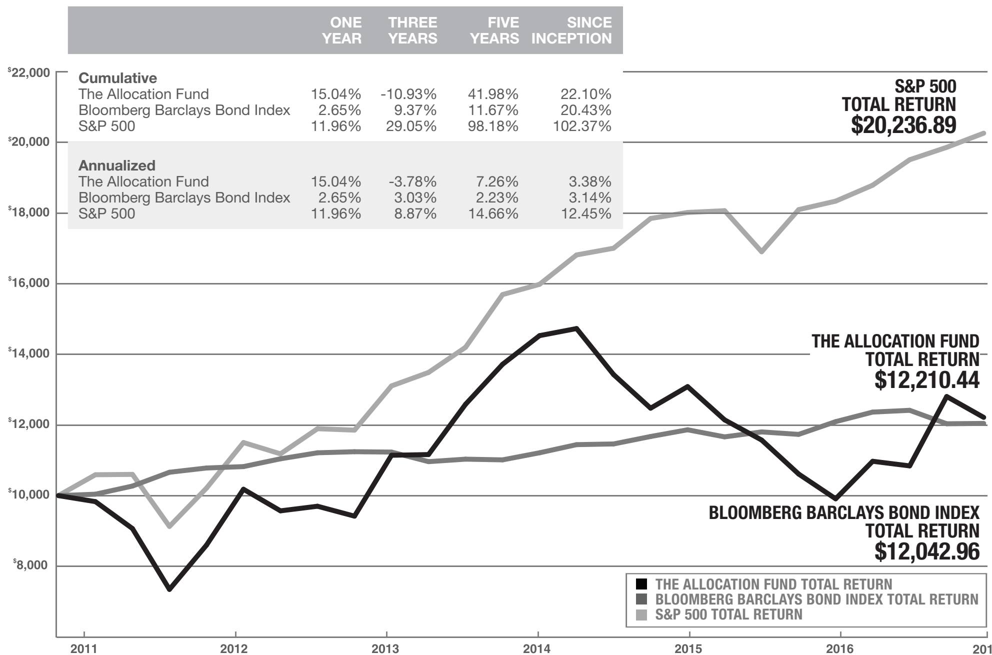
The Income Fund's 30-Day SEC Yield at December 31, 2016, was 5.15%.

The chart on the left covers the period from inception of The Income Fund (December 31, 2009) through December 31, 2016.

The Income Fund increased 32.32% versus an increase of 2.65% gain for the Bloomberg Barclays Bond Index in 2016. Since inception, The Income Fund increased 89.89% versus 28.31% for the Bloomberg Barclays Bond Index. The above graph and performance table compare The Income Fund's unaudited performance (after expenses) with that of the Bloomberg Barclays Bond Index, with dividends and distributions reinvested, for various periods ending December 31, 2016. The value of a $10,000 investment in The Income Fund at its inception was worth $18,989 (assumes reinvestment of distributions into additional Income Fund shares) compared to $12,831 for the Bloomberg Barclays Bond Index at year-end. Of the $18,989, the value of reinvested distributions was $6,809. The year-end net asset value of The Income Fund is $243 million.

*Includes cash, U.S. Treasury Bills, money market funds, and various commercial paper issuers.

The Allocation Fund



	ONE YEAR	THREE YEARS	FIVE YEARS	SINCE INCEPTION
Cumulative				
The Allocation Fund	15.04%	-10.93%	41.98%	22.10%
Bloomberg Barclays Bond Index	2.65%	9.37%	11.67%	20.43%
S&P 500	11.96%	29.05%	98.18%	102.37%
Annualized				
The Allocation Fund	15.04%	-3.78%	7.26%	3.38%
Bloomberg Barclays Bond Index	2.65%	3.03%	2.23%	3.14%
S&P 500	11.96%	8.87%	14.66%	12.45%

TOP 10 ISSUERS (% OF NET ASSETS)	
Cash and Cash Equivalents*	27.2%
Seritage Growth Properties	17.0%
Federal National Mortgage Association	14.1%
Federal Home Loan Mortgage Corp.	12.5%
Sears Holdings Corp.	7.2%
Chesapeake Energy Corp.	5.7%
Imperial Metals Corp.	4.8%
Intelsat Jackson Holdings S.A.	4.1%
Atwood Oceanics, Inc.	4.0%
Lands' End, Inc.	1.7%

The Allocation Fund's 30-Day SEC Yield at December 31, 2016, was 1.80%.
The chart on the left covers the period from inception of The Allocation Fund (December 31, 2010) through December 31, 2016.

The Allocation Fund increased 15.04% versus an increase of 2.65% gain for the Bloomberg Barclays Bond Index and a 11.96% increase for the S&P 500 in 2016. The above graph and performance table compare The Allocation Fund's unaudited performance (after expenses) with that of the Bloomberg Barclays Bond Index and the S&P 500, with dividends and distributions reinvested, for various periods ending December 31, 2016. The value of a $10,000 investment in The Allocation Fund at its inception was worth $12,210 (assumes reinvestment of distributions into additional Allocation Fund shares) compared to $12,043 and $20,237 for the Bloomberg Barclays Bond Index and the S&P 500, respectively, at year-end. Of the $12,210, the value of reinvested distributions was $3,600. The year-end net asset value of The Allocation Fund is $245 million.

The Funds' investment objectives, risks, charges, and expenses should be considered carefully before investing. The prospectus contains this and other important information about the Funds, and it may be obtained by calling Shareholder Services at (866) 202-2263 or visiting our website www.fairholmefunds.com. Read it carefully before investing. The Portfolio Manager's Report and corresponding Appendix are not part of The Fairholme Funds, Inc. Annual Report due to forward-looking statements that, by their nature, cannot be attested to, as required by regulation. The Portfolio Manager's Report and corresponding Appendix are based on calendar-year performance. A more formal Management Discussion and Analysis is included in the Annual Report. Opinions of the Portfolio Manager are intended as such, and not as statements of fact requiring attestation.

Fairholme Distributors, LLC (1/17)

*Includes cash, U.S. Treasury Bills, money market funds, and various commercial paper issuers.