

NORTHWATER

**Northwater Market-Neutral Trust
December 31, 2006
Annual Report**





BACKGROUND

Northwater Market-Neutral Trust (the “Trust”) is a closed-end investment trust established under the laws of the Province of Ontario. Financial statements of the Trust, denominated in Canadian dollars, for the year ended December 31, 2006 are included in this report.

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MESSAGE TO UNITHOLDERS FROM THE INVESTMENT ADVISOR

The Northwater Market-Neutral Trust (the “Trust”) is a closed-end fund traded on the Toronto Stock Exchange under the symbol NMN.UN that delivers the return of a diversified portfolio of market-neutral hedge funds. As at December 31, 2006, the net asset value of the Trust per unit was \$14.15. For the one year period ended December 31, 2006, return of the Trust was 10.39%. During the same time period, the Scotia Capital Universe Bond Index increased by 4.06%, the S&P/TSX Composite Index rose by 17.26% and the S&P 500 in U.S. dollar terms, rose by 15.79% which translates to a gain of 16.08% in Canadian dollar terms as the U.S. dollar strengthened during the period. The Trust made distributions of \$1.14 per unit during the period.

Concerns regarding central bank tightening were high in the first half of 2006 in response to inflation expectations and strong economic growth. These concerns culminated in a sharp sell off in most asset classes in May and June, with acute selling occurring in emerging markets and Japan. Concomitantly, as asset prices fell, volatility increased substantially. In the second half of the year as inflation expectations and growth moderated, central banks adopted a neutral stance. As market participants gained more clarity on central bank near term actions, uncertainty was removed from the market. This caused volatility to fall sharply while asset prices rallied into the final quarter of the year. The portfolio of market-neutral hedge funds managed by Northwater Fund Management Inc. (the “Manager”) to which the Trust has exposure, performed well for the year. Higher realized volatility in asset prices enlarged the opportunity set for many hedge fund strategies in the first half of the year, while declines in risk premia increased opportunities in the second half of the year. Nearly all of the strategies in the portfolio were strong contributors to the success of the portfolio in 2006.

An increased allocation to statistical arbitrage and distressed securities managers in early 2006 benefited the portfolio as the strategies were strong contributors of performance. The energy relative value strategy was removed from the portfolio after a period of disappointing performance. The Manager will continue to monitor this strategy to determine if there is a profitable approach that would fit within the portfolio. The strongest performing strategy for the portfolio in 2006 was activist investing, a strategy that was added to the portfolio in late 2005.

Credit spreads tightened in many asset-backed securities while market fundamentals have deteriorated, particularly for mortgage credit. The portfolio has dealt with this situation by reducing the strategy weight of these strategies after five years of excellent results. The portfolio is being tactically positioned to take advantage of trading oriented strategies such as statistical arbitrage and fixed income arbitrage which reflect our outlook for volatility for the future.

The Manager continues to actively manage the composition of the Trust's hedge fund portfolio. During the year ending December 31, 2006, 15 funds were removed for both declining strategy returns and ineffective implementation, while eight new funds were added to strategies widely represented across the portfolio. The Manager remains focused on improving the portfolio by refining its stable of managers and adding managers in market-neutral strategies that are expected to deliver strong risk-adjusted returns consistent with the investment objectives.



DAVID S. FINCH, CFA
Vice-President
Northwater Capital Management Inc.



DANIEL S. LAWEE, CFA
Vice-President
Northwater Capital Management Inc.

March 16, 2007

MANAGEMENT REPORT OF FUND PERFORMANCE

This Management Report of Fund Performance contains financial highlights for the year ended December 31, 2006 but does not contain the complete financial statements of the investment fund. A copy of the financial statements of the investment fund is attached to this report for your reference.

Security holders may contact us using one of following methods and may, at no cost, request a copy of the investment fund's proxy voting policies and procedures, proxy voting disclosure record, or quarterly portfolio disclosure. You can contact us by calling toll-free 1-888-429-8774 or by writing to us at Northwater Fund Management Inc., Suite 4700, BCE Place, Bay Wellington Tower, 181 Bay Street, P.O. Box 794, Toronto, Ontario, M5J 2T3. You may also visit our website at www.northwatercapital.com or visit the SEDAR website at www.sedar.com.

Northwater Market-Neutral Trust (the "Trust") is managed by Northwater Fund Management Inc. (the "Manager"). The Manager is responsible for managing the business and administration of the Trust pursuant to the provisions of the Trust Agreement as well as monitoring the Trust's investment portfolio. The Manager has retained Northwater Capital Management Inc. (the "Investment Advisor") to provide investment advice and to manage the Trust's investment portfolio in accordance with the Trust's investment objectives. In fulfilling its responsibilities, the Manager must determine that appropriate information systems, procedures and controls are in place in order to ascertain that information used internally and disclosed to unitholders is complete and reliable. The Manager takes this responsibility seriously and is satisfied that appropriate systems, procedures and controls are in place for the Trust.

Investment Objectives and Strategies

Investment Objectives

The investment objectives of the Trust are to:

1. Make quarterly distributions equal to 2% of the net asset value per unit of the Trust as of the month end preceding the relevant calendar quarter end;
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 Strategies

Hedge Funds

The Trust is comprised of market-neutral hedge funds that the Investment Advisor believes have strong expected risk-adjusted returns as well as performance histories that have a low correlation with major equity and debt markets. In establishing the hedge fund “mix,” the Investment Advisor seeks out strategies that also have a low correlation with one another, thereby increasing the benefits of diversification and reducing expected volatility. While there can be no assurance that the Trust’s performance will exhibit strong risk-adjusted returns, the Investment Advisor believes that by constructing a well-diversified portfolio of market-neutral hedge funds, the returns of the Trust should have a low correlation with major equity and fixed income markets and low volatility.

Investment Management Process

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

The Investment Advisor has developed a proprietary selection process to enable it to advise the Trust with respect to the selection and monitoring of potential hedge fund investments to be made by the Trust. The proprietary selection process is an integral part of the Investment Advisor’s strategy for generating value over time and consists of:

1. the development of a multi-faceted set of investment beliefs, which serve as a framework for identifying appropriate market-neutral strategies and the managers that employ those strategies. These investment beliefs have evolved and continue to evolve with the Investment Advisor’s experience in market-neutral hedge fund investing and in managing complex derivative strategies.
2. the use of an established operational infrastructure necessary for managing complex fund of market-neutral hedge fund and derivative strategies. The Investment Advisor has built a team of investment professionals and developed robust portfolio and risk management systems and tools essential to managing a sophisticated fund of market-neutral hedge funds.

3. a progressive global search for market-neutral strategies consistent with the Investment Advisor's investment beliefs and the Trust's investment criteria of market-neutrality and strong risk-adjusted returns. The Investment Advisor's search focuses on managers who have demonstrated expertise in consistently implementing these strategies.
4. a comprehensive quantitative and qualitative assessment of hedge fund managers who employ market-neutral strategies that adhere to the Investment Advisor's investment beliefs and the objectives of the Trust.
5. the use of specific quantitative procedures, including screens that attempt to identify consistency and adaptability, market-neutrality, and portfolio fit, which are integral to the Investment Advisor's investment process. Various portfolio construction techniques are used, including mathematical optimization, statistical process control and factor analysis.
6. an ongoing qualitative assessment of existing and prospective hedge fund managers, including hedge fund manager reviews involving on-site interviews, monthly portfolio reviews and various industry references. The goal of this process is to fully understand the hedge fund manager's investment strategy and risk management processes. The Investment Advisor also seeks to ascertain the strength of a hedge fund manager's competitive advantage, its investment team and its business plans.
7. the construction of a diversified model portfolio across 14 market-neutral strategies. This is a dynamic process.
8. a comprehensive due diligence process that must be completed before the Investment Advisor recommends an investment. This process typically includes on-site interviews conducted by investment professionals from the Investment Advisor, an all-inclusive strategy and operational due diligence report, a legal review of the offering documentation, an analysis of the hedge fund's financial statements, an assessment of the fees charged by the hedge fund's manager and an examination of any administrative or other costs associated with making the investment. Rigorous monitoring and due diligence continues once a hedge fund is added to the Trust. This process includes regular discussions with the hedge fund manager, multiple on-site interviews each year, continual quantitative and qualitative assessments and monthly review of the hedge fund's role within the Investment Advisor's model portfolio.

The Investment Advisor manages and advises client accounts in addition to the Trust. Client accounts with similar investment objectives are generally managed in a similar manner. Investment allocation decisions are subject to client

guidelines and restrictions. Limited investment opportunities will be allocated to client accounts in a manner that the Investment Advisor determines is equitable to clients in the circumstances.

Leverage

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 may borrow an additional 10% of the net asset value in order to re-purchase units under its buy-back programs, to effect cash distributions and to settle currency hedging transactions. The ability of the Trust to borrow will increase the risk to unitholders and may not enhance returns in the event that the securities purchased with the borrowed funds decline in value.

The financial leverage employed by the Trust to make investments as at December 31, 2006 was 24.08% (December 31, 2005: 21.90%).

Risks

The following tables present information for the periods from inception and for the years ended December 31, 2006 and 2005 regarding the risk profile of both the Trust and the Trust's hedge fund holdings.

<u>Trust Statistics</u>	<u>For the period from inception to December 31, 2006</u>	<u>For the period from inception to December 31, 2005</u>
# of positive monthly returns	86	76
# of negative monthly returns	27	25
% of negative months	23.9%	24.8%
Average size of negative months	-1.02%	-1.00%
Worst monthly return	-11.78% (Aug/98)*	-11.78% (Aug/98)*

<u>Single Hedge Fund Statistics</u>	<u>Year Ended December 31, 2006</u>	<u>Year Ended December 31, 2005</u>
# of hedge funds with positive returns ⁽¹⁾	40	40
# of hedge funds with negative returns ⁽¹⁾	0	7
Average annual hedge fund standard deviation ⁽²⁾	3.80%	4.12%
Average correlation between hedge funds ⁽²⁾	0.11	0.14

(1) Measured for hedge funds in the portfolio as at December 31, 2006 and December 31, 2005, respectively.

(2) As measured over the past 24 months for hedge funds in the portfolio as at December 31, 2006 and December 31, 2005 respectively, excludes hedge funds with less than 24 months of historical returns.

* A Russian debt crisis occurred during August 1998 and affected many investors, including many hedge funds. The return for the month of August for the S&P 500 Index was -14.46% and -20.41% for the TSX Index. The month with the second largest loss next to August 1998 was October 1997 with a return of -2.35%

No material changes affecting the overall risk of investing in the Fund were made in the year ended December 31, 2006. The risks of investing in the Trust remain as discussed in the Trust's prospectus. A copy of the prospectus of the Trust is available by visiting the SEDAR website at www.sedar.com.

Results of Operations

During the year ended December 31, 2006, the Trust posted a return of 10.39% (year ended December 31, 2005: 2.21%) taking into account distributions made during the period. Distributions during the year ended December 31, 2006 totaled \$5,592,362 or \$1.14 per unit (year ended December 31, 2005: \$6,066,507 or \$1.16 per unit). The activist strategy contributed most positively to the Trust's return among all the strategies for the year ended December 31, 2006 while the energy relative value strategy was the weakest performer.

The borrowings of the Trust fluctuated between U.S. \$ 13,318,180 and U.S. \$14,318,732 during the year ended December 31, 2006 through a revolving loan facility with a Canadian financial institution (year ended December 31, 2005: US\$13,500,000 throughout the year). The financial leverage as at December 31, 2006 was 24.08% (December 31, 2005: 21.90%). The Trust has employed the loan as leverage to enhance its investment returns.

The Trust was able to capitalize on the share buy-back and cancellation program with 367,400 units of the Trust being repurchased and cancelled during the year ended December 31, 2006 (year ended December 31, 2005: 105,100 units) as the units were offered for sale at less than 92.5% of the net asset value. During the year ended December 31, 2006, this program contributed 0.60% to the overall return (year ended December 31, 2005: 0.22% contribution to overall return).

Summary of Investment Portfolio ⁽¹⁾

The Trust invests in hedge funds that emphasize sectors of the capital markets that the Investment Advisor believes are relatively inefficient or present opportunities to generate uncorrelated returns. The Investment Advisor believes that such sectors offer arbitrage, relative value or absolute return opportunities and should reward insightful investment analysis.

Because the Trust is invested in hedge funds that pursue non-traditional investment strategies, it is subject to the special risks of investing in these strategies. As at December 31, 2006, the Trust was invested in 40 hedge funds (December 31, 2005: 47 hedge funds) with 37 managers (December 31, 2005:

42 managers) engaged in 11 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. Some of these investment strategies are contained within multi-strategy funds. The hedge funds in which the Trust is invested have been established in offshore jurisdictions and prepare annual audited financial statements, in accordance with US or International generally accepted accounting principles (GAAP).

During the year ended December 31, 2006, the Trust placed investments with eight hedge funds (consisting of two distressed securities, three statistical arbitrage and three structural finance) and redeemed from 15 hedge funds (consisting of three capital structure arbitrage, one merger arbitrage, three multi-strategy, one asset-backed securities arbitrage, two distressed securities arbitrage, three convertible bond arbitrage, one energy relative value, and one structured finance) (year ended December 31, 2005, the Trust placed investments with 15 new hedge funds and redeemed from 13 hedge funds).

The following table presents returns by investment strategy for the years ended December 31, 2006 and 2005.

<u>Strategy</u>	<u>Year ended December 31, 2006</u>	<u>Year ended December 31, 2005</u>
Activist	24.75%	1.65%
Asset-backed securities arbitrage	12.51%	8.35%
Capital structure arbitrage	7.01%	0.52%
Convertible bond arbitrage**	10.96%	1.57%
Distressed securities arbitrage	18.42%	7.18%
Fixed-income arbitrage	8.94%	5.16%
Energy relative value*	-6.37%	-13.77%
Merger arbitrage	14.27%	18.95%
Mortgage-backed security arbitrage	9.88%	9.25%
Re-insurance arbitrage	11.75%	-12.10%
Statistical arbitrage	12.5%	-13.59%
Structured finance	11.93%	9.87%
Multi-strategy	8.23%	6.97%

* Represents the return from January 1, 2006 to October 31, 2006.

** Represents the return from January 1, 2006 to September 30, 2006.

Asset Allocation by Investment Strategy

The following table shows the hedge fund holdings by strategy as at December 31, 2006 and December 31, 2005. The multi-strategy funds have not been allocated to any of the underlying hedge fund strategies set out in this table.

<u>Strategy</u>	<u>As at December 31, 2006</u>			<u>As at December 31, 2005</u>		
	<u>No. of Hedge Funds</u>	<u>Fair Value</u>		<u>No. of Hedge Funds</u>	<u>Fair Value</u>	
Activist	1	\$ 2,512,588	3%	1	\$ 2,008,147	3%
Asset-backed securities						
arbitrage	5	10,060,961	12%	6	11,478,407	15%
Capital structure arbitrage	1	450,256	1%	4	4,615,861	6%
Convertible bond arbitrage	—	—	—	3	3,407,699	4%
Distressed securities	6	13,819,434	17%	6	10,210,013	13%
Energy relative value	—	—	—	1	579,205	1%
Fixed-income arbitrage	2	2,571,727	3%	2	2,353,687	3%
Merger arbitrage	1	1,284,879	2%	2	2,589,267	3%
Mortgage-backed security						
arbitrage	4	10,362,344	13%	4	10,507,956	13%
Multi-strategy	7	16,158,899	20%	10	17,827,314	23%
Re-insurance	2	5,520,794	7%	2	4,925,915	6%
Statistical arbitrage	4	5,608,982	7%	—	—	0%
Structured finance	7	12,866,799	15%	6	8,419,804	11%
	<u>40</u>	<u>\$81,217,662</u>	<u>100%</u>	<u>47</u>	<u>\$78,923,275</u>	<u>100%</u>

The following table presents the largest individual hedge fund holding for each investment strategy as a percentage of the total net asset value of the Trust as at December 31, 2006 and December 31, 2005.

<u>Strategy</u>	<u>As at December 31, 2006</u>	<u>As at December 31, 2005</u>
Activist	3.71%	2.81%
Asset-backed securities arbitrage	5.11%	4.21%
Capital structure arbitrage	0.67%	4.05%
Convertible bond arbitrage	—	2.70%
Distressed securities	6.27%	4.90%
Energy relative value	—	0.81%
Fixed-income arbitrage	2.09%	1.81%
Merger arbitrage	1.90%	2.05%
Mortgage-backed security arbitrage	5.68%	6.48%
Multi-strategy	5.33%	4.75%
Re-insurance	6.31%	5.33%
Statistical arbitrage	3.02%	0.00%
Structured finance	5.23%	3.01%

The following table lists the largest 25 hedge funds by fair value held by the Trust as at December 31, 2006. The Trust will disclose the names of those hedge funds which it holds that represent more than 5% of the net assets of the Trust at the end of the period. For hedge funds that represent less than 5% of the Trust's net assets, the Trust has adopted unique fund numbers as identifiers. These numbers are used consistently in reporting by the Fund.

<u>Top 25 Investments</u>	<u>Type of Investment</u>	<u>Cost</u>	<u>Fair Value</u>	<u>Percentage of NAV</u>
Palmetto Fund, Ltd.*	Participating shares	\$4,343,170	\$4,268,243	6.31%
Cerberus International, Ltd.*	Participating shares	1,627,922	4,242,199	6.27%
New Ellington Overseas, Ltd.*	Participating shares	3,365,499	3,844,595	5.68%
Farallon Capital Offshore Fund, Ltd.*	Participating shares	1,400,393	3,608,939	5.33%
D.B. Zwirn Special Opportunities Fund, Ltd.*	Participating shares	3,236,940	3,534,873	5.23%
CRC Global Structured Credit Fund, Ltd.*	Participating shares	2,911,187	3,458,241	5.11%
Fund 183*	Participating shares	2,732,020	3,144,418	4.65%
Fund 121*	Participating shares	2,693,322	3,102,660	4.59%
Fund 146*	Participating shares	2,482,873	2,592,902	3.83%
Fund 200*	Participating shares	2,205,603	2,554,367	3.78%
Fund 209*	Participating shares	1,975,060	2,512,588	3.71%
Fund 214*	Participating shares	2,070,160	2,405,941	3.56%
Fund 189*	Participating shares	2,094,240	2,380,284	3.52%
Fund 101*	Participating shares	1,741,339	2,259,072	3.34%
Fund 208*	Participating shares	2,013,840	2,188,940	3.24%
Fund 210*	Participating shares	1,980,180	2,183,894	3.23%
Fund 190*	Participating shares	1,855,000	2,092,834	3.09%
Fund 213*	Participating shares	1,685,040	2,046,182	3.02%
Fund 160*	Participating shares	1,536,826	2,044,631	3.02%
Fund 196*	Participating shares	1,832,000	2,008,789	2.97%
Fund 175*	Participating shares	1,851,379	1,918,978	2.84%
Fund 187*	Participating shares	1,687,130	1,851,148	2.74%
Fund 171*	Participating shares	1,428,604	1,755,249	2.59%
Fund 129*	Participating shares	1,263,200	1,745,872	2.58%
Fund 104*	Participating shares	1,574,900	1,633,148	2.41%

* held by other investment funds managed by Northwater Fund Management Inc.

- (1) The Summary of Investment Portfolio may change due to ongoing portfolio transactions of the Trust. There are no non-arm's length relationships between the Trust or Northwater Fund Management Inc. and any of the hedge funds held by the Trust. On a quarterly basis, an updated listing of holdings will be available.

Financial Highlights

The following tables show selected key financial information about the Trust and are intended to help understand the Trust's financial performance for the

past five years. This information is derived from the Trust's audited annual financial statements for the years ended 2002 to 2006.

The Trust's Net Asset Value (NAV) per Unit

	<u>For the year ended December 31,</u>				
	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
Net Asset Value, beginning of period . . .	\$ 13.88	\$ 14.73	\$ 15.81	\$ 19.05	\$18.59
Increase (decrease) from operations:					
Total revenue	0.05	0.04	0.03	0.02	0.03
Total expenses	(0.41)	(0.35)	(0.52)	(0.12)	(0.15)
Realized gains (losses) for the period . . .	(0.02)	0.28	1.83	6.69	1.21
Unrealized gains (losses) for the period	1.70	0.33	(0.57)	(4.79)	0.36
Total increase (decrease) from operations ⁽¹⁾	1.32	0.29	0.77	1.80	1.45
Distributions:					
From income (excluding dividends)	0.04052	0.35948	0.00592	4.21072	—
From capital gains	—	—	—	0.82611	—
Return of capital	1.09948	0.80052	1.84054	0.04317	1.08
Total Distributions for the period ⁽²⁾	1.14	1.16	1.84646	5.08000	1.08
Net Asset Value at end of period ⁽³⁾	\$ 14.15	\$ 13.88	\$ 14.73	\$ 15.81	\$19.05

- (1) Net asset value and distributions are based on the actual number of units outstanding at the relevant time. The increase/(decrease) from operations is based on the weighted average number of units outstanding over the financial period.
- (2) Distributions were both paid in cash and reinvested in additional units of the Trust.
- (3) It is not intended that the Trust's Net Asset Value per Unit table act as a reconciliation of the opening and closing of the net asset value per unit of the Trust.

Ratios and Supplemental Data

	<u>For the year ended December 31,</u>				
	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
Net assets (000's) ⁽¹⁾	\$ 67,651	\$ 71,507	\$ 77,232	\$ 82,788	\$ 101,834
Number of units outstanding ⁽¹⁾ . . .	4,782,615	5,150,015	5,243,585	5,237,559	5,344,359
Management expense ratio ⁽²⁾	6.60%	7.08%	7.94%	5.25%	5.43%
Management expense ratio before waivers or absorptions ⁽²⁾	6.60%	7.08%	7.94%	5.25%	5.43%
Portfolio turnover rate ⁽³⁾	22.97%	40.56%	26.96%	42.44%	18.76%
Trading expense ratio ⁽⁴⁾	0.05%	0.00%	0.00%	0.00%	0.00%
Closing market price or pricing NAV	\$ 13.00	\$ 12.55	\$ 15.06	\$ 16.10	\$ 17.34

- (1) This information is provided as at the end of the period shown.

- (2) Management expense ratio is based on total expenses for the stated period and is expressed as an annualized percentage of month-end average net assets during the period. Please note that the management expense ratio includes not only the expenses of the Trust itself but also reflects expenses to which the underlying hedge funds were subject. The expense ratio of the underlying hedge funds included in the above ratios for the year ended December 31, 2006 and for each of the years ended December 31, 2005, 2004, 2003, and 2002 added 3.72% for each of the years to the expense ratio of the Trust. The annualized expense ratio has been calculated using the total expenses of the underlying hedge funds, invested in by the Trust, per their annual audited financial statements. The 2001 to 2005 expense ratios reflect the expenses of the hedge funds for the year 2004. Management continues to receive the audited financial statements for the year 2005 and will reflect the total expenses of the underlying hedge funds once all of such information has been received. The expenses together with estimates for hedge funds with year-ends other than December 31, 2004 have been prorated based on the relative percentage of the hedge funds held by the Trust at December 31, 2004. Performance fees incurred by the underlying hedge funds can vary significantly from period to period based on such factors as the market conditions, fund strategy, manager performance and the timing of redemptions. As a result, the expense ratios of the underlying funds for the prior year may be significantly different than the actual expenses incurred by these underlying hedge funds for the current period.
- (3) The Trust's portfolio turnover rate indicates how actively the Trust's portfolio adviser manages its portfolio investments and rebalances its investments. A portfolio turnover rate of 100% is equivalent to the Trust buying and selling all of the securities in its portfolio once in the course of the year. The higher a fund's portfolio turnover rate in a year, the greater the trading costs payable by the fund in the year, and the greater the chance of an investor receiving taxable capital gains in the year. There is not necessarily a relationship between a high turnover rate and the performance of a fund. Hedge fund trades do not generally result in trading costs.
- (4) The trading expense ratio represents total commissions and other portfolio transaction costs expressed as an annualized percentage of monthly average net assets during the period.

Past Performance

General

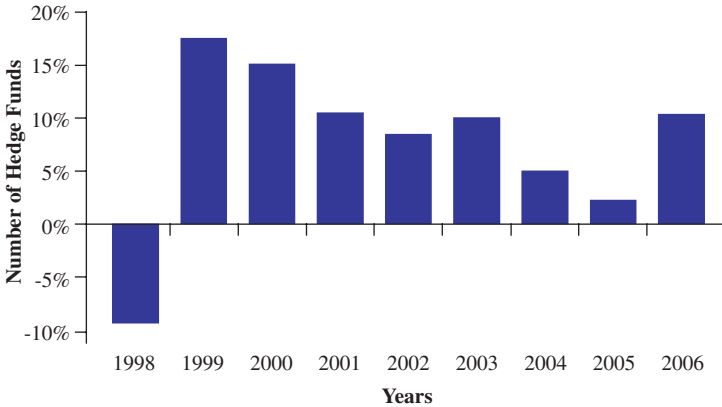
With respect to the following information in the "Past Performance" section of this report, please note the following:

- (a) the performance information shown assumes that all distributions made by the Trust in the periods shown were reinvested in additional securities of the Trust;
- (b) the performance information does not take into account sales and distribution charges that would have reduced returns or performance; and
- (c) how the Trust has performed in the past does not necessarily indicate how it will perform in the future.

Year-by-Year Returns

With respect to the following chart, please note the following:

- the bar chart shows the Trust's annual performance for each of the years shown, and illustrates how the investment fund's performance has changed from year to year; and
- the bar chart shows, in percentage terms, how much an investment made on the first day of each financial year would have grown or decreased by the last day of each financial year.



Annual Compound Returns

This chart compares the historical annual compound returns of the Trust over the periods indicated relative to various market Indices.

	<u>Since inception*</u>	<u>Past 5 years</u>	<u>Past 3 years</u>	<u>Past year</u>
Northwater Market-Neutral Trust	7.29%	7.17%	5.82%	10.39%
S&P/TSX Composite Index	8.78%	6.63%	21.66%	17.26%
Scotia Capital 91 day T-Bill Index	3.75%	3.00%	2.60%	3.98%
Scotia Capital Universe Bond Index	6.55%	4.42%	6.77%	4.06%

* inception date of the Trust is July 30, 1997.

The S&P/TSX Composite Index is a broad index of Canadian common shares.

The Scotia Capital 91-day T-Bill Index shows how a portfolio of three month T-Bills would have performed over the relevant period.

The Scotia Capital Universe Bond Index is a broad index of Canadian federal government, provincial government and corporate fixed income securities.

Management Fees and Related Party Transactions

Northwater Fund Management Inc., (the “Manager”), is responsible for the day-to-day administration, portfolio management and unitholder services to the Trust. In exchange for these services, the Manager is entitled to an annual fee of 1.25% of the net assets of the Trust, calculated on the last Valuation Date of each month. The fee is paid monthly in arrears. During the year ended December 31, 2006, the management fee expense was \$927,729 and the amount payable by the Trust as at December 31, 2006 was \$225,338.

The Manager will pay a portion of its fee to Northwater Capital Management Inc. (the “Investment Advisor”) in consideration of the Investment Advisor’s services to the Trust.

Net Asset Value and Price Per Unit

The value of investments held by the Trust is affected by factors beyond the control of the Investment Advisor, the Manager or the Trust. The process of valuing investments for which no published market price exists is based upon the definitive or provisional net asset value of the hedge funds supplied by the administrators or managers of such underlying hedge funds. These values are net of the management fees and expenses to which the underlying hedge funds are subject.

The Trust’s net asset value per unit is calculated and reported monthly. During the year ended December 31, 2006, the net asset value fluctuated between a low of \$13.85 per unit and a high of \$14.27 per unit (year ended December 31, 2005: low of \$13.88 and a high of \$14.87), after taking into account distributions.

The market price for units of the Trust is determined by the actions of buyers and sellers in the market. During the year ended December 31, 2006, the daily closing price of the units fluctuated between \$12.30 and \$13.80 (year ended December 31, 2005: low of \$12.11 and high of \$15.27).

Distributions

During the year ended December 31, 2006, the Trust made distributions totaling \$1.14 per unit (\$5,592,362 was distributed in aggregate) compared to \$1.16 per unit (\$6,066,507 in aggregate) during the year ended December 31, 2005.

The Trust is required to distribute all of its net income and net realized capital gains so that the Trust will not be liable to pay income tax under Part I of the Income Tax Act.

The character of the quarterly distributions for tax purposes has been determined as of the end of the year in accordance with the trust agreement and the tax laws then in effect. There can be no assurance that income tax laws will not be changed in a manner that adversely affects the Trust or distributions paid by the Trust and the Manager will continue to monitor any changes in the tax laws as they occur.

The following table represents the distribution history since inception of the Trust.

Distribution History

Record Date	Payment Date	Character of distribution for tax purposes	Amount per unit
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
March 31, 2003	April 16, 2003	Return of capital	\$0.00637
		Other income	\$0.62166
		Realized gain	\$0.12197
			<u>\$0.75000</u>
June 30, 2003	July 22, 2003	Return of capital	\$0.00527
		Other income	\$0.51391
		Realized gain	\$0.10082
			<u>\$0.62000</u>
September 30, 2003	October 24, 2003	Return of capital	\$0.00034
		Other income	\$0.03316
		Realized gain	\$0.00650
			<u>\$0.04000</u>
December 31, 2003	January 29, 2004	Return of capital	\$0.03119
		Other income	\$3.04199
		Realized gain	\$0.59682
			<u>\$3.67000</u>

Distribution History

<u>Record Date</u>	<u>Payment Date</u>	<u>Character of distribution for tax purposes</u>	<u>Amount per unit</u>
May 31, 2004	June 25, 2004	Return of capital	\$0.00103
		Other income	\$0.31897
			<u>\$0.32000</u>
June 30, 2004	July 29, 2004	Return of capital	\$0.00101
		Other income	\$0.31545
			<u>\$0.31646</u>
September 30, 2004	October 29, 2004	Return of capital	\$0.00099
		Other income	\$0.30901
			<u>\$0.31000</u>
December 31, 2004	January 28, 2005	Return of capital	\$0.00289
		Other income	\$0.89711
			<u>\$0.90000</u>
March 31, 2005	April 28, 2005	Return of capital	\$0.20703
		Other income	\$0.09297
			<u>\$0.30000</u>
June 30, 2005	July 29, 2005	Return of capital	\$0.20013
		Other income	\$0.08987
			<u>\$0.29000</u>
September 30, 2005	October 28, 2005	Return of capital	\$0.20013
		Other income	\$0.08987
			<u>\$0.29000</u>
December 31, 2005	January 30, 2006	Return of capital	\$0.19323
		Other income	\$0.08677
			<u>\$0.28000</u>
March 31, 2006	April 28, 2006	Return of capital	\$0.27005
		Other income	\$0.00995
			<u>\$0.28000</u>
June 30, 2006	July 31, 2006	Return of capital	\$0.27969
		Other income	\$0.01031
			<u>\$0.29000</u>
September 30, 2006	October 27, 2006	Return of capital	\$0.27969
		Other income	\$0.01031
			<u>\$0.29000</u>
December 31, 2006	January 29, 2007	Return of capital	\$0.27005
		Other income	\$0.00995
			<u>\$0.28000</u>

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 are offered for sale is less than 92.5% of the current net asset value per unit as at the close of business on the preceding valuation date.

On August 21, 2006, the Trust filed a notice of intention to make normal-course purchases of its units with the Toronto Stock Exchange (the “Exchange”). In its filing with the Exchange, the Trust indicated an intention to purchase up to 485,258 of the units of the Trust during the period from August 30, 2006 to August 29, 2007, 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, 2006, the Trust purchased 367,400 units for total proceeds of \$4,759,766 (year ended December 31, 2005: 105,100 units) for cancellation under this program. During the year ended December 31, 2006, this program contributed 0.60% to the overall return (year ended December 31, 2005: 0.22% contribution to 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 issuance from Treasury.

Purchases from treasury made under this plan during the year ended December 31, 2006 amounted to nil units while 14,939 units were purchased in the market (year ended December 31, 2005: 11,530 units were purchased from treasury and 7,387 units were purchased in the market).

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.

NORTHWATER MARKET-NEUTRAL TRUST ADVISORY BOARD REPORT

The advisory board (the “Advisory Board”) to the Trust is pleased to report on its activities for the period ended December 31, 2006.

The Advisory Board’s role is to provide independent advice to the Manager in connection with its responsibilities as trustee and manager of the Trust. This role is expressed in the Advisory Board’s Mandate:

- To monitor, consider and provide impartial judgement on all potential and perceived conflicts of interest referred to the Advisory Board by the Manager;
- To monitor, consider and provide impartial judgement with respect to any related party transactions referred to the Advisory Board by the Manager;
- To receive and review periodic reports provided to the Advisory Board by the Manager about: (i) the operation and performance of the Trust generally, (ii) compliance with the Investment Guidelines of the Trust, and (iii) compliance with the material contracts of the Trust; and
- If appropriate, to review and advise upon any other matter required by the amended and restated trust agreement dated April 19, 2004, and by applicable securities laws, regulations and rules.

The members of the Advisory Board are Jeffrey D. Francoz and Ann Marshall. All of the members of the Advisory Board are non-related and independent of management.

During the period ended December 31, 2006, the members of the Advisory Board held four meetings. Mr. Francoz and Ms. Marshall attended all of the meetings held by the Advisory Board.

During the period ended December 31, 2006, the Advisory Board reviewed; the mandate of the Advisory Board, the reporting to unitholders as required by National Instrument 81-106, periodic reports on the performance and the composition of the investment portfolio of the Trust, compliance with Investment Guidelines, the presentation of certain information in the quarterly and annual reports, and National Instrument 81-107 concerning Independent Review Committees for investment funds that is to become effective in 2007.

The Advisory Board reports that management of the Manager has been open and cooperative, permitting the members to review such documents and speak to

such members of management of the Manager as deemed necessary by the Advisory Board in order to properly execute their responsibilities as set out in the Advisory Board Mandate.

The Advisory Board discharges its duties by reviewing periodic reports prepared by the Manager, reviewing and responding to any potential and perceived conflicts of interest referred to the Advisory Board by the Manager and holding periodic meetings to discuss the Manager's activities as trustee and manager of the Trust.

The purpose and function of the Advisory Board continues to evolve over time in response to changing market conditions, regulations and legislation.



Jeffrey D. Francoz



Ann Marshall

MANAGEMENT'S RESPONSIBILITY

The accompanying financial statements have been prepared by Northwater Fund Management Inc (the "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 judgments. The significant accounting policies that management believes are appropriate for the Trust are described in note 2 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 23.



BENITA M. WARMBOLD, CA
Managing Director and Chief
Financial Officer



SHAUNA CASSIDY, CFA
Vice-President

March 16, 2007

AUDITORS' REPORT TO THE UNITHOLDERS OF NORTHWATER MARKET-NEUTRAL TRUST

We have audited the statement of investment portfolio of Northwater Market-Neutral Trust (the Trust) as at December 31, 2006, the statements of net assets as at December 31, 2006 and 2005 and the statements of operations, changes in net assets and cash flows 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 financial position of the Trust as at December 31, 2006 and 2005 and the results of its operations, the changes in its net assets and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants
Toronto, Ontario
March 16, 2007

NORTHWATER MARKET-NEUTRAL TRUST

Statements of Net Assets

	As at December 31, 2006	As at December 31, 2005
Assets		
Cash and short-term investments (cost: 2006 – \$1,830,529; 2005 – \$8,668,749)	\$ 1,831,019	\$ 8,679,483
Short-term investments held as margin deposited on futures contracts – at market value (note 4) (cost: 2006 – \$1,151,819; 2005 – \$919,965)	1,155,011	922,438
Hedge fund investments – at fair value (note 3) (cost: 2006 – \$68,089,341; 2005 – \$74,561,289)	81,217,662	78,923,275
Prepaid hedge fund investment	815,850	—
Hedge fund redemptions receivable	836,935	210,794
Settlement receivable on currency futures (note 4)	—	134,432
	<u>85,856,477</u>	<u>88,870,422</u>
Liabilities		
Audit, legal and custody fees payable	39,441	32,971
Management fees payable (note 7)	225,338	172,273
Interest and standby fees payable	41,333	55,249
Settlement payable on currency futures (note 4)	267,879	—
Distribution payable	1,339,132	1,442,005
Bank loan (note 5)	16,289,420	15,660,346
Other accounts payable	2,979	—
	<u>18,205,522</u>	<u>17,362,844</u>
Net assets	<u>\$ 67,650,955</u>	<u>\$ 71,507,578</u>
Net assets and unitholders' equity (note 6)		
Unit capital	\$102,443,133	\$109,341,400
Retained earnings (deficit)	(34,792,178)	(37,833,822)
Total	<u>\$ 67,650,955</u>	<u>\$ 71,507,578</u>
Number of units outstanding (note 6)	<u>4,782,615</u>	<u>5,150,015</u>
Net asset value per unit	<u>\$ 14.15</u>	<u>\$ 13.88</u>


Signed on behalf of the Trustee,

RBC Dexia Investor Services Trust

Per:



Per:



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

NORTHWATER MARKET-NEUTRAL TRUST

Statements of Operations

	For the years ended December 31,	
	2006	2005
Investment income		
Interest income	\$ 235,796	\$ 196,243
Other income	16,537	4,778
	<u>252,333</u>	<u>201,021</u>
Expenses		
Management fees (note 7)	927,729	1,010,270
Audit fees	52,460	49,373
Advisory board fees	10,149	—
Custodian fees	15,034	14,142
Legal fees	7,676	6,172
Security Holder Reporting Costs	108,259	92,784
Interest and standby fees	851,936	630,505
Other fees	33,638	34,974
	<u>2,006,881</u>	<u>1,838,220</u>
Net investment loss	<u>(1,754,548)</u>	<u>(1,637,199)</u>
Realized and unrealized gain (loss) on investments		
Net realized gain (loss) on:		
Hedge fund investments	(843,715)	(927,886)
Currency hedging of investments	1,257,230	1,531,370
Change in unrealized appreciation (depreciation) on:		
Hedge fund investments	8,766,335	1,724,549
Currency futures	(402,311)	(31,382)
Net gain (loss) on currency, excluding hedge fund investments	<u>(527,486)</u>	<u>871,342</u>
Net realized and unrealized gain on investments for the year ..	<u>8,250,053</u>	<u>3,167,993</u>
Increase in net assets from operations for the year	<u>6,495,505</u>	<u>1,530,794</u>
Increase in net assets from operations per unit for the year* ..	<u>\$ 1.32</u>	<u>\$ 0.29</u>

* Based on the average number of units outstanding for the period.

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

NORTHWATER MARKET-NEUTRAL TRUST

Statements of Changes in Net Assets

	For the years ended December 31,	
	2006	2005
Net assets – beginning of the year	\$71,507,578	\$77,232,421
Increase (decrease) in net assets from operations for the year	6,495,505	1,530,794
Unit transactions (note 6)		
Net asset value of units reinvested on distribution	—	169,852
Issuance (cancellation) of units	(4,759,766)	(1,358,982)
	(4,759,766)	(1,189,130)
Distribution to unitholders (note 8)		
Return of capital	(5,393,646)	(4,186,458)
From net income	(198,716)	(1,880,049)
	(5,592,362)	(6,066,507)
Net assets – end of the year	<u>\$67,650,955</u>	<u>\$71,507,578</u>

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

NORTHWATER MARKET-NEUTRAL TRUST

Statements of Cash Flows

	For the years ended December 31,	
	2006	2005
Cash flows from operating activities		
Increase (decrease) in net assets from operations	\$ 6,495,505	\$ 1,530,794
Items not affecting cash:		
Change in unrealized depreciation (appreciation) in value of hedge fund investments	(8,766,335)	(1,724,549)
Change in unrealized depreciation (appreciation) in value of currency futures	402,311	31,832
Net realized loss (gain) on hedge fund investments	843,715	927,886
Changes in non-cash working capital:		
Change in payables	48,598	87,530
Purchase of hedge fund investments	(17,055,144)	(30,780,833)
Proceeds on sale of hedge fund investments	21,241,386	34,844,869
	<u>3,210,036</u>	<u>4,917,529</u>
Cash flows from financing activities		
Proceeds from bank loan	629,074	(532,071)
Distributions paid	(5,695,235)	(9,173,877)
Repurchase of units	(4,759,766)	(1,358,982)
	<u>(9,825,927)</u>	<u>(11,064,930)</u>
Net increase (decrease) in cash and short-term investments	(6,615,891)	(6,147,401)
Cash and short-term investments at the beginning of the year	9,601,921	15,749,322
Cash and short-term investments at the end of the year ...	<u>\$ 2,986,030</u>	<u>\$ 9,601,921</u>
Supplementary information:		
Interest paid	\$ 865,852	\$ 610,118

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

NORTHWATER MARKET-NEUTRAL TRUST

Statement of Investment Portfolio

As at December 31, 2006

	<u>Maturity date</u>	<u>Face value</u>	<u>Cost</u>	<u>Fair/Market value</u>	<u>Percentage of investment portfolio</u>
Hedge fund investments*					
Activist			1,975,060	2,512,588	2.99%
Asset-backed securities arbitrage			8,336,972	10,060,961	11.99%
Capital structure arbitrage			441,331	450,256	0.54%
Distressed securities			9,945,541	13,819,434	16.46%
Fixed-income arbitrage			2,233,543	2,571,727	3.06%
Merger arbitrage			1,206,360	1,284,879	1.53%
Mortgage-backed security arbitrage			8,851,565	10,362,344	12.35%
Multi-strategy			12,896,403	16,158,899	19.25%
Re-insurance			5,583,726	5,520,794	6.58%
Structured finance			5,096,440	5,608,982	6.68%
Statistical arbitrage			11,522,400	12,866,798	15.33%
Hedge fund investments			<u>\$68,089,341</u>	<u>\$81,217,662</u>	<u>96.76%</u>
Cash			670,787	670,787	0.80%
Treasury bills **					
Canada* (note 4)	February 2007	233,100	230,468	231,319	0.28%
Canada* (note 4)	March 2007	932,400	921,351	923,691	1.10%
Commercial paper **					
Wells Fargo Financial Canada Inc. *	January 2007	1,165,500	1,159,742	1,160,232	1.38%
Cash and short-term investments		<u>2,331,000</u>	<u>2,982,349</u>	<u>2,986,029</u>	<u>3.56%</u>
Total investment portfolio		<u>2,331,000</u>	<u>71,071,690</u>	<u>83,935,812</u>	<u>100.00%</u>
Liabilities over other assets				\$16,284,857	
Net assets and unitholders' equity ..				<u>\$67,650,955</u>	

* These investments are denominated in U.S. dollars and have been converted to Canadian dollars at the prevailing period end rate.

**Short-term investments held at December 31, 2006 have yields ranging from 5.13% to 5.27%.

Schedule 1—Currency futures contracts:

	<u>Closing price</u>	<u>Notional contract value</u>	<u>Settlement receivable (payable) on futures contracts</u>
March 2007			
676 Canadian Dollar Futures			
Contracts	<u>\$86.02 USD</u>	<u>\$58,149,520 USD</u>	<u>\$(267,879) CAD</u>
		<u>\$67,773,266 CAD</u>	

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, 2006 and 2005

1. Establishment and Operations 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 amended and restated on August 17, 1999 (the “Trust Agreement”). The Trust Agreement was further amended as a result of a special meeting of unitholders held on April 19, 2004. RBC Dexia Investor Services (“RBC Dexia”) 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, 2009, 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., then known as Newcastle Capital Management Inc., (the “Manager”) under a management agreement dated July 18, 1997.

The Trust seeks to achieve a return hedged to Canadian dollars, by investing the assets of the Trust in cash and short-term investments, and a diversified portfolio of market-neutral hedge funds. The Trust has exposure to currency futures contracts used to hedge the Trust to Canadian dollars.

2. Summary of Significant Accounting Policies

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

(a) Investments

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

Cash and short-term investments consist of cash in interest bearing accounts and short-term investments with maturities of less than 90 days when purchased. 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 administrators or the portfolio managers 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 administrators or the portfolio managers of such funds. In determining the definitive or provisional net asset values, certain hedge funds may be required to make estimates and assumptions that affect the reported net asset values. Actual results could differ from those estimates. The difference between fair value and cost is shown as an unrealized gain or loss on hedge fund 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 end of the period. Transactions in currencies other than Canadian dollars during the period are translated at the rates of exchange prevailing on the respective dates of such transactions. Foreign exchange gains and losses are recognized in the Statements 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 Statements of Operations. The settlement receivable or payable on futures contracts represents the daily variation margin owing or due to the Trust on the Valuation Date.

Futures contracts are valued at their settlement price, as published by the clearing house of the relevant exchange, on each Valuation Date. In the absence of reported bid and offer quotations, the Manager may, from time to time, determine a value that 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 Statements 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.

(e) Comparative Figures

Certain of the 2005 comparative figures have been reclassified to conform to the 2006 financial statement presentation.

3. Investment in Market-Neutral Hedge Funds

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

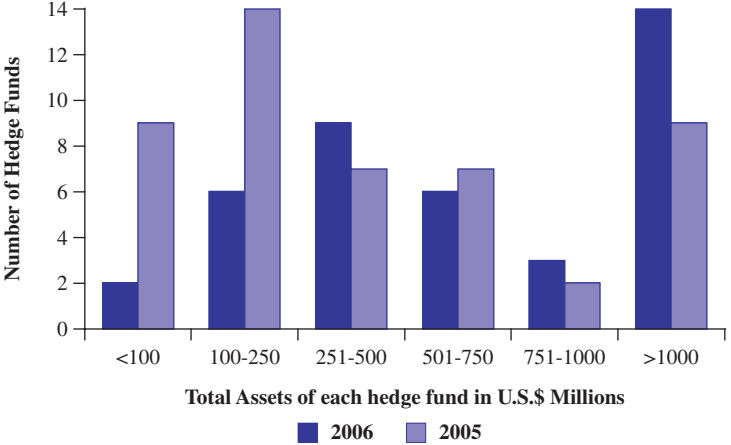
The following table summarizes hedge fund transactions during the relevant periods:

	Years ended December 31,	
	2006	2005
Investments at cost – beginning of the period	\$ 74,561,289	\$ 78,824,202
Cost of investments purchased	16,239,294	30,780,833
Cost of investments sold	(22,711,242)	(35,043,745)
Investments at cost – end of the period	68,089,341	74,561,289
Unrealized appreciation of investments	13,128,321	4,361,986
Market value of investments – end of the period	<u>\$ 81,217,662</u>	<u>\$ 78,923,275</u>
Proceeds of investments sold	21,867,527	34,115,860
Cost of investments sold	(22,711,242)	(35,043,746)
Net realized gain (loss) on investments	<u>\$ (843,715)</u>	<u>\$ (927,886)</u>

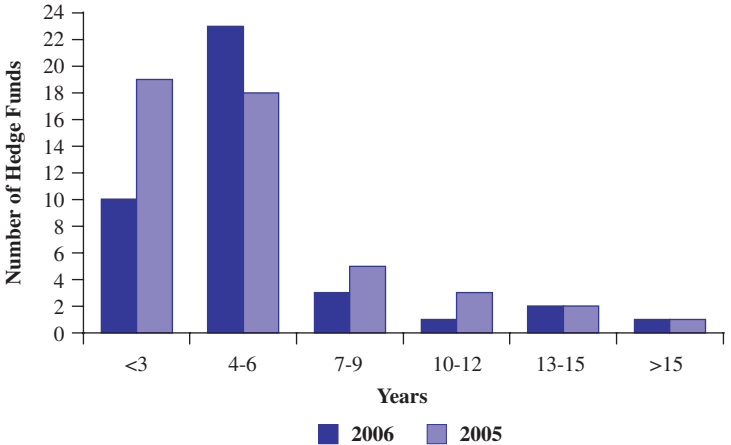
The market-neutral hedge funds included in the Trust's portfolio are organized and domiciled in non-U.S. jurisdictions consisting primarily of Bermuda, the Cayman Islands, the British Virgin Islands and the Bahamas. These market-neutral hedge funds are managed by independent portfolio managers who are compensated for their services by the respective market-neutral hedge funds they manage. Such compensation generally consists of an asset-based advisory fee, ranging from 1% to 2% annually, and a performance-based incentive fee, generally ranging from 10% to 20% of

net profits earned above a high-water mark. Compensation paid to independent portfolio managers of the market-neutral hedge funds is not separately computed and disclosed by the Trust but rather is reflected in the valuation of each market-neutral hedge fund. Redemption provisions for the market-neutral hedge funds vary ranging from 30 days' notice to 180 days' notice and may be subject to lock-up provisions.

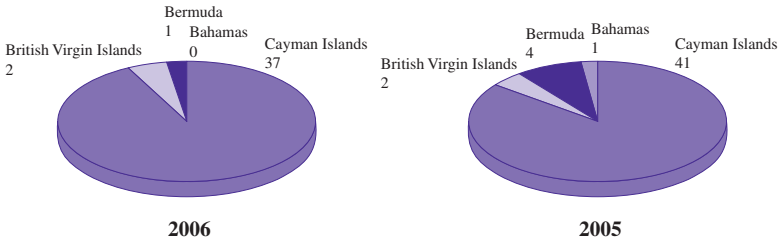
The following table shows the hedge funds held by the Trust as at December 31, 2006 and 2005 categorized by the size of each hedge fund.



The following table shows the hedge funds held by the Trust as at December 31, 2006 and 2005 categorized by the years since inception of each hedge fund.



The following chart illustrates the hedge funds held by the Trust by jurisdiction of organization as at December 31, 2006 and 2005.



4. Futures Contracts

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

As at December 31, 2006, short-term investments with a face value of \$1,000,000 USD (\$1,151,819 CAD) (December 31, 2005: \$800,000 USD; \$922,438 CAD) were deposited as initial margin for currency futures contracts.

During the year ended December 31, 2006, total commissions and other transaction costs in the amount of \$33,638 were paid or payable to dealers by the Trust (2005: \$47,841)

5. 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 exchange 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 the relevant period end dates were denominated in U.S. dollars.

During the year ended December 31, 2006, the bank loan varied between US \$13,318,180 and US \$14,318,732 (2005: US \$13,500,000 throughout the year). The average rate of interest paid on the loan for the year was 5.10%

6. Unitholders' Equity

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.

On August 21, 2006, the Trust filed a notice of intention to make normal-course purchases of its units with the Toronto Stock Exchange (the "Exchange"). In its filing with the Exchange, the Trust indicated an intention to purchase up to 485,258 of the units of the Trust during the period from August 30, 2006 to August 29, 2007, 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.

Under a normal course issuer bid and the Trust's quarterly market support obligation, the Trust purchased 367,400 units for cancellation during the year ended December 31, 2006 (year ended December 31, 2005: 105,100 units were purchased).

Pursuant to the distribution reinvestment plan, no units were issued from Treasury during the year ended December 31, 2006 while 367,400 units were purchased in the market (year ended December 31, 2005: 11,530 units were issued from Treasury and 7,387 units were purchased in the market).

Unitholders' equity is comprised of unit capital and retained earnings (deficit). The following table shows the transactions for unit capital and retained earnings (deficit) during the relevant periods:

<u>Year ended</u> <u>December 31, 2006</u>	<u>Units</u> <u>Outstanding</u>	<u>Unit</u> <u>Capital</u>	<u>Retained</u> <u>Earnings</u> <u>(Deficit)</u>	<u>Unitholders'</u> <u>Equity</u>
Balance –				
December 31, 2005	5,150,015	\$109,341,400	\$(37,833,822)	\$71,507,578
Increase (decrease) in net assets from operations for the year	—	—	6,495,505	6,495,505
Units issued during the year . .	—	—	—	—
Units cancelled during the year	(367,400)	(6,898,267)	2,138,501	(4,759,766)
Distributions	—	—	(5,592,362)	(5,592,362)
Balance –				
December 31, 2006	<u>4,782,615</u>	<u>\$102,443,133</u>	<u>\$(34,792,178)</u>	<u>\$67,650,955</u>
Year ended	Units	Unit	Retained	Unitholders'
<u>December 31, 2005</u>	<u>Outstanding</u>	<u>Capital</u>	<u>Earnings</u>	<u>Equity</u>
			<u>(Deficit)</u>	
Balance –				
December 31, 2004	5,243,585	\$111,146,377	\$(33,913,956)	\$77,232,421
Increase (decrease) in net assets from operations for the year	—	—	—	—
Units issued during the year . .	11,530	169,852	1,530,794	1,700,646
Units cancelled during the year	(105,100)	(1,974,829)	615,847	(1,358,982)
Distributions	—	—	(6,066,507)	(6,066,507)
Balance –				
December 31, 2005	<u>5,150,015</u>	<u>\$109,341,400</u>	<u>\$(37,833,822)</u>	<u>\$71,507,578</u>

* represents the stated value in excess of the cost of units repurchased

7. Management Fees

Northwater Fund Management Inc., the Manager, is responsible for the day-to-day administration, portfolio management and unitholder services to the Trust. In return for these services, the Manager is entitled to an annual fee of 1.25% of the net assets of the Trust, calculated on the last Valuation

Date of each month. The fee is paid quarterly in arrears. The Manager will pay a portion of its fee to the Investment Advisor in consideration of the Investment Advisor's services to the Trust

Northwater Capital Management Inc. (the "Investment Advisor"), a Company formed under the laws of Ontario, Canada, acts as the advisor to the Trust. The Investment Advisor is registered in Canada as an advisor 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 advisor in the category commodity trading manager under the *Commodity Futures Act* (Ontario), as amended. The Investment Advisor is registered as a securities advisor under the *Securities Act* (Quebec), as amended. The Investment Advisor also has equivalent registrations in the Canadian provinces of New Brunswick, Prince Edward Island, Nova Scotia, Saskatchewan, Alberta and British Columbia under the securities legislation in these provinces. The Advisor is also registered in the United States as an investment advisor 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.

8. Distributions

The Trust pays quarterly distributions to unitholders equal to 2% of the net asset value per unit as of the month end preceding the given calendar quarter.

During the year ended December 31, 2006, distributions of \$1.14 per unit and \$5,592,362 in aggregate (2005: \$1.16 per unit and \$6,066,507 in aggregate) were made by the Trust.

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

9. Income Taxes

As at December 31, 2006, 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 taxable 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 may be 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.

Net taxable income may differ from net income for accounting purposes.

As at December 31, 2006, the Trust had no non-capital loss carryforwards (2005: \$nil) and \$8,758,000 in capital loss carryforwards (2005: \$5,910,000).

Effective December 31, 2005, the change in the rules for pension funds and other tax deferred retirement plans has eliminated the foreign property rule for these plans. Although the units of the Trust have always been RRSP and RRIF eligible, as foreign property, this change means unitholders of the Trust are no longer constrained in their holdings as the 30% limit on foreign holdings is no longer applicable.

10. Indemnities

The Trust enters into various agreements that contain indemnity provisions, whereupon payment by the Trust may become due upon the occurrence of certain events including the following indemnities:

- 1) in priority to all and any rights of the Manager or of the unitholders, an indemnity to the trustee and each of its directors, officers, employees and agents, other than the Manager, in respect of any liability and all costs, charges and expenses sustained or incurred in respect of any action, suit or proceeding that is proposed or commenced and all other expenses, costs or charges, sustained or incurred in respect of the administration or termination of the Trust including any taxes, penalties and interest in respect of unpaid taxes and all other liabilities and charges of any nature whatsoever;
- 2) an indemnity to certain of the hedge funds in which the Trust is invested, and to their administrators, for liabilities that may be incurred in the event that the Trust, in completing subscription agreements in making investments in such hedge funds, makes a misrepresentation in such subscription agreements resulting in losses or damages to such hedge funds or their administrators;
- 3) an indemnity to the Trust’s futures broker with respect to any and all losses, costs and reasonable attorney’s fees incurred by it in connection with the Trust’s trading of futures contracts;

- 4) an indemnity to the Trust's Manager from all claims, costs, charges and expenses in connection with the execution of the duties of the Manager and from all other costs, charges and expenses the Manager may sustain or incur in relation to the affairs of the Trust;
- 5) an indemnity to the Trust's auditors with respect to any fraudulent acts or omissions by the Trust, or misrepresentations made or willful defaults caused by the Trust resulting in claims against the Trust's auditors and in connection with third party claims made against the Trust's auditors relating to the services provided to the Trust by its auditors except as such claims may have resulted from the intentional neglect, misconduct or fraudulent behaviour of the Trust's auditors; and
- 6) an indemnity to its soliciting dealer for the April 19, 2004 unitholder meeting by the Trust with respect to any losses, expenses, claims, actions, damages and liabilities arising out of any action, suit, proceeding, investigation or claim made by any person arising out of or based upon, directly or indirectly, the engagement.

Historically, no payments have been required to be made under these indemnities. The Trust estimates the current liability at zero. The indemnities entered into by the Trust can extend for an unlimited period of time. The Trust is unable to estimate the maximum potential liability for these indemnities, as the agreements do not specify a maximum amount and the amounts that may be required to be paid are dependent upon the outcome of future contingent events, the nature and likelihood of which cannot be determined at this time.

NORTHWATER CAPITAL MANAGEMENT INC.

Northwater Capital Management Inc., a leader in financial innovation since January 1989, offers customized portfolio solutions to the global investment community through the firm's Portfolio Platform™, a proprietary platform that incorporates the flexibility and scalability necessary to meet a variety of investor needs.

The firm's established indexing capability allows investors to access global equity and fixed income markets on a cost-effective basis. In addition, utilizing its expertise in constructing market-neutral fund of hedge fund portfolios that seek to generate consistent returns in both normal and extreme markets, Northwater seeks to deliver a reliable source of alpha, or excess return. Northwater's structuring technology combines these two components in a portable alpha framework that seeks to achieve an investor's return/risk objectives in an efficient, cost-effective manner.

With more than ten years of experience in fund of hedge funds, Northwater has steadily grown assets under management to approximately CDN \$10.6 billion total, including CDN \$5.1 billion invested in hedge funds as at December 31, 2006. Northwater has focused on developing, delivering and continuously improving its market-neutral fund of hedge fund portfolios since launching its first such portfolio in 1994.

Northwater advises institutional clients in Canada, the United States, the United Kingdom and the rest of Europe. The firm has offices in Toronto, New York and Chicago.

Northwater also acts as an advisor to the following two closed-ended funds listed on the TSX, in addition to Northwater Market-Neutral Trust:

- Northwater Five-Year Market-Neutral Trust, launched in 2004; and
- Northwater Top 75 Income Trusts^{Plus}, launched in 2005.

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TSE Symbol: NMN.UN

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