

**NORTHWATER**

**Northwater Market-Neutral Trust  
December 31, 2008  
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, 2008 are included in this report.

## CONTENTS

Message to Unitholders from the Investment Advisor .....	2
Management Report of Fund Performance .....	4
Independent Review Committee Report .....	22
Management’s Responsibility .....	27
Auditor’s Report to the Unitholders .....	28
Audited Financial Statements .....	29
Northwater Capital Management Inc. ....	51

## 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, 2008, the net asset value of the Trust per unit was \$7.40. For the year ended December 31, 2008, the return of the Trust was -31.23% including distributions. During the same time period, the DEX Universe Bond Index returned 6.41%, the S&P/TSX Composite Index declined by 33.00% and the S&P 500 in U.S. dollar terms, fell by 37.00% which translates to a loss of 21.20% in Canadian dollar terms. The Trust made distributions of \$0.85 per unit during the period.

Overall, the return of the Trust in 2008 was disappointing from both an absolute return basis as well as from its lack of neutrality in respect of other asset class returns. Performance of all asset classes was impacted by the escalating uncertainty which surrounded the state of the global financial system. The Trust’s hedge fund investments were not immune to these stresses in the capital markets.

The credit crisis which began to unfold in the US sub-prime housing market during the last quarter of 2007, continued to unravel across all markets during 2008. Credit markets contracted, banks restricted lending to each other and the deleveraging spiral negatively impacted all market participants including hedge funds. Strategies that rely on normalization of historical spreads were dramatically impacted by widening spreads while the price and availability of leverage altered the fundamental economics of some profitable trades. Regulatory uncertainty increased in mid 2008 when new short selling rules altered some fund’s abilities to adequately hedge in the equity markets. The bankruptcy of Lehman Brothers and subsequent AIG bailout increased the overall market uncertainty leading into the final quarter of 2008. Spread widening in credit markets combined with technical pricing pressures and increased volatility in the hedging instruments made for extremely volatile and often negative returns in many of the hedge funds held by the Trust. While the hedge fund managers were reducing risk in their portfolios, the investor demand for the return of capital from these hedge fund managers increased leading into year end, putting further pressure on hedge fund’s underlying investments.

Although the market outlook for many of the hedge fund strategies has improved, the Trust is proceeding with an orderly windup scheduled for December 31, 2009 in accordance with the prospectus of the Trust. As such we are focused on creating liquidity and returning capital to unitholders.

Based on current market conditions, the Investment Advisor anticipates that due to liquidity constraints in the underlying hedge funds it is likely that the Fund will continue to exist and be winding down its operations beyond the originally scheduled December 31, 2009 termination.

As of January 31, 2009, approximately 52% of the Trust will continue to have exposure to underlying hedge funds market movements. Based on the most recent information that the Investment Advisor had available to it the Manager anticipates that approximately 37% of the Trust (representing 18 hedge funds) may be subject to restrictions on liquidity that could extend beyond the December 31, 2009 termination date of the Fund.



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Deputy Chief Investment Officer  
Northwater Capital Management Inc.



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Managing Director and  
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Northwater Capital Management Inc.

March 23, 2009

## MANAGEMENT REPORT OF FUND PERFORMANCE

This Management Report of Fund Performance contains financial highlights for the year ended December 31, 2008 but does not contain the complete financial statements of Northwater Market-Neutral Trust (the “Trust”). A copy of the financial statements of the Trust 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, Brookfield 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](http://www.northwatercapital.com) or visit the SEDAR website at [www.sedar.com](http://www.sedar.com).

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.

### Adoption of New Accounting Standards

In December 2006, the Accounting Standards Board issued CICA Handbook Section 3862 “Financial Instruments – Disclosures” (“S. 3862”) and Section 3863, “Financial Instruments – Presentation” (“S. 3863”), which provides comprehensive disclosure and presentation requirements for financial instruments.

In addition, in December 2006, the Accounting Standards Board issued CICA Handbook Section 1535 “Capital Disclosures” (“S.1535”), which provides standards for disclosing information about an entity’s capital and how it is managed.

The requirements of S. 3862, S. 3863 and S.1535 are effective for annual financial statements relating to fiscal years beginning on or after October 1, 2007 and have been reflected in the notes to the financial statements.

## Investment Objectives and Strategies

### *Investment Objectives*

The investment objectives of the Trust comprise steady capital appreciation of the net assets and ability to make regular distributions to unitholders while achieving low volatility and performance that is independent of fixed income and equity 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

Throughout the year the Trust’s investment objectives and strategy were supported by the implementation of a continuous 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.

This investment management process comprises selection and ongoing monitoring of the hedge fund investments, including but not limited to: comprehensive quantitative and qualitative assessment of hedge fund managers, including hedge fund manager reviews involving on-site interviews, monthly

portfolio reviews and various industry references; comprehensive investment and operational due diligence process; the construction of a diversified model portfolio using various portfolio construction techniques, including mathematical optimization, statistical process control and factor analysis and use of an established operational infrastructure necessary for managing complex fund of market-neutral hedge fund and derivative strategies.

The Investment Advisor manages and advises other 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 is authorized to employ leverage to enhance investment returns. The Trust is entitled to borrow up to 25% of the reported net asset value for investment purposes, and may borrow an additional 10% of the reported 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 maintain its investments as at December 31, 2008 was 22.59% (December 31, 2007: 23.39%).

As the Trust continues to unwind its portfolio in anticipation of its scheduled December 31, 2009 termination date, the leverage employed by the Trust is expected to fall.

## Risks

The following tables present information for the periods from inception and for the year ended December 31, 2008 and 2007 regarding the risk profile of both the Trust and the Trust's hedge fund holdings.

<b>Trust Statistics</b>	<b>For the period from inception to December 31, 2008</b>	<b>For the period from inception to December 31, 2007</b>
	# of positive monthly returns .....	96
# of negative monthly returns .....	41	31
% of negative months .....	29.9%	24.8%
Average size of negative months .....	(1.72)%	(1.05)%
Worst monthly return .....	(12.53%)	(11.78%)

<b>Single Hedge Fund Statistics</b>	<b>For the year ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
# of hedge funds with positive returns <sup>(1,2)</sup> .....	6	26
# of hedge funds with negative returns <sup>(1,2)</sup> .....	19	8
Average annual hedge fund standard deviation <sup>(2,3)</sup> .....	15.87%	7.19%
Average correlation between hedge funds <sup>(2,4)</sup> .....	0.41	0.24

1. Measured for hedge funds in the portfolio as at December 31, 2008 and December 31, 2007 respectively.
2. As measured over the past 24 months for hedge funds in the portfolio as at December 31, 2008 and December 31, 2007 respectively, excludes hedge funds with less than 24 months of historical returns.
3. Standard deviation is defined as a measure of dispersion of returns around a mean (average return). A low standard deviation implies low risk of experiencing returns that vary highly in magnitude from the mean.
4. Correlation is a measure of the degree to which variables (such as performance of two hedge funds) move together.

No material changes affecting the overall risk of investing in the Trust were made by the Manager in the year ended December 31, 2008. However, the hedge fund industry, like other market participants, has been subject to unprecedented turmoil in the markets due to the ongoing credit crisis.

The change in the risk characteristics of the Trust reflects the magnitude of the stress felt across the entire financial system in 2008. Trust returns in 2008 were uncharacteristically skewed to the negative on a monthly basis and the Trust experienced its worst monthly return since inception.

As illustrated in the Single Hedge Fund Strategies chart above, diversification across managers was not sufficient to avoid the overwhelming negative impact

from the industry wide deleveraging. The volatility in the underlying managers (as expressed by standard deviation) rose to 15.87% versus the 2007 level of 7.19%.

The similarity of manager returns (average correlation between hedge funds), which had historically been very low and stable, spiked in 2008, which is reflective of the magnitude of the problems across all financial markets.

Many of the trading strategies employed by hedge funds depend on functional financial markets, including the ability of managers to enter into short positions. Hedge funds have not only suffered losses as a result of the stress felt in the markets, including the difficulty encountered in maintaining short positions, but also because of the liquidity freeze experienced in many markets. Certain of the managers have been unable to sell assets to prevent additional losses or fund investor redemptions. Continuing illiquidity has caused numerous underlying hedge funds held by the Trust to invoke various restrictions on redemptions including, without limitation, restricting redemptions to a limited percentage of the aggregate net asset value of such underlying hedge funds, the temporary suspension of redemptions altogether, or the commencement of a controlled liquidation and wind-up of the underlying hedge funds' business.

Based on current market conditions, the Manager anticipates that due to liquidity constraints in the underlying hedge funds it is likely that the Trust will continue to exist and be winding down its operations beyond the originally scheduled December 31, 2009 termination date of the Trust.

As at January 31, 2009, approximately 52% of the Trust will continue to have exposure to underlying hedge funds market movements. Based on the most recent information that the Manager had available to it, the Manager anticipates that approximately 37% of the Trust (representing 18 hedge funds) may be subject to restrictions on liquidity that could extend beyond the December 31, 2009 termination date of the Trust.

As at December 31, 2008, the manager submitted redemption requests to all the underlying hedge funds in anticipation of the Trust's scheduled termination date.

The following table shows the expected payout timeline of redemption proceeds from the underlying hedge fund managers:

**Payments of redemptions expected in 2009, classified by status of the hedge funds being redeemed from:**

	<u>Amount (\$)</u>	<u>% of total hedge fund portfolio</u>
Restricted redemptions <sup>(1,2)</sup> .....	3,928,478	15%
Liquidating .....	1,961,069	7%
Normal Course .....	<u>8,688,618</u>	<u>32%</u>
	<u>14,578,165</u>	<u>54%</u>

**Payments of redemptions expected beyond 2009, classified by status of the hedge funds being redeemed from:**

	<u>Amount (\$)</u>	<u>% of total hedge fund portfolio</u>
Restricted redemptions <sup>(1)</sup> .....	8,177,833	30%
Liquidating .....	<u>4,088,543</u>	<u>16%</u>
	<u>12,266,376</u>	<u>46%</u>

- (1) Restricted redemptions category includes situations where the manager has placed some form of restriction on the redemption request, including suspending redemptions, enforcing gates on redemption or restructuring the fund, to for example, create a liquidating share class.
- (2) Although these redemptions are currently restricted, the Manager anticipates that the redemption proceeds will still be received during 2009.

The detailed risks of investing in the Trust are listed in the Trust's prospectus. A copy of the prospectus of the Trust is available by visiting the SEDAR website at [www.sedar.com](http://www.sedar.com).

As stated above the receipt of redemption proceeds from underlying managers will impact timing of distribution to unitholders.

## Results of Operations

During the year ended December 31, 2008, the Trust posted a loss of -31.23% (year ended December 31, 2007: 3.42%) taking into account distributions made during the period. Distributions during the year ended December 31, 2008, in aggregate, totaled \$3,694,732 or \$0.85 per unit (year ended December 31, 2007: \$13,270,597 or \$2.87 per unit). The asset-backed securities arbitrage strategy, in aggregate, contributed most positively to the Trust's return among all the strategies, for the year ended December 31, 2008 while the structured finance strategy, in aggregate, was the weakest performer.

For 2008, none of the underlying strategies generated returns in line with the Manager's longer term expectations.

The following table presents returns by investment strategy for the years ended December 31, 2008 and 2007.

<u>Strategy</u>	<b>For the years ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
Activist investments .....	(35.34)%	6.09%
Asset-backed securities arbitrage .....	0.61%	10.05%
Distressed securities arbitrage .....	(22.55)%	16.51%
Fixed-income arbitrage .....	(54.01)%	2.24%
Mortgage-backed security arbitrage .....	(33.71)%	(0.90)%
Re-insurance arbitrage .....	(1.88)%	14.17%
Statistical arbitrage .....	(10.93)%	(8.45)%
Structured finance .....	(59.36)%	5.07%
Multi-strategy .....	(38.96)%	8.68%

As the credit crisis continued to unravel across all the markets, the hedge fund performance across almost all strategies was negatively impacted. Strategies which rely on normalization of historical spreads were dramatically impacted by the continued spread widening while the price and availability of leverage altered the fundamental economics of some profitable trades. Regulatory uncertainty increased in mid-2008 when new short selling rules altered some fund's abilities to adequately hedge in the equity markets. While the hedge fund managers were reducing risk in their portfolios, the investor demand for the return of capital from these hedge fund managers increased leading into year end, putting further pressure on hedge fund's underlying investments.

Specific manager returns within the asset-backed securities arbitrage strategy were enough to generate a slightly positive return for the year, however, the returns generated from the mortgage-backed securities arbitrage managers were more reflective of the heightened volatility and illiquidity in the mortgage markets.

Fixed income arbitrage and structured finance strategies were the largest negative contributors to performance and were driven by the negative consequences of a dislocated credit market. The structured finance strategy was also negatively impacted by the full write down of a trade finance hedge fund which was the victim of the Petters fraud uncovered through an FBI investigation in the U.S. that became public in September 2008. Losses related to this writedown were \$2,047,337.

The activist strategy was ineffective as the hedging actions of the underlying hedge fund manager were not sufficient to offset the impact of the negative equity markets.

Multistrategy managers that historically were able to reap the benefits of strategy diversification, were caught up in the technical market behaviours and ultimately in the investor liquidation pressures which combined to deliver the negative result.

The borrowings of the Trust fluctuated between \$3,356,096 and \$12,752,641 throughout the year ended December 31, 2008 through a revolving loan facility with a Canadian financial institution (year ended December 31, 2007 the borrowings of the Trust fluctuated between: \$12,578,644 and \$13,843,299). The financial leverage as at December 31, 2008 was 23.59% (December 31, 2007: 23.39%). In 2008, the leverage contributed to the negative performance of the Trust.

The Trust was able to capitalize on the share buy-back and cancellation program with 398,500 units of the Trust being repurchased and cancelled during the year ended December 31, 2008 for cash of \$3,892,171 (year ended December 31, 2007: 209,700 units for \$2,701,827 in cash) as the units were offered for sale at less than 92.5% of the reported net asset value. During the year ended December 31, 2008, this program contributed 0.90% to the overall return (year ended December 31, 2007: 0.36% contribution to overall return).

### Summary of Investment Portfolio <sup>(1)</sup>

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, 2008, the Trust was invested in 25 hedge funds (December 31, 2007: 37 hedge funds) with 24 managers (December 31, 2007: 34 managers) engaged in nine 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 U.S. or International generally accepted accounting principles (“GAAP”).

During the year ended December 31, 2008, the Trust did not place investments with any new funds and redeemed from twelve hedge funds (consisting of three distressed securities, one asset-backed securities arbitrage, two multi-strategy, two structured finance, two statistical arbitrage, one mortgage-backed securities and one reinsurance) (year ended December 31, 2007, the Trust placed investments with four new hedge funds and redeemed from seven hedge funds).

As at year end, the portfolio composition reflects the managers actions in liquidating the hedge fund portfolio. As no new funds were added to the portfolio, the asset allocation changes are a function of the market moves and the liquidations of specific managers. Redemptions have been submitted for the remaining hedge funds in anticipation of termination of the Trust on December 31, 2009.

### Asset Allocation by Investment Strategy

The following table shows the hedge fund holdings by strategy as at December 31, 2008 and 2007. 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, 2008</u>			<u>As at December 31, 2007</u>		
	<u>No. of Hedge Funds</u>	<u>Fair Value</u>		<u>No. of Hedge Funds</u>	<u>Fair Value</u>	
Activist investments . . . . .	1	\$ 1,351,261	5%	1	\$ 1,705,001	3%
Asset-backed securities arbitrage . . . . .	3	5,790,168	22%	4	8,164,189	13%
Distressed securities arbitrage . . .	2	2,869,818	11%	6	10,299,791	16%
Fixed-income arbitrage . . . . .	3	1,402,414	5%	3	3,459,306	5%
Mortgage-backed security arbitrage . . . . .	3	3,313,968	12%	4	8,043,885	12%
Multi-strategy . . . . .	4	4,236,603	16%	6	12,128,061	19%
Re-insurance arbitrage . . . . .	2	1,048,106	4%	2	3,060,925	5%
Statistical arbitrage . . . . .	3	3,783,424	14%	5	7,371,132	12%
Structured finance . . . . .	4	3,048,779	11%	6	9,270,327	15%
	<u>25</u>	<u>26,844,541</u>	<u>100%</u>	<u>37</u>	<u>\$63,502,617</u>	<u>100%</u>

The following table presents the largest individual hedge fund holding for each investment strategy as a percentage of the net assets of the Trust as at December 31, 2008 and 2007.

<u>Strategy</u>	<u>As at December 31, 2008</u>	<u>As at December 31, 2007</u>
Activist investments .....	4.37%	3.17%
Asset-backed securities arbitrage .....	10.52%	6.66%
Distressed securities arbitrage .....	8.09%	4.85%
Fixed-income arbitrage .....	2.44%	2.31%
Mortgage-backed security arbitrage .....	5.37%	5.67%
Multi-strategy .....	3.80%	4.95%
Re-insurance arbitrage .....	2.21%	4.66%
Statistical arbitrage .....	6.34%	3.98%
Structured finance .....	5.52%	5.94%

The following table lists all hedge funds by fair value as at December 31, 2008. The Trust will disclose the names of those hedge funds held by the Trust that represent more than 5% of the net assets of the Trust at the end of the year. 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 Trust.

<u>Hedge Fund Investments</u>	<u>Type of Investment</u>	<u>Cost</u>	<u>Fair Value</u>	<u>Fair Value as a % of Net Assets</u>
Mariner Tricadia Credit Strategies Fund, Ltd.* . . . . .	Participating shares	\$ 1,592,902	\$ 3,251,787	10.52%
Cerberus International, Ltd.* . . . . .	Participating shares	1,012,154	2,501,383	8.09%
CRC Global Structured Credit Fund, Ltd.* . . . . .	Participating shares	1,668,438	2,248,401	7.27%
Two Sigma Spectrum Cayman Fund, Ltd.* . . . . .	Participating shares	1,692,900	1,958,253	6.34%
Tykhé Portfolios Ltd.* . . . . .	Participating shares	2,905,050	1,762,016	5.70%
D.B. Zwirn Special Opportunity Fund, Ltd.* . . . . .	Voting shares and capital Balance	2,861,120	1,706,207	9.26%
Sorin Offshore Fund* . . . . .	Participating shares	1,706,074	1,658,672	5.37%
Fund 209* . . . . .	Participating shares	1,486,652	1,351,261	4.37%
Fund 146* . . . . .	Participating shares	1,955,073	1,174,552	3.80%
Fund 130* . . . . .	Participating shares	1,912,500	1,094,965	3.54%
Fund 121* . . . . .	Participating shares	1,009,410	1,059,810	3.43%
Fund 224* . . . . .	Participating shares	822,780	1,029,269	3.33%
Fund 190* . . . . .	Participating shares	1,166,616	979,244	3.17%
Fund 183* . . . . .	Participating shares	924,101	907,276	2.94%
Fund 222* . . . . .	Participating shares	1,377,349	752,877	2.44%
Fund 195* . . . . .	Participating shares	544,635	682,805	2.21%
Fund 103* . . . . .	Participating shares	1,076,934	676,052	2.19%
Fund 140* . . . . .	Participating shares	676,143	518,395	1.68%
Fund 212* . . . . .	Participating shares	—	368,435	1.19%
Fund 131* . . . . .	Participating shares	—	365,301	1.18%
Fund 220* . . . . .	Participating shares	678,960	313,292	1.01%
Fund 171* . . . . .	Participating shares	304,800	289,980	0.94%
Fund 191* . . . . .	Participating shares	521,773	131,143	0.42%
Fund 104* . . . . .	Participating shares	157,129	63,171	0.20%
Fund 187* . . . . .	Participating shares	1,687,130	—	—
		<u>\$29,740,622</u>	<u>\$26,844,541</u>	

\* held by other investment funds managed by Northwater Fund Management Inc. or advised by Northwater capital 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 assist in understanding the Trust's financial performance for the past five years. The information included in the below tables has been derived from the Trust's audited annual financial statements.

### The Trust's Net Assets per Unit

	For the year ended December 31,					
	2008	2007	2006	2005	2004	2003
Net assets, beginning of year	\$11.76	\$14.15	\$13.88	\$14.73	\$15.81	\$19.05
<b>Increase (decrease) from operations:</b>						
Total revenue	0.04	0.05	0.05	0.04	0.03	0.02
Total expenses	(0.27)	(0.41)	(0.41)	(0.35)	(0.52)	(0.12)
Realized gains (losses) for the year	(1.88)	2.80	(0.02)	0.28	1.83	6.69
Unrealized gains (losses) for the year	(1.40)	(1.99)	1.70	0.33	(0.57)	(4.79)
<b>Total increase (decrease) from operations<sup>(1)</sup></b>	<b>(3.51)</b>	<b>0.45</b>	<b>1.32</b>	<b>0.29</b>	<b>0.77</b>	<b>1.80</b>
<b>Distributions:</b>						
From income (excluding dividends)	—	1.71	0.04	0.36	0.01	4.21
From capital gains	—	—	—	—	—	0.83
Return of capital	0.85	1.16	1.10	0.80	1.84	0.04
Total Distributions for the year <sup>(2)</sup>	0.85	2.87	1.14	1.16	1.85	5.08
Net Assets, at end of year <sup>(3)</sup>	\$ 7.40	\$11.76	\$14.15	\$13.88	\$14.73	\$15.81

- (1) Net assets 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 for the year ended December 31, 2008.
- (3) It is not intended that the Trust's Net Assets per Unit table act as a reconciliation of the opening and closing net assets per unit of the Trust.

## Ratios and Supplemental Data

	2008	2007	2006	2005	2004
Total net assets (000's) <sup>(1)</sup> . . . . .	\$ 30,906	\$ 53,778	\$ 67,651	\$ 71,507	\$ 77,232
Number of units outstanding <sup>(1)</sup> . . . . .	4,174,415	4,572,915	4,782,615	5,150,015	5,243,585
Management expense ratio <sup>(2)</sup> . . . . .	9.16%	9.17%	6.60%	7.08%	7.94%
Management expense ratio before waivers or absorptions <sup>(2)</sup> . . . . .	9.16%	9.17%	6.60%	7.08%	7.94%
Portfolio turnover rate <sup>(3)</sup> . . . . .	3.87%	12.11%	22.97%	40.56%	26.96%
Trading expense ratio <sup>(4)</sup> . . . . .	0.03%	0.03%	0.05%	0.00%	0.00%
Closing market price, end of year . . . . .	\$ 5.85	\$ 9.58	\$ 13.00	\$ 12.55	\$ 15.06

(1) This information is provided as at December 31 of the years 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 asset value 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, 2008 added 6.51% , for the year ended December 31, 2007 added 6.23% and for each of the years ended December 31, 2006, 2005 and 2004 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 2004 to 2006 expense ratios reflect the expenses of the hedge funds for the year 2005. Management continues to receive the audited financial statements for the year 2008 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 have been prorated based on the relative percentage of the hedge funds held by the Trust at December 31, 2007. 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 asset value during the period.

## Past Performance

### General

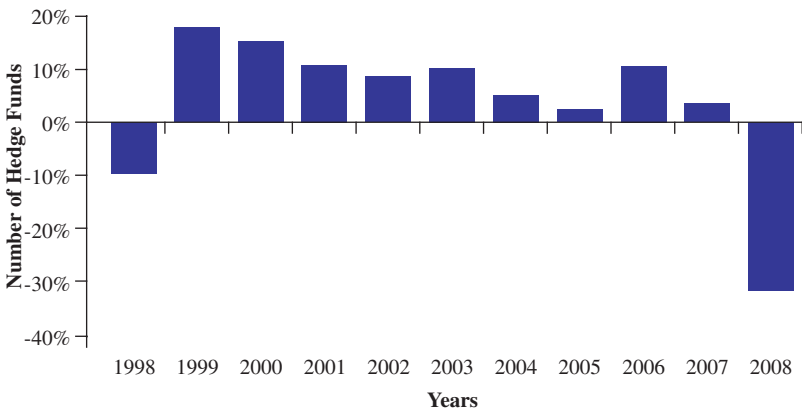
With respect to the following information in the “Past Performance” section of this report, please note the following:

- (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:

- (a) the bar chart shows the Trust’s performance for each of the periods shown, and illustrates how the Trust’s performance has changed from period to period; and
- (b) the bar chart shows, in percentage terms, how much an investment made on the first day of each period would have grown or decreased by the last day of each period.



## 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 .....	2.86%	(3.37)%	(7.75)%	(31.23)%
S&P/TSX Composite Index .....	4.34%	4.16%	(4.80)%	(33.00)%
Scotia Capital 91 day T-Bill Index .....	3.77%	3.32%	3.91%	3.33%
DEX Universe Bond Index .....	6.28%	5.54%	4.71%	6.41%

\* 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 DEX Universe Bond Index is a broad index of Canadian federal government, provincial government and corporate fixed income securities.

The Trust returns do not currently compare favourably to relevant benchmarks as outlined in the above chart. These results are the combination of the leverage employed by the Trust and the unusually poor results delivered by the hedge funds in 2008 due to market dislocation caused by the credit crisis.

## 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 asset value 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, 2008, the management fee expense was \$586,809 and the amount payable by the Trust as at December 31, 2008 was \$108,520.

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. Substantially all of the management fees are applied to the provision of portfolio management and investment advisory services of the Manger and Advisor.

## Net Assets 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 assets 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 assets per unit is calculated and reported monthly. During the year ended December 31, 2008, the reported net asset value fluctuated between a low of \$7.40 per unit and a high of \$11.61 per unit (year ended December 31, 2007: low of \$11.76 and a high of \$14.68), 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, 2008, the daily closing price of the units fluctuated between \$4.50 and \$11.55 (year ended December 31, 2007: low of \$9.58 and high of \$14.30).

## Distributions

During the year ended December 31, 2008, the Trust made distributions totaling \$0.85 per unit (\$3,694,732 was distributed in aggregate) compared to \$2.87 per unit (\$13,270,597 in aggregate during the year ended December 31, 2007).

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 of the Trust 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 presents the distributions of the Trust for the year ended December 31, 2008

### Distribution History

<u>Record date</u>	<u>Date distribution paid</u>	<u>Character of distribution for tax purposes</u>	<u>Amount per unit</u>
March 31, 2008 .....	April 28, 2008	Return of Capital	\$0.24
June 30, 2008 .....	July 29, 2008	Return of Capital	\$0.23
September 30, 2008 .....	Oct 29, 2008	Return of Capital	\$0.22
December 31, 2008 .....	Jan 29, 2009	Return of Capital	\$0.16

### 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 reported net asset value per unit as at the close of business on the preceding valuation date.

On August 24, 2007, 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 467,051 of the units of the Trust during the period from August 30, 2007 to August 29, 2008, representing 10% of the public float of the Trust then outstanding. In August of 2008 the Trust filed a notice of intention to make normal-course purchases of units with the Toronto Stock Exchange. In its filing with the Exchange, the Trust indicated an intention to purchase up to 428,607 of the units of the Trust, representing 10% of the public float of the Trust then outstanding during the period from September 11, 2008 to September 10, 2009. 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, 2008, the Trust purchased 398,500 units for total proceeds of \$3,892,171 (year ended December 31, 2007: 209,700 units for \$2,701,827) for cancellation under this program. During the year ended December 31, 2008, this program contributed 0.90% to the overall return (year ended December 31, 2007: 0.36% contribution to overall return).

## Potential Tax implication of Wind-Up

The Manager anticipates commencing special cash distributions (“Termination Distributions”) to investors effective as of June 30, 2009. Upon the commencement of the payment of Termination Distributions from the Trust, the percentage of a particular illiquid holding in relation to the Trust’s assets is likely to exceed the 10% concentration limits required in order for the Trust to continue to qualify as a unit trust for Canadian income tax purposes.

If and when the Trust fails to qualify as a unit trust it will no longer qualify as a mutual fund trust for Canadian income tax purposes and the Trust will no longer be a “qualified investment” for registered accounts, including without limitation, RRIF’s, RRSP’s and RESP’s. The Manager anticipates that the Trust will lose its “qualified investment” status for Canadian income tax purposes on or about June 30, 2009. Investors are advised to speak with their advisors as soon as possible to obtain tax advice regarding the anticipated failure of the Trust to maintain its “qualified investment” status.

## NORTHWATER MARKET-NEUTRAL TRUST

### INDEPENDENT REVIEW COMMITTEE REPORT

Dear Investor:

Effective November 1, 2007, the advisory board (the “Advisory Board”) of Northwater Market-Neutral Trust (the “Trust”) was designated as the independent review committee of the Trust (the “IRC”) pursuant to the provisions of *National Instrument 81-107, Independent Review Committee for Investment Funds*.

This report is the IRC’s second annual report to unitholders of the Trust under the requirements of National Instrument 81-107. However, the Advisory Board has reported annually to unitholders since March 10, 2006.

Our role as required by securities regulators is to review investment fund conflict of interest matters identified and referred to us by Northwater Fund Management Inc. (the “Manager”) and to give our approval or recommendation with respect to such matters. The focus of our review of such conflict of interest matters is whether or not the Manager’s proposed action achieves a fair and reasonable result for the Trust.

At least once per year, we will also review the Manager’s policies and procedures relating to conflict of interest matters and will assess the adequacy and effectiveness of such policies and procedures in respect of the Trust.

In addition to the regulatory requirements for independent fund governance, we are also retaining our role as an advisory board and, as such, assisting the Manager on other issues relating to the management and operation of the Trust.

As previously disclosed by the Trust, the Trust is scheduled to terminate effective as of December 31, 2009. We will be working with the Manager throughout the scheduled termination of the Trust in accordance with the terms of our mandate.

In addition, we wanted to take this opportunity to advise unitholders that effective as of March 31, 2009, Jeff Francoz has had to resign his position as chair of the independent review committee. Mr. Francoz’ employment relationship has recently changed and his new employer has an internal policy against sitting on boards such as the independent review committee. The remaining members of the independent review committee wish to thank Mr. Francoz for his contribution and will continue to fulfill their mandate under NI 81-107 as they work with the Manager to seek a replacement.

We look forward to continuing our open and effective relationship with the Manager for the benefit of the Trust.

Regards,



Jeffrey D. Francoz  
Chair of the Independent Review Committee

<u>Members of the Independent Review Committee</u>		<u>Length of Service on Advisory Board/IRC</u>
<u>Name</u>	<u>Residence</u>	<u>First Appointed<sup>(1)</sup></u>
Jeffrey D. Francoz ..... Chair of the IRC	Toronto, Ontario	March 10, 2006 <sup>(2)</sup>
Ann Marshall .....	Toronto, Ontario	March 10, 2006 <sup>(2)</sup>
Peter Vesely .....	Toronto, Ontario	November 1, 2007

\* There were no changes in the composition of the IRC during the period.

\* Ann Marshall also serves as an independent review committee member for iShares funds managed by Barclays Global Investors Canada Limited. Jeffrey Francoz and Peter Vesely do not currently serve as independent review committee members for other investment funds other than those managed by the Manager.

## Holdings of Securities

### (a) The Trust

As at December 31, 2008, the percentage of units of the Trust beneficially owned, directly or indirectly, in aggregate, by all members of the IRC did not exceed 10%.

### (b) The Manager

As at December 31, 2008, no member of the IRC beneficially owned, directly or indirectly, any class or series of voting or equity securities of the Manager.

### (c) Service Providers

As at December 31, 2008, no member of the IRC beneficially owned, directly or indirectly, any class or series of voting or equity securities of a company that provides services to the Trust or the Manager that could reasonably result in an actual or perceived loss of independence of the member.

The IRC is pleased to report on its activities for the period ended December 31, 2008.

All of the members of the IRC are non-related and independent of management.

(1) Each member of the IRC listed has been a member of the independent review committee since its inception on November 1, 2007.

(2) Since the inception of the original Advisory Board of the Trust.

## General

During the period ended December 31, 2008, the members of the IRC held four meetings. Mr. Francoz, and Mr. Vesely attended all of the meetings held by the IRC during the period, while Ms. Marshall attended all but one of the meetings.

During the period ended December 31, 2008, the IRC reviewed: (i) the Charter of the IRC, (ii) the reporting to unitholders as required by National Instrument 81-106, (iii) periodic reports on the performance and the composition of the investment portfolio of the Trust, (iv) compliance with Investment Guidelines, (v) the compensation of IRC members to determine whether such compensation continues to be reasonable, (vi) the presentation of certain information in the quarterly and annual reports, and (vii) the standing instructions issued to the Manager in respect of conflict of interest matters under National Instrument 81-107. In addition, the IRC reviewed the various policies and procedures of the Manager related to conflict of interest matters to determine their adequacy and effectiveness.

The IRC 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 IRC in order to properly execute their responsibilities.

## Compensation and Indemnities

The aggregate compensation paid by the Trust to the IRC for the twelve-month period through December 31, 2008 was \$21,620.44.

No indemnities were paid to the IRC during the period.

The initial compensation of the IRC was set by the Manager. At least annually, the IRC will review their compensation giving consideration to the following:

1. the best interests of the Trust;
2. that compensation paid to the IRC by the Trust should fairly and reasonably reflect the general and specific benefits accruing to the Trust;
3. the recommendation of the Manager;
4. the nature and complexity of the Trusts business; and
5. the nature and extent of the workload of each member of the IRC.

## Conflict of Interest Matters

No Conflict of Interest Matters were referred to the IRC during the period. The IRC is not aware of any instance in which the Manager acted in a conflict of interest matter referred to the IRC for which the IRC did not give a positive recommendation.

Furthermore, the IRC is not aware of any instance in which the Manager acted in a conflict of interest matter but did not meet a condition imposed by the IRC in its recommendation or approval.

The Manager relied on the following standing instructions of the IRC in the period. In each case, the standing instructions required the Manager to comply with its related policy and procedures and to report periodically to the IRC.

### *Standing Instructions*

1. allowing transfers between the Trust and other entities advised by the Manager, provided that all such transfers will exclusively involve hedge fund investments transferred at an independently determined net asset value and must be consistent with the investment guidelines of the transferee; and
2. allowing the Manager and its affiliates to act in various capacities with respect to other entities, including without limitation in such capacities as manager, investment advisor, administrator or trustee, provided that the Manager and its affiliates shall in all cases act in accordance with its Procedures for Minimizing Potential Conflicts of Interest and its Code of Ethics.

The Manager also received positive recommendations and standing instructions with respect to the conflict of interest matters addressed by the following policies. In each case, the standing instructions required the Manager to comply with its related policies and procedures and to periodically report to the IRC.

### *Policies that address conflicts of interest matters*

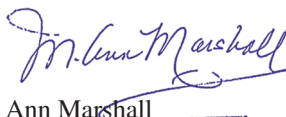
1. Statement of Policies Respecting Related and Connected Issuers and Procedures for Minimizing Potential Conflicts of Interest
2. Code of Ethics
3. Allocation of Trades Procedures

4. Selection of Brokers, Best Execution and Soft Dollar Procedures
5. Consistency of Client Portfolio with Client Investment Objectives
6. Personal Securities Transactions Policy
7. Insider Trading Policy
8. Cross Trading Procedures

We look forward to continuing to discharge our duties in 2009 for the benefit of the Trust.



Jeffrey D. Francoz  
Chair of the IRC



Ann Marshall



Peter Vesely

### 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.



PAUL ROBSON, CFA  
President and Chief  
Operating Officer



EVE N. JĘDRZEJSKA, CA, CFA  
Vice-President and Chief  
Compliance Officer

March 23, 2008

## 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, 2008, the statements of net assets as at December 31, 2008 and 2007 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 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, 2008 and 2007 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,  
Licensed Public Accountants  
March 23, 2009

## NORTHWATER MARKET-NEUTRAL TRUST

## Statements of Net Assets

	As at December 31, 2008	As at December 31, 2007
<b>Assets</b>		
Cash and short-term investments (cost: 2008 – \$11,440,374; 2007 – \$15,180,903) . . . . .	\$ 10,144,376	\$ 15,066,362
Short-term investments held as margin deposited on futures contracts – at market value (note 5) (cost: 2008 – \$1,295,723; 2007 – \$1,602,674) . . . . .	1,297,647	1,573,183
Hedge fund investments – at fair value (note 4) (cost: 2008 – \$29,740,622; 2007 – \$59,431,262) . . . . .	26,844,541	63,502,617
Prepaid interest on loans . . . . .	4,373	—
Settlement receivable on currency futures . . . . .	270,639	—
Hedge fund redemptions receivable (note 3) . . . . .	1,322,384	485,630
Other . . . . .	—	7,664
	<u>39,883,960</u>	<u>80,635,456</u>
<b>Liabilities</b>		
Audit, legal and custody fees payable . . . . .	73,742	43,167
Management fees payable (note 8) . . . . .	108,520	199,571
Interest and standby fees payable . . . . .	1,964	28,724
Settlement payable on currency futures (note 5) . . . . .	—	603,183
Distribution payable . . . . .	667,906	9,145,830
Bank loan (note 6) . . . . .	6,981,592	12,578,644
Hedge fund investment sale in advance . . . . .	1,144,272	4,258,720
	<u>8,977,996</u>	<u>26,857,839</u>
<b>Net assets</b> . . . . .	<u>\$ 30,905,964</u>	<u>\$ 53,777,617</u>
<b>Net assets and unitholders' equity (note 7)</b>		
Unit capital . . . . .	91,014,866	98,502,805
Contributed surplus . . . . .	17,852,138	14,256,371
Deficit . . . . .	(77,961,040)	(58,981,559)
	<u>\$ 30,905,964</u>	<u>\$ 53,777,617</u>
<b>Number of units outstanding (note 7)</b> . . . . .	<u>4,174,415</u>	<u>4,572,915</u>
<b>Net assets per unit</b> . . . . .	<u>\$ 7.40</u>	<u>\$ 11.76</u>

Signed on behalf of the Trustee,  
RBC Dexia Investor Services Trust

Per: 

Per: 

## NORTHWATER MARKET-NEUTRAL TRUST

## Statements of Operations

	For the year ended December 31,	
	2008	2007
<b>Investment income</b>		
Interest income	\$ 183,370	\$ 247,799
Other income	1,581	1,824
	<u>184,951</u>	<u>249,623</u>
<b>Expenses</b>		
Management fees (note 8)	\$ 586,809	\$ 875,781
Audit fees	85,550	70,886
Independent review committee fees	21,620	15,283
Custodian fees	11,349	13,590
Legal fees	55,795	—
Security holder reporting costs	92,696	84,239
Interest and standby fees (note 6)	318,505	858,494
Transaction costs	13,454	22,755
	<u>1,185,778</u>	<u>1,941,028</u>
<b>Net investment loss</b>	<u>(1,000,827)</u>	<u>(1,691,405)</u>
<b>Realized and unrealized gain (loss) on investments</b>		
Net realized gain (loss) on:		
Hedge fund investments	\$ 9,205,521	\$ 622,265
Currency futures (note 5)	(10,111,401)	11,308,531
Change in unrealized appreciation (depreciation) on:		
Hedge fund investments	(6,967,436)	(9,056,966)
Currency futures (note 5)	873,822	(335,304)
Net gain (loss) on currency, excluding hedge fund investments	<u>(7,284,430)</u>	<u>1,251,965</u>
<b>Net realized and unrealized gain (loss) on investments for the year</b>	<u>(14,283,924)</u>	<u>3,790,491</u>
<b>Increase (decrease) in net assets from operations for the year</b>	<u>\$(15,284,751)</u>	<u>\$ 2,099,086</u>
<b>Increase (decrease) in net assets from operations per unit for the year*</b>	<u>\$ (3.51)</u>	<u>\$ 0.45</u>

\* Based on the average number of units outstanding of 4,350,669 (2007 – 4,715,269) for the year.

## NORTHWATER MARKET-NEUTRAL TRUST

## Statements of Changes in Net Assets

	For the year ended December 31,	
	2008	2007
<b>Net assets – beginning of the year</b> .....	\$ 53,777,617	\$ 67,650,955
<b>Increase (decrease) in net assets from operations for the year</b> .....	(15,284,751)	2,099,086
<b>Unit transactions (note 7)</b>		
Issuance (cancellation) of units .....	(3,892,170)	(2,701,827)
	(3,892,170)	(2,701,827)
<b>Distribution to unitholders (note 9)</b>		
Return of capital .....	(3,694,732)	(5,386,622)
From net income .....	—	(7,883,975)
	(3,694,732)	(13,270,597)
<b>Net assets – end of the year</b> .....	<u>\$ 30,905,964</u>	<u>\$ 53,777,617</u>

## NORTHWATER MARKET-NEUTRAL TRUST

## Statements of Cash Flows

	For the year ended December 31,	
	2008	2007
<b>Cash flows from operating activities</b>		
Increase (decrease) in net assets from operations . . . . .	\$(15,284,751)	\$ 2,099,086
Items not affecting cash:		
Change in unrealized (appreciation) depreciation in value of hedge fund investments . . . . .	6,967,436	9,056,966
Change in unrealized depreciation (appreciation) in value of currency futures . . . . .	(873,822)	335,304
Net realized (gain) loss on hedge fund investments . . . . .	(9,205,521)	(622,265)
Changes in non-cash working capital:		
Change in payables and other assets . . . . .	(79,572)	(45,293)
Purchase of hedge fund investments . . . . .	(4,725,414)	(3,986,845)
Proceeds on sale of hedge fund investments . . . . .	39,666,001	18,693,064
Change in cash pledged as collateral on futures contracts . . . . .	275,536	(418,172)
	<u>16,739,893</u>	<u>25,111,845</u>
<b>Cash flows from financing activities</b>		
Repayment of bank loan . . . . .	(5,597,052)	(3,710,776)
Distributions paid . . . . .	(12,172,656)	(5,463,899)
Repurchase of units . . . . .	(3,892,171)	(2,701,827)
	<u>(21,661,879)</u>	<u>(11,876,502)</u>
Net increase (decrease) in cash and short-term investments . . . . .	(4,921,986)	(13,235,343)
Cash and short-term investments at the beginning of the year . . . . .	15,066,362	1,831,019
<b>Cash and short-term investments at the end of the year . . . . .</b>	<u>\$ 10,144,376</u>	<u>\$ 15,066,362</u>
Supplementary information:		
Interest paid . . . . .	\$ 308,298	\$ 830,914

## NORTHWATER MARKET-NEUTRAL TRUST

Statement of Investment Portfolio

As at December 31, 2008

	Credit Rating	Maturity date	Face value	Cost	Fair Value	Fair Value as a % of Net Assets
<b>Hedge Fund Investments*</b>						
Activist investments . . . .				\$ 1,486,652	\$ 1,351,261	4.37%
Asset-backed securities arbitrage . . . . .				3,566,140	5,790,168	18.74%
Distressed securities arbitrage . . . . .				1,012,154	2,869,829	9.29%
Fixed-income arbitrage . . . . .				2,575,264	1,402,414	4.54%
Mortgage-backed security arbitrage . . . . .				3,949,623	3,313,957	10.72%
Multi-strategy . . . . .				5,801,084	4,236,603	13.71%
Re-insurance arbitrage . . .				544,635	1,048,106	3.39%
Structured finance . . . . .				6,049,991	3,048,779	9.86%
Statistical arbitrage . . . .				4,755,079	3,783,424	12.24%
<b>Hedge Fund Investments</b> . . . . .				<u>\$29,740,622</u>	<u>26,844,541</u>	<u>86.85%</u>
<b>Cash</b> . . . . .				\$ 1,190,740	\$ 1,190,740	3.85%
<b>Treasury Bills **</b>						
Government of Canada . . . . .		January 5, 2009	\$3,000,000	\$ 3,641,664	3,641,591	11.78%
Government of Canada . . . . .		January 30, 2009	1,200,000	1,456,622	1,456,432	4.71%
Government of Canada (note 5) . . . . .		March 19, 2009	1,300,000	1,295,723	1,297,647	4.20%
Province of Ontario . . . . .		March 5, 2009	400,000	485,303	485,249	1.57%
<b>Banker's Acceptances ***</b>						
Bank of Montreal . . . . . R-1 (High)		January 2, 2009	800,000	971,101	971,091	3.14%
Royal Bank of Canada . . . . R-1 (High)		January 2, 2009	700,000	700,000	700,000	2.26%
Canadian Imperial Bank of Commerce . . . . . R-1 (High)		January 8, 2009	1,400,000	1,699,222	1,699,273	5.50%
<b>Cash and Short-Term Investments</b> . . . . .				<u>11,440,374</u>	<u>11,442,023</u>	<u>37.02%</u>
<b>Total Investment Portfolio</b> . . . . .				<u>\$41,180,996</u>	<u>\$38,286,564</u>	<u>123.88%</u>
<b>Other Net Assets</b> . . . . .					<u>7,380,600</u>	<u>23.88%</u>
<b>Total net assets and unitholders' equity</b> . . . . .					<u>\$30,905,964</u>	<u>100.00%</u>

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

\*\* Short-term investments held at December 31, 2008 have yields ranging from 0.20% to 1.50%.

\*\*\* Credit ratings as at December 31, 2008 as per DBRS rating agency.

**Schedule 1—Currency futures contracts:**

	<u>Bid Price</u>	<u>Notional contract value</u>	<u>Settlement receivable (payable) on futures contracts</u>
343 Canadian Dollar Futures Contract—March 2009 . . . . .	<u>\$82.24</u>	<u>\$ 28,208,320 USD</u> <u>\$34,242,680 CAD</u>	<u>\$270,639 CAD</u>

## NORTHWATER MARKET-NEUTRAL TRUST

Notes to Financial Statements

For the year ended December 31, 2008 and 2007

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### 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 retained Northwater Fund Management Inc., then known as Newcastle Fund Management Inc., (the “Manager”) under a management agreement dated July 18, 1997. 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 has begun the process of winding up its operations and is scheduled to terminate on or about December 31, 2009, (the “Termination Date”). Based on the information available to the Manager as of December 31, 2008, the Manager anticipates that approximately 41% of the Trust may be subject to restrictions on liquidity that extend beyond the Termination Date. The Manager anticipates that net assets will begin to be distributed pro-rata to unitholders around June 30, 2009. Based on the current market conditions the Manager anticipates that it is likely that the Trust will continue to operate and wind down its portfolio beyond the scheduled Termination Date.

Throughout the year the assets of the Trust were invested in cash and short-term investments, a diversified portfolio of market-neutral hedge funds and currency futures contracts.

### 2. Summary of Significant Accounting Policies

These financial statements are prepared in accordance with Canadian generally accepted accounting principles (“GAAP”).

#### Adoption of New Accounting Standards

In December 2006, the Accounting Standards Board issued CICA Handbook Section 3862 “Financial Instruments – Disclosures” (“Section. 3862”) and Section 3863, “Financial Instruments – Presentation” (“S. 3863”), which provide comprehensive disclosure and presentation requirements for financial instruments.

In addition, in December 2006, the Accounting Standards Board issued CICA Handbook Section 1535 “Capital Disclosures” (“S.1535”), which provides standards for disclosing information about an entity’s capital and how it is managed.

The requirements of S. 3862, S.3863 and S.1535 are effective for annual financial statements relating to fiscal years beginning on or after October 1, 2007 and have been reflected in the notes to the financial statements.

The following paragraphs outline the accounting policies of the Trust.

**(a) Cash and short-term investments**

Cash and short-term investments including short-term investments held as margin consist of cash in interest bearing accounts at RBC Dexia, cash held with the futures broker and short-term investments with maturities generally 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.

**(b) Investments in market-neutral hedge funds**

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

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 reported net asset values based on preliminary returns reported by the administrators or the portfolio managers of such funds. In determining the definitive or provisional reported net asset values, certain hedge funds may be required to make estimates and assumptions that affect the reported net asset values. The Manager may, in its sole discretion, use a different valuation methodology to price the underlying hedge funds, that in the opinion of the Manager, is more reflective of fair value. 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.

### (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 mark-to-market 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 bid 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) 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 year. 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.

### (e) 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.

### (f) Transaction Costs

Transaction costs are expensed and are included in the Statement of Operations. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of an investment.

### 3. Financial Instrument Risk

The Trust's investment activities may expose it to a variety of financial risks including market price risk, liquidity risk, currency risk, interest rate risk, and credit risk. The following provides an overview of these risks and describes actions taken by the Trust in an effort to mitigate the potential adverse impact of these risks on the performance of the Trust.

No material changes affecting the overall risk of investing in the Trust were made by the Manager in the year ended December 31, 2008. However, the hedge fund industry, like other market participants, has been subject to unprecedented turmoil in the markets due to the ongoing credit crisis. This has had both an impact on the returns and the volatility the Trust has experienced in 2008. In addition, as the Trust goes through the wind up process its exposure to hedge funds will continuously change and the diversification of its hedge fund holdings will decrease, causing concentration risk to increase. Hence, the overall risk profile of the Trust has been impacted as discussed below.

#### Market price risk

Market price risk is the risk that the future value of a financial instrument will fluctuate as a result of changes in its market price, whether caused by factors specific to the individual investment, its issuer, or any other market factor that may affect its price.

The Trust invests its assets primarily in a portfolio of privately offered market-neutral hedge funds. The hedge funds are priced in the Trust's portfolio based on net asset values and monthly returns reported by administrators and managers of such funds. No published market exists for the hedge funds held by the Trust. The process of fair valuing these hedge funds is based upon the fair value of the underlying holdings of each hedge fund. These values may differ from values available had a ready market existed for such hedge funds and may differ from the prices at which such hedge funds may be sold.

The Investment Advisor of the Trust attempts to mitigate market price risk by investing in a diversified portfolio of hedge funds whose returns exhibit low correlation to the markets and each other. In addition, the Investment Advisor monitors the investments on a regular basis in order to ensure the decision to invest in a particular hedge fund strategy continues to be suitable for the Trust's portfolio, including performing ongoing qualitative and quantitative assessments and comprehensive investment and operational due diligence. Special attention is paid to organizational changes made by the hedge fund managers and to changes in policy

relative to their investment objectives, valuation, hedging strategy, degree of diversification, leverage and costs.

The impact on net assets of the Trust, based on a change in the strategy's returns, as approximated by that strategy's standard deviation, as at December 31, 2008, is included in the following table.

<b>Strategy</b>	<b>Potential change</b>	<b>Impact on net assets</b>
	<b>in strategy return</b>	<b>(\$)</b>
	<b>*(% )</b>	
Activist Investment . . . . .	16.72%	186,164
Asset-backed securities arbitrage . . . . .	4.93%	235,537
Distressed securities arbitrage . . . . .	10.38%	245,491
Fixed-income arbitrage . . . . .	28.19%	325,719
Mortgage-backed security arbitrage . . . . .	12.94%	353,309
Multi-strategy . . . . .	17.23%	601,476
Re-insurance arbitrage . . . . .	4.46%	38,551
Structured finance . . . . .	30.09%	755,729
Statistical arbitrage . . . . .	14.44%	449,949

\* Potential change in strategy return is based on standard deviation for each strategy as measured over the past 24 months for hedge funds in the hedge fund portfolio as at December 31, 2008.

## Liquidity risk

Liquidity risk is the risk that the Trust will encounter difficulty in meeting its obligations associated with its financial liabilities. The financial liabilities of the Trust may consist of loans, distributions, settlement of futures contracts, obligations due to market support requirements and fees to service providers.

The Trust investments primarily consist of privately offered hedge funds for which there is no active secondary market. As such the investments may be considered illiquid. The Trust is subject to redemption restrictions for each of the hedge funds forming part of its portfolio that are generally monthly, quarterly, semi-annually or annually. Notice periods for redemptions range from 30 days notice to 180 days. Redemptions may, in some cases, be subject to lock-up periods, gates, suspensions and side pocket restrictions.

To assist the Trust in its ability to meet its ongoing financial obligations, a credit facility is available to provide liquidity within certain restrictions.

To mitigate liquidity risk, the hedge fund portfolio has been diversified across different managers and strategies. However, due to the ongoing credit crisis, many of the trading strategies employed by hedge funds,

which depend on functional financial markets, including the ability of managers to enter into short positions, have suffered losses not only due to market movements, but also due to liquidity constraints. Certain of the managers have been unable to sell assets to prevent additional losses or fund investor redemptions. Continuing illiquidity has caused numerous underlying hedge funds held by the Trust to invoke various restrictions on redemptions including, without limitation restricting redemptions to a limited percentage of the aggregate net asset value of such underlying hedge funds (invoking gates), the temporary suspension of redemptions altogether, or the commencement of a controlled liquidation and wind-up of the underlying hedge funds' business.

The Investment Advisor has been managing the Trust's portfolio taking into account the Trust's Termination Date. As such, as of December 31, 2008 the Manager submitted redemption requests to all of the underlying hedge funds.

The value of total redemption requests made prior to December 31, 2008, for hedge funds held as equity as at December 31, 2008 broken out by effective date of redemption, are included in the table below:

<u>Effective Date of redemption</u>	<u>Amount (\$) as at December 31, 2008</u>	<u>% of total hedge fund held</u>	<u>Amount (\$) received subsequent to year end</u>
January 1, 2008 .....	1,706,207	6%	128,365
April 1 2008 .....	721,571	3%	102,737
July 1, 2008 .....	2,643,143	10%	324,517
August 1,2008 .....	365,301	1%	222,861
October 1, 2008 .....	518,406	2%	61,254
January 1, 2009 .....	17,167,815	64%	8,447,921 <sup>(1)</sup>
June 1, 2009 .....	2,248,401	8%	—
July 1, 2009 .....	1,029,262	4%	—
January 1, 2010 .....	444,435	2%	74,072
	<u>26,844,541</u>	<u>100%</u>	<u>9,361,727</u>

- (1) For one of the hedge funds, the Fund received the redemption proceeds prior to the effective date of redemption. This amount is included here and is disclosed in the Statement of Net Assets as hedge fund investment sales in advance. The amount is \$1,144,272.

The following table shows the expected payout timeline of redemption proceeds from the underlying hedge fund managers:

**Payments of redemptions expected in 2009, classified by status of the funds being redeemed from:**

	<u>Amount (\$)</u>	<u>% of total hedge fund portfolio</u>
Restricted redemptions <sup>(1, 2)</sup> .....	3,928,478	15%
Liquidating .....	1,961,069	7%
Normal Course .....	8,688,618	32%
	<u>14,578,165</u>	<u>54%</u>

**Payments of redemptions expected beyond 2009, classified by status of the funds being redeemed from:**

	<u>Amount (\$)</u>	<u>% of total hedge fund portfolio</u>
Restricted redemptions <sup>(1)</sup> .....	8,177,833	30%
Liquidating .....	4,088,543	16%
	<u>12,266,376</u>	<u>46%</u>

- (1) Restricted redemptions category includes situations where the manager has placed some form of restriction on the redemption request, including suspending redemptions, enforcing gates on redemption or restructuring the fund, to for example, create a liquidating share class.
- (2) Although these redemptions are currently restricted, the Manager anticipates that the redemption proceeds will still be received during 2009.

The receipt of redemption proceeds by the trust could extend beyond the scheduled Termination Date and hence impact the ultimate distribution of the assets to unitholders.

The Trust has hedge fund redemption receivables outstanding of \$1,322,384 as at December 31, 2008. The Trust is exposed to liquidity risk as these amounts may not be realized (collected) for an extended period of time. As at December 31, 2008 the hedge fund redemptions receivable aging was as follows:

	<u>&lt; 60 days</u>	<u>61-90 days</u>	<u>91 -120 days</u>	<u>&gt; 120 days</u>	<u>Total</u>
Hedge Fund Redemptions Receivable . . . .	\$137,251	—	\$201,274	\$983,859	\$1,322,384

The Investment Advisor is in regular contact with hedge fund administrators to determine timing of receipt of remaining redemptions. Most of the receivables outstanding as at year end fall into two categories: audit holdbacks, which represent a small percentage of redemptions being withheld by the hedge fund managers on full redemptions pending completion of the audit; and liquidation, which primarily represent underlying of hedge fund positions in assets that are being liquidated.

The below table shows hedge fund redemptions receivable as at December 31, 2008 broken down by type.

<u>Type</u>	<u>Amount (\$)</u>
Audit Holdbacks .....	714,797
Liquidations .....	607,587
	<u>1,322,384</u>

### Credit risk

The Trust invests in debt obligations of both government and corporate issuers in addition to its hedge fund investments. These financial instruments involve the risk that the counterparty cannot or will not fulfill its obligations in respect of such financial instruments.

The Trust also assumes credit risk to its financial counterparties in connection with derivatives, loans and cash. In evaluating credit risk, the Manager will often be dependent upon information provided by the counterparty or a rating agency which may be materially inaccurate. As at December 31, 2008, the credit rating of the counterparty was as follows:

<u>Counterparty to:</u>	<u>Credit Rating *</u>
Cash at custodian .....	AA-
Cash at broker .....	A+
Credit facilities .....	AA-

\* credit ratings as per Standard and Poor's rating agency.

For all debt securities purchased the debt issuer must have a credit rating of R-1 Mid or higher as per DBRS. For a listing of all current ratings by debt issuer see the Statement of Investment Portfolio.

Certain of the hedge funds invest in various debt securities and as such are exposed to movements in credit markets in many cases hedge fund managers mitigate their risk to overall credit market changes through various hedging techniques.

In addition credit risk on hedge fund investments is mitigated through an extensive due diligence process which focuses on monitoring each hedge fund investment in order to ensure the decision to invest in a particular hedge fund strategy continues to be suitable for the Trust's portfolio.

### Currency risk

Currency risk arises from the Trust holding financial instruments denominated in a currency other than Canadian dollars, which is the Trust's functional currency.

As the Trust invests in hedge fund investments that are primarily denominated in U.S. dollars, the value of such investments may fluctuate with the exchange rate. To manage its currency risk, the Trust attempts to hedge such currency fluctuations through the use of currency futures.

As at December 31, 2008, the impact on net assets per 1% change in the Canadian dollar would have been \$ 15,422.

### Interest rate risk

Interest rate risk is the risk that a change in interest rates will adversely affect the fair value of fixed income securities or cause fluctuations in future cash flows of a financial instrument. The financial instruments which potentially expose the Trust to interest rate risk are short-term fixed income securities and the bank loan. Effective duration, a commonly used measure of interest rate risk, incorporates a security's yield, coupon, final maturity, call features and other embedded options into one number expressed in years that indicates how price sensitive a security is to changes in interest rates. The effective duration of a security indicates the approximate change in fair value expected for a 1% change in interest rates. The longer the duration, the more sensitive the security is to changes in interest rates. The Trust has minimal sensitivity to changes in interest rates since fixed-income securities are usually held to maturity and are short-term in nature.

As at December 31, 2008, assuming that the yield curve shifts in a parallel move and the bank loan balance remains at the December 31, 2008 level until June 30, 2009, if the interest rates are increased/decreased by 1%, the impact on the Trust's net assets would be \$34,908.

#### 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. In anticipation of its scheduled Termination Date, the Trust began the redemption process from the underlying hedge funds towards the end of 2008.

The market-neutral hedge funds included in the Trust's portfolio are organized and domiciled in non-U.S. jurisdictions consisting primarily of the Cayman Islands, Bermuda and the British Virgin Islands. 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 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 generally from 30 days' notice to 180 days' notice and may be subject to lock-up and gating provisions.

The Manager of the Trust may from time to time, in very limited circumstances, affect the purchase or sale of certain hedge funds to other investment vehicles advised by Northwater Capital Management Inc. These transactions are executed at the monthly net asset value as reported by the hedge fund.

During the year one of the hedge funds that the Trust was invested in was a victim of fraud and has since declared bankruptcy. As at December 31, 2008, the value of this holding is reflected at zero resulting in a loss of \$2,047,337.

The following table shows the hedge fund holdings by strategy as at December 31, 2008 and December 31, 2007. The multi-strategy funds have not been allocated to any of the underlying hedge fund strategies set out in this table.

Strategy	As at December 31, 2008			As at December 31, 2007		
	No. of Hedge Funds	Fair Value		No. of Hedge Funds	Fair Value	
Activist investments . . . . .	1	\$ 1,351,261	5%	1	\$ 1,705,001	3%
Asset-backed securities arbitrage . . . . .	3	5,790,168	22%	4	8,164,189	13%
Distressed securities arbitrage . . . . .	2	2,869,818	11%	6	10,299,791	16%
Fixed-income arbitrage . . . . .	3	1,402,414	5%	3	3,459,306	5%
Mortgage-backed security arbitrage . . . . .	3	3,313,968	12%	4	8,043,885	12%
Multi-strategy . . . . .	4	4,236,603	16%	6	12,128,061	19%
Re-insurance arbitrage . . . . .	2	1,048,106	4%	2	3,060,925	5%
Statistical arbitrage . . . . .	3	3,783,424	14%	5	7,371,132	12%
Structured finance . . . . .	4	3,048,779	11%	6	9,270,327	15%
	<u>25</u>	<u>\$26,844,541</u>	<u>100%</u>	<u>37</u>	<u>\$63,502,617</u>	<u>100%</u>

The following table shows the hedge funds held by the Trust as at December 31, 2008 and 2007 categorized by the size of each hedge fund.

Total Assets of each hedge fund in U.S.\$ Millions	2008	2007
< 100 . . . . .	4	0
100-250 . . . . .	2	2
250-500 . . . . .	5	0
500-750 . . . . .	1	3
750-1000 . . . . .	1	1
> 1000 . . . . .	12	31
	<u>25</u>	<u>37</u>

The following table shows the number of hedge funds held by the Trust as at December 31, 2008 and 2007 categorized by the years since inception of each hedge fund.

<u>Years</u>	<u>2008</u>	<u>2007</u>
< 3 .....	1	4
3 – 6 .....	8	14
6 – 9 .....	9	11
9 – 12 .....	3	3
12 – 15 .....	2	3
> 15 .....	<u>2</u>	<u>2</u>
	<u>25</u>	<u>37</u>

The following chart illustrates the number of hedge funds held by the Trust by jurisdiction of organization as at December 31, 2008 and 2007.

<u>Location</u>	<u>2008</u>	<u>2007</u>
Cayman Islands .....	23	37
British Virgin Islands .....	1	2
Bermuda .....	<u>1</u>	<u>1</u>
	<u>25</u>	<u>40</u>

## 5. 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, 2008, short-term investments with a face value of U.S.\$1,000,000 (2007: U.S.\$1,600,000) were deposited as initial margin for currency futures contracts. As at December 31, 2008, the initial margin requirement for the futures contracts was U.S.\$1,131,900 (2007 – U.S.\$1,386,900) The initial margin deficit as at December 31, 2008 was a result of mark-to-market movements and was corrected the following day.

## 6. 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 reported 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 reported 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 year end were denominated in U.S. dollars and Canadian dollars.

Throughout the year ended December 31, 2008, the bank loan fluctuated between \$3,356,096 and \$12,752,641 (year ended December 31, 2007 the loan varied between: \$12,578,644 and \$13,843,299 throughout the period). The average rate of interest paid on the loan for the year was 4.04%.

## 7. Unitholders’ Equity

The authorized capital of the Trust consists of an unlimited number of non-redeemable units and was derived from the initial public offering. The capital is managed in accordance with the Trust’s investment objectives and is not subject to any external capital requirements. The Trust is a closed end vehicle and as such redemptions are not permitted. Unitholders may trade their units on the exchange. 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.

In August 2007, 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 467,051 of the units of the Trust during the period from August 30, 2007 to August 29, 2008, representing 10% of the public float of the Trust then outstanding. In August of 2008, the Trust filed a notice of intention to make normal-course purchases of units with the Toronto Stock Exchange. In its filing with the Exchange, the Trust indicated an intention to purchase

up to 428,607 of the units of the Trust, representing 10% of the public float of the Trust then outstanding during the period from September 11, 2008 to September 10, 2009. 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 398,500 units for cancellation for cash of \$3,892,171 during the year ended December 31, 2008 (year ended December 31, 2007: 209,700 units were purchased for cash of \$2,701,827).

Pursuant to the distribution reinvestment plan, no units were issued from Treasury during the year ended December 31, 2008 while 17,621 were purchased in the market (year ended December 31, 2007: no units were issued from Treasury and 37,815 units were purchased in the market).

Unitholders' equity is comprised of unit capital and deficit. The following table shows the transactions for unit capital and deficit during the relevant years:

<b>Year ended</b>	<b>Units</b>	<b>Unit</b>	<b>Contributed</b>	<b>Retained</b>	<b>Unitholders'</b>
<b>December 31, 2008</b>	<b>Outstanding</b>	<b>Capital</b>	<b>Surplus</b>	<b>Earnings (Deficit)</b>	<b>Equity</b>
<b>Balance –</b>					
<b>December 31, 2007</b> ..	4,572,915	\$98,502,805	\$14,256,371	\$(58,981,559)	\$ 53,777,617
Increase (decrease) in net assets from operations for the year .....				(15,284,751)	(15,284,751)
Units cancelled during the year .....	(398,500)	(7,487,938)	3,595,767	—	(3,892,171)
Distributions .....				(3,694,732)	(3,694,732)
<b>Balance –</b>					
<b>December 31, 2008</b> ..	<u>4,174,415</u>	<u>91,014,867</u>	<u>17,852,138</u>	<u>(77,961,042)</u>	<u>30,905,963</u>

<b>Year ended</b>	<b>Units</b>	<b>Unit</b>	<b>Contributed</b>	<b>Retained</b>	<b>Unitholders'</b>
<b>December 31, 2007</b>	<b>Outstanding</b>	<b>Capital</b>	<b>Surplus</b>	<b>Earnings (Deficit)</b>	<b>Equity</b>
<b>Balance –</b>					
<b>December 31, 2006</b> ..	4,782,615	\$102,443,133	\$13,017,870	(47,810,048)	\$ 67,650,955
Increase (decrease) in net assets from operations for the year .....	—	—	—	2,099,086	2,099,086
Units cancelled during the year .....	(209,700)	(3,940,328)	1,238,501	—	(2,701,827)
Distributions .....	—	—	—	(13,270,597)	(13,270,597)
<b>Balance –</b>					
<b>December 31, 2007</b> ..	<u>4,572,915</u>	<u>\$ 98,502,805</u>	<u>\$14,256,371</u>	<u>\$(58,981,559)</u>	<u>\$ 53,777,617</u>

## 8. 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 asset value 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.

## 9. Distributions

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

During the year ended December 31, 2008, distributions of \$0.85 per unit and \$3,694,732 in aggregate (year ended December 31, 2007: \$2.87 per unit and \$13,270,597 in aggregate) were made by the Trust.

Throughout the year unitholders had the option of receiving distributions in cash, or in the form of additional units by way of the distribution reinvestment plan. No units were issued under this plan during the year.

## 10. Income Taxes

As at December 31, 2008, 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, 2008, the Trust had \$7,017,956 (2007: \$nil) in non-capital loss carryforwards and \$33,652 (2007: \$2,716,191) in gross capital loss carryforwards.

## 11. 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. Historically, no payments have been required to be made under these indemnities and the Trust estimates the current liability at zero.

## 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 fourteen years of experience in fund of hedge funds, Northwater has steadily grown exposure under management to approximately CDN \$7.9 billion total, including \$2.8 billion USD invested in hedge funds as at December 31, 2008. 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, Australia, 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 <sup>Plus</sup>, launched in 2005.

## **NORTHWATER MARKET-NEUTRAL TRUST**

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## **INVESTMENT ADVISOR**

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## **LEGAL ADVISORS**

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## **AUDITORS**

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## **DISTRIBUTION REINVESTMENT PLAN AGENT**

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Toronto, Ontario M5C 2W9  
Answerline: 1-800-387-0825

## **FOR FURTHER INFORMATION PLEASE CONTACT:**

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For most recent reported net asset value update call: 1 (888) 429-8774

TSE Symbol: NMN.UN

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