

# FAIRHOLME

SEMI-ANNUAL REPORT

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## THE FAIRHOLME FUND

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*A No-Load Capital Appreciation Fund*

*For the Six Months Ended:*

**May 31, 2006**

**[www.fairholmefunds.com](http://www.fairholmefunds.com)**

**(866) 202-2263**

# THE FAIRHOLME FUND

## MANAGEMENT DISCUSSION & ANALYSIS

For the Six Months Ended May 31, 2006

At May 31, 2006, the end of the second fiscal quarter of 2006, the unaudited net asset value (NAV) attributable to the 92,483,022 shares outstanding of The Fairholme Fund (the "Fund") was \$27.47 per share. This compares with an audited net asset value of \$25.45 per share at November 30, 2005, and an unaudited net asset value of \$23.74 per share at May 31, 2005 (stated NAVs reflect any distributions to shareholders). At June 30, 2006, the unaudited net asset value was \$27.44 per share.

	Six Months Ended <u>5/31/2006</u>	One Year Ended <u>5/31/2006</u>	Three Years Ended <u>5/31/2006</u>	Five Years Ended <u>5/31/2006</u>	Since Inception 12/29/1999 to <u>5/31/2006</u>
The Fairholme Fund (Cumulative)	10.91%	18.96%	82.30%	98.58%	200.35%
S&P 500 Index (Cumulative)	2.60%	8.64%	39.14%	10.21%	-3.82%
The Fairholme Fund (Annualized)		18.96%	22.16%	14.71%	18.68%
S&P 500 Index (Annualized)		8.64%	11.63%	1.96%	-0.60%

In the opinion of the Fund's Adviser, performance over short intervals is likely to be less meaningful than a comparison of longer periods.

Portfolio holdings are subject to change without notice. Below is a chart disclosing the top ten holdings of the Fund listed by their percentage of net assets as well as a chart detailing the top ten categories in which the Fund holds securities, listed by the aggregate percentage of net assets in each of these categories.

Top Ten Holdings* (% of Net Assets)		Top Ten Categories (% of Net Assets)	
Berkshire Hathaway, Inc.	16.29%	Diversified Holding Companies	22.00%
EchoStar Communications Corp.	10.61%	U.S. Gov't and Agency Obligations	21.91%
Canadian Natural Resources Ltd.	9.27%	Oil and Gas Producers	16.10%
Penn West Energy Trust	6.83%	Pay Television Services	10.61%
Leucadia National Corp.	5.71%	Telecommunications	4.86%
Sears Holdings Corp.	4.53%	Retail Department Stores	4.53%
Mohawk Industries, Inc.	4.51%	Carpet-Floor Coverings	4.51%
Ensign Energy Services, Inc.	4.17%	Oil and Gas Drilling	4.17%
IDT Corp.	3.79%	Miscellaneous Investments	3.05%
Miscellaneous Investments	3.05%	Energy Services	2.13%
	<u>68.76%</u>		<u>93.87%</u>

\*Excludes cash, money market funds and U.S. Treasury bills

# THE FAIRHOLME FUND

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## MANAGEMENT DISCUSSION & ANALYSIS (Continued) For the Six Months Ended May 31, 2006

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During the six months beginning December 1st and ending May 31st, the Fund purchased the following securities that were not owned at December 1, 2005 and which are listed as portfolio investments at May 31, 2006:

- Duke Energy
- Ensign Energy Services
- Mohawk Industries

The Fund also made initial purchases of common shares of IDT Corporation in addition to the IDT Class “B” shares previously owned. It is worth noting that the Fund substantially increased its investments in several existing portfolio holdings, although such changes may not appear obvious as a result of significant growth of Fund assets through appreciation and new subscriptions during the six month period ended May 31, 2006. During the six months ended May 31, 2006, the Fund added materially to existing holdings in Berkshire Hathaway, Inc., Canadian Natural Resources, EchoStar Communications, IDT Corporation, Penn West Energy Trust, and Sears Holdings.

Also, during the six months ended May 31, 2006, the Fund disposed of positions listed at November 30, 2005 and for which no shares were held on May 31, 2006 as follows:

- Countrywide Financial
- Ethan Allen
- Freddie Mac
- MCI (and merger successor Verizon)
- Mercury General
- RHJ International

Shareholders are cautioned that not all additions or dispositions to the portfolio are material, and that while the Fund and its adviser have long-term objectives, it is possible that a security purchased or sold in one period may be sold or purchased in a subsequent period. Generally, the Fund’s adviser determines to buy and sell based on its estimates of the intrinsic values and fundamental dynamics of a particular company and its industry, and not on short-term price movements. However, certain strategies of the adviser in carrying out the Fund’s investment policies may result in shorter holding periods. Investors are further cautioned not to rely on short-term results, both with respect to profits and losses on any individual investment in the Fund, as well as with respect to Fund shares themselves.

Securities whose gains most affected the Fund’s portfolio (including realized and unrealized gains) for the period included the following:

- Leucadia National
- Penn West Energy Trust
- IDT Corporation
- EchoStar Communications
- Sears Holdings
- Canadian Natural Resources
- Berkshire Hathaway
- Ensign Energy Services

# THE FAIRHOLME FUND

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## MANAGEMENT DISCUSSION & ANALYSIS (Continued) For the Six Months Ended May 31, 2006

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In the opinion of the Fund's investment adviser, the following factors had a bearing on the change in value of the above securities (although other unmentioned factors may have also contributed to price changes): Leucadia completed the sale of its WilTel division to SBC (now renamed AT&T) while retaining \$5 billion in future potential tax benefits and saw prospects for several subsidiaries improve; Penn West Energy Trust increased as energy prices remained strong and merger activity in the oil and gas industry increased; IDT Corporation gained after proposing the sale of its entertainment division to Liberty Media; EchoStar Communications gained as subscriber counts continued to increase; Sears Holdings rose as the company continued to repurchase stock while its recent results reflected increased retailing gross margins; Canadian Natural Resources rose as energy prices remained strong and the Horizon oil sands project remained on track; Berkshire Hathaway rose as the company reported strong operating results amid strengthened reinsurance pricing; and Ensign Energy Services rose as backlogs remained strong amid high energy prices.

Securities whose declines most affected the Fund's portfolio (including realized and unrealized losses) for the period included the following:

- Mohawk Industries
- USA Mobility
- MDC Holdings

In the opinion of the Fund's investment adviser, the following factors had a bearing on the change in value of the above securities (although other unmentioned factors may have also contributed to price changes): Mohawk Industries fell amid higher energy prices and increased concerns about its growth strategies as housing markets slowed; USA Mobility declined as paging subscriber counts continued to decrease at a rapid rate even as the company paid significant cash distributions to shareholders; and MDC Holdings declined as order cancellations rose sharply amid a general slowdown in the housing industry.

The fact that certain securities declined in value does not always indicate that the investment adviser believes these securities to be less attractive — in fact the investment adviser believes that some price declines may present significant buying opportunities. However, investors are also cautioned that it is possible that some securities mentioned in this discussion may no longer be owned by the Fund subsequent to the end of the fiscal period and that the Fund may have made significant new purchases that are not yet required to be disclosed. It is the Fund's general policy not to disclose portfolio holdings other than when required by relevant law or regulation.

The Adviser invests Fund assets in securities to the extent it finds sensible investment opportunities and the Fund may invest a significant portion of its assets in liquid low-risk securities or cash. During the period ended May 31, 2006, the Fund's liquidity (consisting of cash, money-market funds, and U.S. Treasury bills) represented a significant portion of Fund assets. It should be noted that since inception, the Fund has held, on average, a significant percentage of assets in liquid low-risk securities or cash without impacting performance, although there is no guarantee that future performance will not be negatively affected by the Fund's liquidity.

# THE FAIRHOLME FUND

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## MANAGEMENT DISCUSSION & ANALYSIS (Continued) For the Six Months Ended May 31, 2006

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In the six months ended May 31, 2006, significant cash inflows were recorded by the Fund, largely from new shareholder subscriptions believed to have resulted from positive performance and publicity received by the Fund. The board and management are aware that large cash inflows have the potential to adversely affect Fund performance under certain conditions. However, management of the Fund, after consulting with the Fund's Adviser, does not believe that recent inflows have materially affected performance to date. To the contrary, the Adviser believes that such cash inflows have helped the Fund make opportunistic investments and that levels of liquidity in the Fund are appropriate given the Adviser's view on liquidity and current investment conditions. Management and the board of the Fund monitor cash inflows and outflows and intend, after consultation with the Fund's Adviser, to take appropriate actions if they believe future performance is likely to be materially impacted. As of the date of this Semi-Annual report, no such actions are immediately contemplated.

Although the Fund has a policy of normally investing 75% of its assets in U.S. common stocks, at May 31, 2006 the Fund had a lower percentage of assets invested in U.S. common stocks and there is no guarantee that the Fund's U.S. common stock investments will be above 75% in the next six months. Investors should note that the Fund is in the process of amending its prospectus to eliminate certain non-fundamental restrictions with regard to its investment policies, including a provision that would no longer guide the Fund to invest any specified percentage of the portfolio in common stocks. For further information, we refer shareholders to Note 7 to the Financial Statements of this Semi-Annual Report, titled "Subsequent Events."

Certain financial organizations may not distribute all communications from the Fund to its shareholders. Accordingly, shareholders should be aware that all important communications from the Fund will be posted promptly on the Fund's website at [www.fairholmefunds.com](http://www.fairholmefunds.com) or may be obtained by calling the Fund's transfer agent, Citco Mutual Fund Services, Inc., toll free at 1-866-202-2263.

Since inception, the Fund has been advised by Fairholme Capital Management, L.L.C. Certain directors and officers of Fairholme Funds, Inc. are also members and officers of Fairholme Capital Management, L.L.C. For more complete information about the Fund and its adviser, or to obtain a current prospectus, please visit [www.fairholmefunds.com](http://www.fairholmefunds.com), or call 1-866-202-2263.

# THE FAIRHOLME FUND

## EXPENSES

May 31, 2006 (Unaudited)

As a shareholder of the Fund, you incur two types of costs: direct costs, which may include, but are not limited to, transaction fees at some broker-dealers, custodial fees for retirement accounts, redemption fees (on shares redeemed within 60 days of purchase), and wire transfer fees. As a shareholder, you also incur indirect costs, such as the management and administration fees paid to the adviser of the Fund.

The example below is intended to help you understand your indirect costs (also referred to as “ongoing costs” and measured in dollars) when investing in the Fund and to compare these costs with the ongoing costs of investing in other mutual funds. This example below is based on an investment of \$1,000 invested in the Fund at December 1, 2005 and held for the entire six month period ending May 31, 2006.

### Actual Expenses

The first line of the table below provides information about actual account values and actual expenses. You may use the information in this line, together with the amount you had invested at the beginning of the period, to estimate the expenses that you paid over the period. Simply divide your account value by \$1,000 (for example, an \$8,600 account value divided by \$1,000 = 8.6), then multiply the result by the number in the first line under the heading “Expenses Paid During the Period” to estimate the expenses you paid on your account during this period.

### Hypothetical Example for Comparison Purposes

The second line of the table provides information about hypothetical account values and hypothetical expenses based on the Fund’s actual expense ratio and an assumed rate of return of 5% per year before expenses, which is not the Fund’s actual return for the period presented. The hypothetical account values and expenses may not be used to estimate the actual ending account balance or expenses that you paid for the period presented. However, you may use this information to compare ongoing costs of investing in the Fund with the ongoing costs of investing in other funds. To do so, compare this 5% hypothetical example with the 5% examples that appear in the shareholder reports of other funds.

Please note that the column titled “Expenses Paid During the Period” in the table below is meant to highlight your ongoing costs only. Therefore, the second line of the table is useful in comparing ongoing costs only, does not reflect any direct costs, and will not help you determine the relative total costs of owning different funds. In addition, if these direct costs were included, your total costs would be higher.

	<u>Beginning Account Value December 1, 2005</u>	<u>Ending Account Value May 31, 2006</u>	<u>Expenses Paid During the Period* December 1, 2005 Through May 31, 2006</u>
Actual	\$1,000.00	\$1,109.10	\$5.26
Hypothetical (5% return before expenses)	\$1,000.00	\$1,019.95	\$5.04

\* Expenses are equal to the Fund’s annualized expense ratio of 1.00%, multiplied by the average account value over the period, multiplied by 182 days/365 days (to reflect the one-half year period). The Fund’s ending account value on the first line in the table is based on its actual total return of 10.91% for the six month period of December 1, 2005, to May 31, 2006.

# THE FAIRHOLME FUND

## SCHEDULE OF INVESTMENTS

May 31, 2006 (Unaudited)

<u>Shares</u>		<u>Market Value</u>
	<b>DOMESTIC COMMON STOCKS - 51.85%</b>	
	<b>CARPET - FLOOR COVERINGS - 4.51%</b>	
1,554,900	Mohawk Industries, Inc.*	\$ 114,596,130
	<b>DIVERSIFIED HOLDING COMPANIES - 22.00%</b>	
3,880	Berkshire Hathaway, Inc. Class A*	358,085,200
18,200	Berkshire Hathaway, Inc. Class B*	55,855,800
2,264,837	Leucadia National Corp.	145,040,162
		<u>558,981,162</u>
	<b>ENERGY SERVICES - 2.13%</b>	
1,917,800	Duke Energy Corp.	54,120,316
	<b>INSURANCE BROKERS - 0.90%</b>	
812,000	Marsh & McLennan Cos., Inc.	22,760,360
	<b>NEWSPAPERS: PUBLISHING AND PRINTING - 0.08%</b>	
48,645	Daily Journal Corp. *	2,043,090
	<b>PAY TELEVISION SERVICES - 10.61%</b>	
9,002,624	EchoStar Communications Corp.*	269,448,536
	<b>REAL ESTATE INVESTMENT TRUST - 1.97%</b>	
3,853,500	Annaly Mortgage Management Corp.	50,095,500
	<b>REAL ESTATE OPERATIONS - 0.26%</b>	
103,768	Homefed Corp.	6,744,920
	<b>RETAIL DEPARTMENT STORES - 4.53%</b>	
757,671	Sears Holdings Corp. *	115,067,495
	<b>TELECOMMUNICATIONS - 4.86%</b>	
1,310,500	IDT Corp. *	17,980,060
5,660,000	IDT Corp. Class B*	78,334,400
1,335,486	USA Mobility, Inc.*	27,097,011
		<u>123,411,471</u>
	<b>TOTAL DOMESTIC COMMON STOCKS</b>	
	<b>(COST \$1,172,564,750)</b>	<u>\$1,317,268,980</u>

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

# THE FAIRHOLME FUND

## SCHEDULE OF INVESTMENTS (Continued) May 31, 2006 (Unaudited)

<u>Shares</u>		<u>Market Value</u>
	<b>FOREIGN COMMON STOCKS - 20.92%</b>	
	<b>BERMUDA - 0.15%</b>	
	<b>PROPERTY AND CASUALTY INSURANCE - 0.15%</b>	
7,000	White Mountains Insurance Group Ltd. <sup>(a)</sup>	\$ 3,727,920
	<b>CANADA - 20.27%</b>	
	<b>OIL &amp; GAS DRILLING - 4.17%</b>	
4,575,800	Ensign Energy Services, Inc.	105,965,896
	<b>OIL AND GAS PRODUCERS - 16.10%</b>	
4,383,900	Canadian Natural Resources Ltd.	235,590,786
4,395,600	Penn West Energy Trust	173,510,525
		<u>409,101,311</u>
	<b>TOTAL CANADA</b>	<u>515,067,207</u>
	<b>UNITED KINGDOM - 0.50%</b>	
	<b>INVESTMENT TRUST - 0.50%</b>	
4,076,876	JZ Equity Partners PLC	12,690,842
	<b>TOTAL FOREIGN COMMON STOCKS</b>	
	<b>(COST \$406,648,268)</b>	<u>531,485,969</u>
	<b>MISCELLANEOUS INVESTMENTS - 3.05%<sup>(b)</sup></b>	
	<b>TOTAL MISCELLANEOUS INVESTMENTS</b>	
	<b>(COST \$81,707,523)</b>	<u>77,497,272</u>
	<b><u>Principal</u></b>	
	<b>U.S. GOVERNMENT AND AGENCY</b>	
	<b>OBLIGATIONS - 21.91%</b>	
40,000,000	T-Bill 0.00% <sup>(c)</sup> , 06/01/2006	40,000,000
30,000,000	T-Bill 4.02% <sup>(c)</sup> , 06/08/2006	29,973,604
40,000,000	T-Bill 4.25% <sup>(c)</sup> , 06/15/2006	39,930,311
40,000,000	T-Bill 4.34% <sup>(c)</sup> , 06/22/2006	39,895,700
30,000,000	T-Bill 4.41% <sup>(c)</sup> , 06/29/2006	29,895,291
30,000,000	T-Bill 4.52% <sup>(c)</sup> , 07/06/2006	29,867,000
50,000,000	T-Bill 4.58% <sup>(c)</sup> , 07/20/2006	49,688,646
50,000,000	T-Bill 4.66% <sup>(c)</sup> , 07/27/2006	49,638,722
50,000,000	T-Bill 4.70% <sup>(c)</sup> , 08/03/2006	49,594,400
80,000,000	T-Bill 4.73% <sup>(c)</sup> , 08/10/2006	79,278,880
40,000,000	T-Bill 4.74% <sup>(c)</sup> , 08/17/2006	39,602,560
40,000,000	T-Bill 4.75% <sup>(c)</sup> , 08/24/2006	39,566,440
40,000,000	T-Bill 4.76% <sup>(c)</sup> , 08/31/2006	39,529,280
		<u>39,529,280</u>
	<b>TOTAL U.S. GOVERNMENT AND AGENCY</b>	
	<b>OBLIGATIONS (COST \$556,439,576)</b>	<u>\$ 556,460,834</u>

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



# THE FAIRHOLME FUND

## SCHEDULE OF INVESTMENTS (Continued) May 31, 2006 (Unaudited)

<u>Shares</u>		<u>Market Value</u>
	<b>MONEY MARKET FUNDS - 1.84%</b>	
46,622,617	UMB Money Market, 3.42% <sup>(c)</sup>	\$ 46,622,617
	<b>TOTAL MONEY MARKET FUNDS (COST \$46,622,617)</b>	<u>46,622,617</u>
	<b>TOTAL INVESTMENTS (COST \$2,263,982,734) - 99.57%</b>	<u>2,529,335,672</u>
	<b>OTHER ASSETS IN EXCESS OF LIABILITIES, NET - 0.43%</b>	<u>10,964,667</u>
	<b>NET ASSETS - 100.00%</b>	<u>\$2,540,300,339</u>

\* Non-income producing securities.

<sup>(a)</sup> Income from White Mountains Insurance Group Ltd., an investment affiliated with Bruce R. Berkowitz, a Director of the Fund, totaled \$28,000 for the six months ended May 31, 2006.

<sup>(b)</sup> Represents previously undisclosed securities which the Fund has held for less than one year.

<sup>(c)</sup> Rates shown are the effective yields as of May 31, 2006.

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

# THE FAIRHOLME FUND

## STATEMENT OF ASSETS & LIABILITIES

May 31, 2006 (Unaudited)

### Assets

Investments, at Market Value (Cost - \$2,263,982,734)	\$2,529,335,672
Cash	8,010,631
Dividends and Interest Receivable	2,175,393
Receivable for Capital Shares Sold	6,754,388
Receivable for Investments Sold	20,607,865
Total Assets	<u>2,566,883,949</u>

### Liabilities

Payable for Capital Shares Redeemed	1,802,155
Payable for Investments Purchased	22,684,288
Accrued Management Fees	2,097,167
Total Liabilities	<u>26,583,610</u>

### Net Assets

Paid-In Capital	2,239,623,414
Accumulated Undistributed Net Investment Income	9,553,257
Net Accumulated Realized Gain on Investments	25,768,791
Net Unrealized Appreciation on Investments	265,354,877

### NET ASSETS

\$2,540,300,339

Shares of Common Stock Outstanding* (\$0.0001 par value)	<u>92,483,022</u>
Net Asset Value, Offering and Redemption Price Per Share (\$2,540,300,339/92,483,022 shares)	<u>\$ 27.47</u>

\* 125,000,000 shares authorized in total.

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

# THE FAIRHOLME FUND

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## STATEMENT OF OPERATIONS (Unaudited)

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	<b>For the Six Months Ended May 31, 2006</b>
<b>Investment Income</b>	
Interest	\$ 11,698,757
Dividends (net of \$1,019,765 foreign taxes withheld)	<u>10,486,362</u>
Total Investment Income	<u>22,185,119</u>
<b>Expenses</b>	
Management Fees (Note 3)	10,076,137
Other Expenses	<u>(20,258)</u>
Total Expenses	<u>10,055,879</u>
Net Investment Income	<u>12,129,240</u>
<b>Realized and Unrealized Gain on Investments</b>	
Net Realized Gain on Investments	25,777,265
Net Realized Loss on Foreign Currency Transactions	(2,023)
Net Change in Unrealized Appreciation on Investments	<u>157,413,996</u>
Net Realized and Unrealized Gain on Investments	<u>183,189,238</u>
<b>NET INCREASE IN NET ASSETS FROM OPERATIONS</b>	<u><u>\$195,318,478</u></u>

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

# THE FAIRHOLME FUND

## STATEMENTS OF CHANGES IN NET ASSETS

	For the Six Months Ended May 31, 2006 (Unaudited)	For the Fiscal Year Ended November 30, 2005
<b>CHANGE IN NET ASSETS</b>		
<b>From Operations</b>		
Net Investment Income	\$ 12,129,240	\$ 11,568,408
Net Realized Gain on Investments	25,777,265	27,488,551
Net Realized Loss on Foreign Currency Transactions	(2,023)	—
Net Change in Unrealized Appreciation on Investments	<u>157,413,996</u>	<u>63,887,869</u>
Net Increase in Net Assets from Operations	<u>195,318,478</u>	<u>102,944,828</u>
<b>From Distributions to Shareholders</b>		
Net Investment Income	(12,476,449)	(1,200,051)
Net Realized Capital Gains from Security Transactions	<u>(27,465,547)</u>	<u>(5,736,115)</u>
Net Decrease in Net Assets from Distributions	<u>(39,941,996)</u>	<u>(6,936,166)</u>
<b>From Capital Share Transactions</b>		
Proceeds from Sale of Shares	1,111,596,189	1,373,343,214
Shares Issued in Reinvestment of Dividends	38,331,418	6,728,343
Redemption Fees	242,781	215,899
Cost of Shares Redeemed	<u>(206,114,055)</u>	<u>(270,446,677)</u>
Net Increase in Net Assets from Shareholder Activity	<u>944,056,333</u>	<u>1,109,840,779</u>
<b>NET ASSETS</b>		
Net Increase in Net Assets	1,099,432,815	1,205,849,441
Net Assets at Beginning of Period	<u>1,440,867,524</u>	<u>235,018,083</u>
Net Assets at End of Period	<u>\$2,540,300,339</u>	<u>\$1,440,867,524</u>
Accumulated Undistributed Net Investment Income	<u>\$ 9,553,257</u>	<u>\$ 9,900,467</u>
<b>SHARES TRANSACTIONS</b>		
Issued	42,129,966	56,896,881
Reinvested	1,520,484	295,892
Redeemed	<u>(7,779,661)</u>	<u>(11,092,655)</u>
Net Increase in Shares	35,870,789	46,100,118
Shares Outstanding at Beginning of Period	<u>56,612,233</u>	<u>10,512,115</u>
Shares Outstanding at End of Period	<u>92,483,022</u>	<u>56,612,233</u>

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

# THE FAIRHOLME FUND

## FINANCIAL HIGHLIGHTS

	For the Six Months Ended May 31, 2006 (Unaudited)	For the Fiscal Year Ended Nov. 30, 2005	For the Fiscal Year Ended Nov. 30, 2004	For the Fiscal Year Ended Nov. 30, 2003	For the Fiscal Year Ended Nov. 30, 2002	For the Fiscal Year Ended Nov. 30, 2001
<b>NET ASSET VALUE, BEGINNING OF PERIOD</b>	<u>\$25.45</u>	<u>\$22.36</u>	<u>\$18.08</u>	<u>\$15.14</u>	<u>\$14.99</u>	<u>\$13.55</u>
<b>Investment Operations</b>						
Net Investment						
Income/(Loss)	0.16**	0.38**	0.01	(0.02)	0.01	0.05
Net Realized and Unrealized Gain on Investments	<u>2.56</u>	<u>3.31</u>	<u>4.28</u>	<u>3.09</u>	<u>0.26</u>	<u>1.67</u>
Total from Investment Operations	<u>2.72</u>	<u>3.69</u>	<u>4.29</u>	<u>3.07</u>	<u>0.27</u>	<u>1.72</u>
<b>Distributions</b>						
From Net Investment Income	(0.22)	(0.07)	—	(0.00)*	(0.03)	(0.04)
In Excess of Net Investment Income*	—	—	—	(0.03)	—	—
From Realized Capital Gains	<u>(0.48)</u>	<u>(0.53)</u>	<u>(0.01)</u>	<u>(0.10)</u>	<u>(0.09)</u>	<u>(0.24)</u>
Total Distributions	<u>(0.70)</u>	<u>(0.60)</u>	<u>(0.01)</u>	<u>(0.13)</u>	<u>(0.12)</u>	<u>(0.28)</u>
<b>NET ASSET VALUE, END OF PERIOD</b>	<u>\$27.47</u>	<u>\$25.45</u>	<u>\$22.36</u>	<u>\$18.08</u>	<u>\$15.14</u>	<u>\$14.99</u>
<b>TOTAL RETURN</b>	10.91%	16.84%	23.71%	20.50%	1.77%	12.75%
<b>Ratios/Supplemental Data</b>						
Net Assets, End of Year (in 000's)	\$2,540,300	\$1,440,868	\$235,018	\$88,968	\$47,809	\$28,753
Ratio of Expenses to Average Net Assets	1.00% <sup>(a)</sup>	1.00%	1.00%	1.00%	1.00%	1.00%
Ratio of Net Investment Income/(Loss) to Average Net Assets	1.20% <sup>(a)</sup>	1.55%	0.05%	(0.13)%	0.05%	0.24%
Portfolio Turnover Rate	17.58%	37.36%	23.33%	12.66%	47.68%	29.40%

\* Represents less than \$0.01.

\*\* Based on average shares outstanding.

<sup>(a)</sup> Annualized.

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

## **Note 1. Organization**

Fairholme Funds, Inc. (the “Company”), a Maryland corporation, is registered under the Investment Company Act of 1940, as amended, as an open-end management investment company. The Company’s Articles of Incorporation permit the Board of Directors of the Company (the “Board” or the “Directors”) to issue 200,000,000 shares of common stock at \$.0001 par value. The Board has the power to designate one or more separate and distinct series and/or classes of shares of common stock and to classify or reclassify any shares not issued with the respect to such series. 125,000,000 shares of one series have been authorized, which shares constitute the interests in the The Fairholme Fund (the “Fund”), a non-diversified fund. The Fund’s investment objective is to provide long-term growth of capital. The Fund seeks to achieve its objective by investing in common stocks without restrictions regarding market capitalization. The Fund will normally invest at least 75% of total net assets in U.S. common stocks and intends to hold a focused portfolio of no more than 25 stocks under normal circumstances. Fairholme Capital Management, L.L.C. (the “Adviser”) serves as investment adviser to the Fund.

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

The following is a summary of significant accounting policies followed by the Fund in the preparation of its financial statements.

*Security Valuation:* Securities, which are traded on any exchange or on the NASDAQ over-the-counter market, are valued at the last quoted sale price. Lacking a last sale price, a security is valued at its last bid price. All other securities for which over-the-counter market quotations are readily available are valued at their last bid price. When market quotations are not readily available, when the Adviser determines the last bid price does not accurately reflect the current value or when restricted securities are being valued, such securities are valued as determined in good faith by the Adviser, in conformity with guidelines adopted by and subject to review of the Directors.

Fixed income securities generally are valued by using market quotations, but may be valued on the basis of prices furnished by a pricing service when the Adviser believes such prices accurately reflect the fair market value of such securities. A pricing service utilizes electronic data processing techniques based on yield spreads relating to securities with similar characteristics to determine prices for normal institutional-size trading units of debt securities without regard to sale or bid prices. When prices are not readily available from a pricing service, or when restricted or illiquid securities are being valued, securities are valued at fair value as determined in good faith by the Adviser, subject to review of the Directors. Short-term investments in fixed income securities with maturities of less than 60 days when acquired, or long-term securities which are within 60 days of maturity, are valued by using the amortized cost method of valuation, which the Adviser and the Board have determined will represent fair value.

*Federal Income Taxes:* The Fund intends to qualify each year as a “Regulated Investment Company” under the Internal Revenue Code of 1986, as amended. By so qualifying, the Fund will not be subject to federal income taxes to the extent that it distributes all of its net investment income and any realized capital gains.

*Dividends and Distributions:* The Fund intends to distribute substantially all of its net investment income as dividends to its shareholders on an annual basis. The Fund intends to distribute its net long-term capital gains and its net short-term capital gains at least once a year.

*Foreign Currency Translation:* The books and records of the Fund are maintained in U.S. dollars. Foreign currency amounts are translated into U.S. dollars on the following basis: (i) market value of investment securities, assets and liabilities at the current rate of exchange; and (ii) purchases and sales of investment securities, income and expenses at the relevant rates of exchange prevailing on the respective dates of such transactions. The Fund does not isolate that portion of gains and losses on investment securities which is due to changes in the foreign exchange rates from that which is due to changes in the market prices of such securities.

*Estimates:* The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of both contingent assets and liabilities, at the date of the financial statements; and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

*Other:* The Fund follows industry practice and accounts for security transactions on the trade date for financial statement purposes. The specific identification method is used for determining gains or losses for financial statements and income tax purposes. Dividend income is recorded on the ex-dividend date and interest income is recorded on an accrued basis. Discounts and premiums on securities purchased are amortized over the life of the respective securities. Securities denominated in currencies other than U.S. dollars are subject to changes in value due to fluctuation in exchange rates. The Fund may invest in countries that require governmental approval for the repatriation of investment income, capital, or the proceeds of sales of securities by foreign investors. In addition, if there is deterioration in a country's balance of payments or for other reasons, a country may impose temporary restrictions on foreign capital remittances abroad.

### **Note 3. Related Party Transactions**

The Adviser is a Delaware limited liability company and is registered with the Securities and Exchange Commission as an investment adviser. The Adviser's principal business and occupation is to provide financial management and advisory services to individuals, corporations, and other institutions throughout the world. The Fund pays the Adviser for its advisory and administrative services, an annualized management fee equal to 1.00% (0.50% of which are investment advisory fees and 0.50% for administrative and other services) of the average net assets of the Fund, such fees to be computed daily based upon the daily average net assets of the Fund. Pursuant to an Operating Services Agreement, the Fund's Adviser is responsible for paying all the Fund's expenses except commissions and other brokerage fees, taxes, interest, litigation expenses and other extraordinary expenses. The Fund paid commissions and other brokerage fees, but did not incur any other extraordinary expenses during the period. The Adviser received

# THE FAIRHOLME FUND

## NOTES TO FINANCIAL STATEMENTS (Continued) May 31, 2006 (Unaudited)

\$10,076,137 for their services during the six month period ended May 31, 2006. Certain directors and officers of Fairholme Funds, Inc. are also members and officers of Fairholme Capital Management, L.L.C.

Income from White Mountains Insurance Group Ltd. an investment affiliated with Bruce R. Berkowitz, an Officer and a Director of the Fund, totaled \$28,000 for the six month period ended May 31, 2006.

### Note 4. Investments

For the six months ended May 31, 2006, purchases and sales of investment securities, other than short-term investments, aggregated \$1,021,916,470, and \$257,582,396, respectively.

### Note 5. Tax Matters

For U.S. federal income tax purposes, the cost of securities owned, gross appreciation, gross depreciation, and net unrealized appreciation/(depreciation) of investments at May 31, 2006 was as follows:

	<u>Cost</u>	<u>Gross Unrealized Appreciation</u>	<u>Gross Unrealized Depreciation</u>	<u>Net Unrealized Appreciation/ (Depreciation)</u>
The Fairholme Fund	\$2,263,989,184	\$304,962,243	\$(39,615,755)	\$265,346,488

The difference between book basis and tax basis net unrealized appreciation/(depreciation) is attributable primarily to the tax deferral of losses on wash sales.

The Fund's tax basis capital gains and losses are determined only at the end of each fiscal year. As of November 30, 2005, the components of distributable earnings on a tax basis were as follows:

	<u>Amount</u>
Undistributed Ordinary Income	\$ 9,900,467
Undistributed Capital Gain	27,465,546
Unrealized Appreciation	107,934,431
	<u>\$145,300,444</u>

### Note 6. Distribution to Shareholders

Income and long-term capital gain distributions are determined in accordance with Federal income tax regulations, which may differ from accounting principles generally accepted in the United States of America.



# THE FAIRHOLME FUND

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NOTES TO FINANCIAL STATEMENTS (Continued)  
May 31, 2006 (Unaudited)

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The tax character of dividends and distributions paid by the Fund was as follows:

	<u>2006</u>	<u>2005</u>
Distributions paid from:		
Ordinary Income	\$12,476,449	\$1,200,051
Short-Term Capital Gain	7,737,553	871,461
Long-Term Capital Gain	19,727,994	4,864,654
	<u>\$39,941,996</u>	<u>\$6,936,166</u>

## Note 7. Subsequent Events

On May 4th, 2006 the Board of the Fund approved certain changes to the prospectus with respect to the Fund's non-fundamental investment restrictions and on May 19th, 2006 the Fund filed with the Securities and Exchange Commission to amend its Prospectus accordingly. We anticipate that the new Prospectus incorporating these amendments will become effective on August 15, 2006. The Board adopted these amendments to provide greater flexibility to the Adviser to help achieve the Fund's overall objective, which remains unchanged. Once effective, there will be no restriction on the percentage of Fund assets that can be held in non-U.S. securities or certain "special situation" investments. Previously, both categories had been limited to 25% of the Fund's total assets respectively. In addition, the language stating that the Fund's assets would "normally be invested 75% in U.S. common stocks" will be replaced by language stating that the Fund's assets will be invested "primarily in equity securities of public companies, including but not limited to, common stocks, partnership interests, business trust shares, convertible securities, and rights and warrants to subscribe for the purchase of such equity securities without regard to market capitalizations or other categorizations". The Adviser has informed the Board that it has no immediate plans to make significant changes in the Fund's investment portfolio based on the amendments becoming effective, but that it believes such changes may help the Fund better achieve its objectives under certain potential economic and market conditions.

# THE FAIRHOLME FUND

## ADDITIONAL INFORMATION

May 31, 2006 (Unaudited)

### Board of Directors (unaudited)

The Board of Directors has overall responsibility for conduct of the Company's affairs. The day-to-day operations of the Fund are managed by the Adviser, subject to the Bylaws of the Company and review by the Board. The Directors, including those Directors who are also officers of the Company, are listed below.

Name, Age & Address	Position(s) Held with the Company	Term of Office & Length of Time Served	Principal Occupation(s) During Past 5 Years	Funds Overseen by Director	Other Directorships Held by Director
Bruce R. Berkowitz* Age 48 51 JFK Parkway Short Hills, NJ 07078	Director, President	Each Director serves for an indefinite term. Mr. Berkowitz has served as a director of the Fund since the Fund's inception on December 29, 1999.	Managing Member, Fairholme Capital Management, L.L.C., a registered investment adviser, since October 1997.	1	Trustee, First Union Real Estate; Director, TAL International Group, Inc.; Director, White Mountains Insurance Group, Ltd.
Keith D. Trauner* Age 49 51 JFK Parkway Short Hills, NJ 07078	Director, Treasurer/ Secretary	Each Director serves for an indefinite term. Mr. Trauner was appointed by the Board to replace an outgoing director in January 2002.	Chief Financial Officer, Fairholme Capital Management L.L.C., a registered investment adviser, employed since February 1999.	1	None
Joel L. Uchenick Age 57 217 Rowley Bridge Road, Topsfield, MA 01983	Independent Director	Each Director serves for an indefinite term. Mr. Uchenick has served as a director of the Fund since the Fund's inception on December 29, 1999.	General Partner, Sherbrooke Capital, a private equity firm, since November 1998. Previously, Senior Partner, Sherbrooke Associates Inc.	1	Director and Chairman, Oregon Chai Inc.; Director and Chief Financial Officer, Cooke PH, Inc.
Avivith Oppenheim, Esq. Age 56 211 Mountain Avenue, Springfield, NJ 07081	Independent Director	Each Director serves for an indefinite term. Ms. Oppenheim has served as a director of the Fund since the Fund's inception on December 29, 1999.	Attorney-at-Law (private practice).	1	None
Leigh Walters, Esq. Age 60 1 Cleveland Place Springfield, NJ 07081	Independent Director	Each Director serves for an indefinite term. Mr. Walters has served as a director of the Fund since the Fund's inception on December 29, 1999.	Vice-President and Director, Valcor Engineering Corporation. Attorney-at-Law.	1	Director, Valcor Engineering Corporation

\* Indicates an interested person as defined in the 1940 Act.

## **Other Information (unaudited)**

The Company has adopted policies and procedures which provide guidance and set forth parameters for the voting of proxies relating to securities held in the Fund's portfolio. These policies, procedures and records for the twelve month period ended June 30, 2005 are available to you upon request and free of charge by writing to Fairholme Funds, Inc., c/o Citco Mutual Fund Services, Inc., P.O. Box C1100, Southeastern, PA 19398-1100, or by calling the Company toll free at 1-866-202-2263, or by visiting the Company's website at [www.fairholmefunds.com](http://www.fairholmefunds.com). The Company's proxy voting policies, procedures, and records may also be obtained by visiting the Securities and Exchange Commission website at [www.sec.gov](http://www.sec.gov). The Company shall respond to all shareholder requests for records within three business days of such request by first-class mail or other means designed to ensure prompt delivery.

## **N-Q Filing (unaudited)**

The SEC has adopted the requirement that all Funds file a complete schedule of investments with the SEC for their first and third fiscal quarters on Form N-Q for fiscal quarters ending after July 9, 2004. The Fairholme Fund files Form N-Q for the fiscal quarters ending February 28 (February 29 during leap year) and August 31. The Form N-Q filing must be made within 60 days of the end of the quarter. The Fairholme Fund Form N-Q will be available on the SEC's website at <http://sec.gov>, or they may be reviewed and copied at the SEC's Public Reference Room in Washington, DC (call 1-800-732-0330 for information on the operation of the Public Reference Room).

**Board of Directors**

Bruce R. Berkowitz  
Avivith Oppenheim, Esq.  
Keith D. Trauner  
Joel L. Uchenick  
Leigh Walters, Esq.

**Officers**

Bruce R. Berkowitz, President  
Keith D. Trauner, Secretary & Treasurer

**Investment Adviser**

Fairholme Capital Management, L.L.C.  
51 JFK Parkway  
Short Hills, NJ 07078  
Telephone: 973-379-6557

**Dividend Paying Agent,  
Shareholders' Servicing Agent,  
Transfer Agent**

Citco Mutual Fund Services, Inc.  
83 General Warren Boulevard, Suite 200  
Malvern, PA 19355  
Telephone: 866-202-2263

**Custodian**

UMB Bank N.A.  
1010 Grand Boulevard  
Kansas City, MO 64106

**Independent Registered  
Public Accounting Firm**

Deloitte & Touche L.L.P.  
1700 Market Street  
Philadelphia, PA 19103

**Fund Counsel**

Seward & Kissel L.L.P.  
1200 G Street, N.W.  
Washington, D.C. 20005

This report is provided for the general information of the shareholders of The Fairholme Fund. This report is not intended for distribution to prospective investors in the Fund, unless preceded or accompanied by an effective prospectus, which contains more information on fees, charges, and other expenses and should be read carefully before investing or sending money. Past performance is not a guarantee of future results.