

**NORTH WATER**

**Northwater Market-Neutral Trust  
December 31, 2002  
Annual Report**

**N**



**CONTENTS**

Message to Unitholders from the Advisor	2
Management Discussion and Analysis	4
Management's Responsibility	11
Auditors' Report to the Unitholders and Audited Financial Statements	13
Northwater Capital Management Inc.	26

## Message to Unitholders from the Advisor

The Northwater Market-Neutral Trust (the "Trust") is a closed-end fund comprising a diversified portfolio of market-neutral hedge funds that is traded on The Toronto Stock Exchange. As of December 31, 2002, the net asset value of the Trust per unit was \$19.05. For the fourth quarter, the net asset value of the Trust per unit rose by 4.17%. For the year, the net asset value per unit increased 8.47% after taking into account distributions per unit of \$1.08.

2002 marked the third year of the bear market in equities, with the S&P 500 falling over 22%. In addition to the general malaise experienced by equity markets and a worsening economic climate, investor sentiment was further influenced by company-specific events. The bankruptcy and corporate fraud at Enron proved to be the tip of the iceberg; notable bankruptcy filings in 2002 included K-Mart, Global Crossing, WorldCom, Adelphia, US Air and United Airlines. Particularly distressing to investors was the accounting irregularities found at Tyco, Adelphia, ImClone and others. The discovery of fraud and credit concerns in previously reputable companies led to a significant widening of credit spreads as investors demanded compensation for the increased risk of holding "risky" securities.

The overall widening of credit spreads, especially throughout the second and third quarter, had a negative impact on Northwater's distressed securities managers. Fortunately, the portfolio's approach to credit-sensitive strategies follows a market-neutral approach. Although Northwater's managers were negatively impacted by surprise corporate announcements, those losses were mitigated by the managers' utilization of strategies with a hedged exposure to credit spreads. The temporary panic in credit-sensitive securities corrected itself towards the end of the year and positions returned to more rational levels; Northwater's distressed security managers ended the year in positive territory despite the turbulent market environment.

A secondary consequence of investors and regulators becoming skittish about companies with complex balance sheets was the unwillingness of companies to merge or restructure. The accounting treatment of mergers and acquisitions became a significant issue early in the year as regulators probed Tyco's balance sheet for evidence of wrongdoing. This increased scrutiny, when coupled with the uncertain economic environment and declining stock prices, led to a reduced number of mergers and acquisitions throughout 2002.

Finally, interest rates continued to decline amid economic uncertainty and geopolitical instability. The US Federal Reserve lowered interest rates from 1.75% to 1.25% over the course of the year. Yields on the 10-Year Treasury bond fell from approximately 5% to 3.8%. One of the many effects of the rally in bond markets and fall in rates is that homeowners are flocking to refinance their mortgages. The high level of refinancings in the mortgage-backed securities (MBS) market, coupled with strong collateralized mortgage obligations issuance and the general reluctance of the broker/dealer community to trade mortgage-related securities from a proprietary standpoint has created an ideal environment for duration-neutral MBS managers. As a result, Northwater's MBS securities managers were among the top performing funds in the portfolio.

Northwater continued to alter the Trust's portfolio in order to capitalize on the shifting financial environment. Over the course of the year, 7 new funds were added to the portfolio and 10 funds were removed. The changes were made to assist the Trust in furthering its objective of generating consistent results regardless of the overall market environment. The Trust's focus continues to be building as diversified and resilient a portfolio as practicable.

In 2002, Northwater increased the portfolio weight of distressed securities. Northwater has identified unique managers whose investments in this area are non-traditional. Specifically, the Trust's managers invest primarily in the senior, secured bank debt of financially distressed companies where the probability of substantial cash recovery is high. Furthermore, these positions are often combined with securities that mitigate the impact of systemic risks across the entire industry. Northwater's inclusion of non-traditional and hedged distressed security managers enables the Trust to capitalize on the lucrative environment for troubled companies without sacrificing the fund's market-neutral mandate.

By contrast, Northwater's assessment of the merger arbitrage environment is negative. Not only has the bear market in equities led to an overall decline in corporate activities, but the amount of capital chasing the few remaining deals has also negatively impacted the risk/reward metric. The Trust's managers report tighter spreads for announced deals, thereby requiring a manager to either take larger, more concentrated positions or remain underinvested, thereby diluting returns. Consequently, Northwater has continued to reduce its exposure to merger arbitrage.

Northwater continues to focus on improving the portfolio by refining its stable of managers and focusing on market-neutral strategies that, despite a difficult economic environment, are able to deliver strong, risk-adjusted returns. Northwater's strategy is to replace existing managers with others who are either better hedged or who are perceived to be better able to add value through their unique investment approaches.

Northwater remains committed to market-neutral investing as an essential element of any truly diversified portfolio. The Trust's well-constructed portfolio of market-neutral hedge funds offers among the best risk-adjusted returns available in the market today.



DAVID G. PATTERSON

Chair and Chief  
Executive Officer



GEORGE I. MAIN, CFA

Managing Director

February 19, 2003

## MANAGEMENT DISCUSSION AND ANALYSIS

### Investment Objectives

The Trust's investment objectives are:

1. Distribute \$0.40 per unit per quarter (\$1.60 per annum);
2. Steadily grow the net asset value;
3. Ensure that the performance of the Trust is substantially independent of fixed income and equity markets; and
4. Achieve low volatility, which is expected to be less than that of a mid-term bond portfolio and less than one-half that of major North American stock markets.

### Investment Management Process

The Trust's investment objectives are supported by the implementation of an investment management process. The Advisor's ability to deliver results is managed by a team of investment professionals that research, analyze and monitor the investments of the Trust. The Advisor conducts all of its investment research in-house and has developed all of its trading, risk management and accounting software systems internally.

The Advisor has developed a proprietary selection process that it uses to select and monitor potential hedge fund investments to be made by the Trust. This process is an integral part of the Advisor's strategy for generating value over time and includes:

1. A broad ongoing search for candidate hedge funds that have exceptional return/risk profiles.
2. Rigorous quantitative analysis of the historical performance of the hedge funds identified as candidates for investment that focuses on consistency and sustainability of return and assesses whether the manager of the candidate hedge fund is adding value to the investment process.
3. Statistical analysis to determine the effect on the Trust as a whole of adding and deleting a particular hedge fund or strategy.
4. Qualitative judgments on the strength of the management team and operations of a candidate hedge fund.
5. Mathematical techniques to help determine the weightings of each hedge fund within the Trust's portfolio. These tools compliment the Advisor's qualitative assessment of particular managers and strategies.

In addition, a due diligence process is completed before the Trust makes an investment. All investments within the Trust's portfolio are subject to regular review. Among other factors, the investment team monitors organizational changes made by the hedge fund managers selected as well as changes in policy relative to their investment objectives, hedging strategy, degree of diversification, leverage, and costs.

## Investment Strategy

The Trust comprises market-neutral hedge funds that the Advisor believes have excellent expected returns as well as performance histories that have a low correlation with major equity and debt markets. In establishing the hedge fund "mix," the Advisor selects strategies that also have a low correlation with one another, thereby increasing diversification and reducing expected volatility.

The Trust employs leverage as it believes that leverage may enhance investment returns. The Trust is entitled to borrow up to 25% of the net asset value for investment purposes, and an additional 10% of the net asset value for effecting the purchase and buy-back program, maintaining liquidity to effect cash distributions and settling currency hedging transactions. The financial leverage as at December 31, 2002 was 24.80% (2001: 25.58%). The decreased leverage reflects a reduction of temporary borrowings made for investment purposes.

## Investment Activity

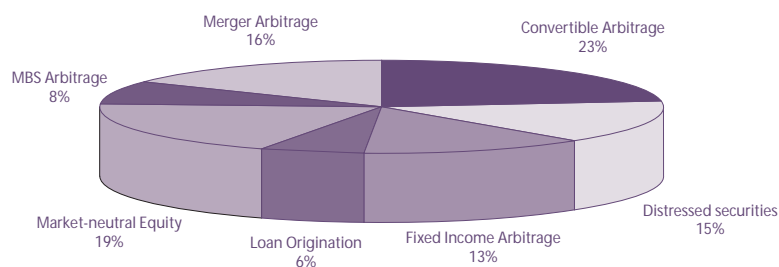
During the year, as part of its regular investing activities and with a view to enhancing diversification and providing risk reduction to the overall portfolio, the Trust placed investments with seven new hedge fund managers (2001: 16 hedge fund managers) and redeemed investments from seven other hedge fund managers (2001: ten hedge fund managers).

As at December 31, 2002, the Trust was invested in 41 hedge funds (2001: 44 hedge funds) with 35 managers (2001: 35 managers) engaged in seven unique market-neutral or hedged investment strategies. This wide array of hedge fund investments has created broad diversification through which the Trust seeks to achieve its risk/return objectives and market neutrality.

## Asset Allocation by Investment Strategy

### Hedge Fund Investments

Strategy	As at December 31, 2002			As at December 31, 2001		
	No. of Hedge Funds	Fair Value		No. of Hedge Funds	Fair Value	
Convertible arbitrage	8	\$ 28,295,170	23%	11	\$ 33,646,124	27%
Distressed securities	6	17,951,387	15%	4	8,068,872	6%
Fixed income arbitrage	5	15,837,957	13%	5	13,155,070	11%
Loan origination	3	7,530,959	6%	3	8,941,899	7%
Market-neutral equity	9	23,069,210	19%	8	22,662,624	18%
Mortgage-backed securities arbitrage	3	9,644,827	8%	2	6,505,284	5%
Merger arbitrage	7	19,271,280	16%	11	31,934,015	26%
	41	121,600,790	100%	44	124,913,888	100%
Settlement due on currency futures		81,428			(81,939)	
		\$ 121,682,218			\$ 124,831,949	



## Review of Financial Results

### Performance

During 2002, the performance of the Trust continued the trend established in 2001, posting a return of 8.47% (2001: 10.58%) for the year, taking into account distributions made during the year. All seven of the Trust's strategies contributed significantly to the overall return. In particular, convertible arbitrage, fixed income arbitrage and loan origination strategies were key to the success of the Trust in 2002. The strong performance of the Trust, despite the declines experienced in the equity and bond markets, reflects the market-neutral nature of the Trust's hedge fund portfolio.

With the continued trading discounts prevalent in the market, the Trust was again able to capitalize on the share buy-back and cancellation program during the year to provide additional returns to the unitholders. Over the year, this program contributed 0.50% (2001: 0.46%) to returns.

### Net Asset Value and Price Per Unit

The Trust's net asset value per unit is calculated and reported monthly. For the year ended December 31, 2002, the net asset value per unit of the Trust fluctuated between a low of \$18.66 and a high of \$19.27 (2001: low of \$18.55 and high of \$19.71 per unit), after taking into account distributions. The relatively narrow band around the net asset values in 2002 reflects the payment of distributions out of the growth of the Trust throughout the year.

As in prior years, the Trust traded at a discount. The trading price of the units fluctuated between \$16.50 and \$18.00 (2001: \$15.85 and \$18.75) during the year.

### Distributions

The Trust is obligated to distribute \$0.40 per unit to unitholders on a quarterly basis. Distributions are determined using the net asset value per unit for the month prior to each quarter end, and are permitted under the trust agreement as long as the net asset value per unit of the Trust at such time is greater than the initial net asset value per unit of the Trust of \$18.79. During the year, the Trust made distributions in all of the quarters totalling \$1.08 per unit (\$5,909,697 was distributed in aggregate) as compared to three distributions in 2001 in the amount of \$2.17 per unit (\$12,475,419 in aggregate). The distributions of \$1.08 per unit (2001: \$2.17 per unit) included payments of \$0.13 per unit (2001: \$0.97 per unit) towards distributions that were in arrears. As at year end, distributions in arrears amounted to \$1.00 per unit and \$5,344,359 in aggregate (2001: \$0.48 per unit; \$2,731,036 in aggregate). The remaining distributions in arrears will be paid to investors, on a quarterly basis, as they are earned. Northwater's interests remain

aligned with those of the investor: as long as there are any distributions owing to the investors, Northwater's management fee is not paid nor reflected in the net asset value of the Trust. Once all distributions in arrears have been paid, management fees will only be accrued and paid if such an accrual and payment will not prohibit the payment of current distributions to unitholders. As at December 31, 2002 the management fees in arrears that had not been accrued were \$8,356,051 (2001: \$7,051,825).

## Distribution History

<b>Record date</b>	<b>Date distribution paid</b>	<b>Character of distribution for tax purposes</b>	<b>Amount per unit</b>
March 31, 1998	April 22, 1998	Return of capital	\$0.32
June 30, 1998	July 21, 1998	Return of capital	\$0.37
December 31, 1999	January 31, 2000	Return of capital	\$0.57
March 31, 2000	April 14, 2000	Return of capital	\$0.97
June 30, 2000	July 14, 2000	Return of capital	\$0.88
September 29, 2000	October 13, 2000	Return of capital	\$0.73
December 29, 2000	January 12, 2001	Return of capital	\$0.31
March 30, 2001	April 17, 2001	Return of capital	\$0.92
June 29, 2001	July 17, 2001	Return of capital	\$0.84
September 28, 2001	October 19, 2001	Return of capital	\$0.41
March 28, 2002	April 19, 2002	Return of capital	\$0.07
June 28, 2002	July 19, 2002	Return of capital	\$0.48
September 30, 2002	October 18, 2002	Return of capital	\$0.08
December 31, 2002	January 17, 2003	Return of capital	\$0.45

## Net Income from Operations

For the year ended December 31, 2002, the Trust's net income from operations was \$7,993,620 (2001: \$10,841,484). As in 2001, and consistent with the Trust's objectives, the key contributing factors were the realized and unrealized gains on hedge fund investments.

The impact of expenses for the years ended December 31, 2002 and 2001 is analyzed in the following table:

<b>Ratio of expenses to weighted-average net assets</b>	<b>2002</b>	<b>2001</b>
Excluding loan interest and stand-by fees	0.20%	0.19%
Including loan interest and stand-by fees	0.80%	1.50%
If management fees were payable in the year	2.05%	2.75%

### Currency Hedging

The Trust uses derivative contracts to hedge the currency exposure of investments denominated in U.S. dollars. A portion of the Trust's liabilities, which are denominated in U.S. dollars, provides a natural hedge to the U.S. dollar denominated assets.

The following table summarizes the impact of currency exchange for the years ended December 31, 2002 and 2001 after taking into account the hedging activities of the Trust.

	<b>2002</b>	<b>2001</b>
Currency exchange on hedge fund investments denominated in U.S. dollars:		
Net realized gain	\$ 1,289,942	1,984,261
Change in unrealized appreciation (depreciation)	(2,024,914)	5,700,516
Currency hedging of U.S. dollar denominated investments	1,508,529	(6,555,735)
Translation gain (loss) on natural hedge	303,612	(974,182)
<b>Net impact of currency exchange</b>	<b>\$ 1,077,169</b>	<b>154,860</b>

### Purchases for Cancellation

Under its trust agreement, the Trust is required to make purchases of units of up to 2% of the outstanding units per quarter if the price at which the units trade in the market is less than 92.5% of the net asset value per unit as at the close of business on the preceding valuation date. In addition, the Trust may purchase units whenever they are offered for sale at less than their net asset value.

In December 2002, the Trust filed a notice of intention to make normal-course purchases of its units with The Toronto Stock Exchange. In its

filing with the exchange, the Trust indicated an intention to purchase up to 527,764 of the units of the Trust, representing 10% of the public float of the Trust then outstanding. In accordance with exchange rules and by-laws, the Trust may not pay more than the most recent market price for the units purchased. Units purchased under the bid are cancelled.

During the year ended December 31, 2002, the Trust purchased 345,300 units (2001: 219,500 units) for cancellation under these programs for a total amount of \$6,023,255 (2001: \$ 3,732,907). Given that the net asset value of the units cancelled amounted to \$6,545,379 (2001: \$ 4,241,738), this resulted in a gain of \$522,124 (2001: \$ 508,831) for the Trust. This gain reflects a 0.50% (2001: 0.46%) addition to the overall return.

## Distribution Reinvestment Plan

The Trust offers investors the opportunity to enroll in a Distribution Reinvestment Plan (the "Plan"). The Plan allows investors to conveniently acquire additional units of the Trust by reinvesting their cash distributions. Purchases are made in the market if units of the Trust are trading at a price that is less than their net asset value. If units of the Trust are trading at a price that is greater than their net asset value, new units will be issued at a price that is the greater of their net asset value and 95% of the weighted average of the trading prices of the units over the five-day period prior to the declaration of the distribution. Purchases made under this plan in 2002 amounted to 1,477 units (2001: 23,916 units).

The Plan is a way to participate in the growth of the Trust. There is no charge to the participant for enrollment in the Plan.

If you are a registered unitholder and are interested in enrolling in the Plan, please complete an enrollment form and send it to the Plan Agent: CIBC Mellon Trust, P.O. Box 7010, Adelaide Street Postal Station, Toronto, Ontario M5C 2W9, or call 1-800-387-0825. Enrollment forms are available from your broker.

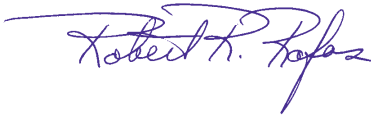
If you are the owner of units in an account with a broker or financial institution, you may provide them with a direction to enroll your units in the Plan.

## Management's Responsibility

The accompanying financial statements have been prepared by Northwater Fund Management Inc., the Manager of the Trust ("Manager"), and approved by the Board of Directors of the Manager. The Manager is responsible for the information and representations contained in these financial statements and other sections of the Annual Report.

The Manager maintains appropriate processes to ensure that relevant and reliable financial information is produced. The financial statements have been prepared in accordance with accounting principles generally accepted in Canada and include certain amounts that are based on estimates and judgements. The significant accounting policies that management believes are appropriate for the Trust are described in note 3 to the financial statements.

PricewaterhouseCoopers LLP are the external auditors of the Trust. They have audited the financial statements in accordance with Canadian generally accepted auditing standards to enable them to express to the unitholders their opinion on the financial statements. Their report is set out on page 13.



Robert R. Rafos  
President  
Northwater Fund  
Management Inc.



Benita M. Warmbold, CA  
Treasurer  
Northwater Fund  
Management Inc.

## **NORTHWATER MARKET-NEUTRAL TRUST**

Financial statements

For the year ended December 31, 2002

---

## Auditors' Report To the Unitholders of Northwater Market-Neutral Trust

We have audited the statement of investment portfolio as at December 31, 2002 and the statements of net assets of Northwater Market-Neutral Trust (the "Trust") as at December 31, 2002 and 2001 and the statements of operations and changes in net assets for the years then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We have conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the investment portfolio as at December 31, 2002, the financial position of the Trust as at December 31, 2002 and 2001 and the results of its operations and the changes in net assets for the years then ended in accordance with Canadian generally accepted accounting principles.

The image shows a handwritten signature in blue ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

Chartered Accountants

February 27, 2003

**NORTHWATER MARKET-NEUTRAL TRUST**

## Statement of Net Assets

As at December 31, 2002 and 2001

	<b>2002</b>	<b>2001</b>
<b>Assets</b>		
Cash and short-term investments	\$ 4,423,068	3,424,244
Hedge fund investments, at fair value (note 4) (cost: 2002 - \$90,571,350; 2001 - \$ 95,889,455)	121,682,218	124,831,949
Hedge fund redemptions receivable	3,450,448	4,651,189
	<u>129,555,734</u>	<u>132,907,382</u>
<b>Liabilities</b>		
Professional and custody fees payable	38,993	45,771
Interest and standby fees payable	22,629	32,883
Distribution payable	2,404,962	-
Bank loan (note 7)	25,254,941	27,055,187
	<u>27,721,525</u>	<u>27,133,841</u>
<b>Net assets and unitholders' equity</b>	<u>\$ 101,834,209</u>	<u>105,773,541</u>
<b>Number of units outstanding (note 5)</b>	<u>5,344,359</u>	<u>5,689,659</u>
<b>Net asset value per unit</b>	<u>\$ 19.05</u>	<u>18.59</u>

Signed on behalf of the Trustee,

The Royal Trust Company  
 Per:  Danny Thompson  
 Director, Client Service  
 RBC Global Services, IIS

Per:  Chris Lim  
 Client Service Manager  
 RBC Global Services, IIS

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

**NORTHWATER MARKET-NEUTRAL TRUST**

## Statement of Operations

For the years ended December 31, 2002 and 2001

	<b>2002</b>	<b>2001</b>
<b>Investment income</b>		
Interest	\$ 86,015	191,873
Other Income	106,037	89,806
	<u>192,052</u>	<u>281,679</u>
<b>Expenses</b>		
Interest and standby fees	627,653	1,437,478
Management fees (note 6)	-	-
Professional and custody fees	58,086	56,244
Other fees	153,961	152,907
	<u>839,700</u>	<u>1,646,629</u>
<b>Investment loss</b>	<u>(647,648)</u>	<u>( 1,364,950)</u>
<b>Realized and unrealized gain (loss) on investments</b>		
Net realized gain (loss) on:		
Hedge fund investments	3,534,178	14,214,000
Currency exchange on hedge fund investments	1,289,942	1,984,261
Currency hedging of investments	1,508,529	( 6,555,735)
Change in unrealized appreciation (depreciation) on:		
Hedge fund investments	4,029,921	(2,162,426)
Currency exchange on hedge fund investments	(2,024,914)	5,700,516
Net gain (loss) on currency, excluding hedge fund investments	303,612	( 974,182)
<b>Net gain on investments for the year</b>	<u>8,641,268</u>	<u>12,206,434</u>
<b>Net income from operations for the year</b>	<u>\$ 7,993,620</u>	<u>10,841,484</u>
<b>Net income from operations per unit for the year*</b>	<u>\$ 1.45</u>	<u>1.89</u>

\*Based on the average number of units of 5,516,926 outstanding for the year (2001 - 5,735,009).

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

**NORTHWATER MARKET-NEUTRAL TRUST**

## Statement of Changes in Net Assets

For the years ended December 31, 2002 and 2001

	2002	2001
<b>Net assets - beginning of the year</b>	\$ 105,773,541	111,140,383
<b>Net income from operations for the year</b>	7,993,620	10,841,484
<b>Unit transactions (note 5)</b>		
Net asset value of units cancelled	(6,545,379)	( 4,241,738)
Gain on units acquired and cancelled	522,124	508,831
	(6,023,255)	( 3,732,907)
<b>Distributions to unitholders</b>		
Return of capital (note 8)	(5,909,697)	( 12,475,419)
<b>Net assets - end of the year</b>	\$ 101,834,209	105,773,541
<b>Distributions per unit for the year*</b>	\$ 1.08	2.17

\*Based on the actual number of units outstanding on record date.

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

## NORTHWATER MARKET-NEUTRAL TRUST

## Statement of Investment Portfolio

As at December 31, 2002

	Maturity Date	Face Value	Cost	Fair Value	Percentage of Investment Portfolio
<b>Hedge fund investments</b>					
Convertible arbitrage			\$ 20,114,145	\$ 28,295,170	22.44 %
Distressed securities			14,327,754	17,951,387	14.24
Fixed income arbitrage			13,197,493	15,837,957	12.56
Loan origination			4,240,052	7,530,959	5.97
Market-neutral equity			17,975,246	23,069,210	18.29
Mortgage-backed securities arbitrage			6,655,335	9,644,827	7.65
Merger arbitrage			14,061,325	19,271,280	15.28
			90,571,350	121,600,790	96.43
Settlement due on currency futures contracts (note 9)			-	81,428	0.06
<b>Hedge fund investments, at fair value</b>					
			90,571,350	121,682,218	96.49
<b>Cash</b>					
			1,825,931	1,825,931	1.45
<b>Bankers' acceptance</b>					
RBC	January 2, 2003	\$ 300,000	300,000	300,000	0.24
<b>Commercial paper</b>					
Core Trust	March 6, 2003	800,000	797,208	798,007	0.63
Macro Trust	January 16, 2003	1,500,000	1,498,320	1,499,130	1.19
<b>Cash and short-term investments</b>					
		2,600,000	4,421,459	4,423,068	3.51
<b>Total investment portfolio</b>					
		\$2,600,000	\$ 94,992,809	126,105,286	100.00 %
<b>Liabilities over other assets</b>					
				(24,271,077)	
<b>Net assets and unitholders' equity</b>					
				\$ 101,834,209	

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

## NORTHWATER MARKET-NEUTRAL TRUST

### Notes to Financial Statements

For the years ended December 31, 2002 and 2001

---

#### 1. Establishment of the Trust

The Northwater Market-Neutral Trust (the "Trust") is a closed-end investment trust established under the laws of the Province of Ontario pursuant to a trust agreement made as of July 18, 1997, and restated on August 17, 1999. The Royal Trust Company ("Royal Trust"), acts as Trustee. The Trust began operations on July 30, 1997 when it completed its initial public offering. The Trust's units are listed on The Toronto Stock Exchange under the symbol NMN.UN. The Trust will terminate on or about December 31, 2007, and the net assets will be distributed pro rata to the unitholders unless an alternative later termination date is approved by a two-thirds majority vote of the unitholders at a meeting called for this purpose. The Trust retained Northwater Fund Management Inc. (the "Manager"), under a management agreement dated July 18, 1997. Northwater Capital Management Inc. (the "Advisor") acts as the advisor for the Trust. The Advisor is registered in Canada as an adviser in the categories investment counsel and portfolio manager and as a dealer in the category limited market dealer under the Securities Act (Ontario), as amended, and as an adviser in the category commodity trading manager under the Commodity Futures Act (Ontario), as amended. The Advisor is registered as a securities adviser under the Securities Act (Quebec), as amended. The Advisor also has equivalent registrations in the Canadian provinces of New Brunswick, Prince Edward Island, Nova Scotia, Saskatchewan and Alberta under the securities legislations in these provinces. The Advisor is also registered in the United States as an investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and as a commodity trading advisor and commodity pool operator under the U.S. Commodity Exchange Act, as amended. The Advisor is a member of the U.S. National Futures Association (the "NFA").

#### 2. Investment Objectives of the Trust

The Trust's investment objectives are to: (i) distribute \$0.40 per unit at each quarter end (\$1.60 per annum); (ii) steadily grow the net asset value per unit; (iii) ensure that the performance of the Trust is substantially independent of fixed income and equity markets; and (iv) achieve low volatility, which is expected to be less than that of a mid-term bond portfolio and less than one-half that of major North American stock markets.

#### 3. Summary of Significant Accounting Policies

These financial statements are prepared in accordance with Canadian generally accepted accounting principles.

### (a) Investments

The assets of the Trust are invested in cash and short-term investments, market-neutral hedge funds and currency futures contracts.

Investment transactions are accounted for on a trade date basis. Investments are valued on the last day of each month ("Valuation Date").

Cash and short-term investments consist of cash in interest bearing accounts at Royal Trust, cash held with the futures broker and short-term investments with maturity of generally less than 90 days when purchased. Cash and short-term investments are valued at the bid price for such instruments on each Valuation Date. Interest income is accrued on a monthly basis.

Investments in market-neutral hedge funds are valued on the basis of the definitive net asset values reported by the portfolio managers or administrators of such funds on the Valuation Date or, if not available, the most recent provisional net asset values based on preliminary returns reported by the portfolio managers or administrators of such funds. The difference between fair value and cost is shown as unrealized gain or loss on investments. Average cost is used to compute realized and unrealized gains and losses.

### (b) Foreign Currency Translation

Assets and liabilities in foreign currencies are translated into Canadian dollars at the rate of exchange prevailing at the year end. Transactions during the year in currencies other than Canadian dollars are translated at the rates of exchange prevailing on the respective dates of such transactions. Foreign exchange gains and losses are recognized in the Statement of Operations on each Valuation Date.

### (c) Currency Hedging

The Trust enters into exchange-traded currency futures contracts to hedge the Canadian dollar value of portfolio securities and liabilities denominated in foreign currencies.

Upon entering into a futures contract, the Trust is required to deposit an "initial margin" with a broker based on a certain amount per contract. Subsequent payments representing variation margin are made or received each day depending on the daily fluctuation in the value of the contract. These daily changes are recorded as gains or losses in the Statement of Operations. The settlement due on futures contracts represents the daily variation margin due to or owing by the Trust on the Valuation Date.

Futures contracts are valued at their settlement price, as published by the appropriate clearing house of the exchange, on each Valuation Date. In the absence of reported bid and offer quotations, the Manager may, from time to time, determine a value which more accurately reflects the fair value based on the current market value of the underlying interest. The notional values of the futures contracts are not recorded as assets in the Statement of Net Assets.

#### (d) Use of Estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires the Trust to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

#### 4. Investment in Market-Neutral Hedge Funds

As part of its investment strategy, the Trust invests in a diversified portfolio of market-neutral hedge funds.

The following table summarizes hedge fund transactions during the year:

	2002	2001
<b>Investments at cost - beginning of year</b>	\$ 95,889,455	98,587,432
Cost of investments purchased	22,699,542	35,228,738
Cost of investments sold	28,017,647	37,926,715
<b>Investments at cost - end of year</b>	90,571,350	95,889,455
Unrealized appreciation of investments	31,029,440	29,024,433
<b>Market value of investments - end of year</b>	\$ 121,600,790	124,913,888
Proceeds of investments sold	\$ 32,841,767	54,124,976
Cost of investments sold	28,017,647	37,926,715
<b>Net realized gain on investments</b>	\$ 4,824,120	16,198,261

#### 5. Units Issued and Outstanding

The authorized capital of the Trust consists of an unlimited number of non-redeemable units. Units are transferable and represent an equal, undivided interest in the net assets of the Trust. All units are of the same class with equal rights and privileges. Each unit is entitled to one vote at any meeting of unitholders and to equal participation in any distributions made by the Trust. Fractional units will not be issued. During 2002, under a normal course issuer bid and the Trust's quarterly market support obligation, the Trust purchased 345,300 units (2001: 219,500 units) for cancellation. Units purchased in the market pursuant to the distribution reinvestment plan during 2002 totalled 1,477 (2001: 23,916).

The following unit transactions took place during the year:

	2002	2001
<b>Balance of units outstanding - beginning of the year</b>	5,689,659	5,909,159
Units acquired and cancelled during the year	(345,300)	( 219,500)
<b>Balance of units outstanding - end of the year</b>	5,344,359	5,689,659

## 6. Management Fees

The Manager provides the day-to-day administration, portfolio management and unitholder services to the Trust. In return for these services, the Manager receives an annual fee of 1.25% of the net assets of the Trust, calculated on the last Valuation Date of each fiscal quarter. The fee is paid quarterly in arrears, provided that distributions to unitholders are not in arrears. If distributions are in arrears, management fees are not paid nor payable until any shortfall has been made up to unitholders. Management fees in arrears at December 31, 2002 amounted to \$8,356,051 (2001: \$ 7,051,825) and will be paid to the Manager when the shortfall in distributions has been paid (see note 8). The management fees in arrears will only be paid or accrued to the extent that such payment or accrual will not prohibit the payment of distributions to unitholders. The Manager will pay a portion of its fee to the Advisor in consideration of the Advisor's services to the Trust.

## 7. Bank Loan

The Trust has a revolving loan facility with a Canadian financial institution (the "Bank"). The facility entitles the Trust to borrow funds in Canadian or U.S. dollars up to an amount not exceeding 25% of the net asset value of the Trust for the purposes of making additional investments. In addition, the Trust may borrow, on a temporary basis, up to 10% of the net asset value of the Trust for the purposes of (i) effecting market purchases of units; (ii) maintaining liquidity to effect cash distributions; and (iii) settling currency hedging transactions. Borrowing limits for U.S. dollar loans are evaluated by converting to Canadian dollars using the Bank's notional conversion rates. Interest and stand-by fees are payable on a monthly basis. Interest rates are based on bank prime and/or Bankers' Acceptances for Canadian funds and bank prime and/or LIBOR for U.S. funds. A general security interest in the assets of the Trust has been provided in favour of the Bank. Loans outstanding as at December 31, 2002 were denominated in Canadian dollars and U.S. dollars.

## 8. Distributions

The Trust pays quarterly distributions to unitholders of \$0.40 per unit to the extent that the net asset value per unit after giving effect to the distribution is greater than the net asset value on July 30, 1997 of \$18.79. If less than \$0.40 per unit is distributed in any quarter, the amount of the shortfall is carried forward and paid in the next quarter, or quarters, as long as the net asset value per unit after giving effect to the distribution remains greater than \$18.79 per unit.

During the year ended December 31, 2002, distributions of \$1.08 per unit and \$5,909,697 in aggregate (2001: \$2.17 per unit; \$12,475,419 in aggregate) were made by the Trust. At December 31, 2002 distributions of \$1.00 per unit and \$5,344,359 in aggregate (2001: \$0.48 per unit; \$2,731,036 in aggregate) were in arrears.

Unitholders have the option of receiving distributions in cash, or in the form of additional units by way of the distribution reinvestment plan.

## 9. Futures Contracts

As at December 31, 2002, commercial paper with a face value of US \$800,000 (2001: US \$700,000) was deposited as margin for the futures contracts.

The Trust has entered into futures contracts to hedge the currency exposure of portfolio securities and liabilities denominated in foreign currencies.

At December 31, 2002, the Trust held the following currency futures contracts:

	<b>Closing price</b>	<b>Notional contract value</b>	<b>Settlement receivable on futures contracts</b>
1,031 March 2003 Canadian Dollar Futures Contracts	US \$63.22	US \$65,179,820	
		CDN \$102,958,044	CDN \$81,428

## 10. Income Taxes

The Trust qualifies as a "mutual fund trust" within the meaning of the Income Tax Act (Canada) (the "Tax Act"). As all of the net income of the Trust, including net realized gains from private investment funds and deemed income computed under Section 94.1 of the Tax Act, will be paid or payable to unitholders in each calendar year, no income tax will be payable by the Trust under the present provisions of the Tax Act. Such income is taxable in the hands of the unitholder. Occasionally, more income is distributed than is earned by the Trust for tax purposes. This excess distribution is called a "return of capital" and is not taxable to the unitholder but reduces the adjusted cost base of the unit for tax purposes.

As at December 31, 2002 the Trust had \$6,500,000 (2001: \$10,000,000) available in non-capital loss carry forwards and no capital loss carryforwards (2001: \$nil).

## 11. Financial Highlights

### Net asset value per unit - beginning of the year

---

### Net investment income (loss) per unit

---

### Net gain (loss) on investments

---

### Distribution per unit

Return of capital

---

### Effect of capital transactions over original cost

---

### Net asset value per unit - end of the year

---

### Ratios and supplemental information

---

Net assets - end of the period

Weighted-average net assets

Ratio of expenses to weighted-average net assets

Annual rate of return

---

Net asset value per unit is computed by dividing the net asset value of the Trust by the total number of units of the Trust outstanding, as at the beginning or the end of the year.

Net investment income or loss per unit and net gain or loss on investments are based on the average number of units outstanding during the year. Distributions to unitholders per unit are based on the actual number of units outstanding on record date.

Weighted-average net assets are calculated as the average of the monthly net asset values of the Trust during the year.

The ratio of expenses to weighted-average net assets for the Trust is based on all expenses of the Trust, including interest, stand-by fees and GST, expressed as a percentage of the weighted-average net assets.

	2002	2001	2000	1999	1998
\$	18.59	18.81	18.97	16.63	19.00
	(0.12)	(0.24)	(0.26)	0.02	0.04
	1.57	2.13	2.71	2.40	(2.15)
	(1.08)	(2.17)	(2.89)	(0.57)	(0.69)
	0.09	0.06	0.28	0.49	0.43
\$	19.05	18.59	18.81	18.97	16.63

\$	101,834,209	105,773,541	111,140,383	121,925,046	123,031,606
\$	104,515,541	109,436,120	117,409,394	123,106,315	147,004,084
	0.80%	1.50%	2.03%	1.66%	1.95%
	8.47%	10.58%	15.12%	17.50%	(9.28)%

Annual rate of return is calculated as the annualized geometric return of the monthly net asset values per unit of the Trust during the year, and takes into account distributions made by the Trust.

The effect of capital transactions over original cost represents calculational differences resulting from the use of different base numbers of units outstanding in the various calculations as described above. This difference can be substantial if the Trust experienced significant cancellations of units during the year.

## NORTHWATER CAPITAL MANAGEMENT INC.

Northwater is a leading investment management firm in Canada and the U.S., specializing in hedge fund strategies, synthetic indexing, and enhanced asset-class portfolios for pension plans and endowment funds. Wholly owned by its employees, Northwater is dedicated to providing clients with attractive risk-adjusted returns and first-class client service. The firm has assets under management of C\$8.5 billion as at December 31, 2002. Northwater's clients include the pension funds of many of the largest corporations in Canada, the U.S. and Europe. Northwater also manages pension assets for a number of universities and public sector institutions.

Northwater is known as an innovator and a leader in applying derivatives and other quantitative strategies to create unique investment products for institutional clients. The Northwater Market-Neutral Trust is the first publicly-listed investment vehicle of its kind in Canada to invest in a diversified portfolio of hedge funds. As of December 31, 2002, Northwater had approximately C\$4.3 billion under management in funds of market-neutral hedge funds, making it the largest such provider in Canada, and among the largest in the world.

## NORTHWATER MARKET-NEUTRAL TRUST

---

Suite 4700, BCE Place  
Bay Wellington Tower  
P.O. Box 794, 181 Bay Street  
Toronto, Ontario M5J 2T3  
Telephone: (416) 360-5435  
Fax: (416) 360-0671  
E-mail: [mpt@northwatercapital.com](mailto:mpt@northwatercapital.com)

## INVESTMENT MANAGER

---

Northwater Fund Management Inc.  
Suite 4700, BCE Place  
Bay Wellington Tower  
P.O. Box 794, 181 Bay Street  
Toronto, Ontario M5J 2T3  
Telephone: (416) 360-5435  
Fax: (416) 360-0671  
E-mail: [mpt@northwatercapital.com](mailto:mpt@northwatercapital.com)

## INVESTMENT ADVISOR

---

Northwater Capital Management Inc.  
Suite 4700, BCE Place  
Bay Wellington Tower  
P.O. Box 794, 181 Bay Street  
Toronto, Ontario M5J 2T3  
Telephone: (416) 360-5435  
Fax: (416) 360-0671  
E-mail: [mpt@northwatercapital.com](mailto:mpt@northwatercapital.com)

## LEGAL ADVISORS

---

McCarthy Tétrault LLP  
Suite 4700, Box 48  
Toronto Dominion Bank Tower  
Toronto, Ontario M5K 1E6

## AUDITORS

---

PricewaterhouseCoopers LLP  
Suite 3000, Box 82  
Royal Trust Tower, Toronto Dominion Centre  
Toronto, Ontario M5K 1G8

## DISTRIBUTION REINVESTMENT PLAN AGENT

---

CIBC Mellon Trust Company  
P.O. Box 7101  
Adelaide Street Postal Station  
Toronto, Ontario M5C 2W9  
Answerline: 1-800-387-0825

FOR FURTHER INFORMATION PLEASE CONTACT:

---

Robert Rafos or Shirley Hope  
Telephone: (416) 360-5435  
Fax: (416) 360-0671  
E-mail: [mpt@northwatercapital.com](mailto:mpt@northwatercapital.com)  
For most recent net asset value update call: 1-888-429-8774

TSE Symbol: NMN.UN

Aussi disponible en français.

