THE FAIRHOLME FUND

A NO-LOAD CAPITAL APPRECIATION FUND

FAIRX

FAIRHOLME

Ignore the crowd.

INVESTMENT ADVISER'S LETTER

JANUARY 22, 2007

FAIRHOLMEFUNDS.COM

866.202.2263

FAIRHOLME CAPITAL MANAGEMENT, L.L.C.

The Board of Directors of The Fairholme Fund is forwarding this letter from the Fund's investment adviser to help explain the adviser's performance, philosophy, and strategy to our shareholders. It is not a complete discussion of all factors affecting the Fund and has not been reviewed by the Fund's independent registered public accountants. Performance information quoted below represents past performance and is not a guarantee of future results. The investment return and principal value of an investment in the Fund will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than the performance information quoted within. Any questions you may have regarding the latest month-end performance can be obtained by calling the Fund's transfer agent at 1-866-202-2263 or by visiting our website at www.fairholmefunds.com. Refer to the back cover of this document for additional important information.

January 12, 2007

To the Directors of The Fairholme Fund:

Below is a comparison of the Fund's performance with that of the Standard & Poor's 500 Index (both with dividends reinvested):

	One Year Ended 12/31/2006	**Three Years Ended 12/31/2006**	**Five Years Ended 12/31/2006**	**Since Inception 12/29/1999 to 12/31/2006**
The Fairholme Fund (Cumulative)	**16.72%**	**65.84%**	**102.35%**	**221.46%**
S&P 500 Index (Cumulative)*	**15.79%**	**34.70%**	**35.03%**	**8.58%**
The Fairholme Fund (Annualized)	**16.72%**	**18.37%**	**15.14%**	**18.13%**
S&P 500 Index (Annualized)*	**15.79%**	**10.43%**	**6.19%**	**1.18%**

***The S&P 500 Index (the "S&P 500") is an unmanaged and capitalization-weighted index composed of 500 of the largest public companies and is not available for direct investment. The Fund, which intends to hold no more than 25 securities, is less diversified than the S&P 500 and may hold securities that are smaller, less liquid, and more volatile than those included in the S&P 500.**

Since inception, $10,000 invested in The Fairholme Fund with dividends reinvested has grown to $32,146 while $10,000 invested in the S&P 500 Index with dividends reinvested has grown to $10,858. In other words, the Fund since inception has appreciated about 18.1% per annum after all expenses compared to a gain of 1.2% per annum before any expenses for the S&P 500.

While holding much cash (and equivalent securities), the Fund has generated good absolute returns since inception and handily beaten most indices. We strive to maintain this record by ignoring short-term market fluctuations, focusing on the business of business, and patiently waiting for opportunities to deploy the Fund's liquidity. To paraphrase Ben Graham, you are not right because others agree, you are right when your facts and figures are correct, regardless of what Mr. Market is doing. Combining the right facts with a bargain price eventually leads to solid performance.

Last year's success resulted mostly from investors' belated recognition of Berkshire Hathaway's large and growing earnings potential and a benign hurricane season; EchoStar's continuation of profitable growth; Sears' redeployment of capital, including stock repurchases; and Leucadia's ongoing demonstration of investment prowess.

Despite good business performance, prices of the Fund's sizeable energy holdings weakened as investors reacted to plummeting natural gas prices and Canada's surprise tax proposal on royalty trusts. Nevertheless, Canadian Natural Resources' oil sands mega-venture is on-time and on-budget, and the company acquired most of Anadarko's Canadian assets on the cheap. Penn West Energy Trust acquired Petrofund Energy Trust and began developing thousands of acres of valuable oil sands purchased for a pittance. Ensign Energy Services enjoyed price increases for its well utilized fleet and remains debt-free.

Asia's acquired interest in all material things suggests growing long-term energy demand, while new discoveries are a fraction of current production and increasingly costly. The era of cheap energy seems to have ended.[1] Although agnostic about near-term oil and gas prices, we chose our energy companies for their managements' past success in low-price environments, for their extensive and valuable assets, and for their geographic safety.

Because bargains are usually found among securities out of favor, stressed industries attract us like children to a locked cabinet. Accordingly, we have pried open the residential housing industry. While not drawn to most homebuilders, whose business models we find unattractive, we have identified two related businesses that seem overly depressed by current conditions, Mohawk Industries and USG. Both have the talented managers, free cash flows, and strong balance sheets necessary to take advantage of others' pain. Hopefully, the current residential construction downturn has not seen its nadir. The worse it gets, the better we'll do down the road.

With Warren Buffett at Berkshire Hathaway, Murray Edwards at Canadian Natural and Ensign, Charlie Ergen at EchoStar, Eddie Lampert at Sears, and other all-star owner/managers, the Fund has never been blessed with so much talent—and we are searching for more.

Expectations for the Fund remain high. Please understand that bouts of volatility and underperformance are needed for success. Volatility lets us buy and sell advantageously and underperformance may allow a chance to buy more of what we own. As was demonstrated when the Fund began, the best seeds of performance are sown when we *Ignore the crowd.*[2]

Respectfully submitted,

Bruce Berkowitz | Larry Pitkowsky | Keith Trauner

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[1]In September, 2006, *The Wall Street Journal* reported that partners Chevron, Devon, and Statoil announced a discovery well in the deep Gulf of Mexico, more than five and one-half miles below the surface of the earth at an estimated cost to drill of more than $100,000,000. Certain facts are hard to ignore.

[2]Fairholme Capital Management, the Fund's adviser, has applied for, and been granted in certain jurisdictions, a service mark for the phrase "Ignore the crowd." At no charge, Fairholme Capital Management has agreed to license the use of this phrase, where applicable, to The Fairholme Fund.

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