Mutual fund investing involves risks, including possible loss of principal. Unless otherwise specified, all holdings information is shown as of June 30, 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 Barclays Capital U.S. Aggregate Bond Index (the "Barclays Bond Index") is an unmanaged market-weighted index comprised of investment grade (rated Baa3/BBB-/BBB- or higher) taxable bonds, mortgage-backed securities, asset-backed securities, corporate securities, government-related securities, including U.S. Treasury and government agency issues, with at least one year to maturity. The S&P 500 and the 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 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' Semi-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.

July 28, 2016

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

At Fairholme, we don't try to predict uncertain futures, but rather price securities for a wide range of potential outcomes. We aim to achieve long-term outperformance while minimizing the risks of permanent loss of capital. We target securities priced far below their intrinsic values to counter potential mistakes in estimates and occasional bad luck. Of course, we encounter real risks along the way. After all, there is no free lunch when it comes to success over a lifetime. It is either not free, or it's not lunch.

Unable to disprove our highest conviction ideas, we added to positions when prices dropped – much in the same way you would expect us to sell when prices rise. Plunging commodity prices allowed for the purchase of corporate bonds that are more senior than common stock at prices that yield equity-like returns. We don't plan on dramatic portfolio changes, but do expect the Funds to continue this trend toward more current income. The following securities are expected to dramatically move the Funds' performance.

Fannie Mae and Freddie Mac

Fannie and Freddie are two of the best businesses ever owned by the Funds. Think of these two mortgage insurers as public utilities, just like your local electric company: every day, Fannie and Freddie provide essential services to millions of families by making home mortgages affordable and accessible. For decades, in good times and bad, they have supported the middle class in pursuing the American Dream – a home to raise children, a nest for a worry-free retirement – at no cost to taxpayers.

Last year, Fannie and Freddie earned a combined $17.3 billion in net income. This is not an aberration: Fannie and Freddie have consistently generated revenue in excess of their cash expenses. Given their substantial profitability, these two companies should be the safest of preferred stock issuers. But, the government's imposition of a "Net Worth Sweep" that usurps all of the companies' capital has turned common sense on its head. In February, Federal Housing Finance Agency ("FHFA") Director Mel Watt publicly acknowledged that the "lack of capital" resulting from the Net Worth Sweep is "the most serious risk and the one that has the most potential for escalating in the future."[1] Legislators agree, but have failed to resolve the issue.

A key lesson from the 2008 crisis is that *all* financial institutions need adequate capital. Regulators, including FHFA and the United States Treasury ("Treasury"), readily acknowledge that *large* financial institutions need even more. However, in the context of Fannie and Freddie – the *largest* financial institutions in America – FHFA and Treasury pretend that neither company needs tangible equity capital on its balance sheet because of a government standby commitment. This is neither safe nor sound. The ability to "Phone-a-Friend" is not capital and certainly does not protect taxpayers. Our ongoing litigation seeks to ensure that Fannie and Freddie retain earnings to prudently rebuild capital and honor all obligations. In this regard, there have been several positive developments:

- In the U.S. Court of Federal Claims, Judge Margaret Sweeney unsealed documents obtained through discovery that shed more light on the unlawful actions of FHFA and Treasury in expropriating the assets of Fannie and Freddie. Judge Sweeney rejected assertions that their release would negatively impact global financial markets, and suggested that the defendants' sole motivation was avoiding embarrassment: "Instead of harm to the Nation resulting from disclosure, the only 'harm' presented is the potential for criticism. The court will not condone the misuse of a protective order as a shield to insulate public officials from criticism in the way they execute their public duties."[2]

[1] Watt, Melvin L. (2016, February 18). Prepared remarks of Melvin L. Watt Director of FHFA at the Bipartisan Policy Center. Retrieved from www.fhfa.gov.

[2] *Fairholme Funds, Inc. et al., v. The United States* (Case No. 13-465C). United States Court of Federal Claims (2016, April 11). Order Granting Motion to De-Designate Seven Documents.

- Unsealed documents provide convincing evidence that FHFA and Treasury violated the law when they decided to de facto nationalize Fannie and Freddie. Since the U.S. Judicial Panel on Multidistrict Litigation denied the government's attempt to consolidate lawsuits from around the country, these incriminating materials are now being used by numerous plaintiffs to show that bureaucrats made a premeditated and deliberate decision to operate the companies for the exclusive benefit of the government – at the expense of shareholders. While virtually all other institutions that received federal assistance during the 2008 crisis were permitted to promptly repay the government, the same was not true for Fannie and Freddie. Matt Taibbi's colorful metaphor in *Rolling Stone* highlights this point: "Like a restaurant owner who borrows money from a mobster, [Fannie and Freddie] found themselves in an unseverable relationship."[3]
- We soon expect a ruling in the U.S. Court of Appeals for the District of Columbia Circuit. George Will's *Washington Post* article summarized the crux of the matter before the court: Conservatorship "is supposed to be temporary and rehabilitative. A conserved entity should be returned to normal business in private ownership. Fannie and Freddie have recuperated profitably. They also have been nationalized … [T]he government (Treasury) negotiated with itself (FHFA) to achieve a windfall for itself. And the conservator abandoned its duty to safeguard the assets of the entities in conservatorship."[4] Legal scholar Richard Epstein of the NYU School of Law is even more pointed: "[T]he earlier opinion of Judge Royce Lamberth on September 30, 2014 – which wrongly sustained the government's position on all counts – should not be allowed to stand given its incurable internal weaknesses," and that "a close examination of the [Senior Preferred Stock Purchase Agreement] supports the conclusion that the entire [Net Worth Sweep] was an elaborate device to strip the private shareholders of all their wealth in Fannie Mae and Freddie Mac, by devices so crude that if [they had] been adopted by private parties, all of them would have gone to jail."[5]

Sears Holdings Corporation

The Funds' investments in Sears span the capital structure – from common equity to short-duration bonds yielding over 10% – and yours truly joined the Board of Directors in February. The company is "focused on restoring profitability" and improving operating performance by transforming "from a traditional, store-only based retailer into a more asset-light, member-centric integrated retailer."[6] Sears also announced that it intends to unlock more value for shareholders by exploring strategic alternatives for its Home Services as well as Kenmore, Craftsman, and DieHard brands. Similar public businesses have enterprise values that range from one-half to two times revenues. Market observers are just discovering parts of Sears that they hardly knew existed. Case in point: a press article recently "uncovered" developments at Innovel Solutions (previously known as Sears Logistics Services), a profitable 1,100-truck delivery service with a distribution network consisting of 11 regional warehouses and 24- to 48-hour delivery capability for the majority of households in the United States. The service "has grown 238 percent since 2014"[7] and is expanding relationships with manufacturing customers, retailers like Costco, and even the U.S. military. It's taking much longer than we thought, but we're still optimistic.

Seritage Growth Properties

Having recently celebrated its first anniversary as an independent and publicly traded real estate investment trust (REIT), Seritage is making steady progress in repurposing, re-tenanting, and redeveloping many of the 266 properties that it purchased from Sears last year. In the company's inaugural Annual Report, CEO Ben Schall explains why the company's genesis within Sears will prove lucrative:

> The origins of our real estate portfolio trace back 30 to 40 years ago, during a period of expansive retail real estate development and the proliferation of super regional malls. Sears played a central role as a leading anchor, property owner and, at times, co-developer of many of these new developments. Sears' prominence during this era is reflected in two important outcomes evident in today's real estate landscape. First, Sears received fee ownership over large parcels of land to construct its department stores, auto centers and related uses. Second, and equally important, Sears was able to select prime locations at the front entrance and at the primary intersections at many of these new developments. Seritage Growth Properties is now the beneficiary of this real estate lineage, with fee ownership over some of the most desirable and visible locations in many of the top markets across the country. The premise of Seritage, the reason we were formed, and what we're focused on each and every day, is unlocking the underlying real estate value of our high quality portfolio, and in turn, creating significant returns for our shareholders.[8]

Consider the significant growth potential for retail property owners like Seritage (and for that matter, Sears): "Redeveloping anchor space comes at a cost to landlords, but holds the promise of hefty returns as department stores paying as little as $2 a square foot in rent are replaced by new anchors paying $15 to $20 a square foot, real estate executives said. If the space is carved into smaller parcels for specialty retailers, rent can approach $100 a square foot. At the same time, the new, more productive tenants help lift sales at the overall mall by pulling in more shoppers, the executives said."[9] With time, we expect Seritage's net operating income and dividend payout to grow rather dramatically, and for our longstanding investment thesis on the repurposing of Sears-related assets to come to fruition.

The St. Joe Company

St. Joe is accelerating development plans to meet growing demand for commercial and residential properties in Northwest Florida. The company's joint venture commercial development project at Pier Park North is now 93% leased, with four new tenants recently added

[3] Taibbi, Matt (2016, April 18). Why Is the Obama Administration Trying to Keep 11,000 Documents Sealed? *Rolling Stone.* Retrieved from www.rollingstone.com.
[4] Will, George F. (2016, May 4). Treasury's Fannie and Freddie rip-off. *Washington Post.* Retrieved from www.washingtonpost.com.
[5] Epstein, Richard (2016, June 15). Untangling the GSE Foolishness: The D.C. Circuit Should Upend Treasury's Net Worth Sweep. *Forbes.* Retrieved from www.forbes.com.
[6] Sears Holdings First Quarter Results Pre-Recorded Conference Call Transcript (2016, May 26). Retrieved from http://searsholdings.com/invest/events-presentations.
[7] Fickenscher, Lisa (2016, July 14). Sears finds a new way to rake in cash. *New York Post.* Retrieved from www.nypost.com.
[8] Seritage Growth Properties 2015 Annual Report (2016, March 11). Retrieved from ir.seritage.com.
[9] Kapner, Suzanne (2016, July 10). Mall Owners Push Out Department Stores. *Wall Street Journal.* Retrieved from www.wsj.com.

to the rent roll. VentureCrossings, an industrial and technology park adjacent to the Northwest Florida Beaches International Airport, is generating interest. The WaterSound Origins residential project will surpass 270 homes in the next year, with more residential and commercial development expected. The company is evaluating opportunities to (i) dispose of additional non-core assets, (ii) build a portfolio of income-producing commercial properties, and (iii) further reduce operating expenses – all positive trends. We remain optimistic about St. Joe's current trajectory and owned land – a good hedge against rising inflation.

Imperial Metals Corporation

"Copper is used in everything from automobiles to air conditioners, but it has one property that makes it especially attractive for medical use: it kills bacteria" – a new demand.[10] Imperial Metals is on pace to double annual copper output and rival the lowest-cost producers with its Red Chris mine. Further improvements in production and recovery rates at both Red Chris and Mount Polley will generate significant cash profits. Higher prices will speed repayment of debts and plans for new developments within.

Chesapeake Energy Corporation

Short-duration bonds of Chesapeake Energy, such as the 7.250% bonds maturing in 2018, were purchased at substantial discounts to par to yield double digit returns. Chesapeake is one of America's largest producers of natural gas, oil, and natural gas liquids. The company's assets span numerous U.S. shale basins. New management has navigated the cyclical downturn in oil and gas prices by cutting costs, raising liquidity, and reducing outstanding debt to the lowest level in the last nine years. Though we normally shy away from commodity price forecasting, data shows that natural gas markets have tightened due to waning production growth, expanding exports (to Mexico or via liquefied natural gas), and record domestic demand for electricity generation. Price forges its own anchor. While the company maintains an active hedging program to mitigate future commodity price fluctuations, small improvements in commodity prices can have a significantly positive impact on Chesapeake's operating results. The company's $4 billion revolving credit facility was recently reaffirmed and remains almost entirely untapped, which should provide flexibility for Chesapeake to renegotiate gas gathering contracts and shed additional assets to further reduce obligations.

Atwood Oceanics, Inc.

The Funds own senior bonds of Atwood due 2020 with a 17% yield to maturity. Year-to-date, Atwood has retired over 30% these bonds due 2020 via open market purchases and a $150 million cash tender offer announced in late June. These events indicate that management believes it has the financial wherewithal to meet all obligations and take advantage of market mispricing. An existing $220 million cash balance, available credit line, and current contractual backlog provide ample liquidity. Atwood's fleet of 11 high-spec rigs has a superb operating record and management continues to blend and extend transaction dates with both customers and suppliers.

Bank of America

Improving operating efficiencies more than counter declining net interest margins. Bank of America's return on tangible assets has hit our 10% goal. Yet, common share prices remain below tangible assets (on a per share basis). Recent regulatory approval for a 50% increase in dividends and another $5 billion of stock buybacks will improve capital allocation.

American International Group

Except for last year's large tax bill, we have little to complain about. Our views on AIG are well documented. Remaining warrants are attractive given (i) a 2021 expiry, repricing terms, and related stock price, and (ii) increases in underwriting margins, operational efficiencies, and share repurchases.

Finding new investments is always difficult. It's certain to be so, but as opportunities emerge in new sectors and securities, our Funds have the necessary liquidity. The appendix to this letter shows performance and issuer data for each Fund. I look forward to providing additional information during our next conference call in October.

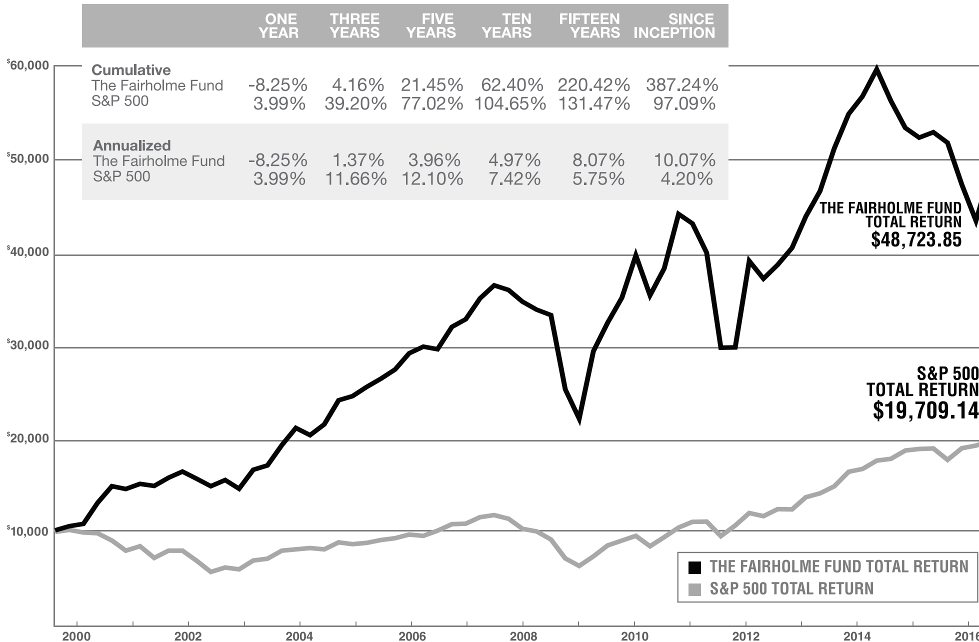
Thank you for your continued trust.

Respectfully submitted,

Bruce R. Berkowitz
Chief Investment Officer
Fairholme Capital Management

[10] Yang, Stephanie (2016, July 25). Paging Doctor Copper: Metal Wins Fans in Health Care. *Wall Street Journal.* Retrieved from www.wsj.com.

The Fairholme Fund



	ONE YEAR	THREE YEARS	FIVE YEARS	TEN YEARS	FIFTEEN YEARS	SINCE INCEPTION
Cumulative						
The Fairholme Fund	-8.25%	4.16%	21.45%	62.40%	220.42%	387.24%
S&P 500	3.99%	39.20%	77.02%	104.65%	131.47%	97.09%
Annualized						
The Fairholme Fund	-8.25%	1.37%	3.96%	4.97%	8.07%	10.07%
S&P 500	3.99%	11.66%	12.10%	7.42%	5.75%	4.20%

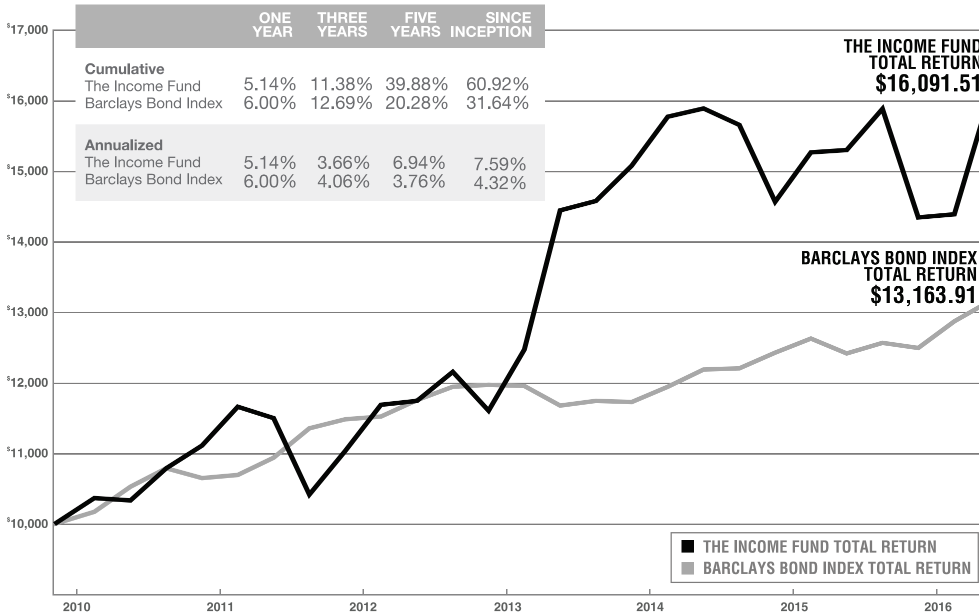
TOP 10 HOLDINGS BY ISSUER	
Cash and Cash Equivalents	23.3%
The St. Joe Co.	14.2%
Federal National Mortgage Association	11.2%
Sears Holdings Corp.	10.9%
Federal Home Loan Mortgage Corp.	9.8%
Chesapeake Energy Corp.	8.5%
Imperial Metals Corp.	6.1%
Bank of America Corp.	4.9%
Seritage Growth Properties	3.6%
American International Group, Inc.	2.8%

The chart on the left covers the period from inception of The Fairholme Fund (December 29, 1999) through June 30, 2016.

The Fairholme Fund increased 2.70% versus a 3.84% gain for the S&P 500 for the six-month period that ended June 30, 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 June 30, 2016.

At June 30, 2016, the value of a $10,000 investment in The Fairholme Fund at its inception was worth $48,724 (assumes reinvestment of distributions into additional Fairholme Fund shares) compared to $19,709 for the S&P 500. Of the $48,724, the value of reinvested distributions was $29,724.

The Income Fund



	ONE YEAR	THREE YEARS	FIVE YEARS	SINCE INCEPTION
Cumulative				
The Income Fund	5.14%	11.38%	39.88%	60.92%
Barclays Bond Index	6.00%	12.69%	20.28%	31.64%
Annualized				
The Income Fund	5.14%	3.66%	6.94%	7.59%
Barclays Bond Index	6.00%	4.06%	3.76%	4.32%

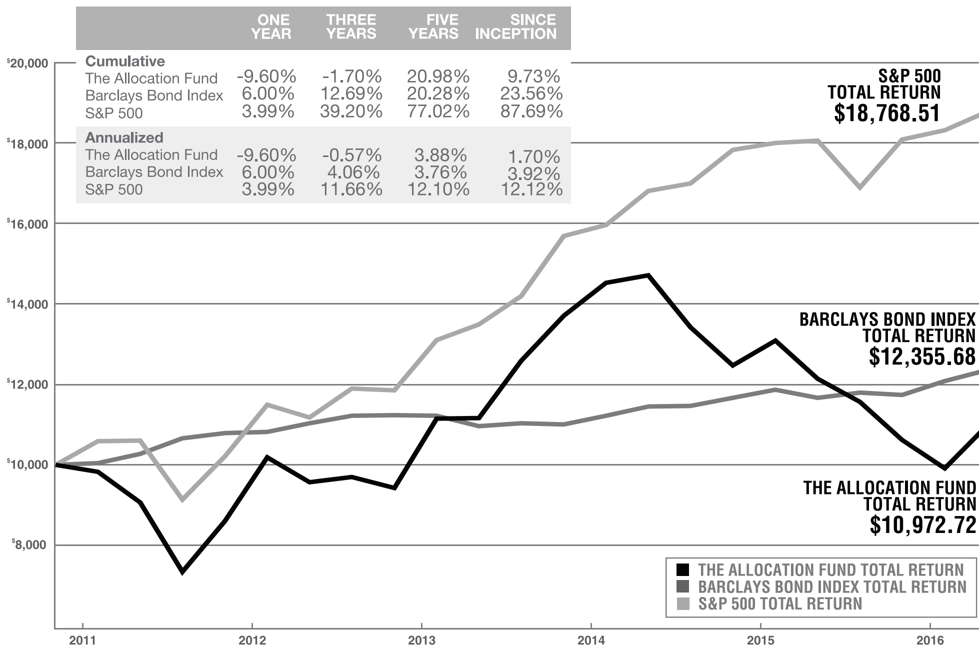
TOP 10 HOLDINGS BY ISSUER	
Cash and Cash Equivalents	22.8%
Imperial Metals Corp.	20.3%
Sears Holdings Corp.	10.4%
Seritage Growth Properties	8.8%
Chesapeake Energy Corp.	8.1%
Federal National Mortgage Association	6.1%
Federal Home Loan Mortgage Corp.	5.8%
GMAC Capital Trust I, Inc.	5.0%
Atwood Oceanics, Inc.	4.9%
Homefed Corp.	4.4%

The Income Fund's 30-Day SEC Yield at June 30, 2016, was 5.10%.
The chart on the left covers the period from inception of The Income Fund (December 31, 2009) through June 30, 2016.

The Income Fund increased 12.13% versus an increase of 5.31% for the Barclays Bond Index for the six-month period that ended June 30, 2016. Since inception, The Income Fund increased 60.92% versus 31.64% for the Barclays Bond Index. The above graph and performance table compare The Income Fund's unaudited performance (after expenses) with that of the Barclays Bond Index, with dividends and distributions reinvested, for various periods ending June 30, 2016.

At June 30, 2016, the value of a $10,000 investment in The Income Fund at its inception was worth $16,092 (assumes reinvestment of distributions into additional Income Fund shares) compared to $13,164 for the Barclays Bond Index. The Income Fund returned 1.9 times more than the Barclays Bond Index since inception. Of the $16,092, the value of reinvested distributions was $5,452.

The Allocation Fund



	ONE YEAR	THREE YEARS	FIVE YEARS	SINCE INCEPTION
Cumulative				
The Allocation Fund	-9.60%	-1.70%	20.98%	9.73%
Barclays Bond Index	6.00%	12.69%	20.28%	23.56%
S&P 500	3.99%	39.20%	77.02%	87.69%
Annualized				
The Allocation Fund	-9.60%	-0.57%	3.88%	1.70%
Barclays Bond Index	6.00%	4.06%	3.76%	3.92%
S&P 500	3.99%	11.66%	12.10%	12.12%

TOP 10 HOLDINGS BY ISSUER	
Cash and Cash Equivalents	21.7%
Seritage Growth Properties	20.9%
Sears Holdings Corp.	10.9%
Chesapeake Energy Corp.	9.3%
Federal National Mortgage Association	8.3%
Federal Home Loan Mortgage Corp.	7.7%
Imperial Metals Corp.	5.6%
Bank of America Corp.	4.9%
Atwood Oceanics, Inc.	3.1%
American International Group, Inc.	3.0%

The Allocation Fund's 30-Day SEC Yield at June 30, 2016, was 1.40%.
The chart on the left covers the period from inception of The Allocation Fund (December 31, 2010) through June 30, 2016.

The Allocation Fund increased 3.38% versus an increase of 5.31% for the Barclays Bond Index and a 3.84% increase for the S&P 500 for the six-month period that ended June 30, 2016. The above graph and performance table compare The Allocation Fund's unaudited performance (after expenses) with that of the Barclays Bond Index and S&P 500, with dividends and distributions reinvested, for various periods ending June 30, 2016.

At June 30, 2016, the value of a $10,000 investment in The Allocation Fund at its inception was worth $10,973 (assumes reinvestment of distributions into additional Allocation Fund shares), compared to $12,356 and $18,769 for the Barclays Bond Index and the S&P 500, respectively. Of the $10,973, the value of reinvested distributions was $2,703.

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. Semi-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 Semi-Annual Report. Opinions of the Portfolio Manager are intended as such, and not as statements of fact requiring attestation.

Fairholme Distributors, LLC (8/16)