

**NORTHWATER**

**Northwater Market-Neutral Trust  
March 31, 2006  
Quarterly Portfolio Disclosure and Update**





**CONTENTS**

Message to Unitholders from the Investment Advisor . . . . .	2
Unaudited Statement of Net Assets and Statement of Operations . . . . .	4-5
Unaudited Summary of Investment Portfolio . . . . .	6
Additional Portfolio Information . . . . .	8
Northwater Capital Management Inc. . . . .	12

## 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. For the first quarter of 2006, the return of the Trust was 3.26%. During the same time period, the Scotia Capital Universe Bond Index decreased by 0.43%, the TSX Composite Index rose by 7.98% and the S&P 500 rose by 4.21%. The Trust made distributions of \$0.28 per unit during the quarter.

The U.S. Federal Open Market Committee raised the federal funds rate twice in the first quarter, to 4.75%. Longer term rates in Canada and the U.S. rose as well. The benchmark 10-year U.S. treasury bond rose from 4.40% to 4.85% and the Canadian 10-year bond rose by 0.28% to close at 4.26%.

Broader global equity markets registered strong gains during the second quarter, as investors shrugged off higher energy prices in light of strong economic news and corporate profits. Economic indicators, including GDP and employment were all very strong during the quarter. Real estate prices continued their extraordinary rise, but the rate of price appreciation began to moderate in response to rising interest rates.

Credit markets during the first quarter were largely positive and stable. A flurry of high yield issuance resulting from leveraged buy-out activity was met with equal or greater demand from CDO (Collateralized Debt Obligation) buyers. Corporate balance sheets have been very strong, with high operating cash flows and low capital expenditures driving their conservative stance.

Overall, the Trust’s portfolio of market-neutral hedge funds experienced robust returns in the first quarter. The vast majority of the hedge funds recorded gains for the quarter and these profits were generated in almost every hedge fund strategy.

Convertible bond arbitrage enjoyed a strong quarter because of renewed investor interest and positive cash flows into the sector. Managers engaged in market-neutral equity and statistical arbitrage strategies posted strong results due to favorable equity conditions for their strategies. Distressed securities managers also experienced strong gains in their strategy, as positions in both energy-related distressed holdings and in aircraft holdings were higher during the quarter.

Asset-backed securities were relatively strong for the quarter but conditions are becoming more difficult in asset-backed markets due to tight spreads and a

limited number of distressed asset-backed securities in the market. The performance of the underlying collateral has been very good due to appreciating home prices and low unemployment leading to strong consumer credit performance.

During the first quarter, Northwater continued to actively manage the Trust's portfolio by adding, three new hedge funds while redeeming from three existing funds. Northwater continues to focus on improving the portfolio by refining its stable of managers and focusing on market-neutral strategies that are able to deliver strong risk-adjusted returns consistent with the investment objectives.



DANIEL C. R. MILLS, CFA  
Managing Director and  
Chief Investment Officer,  
Northwater Capital Management Inc.



PETER B. SCHENDEL, CFA  
Vice-President,  
Northwater Capital Management Inc.

May 16, 2006

## NORTHWATER MARKET-NEUTRAL TRUST

Statement of Net Assets  
(in Canadian dollars)

	<b>As at March 31, 2006 (unaudited)</b>
<b>Assets</b>	
Cash and short-term investments (cost: 2005 – \$2,280,932) .....	\$ 2,282,644
Hedge fund investments – at fair value (cost: 2005 – \$71,844,443) .....	79,868,393
Hedge fund redemptions receivable .....	161,945
Short-term investments held as margin deposited on futures contracts – at market value (cost: 2005 – \$923,074) .....	925,719
Prepaid hedge fund subscription .....	5,841,000
	<u>89,079,701</u>
<b>Liabilities</b>	
Audit, legal and custody fees payable .....	51,650
Management fees payable .....	182,080
Interest and standby fees payable .....	71,959
Distribution payable .....	1,413,164
Bank loan .....	15,673,271
Settlement payable on currency futures .....	461,965
Other accounts payable .....	118,966
	<u>17,973,055</u>
<b>Net assets and unitholders' equity</b> .....	<u>\$71,106,646</u>
<b>Number of units outstanding</b> .....	<u>5,047,015</u>
<b>Net asset value per unit</b> .....	<u>\$ 14.09</u>

## NORTHWATER MARKET-NEUTRAL TRUST

Statement of Operations  
(in Canadian dollars)

	<b>For the three-month period ended March 31, 2006 (unaudited)</b>
<b>Investment income</b>	
Interest .....	\$ 103,410
	<u>103,410</u>
<b>Expenses</b>	
Interest and standby fees .....	196,128
Management fees .....	241,484
Audit fees .....	8,025
Directors fees .....	2,537
Custodian fees .....	4,475
Legal fees .....	3,271
Security holder reporting costs .....	30,996
Other fees .....	8,791
	<u>495,707</u>
<b>Net investment loss</b> .....	<u>(392,297)</u>
<b>Realized and unrealized gain (loss) on investments</b>	
Net realized gain (loss) on:	
Hedge fund investments .....	(296,672)
Currency hedging of investments .....	126,328
Change in unrealized appreciation (depreciation) on:	
Hedge fund investments .....	3,661,964
Currency futures .....	(596,397)
Net gain (loss) on currency, excluding hedge fund investments .....	<u>(169,522)</u>
<b>Net realized and unrealized gain on investments for the period</b> ...	<u>2,725,701</u>
<b>Net income from operations for the period</b> .....	<u>\$2,333,404</u>
<b>Net income from operations per unit for the period*</b> .....	<u>\$ 0.46</u>

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

**NORTHWATER MARKET-NEUTRAL TRUST**

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

As at March 31, 2006

(in Canadian dollars)

(unaudited)

The following table presents the asset allocation by investment strategy, the number of hedge funds by investment strategy and the largest individual hedge fund holding for each investment strategy as a percentage of the total net asset value of the Trust as at March 31, 2006. The multi-strategy funds may invest in multiple investment strategies.

<b>Strategy</b>	<b>Asset allocation by hedge fund strategy As at March 31, 2006</b>			<b>Largest individual hedge fund holding for each individual strategy As at March 31, 2006</b>
	<b>No. of Hedge Funds</b>	<b>Fair Value</b>	<b>Percentage</b>	<b>Percentage of Net Assets of the Trust</b>
Activist . . . . .	1	\$ 2,100,457	3%	2.90%
Asset-backed securities arbitrage . . . . .	6	11,853,769	15%	4.30%
Capital structure arbitrage . . . .	2	2,645,448	3%	2.81%
Convertible bond arbitrage . . . .	3	2,571,534	3%	1.83%
Distressed securities . . . . .	7	11,389,093	14%	4.94%
Energy relative value . . . . .	1	474,307	1%	0.65%
Fixed-income arbitrage . . . . .	2	2,449,101	3%	1.84%
Merger arbitrage . . . . .	1	1,219,486	2%	1.68%
Mortgage-backed security arbitrage . . . . .	4	10,803,583	14%	6.39%
Multi-strategy . . . . .	11	18,379,206	23%	4.81%
Re-insurance . . . . .	2	4,998,231	6%	5.25%
Statistical arbitrage . . . . .	2	2,256,754	3%	1.56%
Structured finance . . . . .	5	8,727,424	10%	3.07%
	<u>47</u>	<u>\$79,868,393</u>	<u>100%</u>	<u>42.03%</u>

The following table lists the largest 25 hedge funds by fair value held by the Trust as at March 31, 2006. The Trust will disclose the names of those hedge funds which it holds that represent more than 5% of the net assets of the Trust at quarter-end. 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 will be used consistently in reporting going forward.

<u>Top 25 Investments</u>	<u>Type of Investment</u>	<u>Percentage of Net Assets</u>
New Ellington Overseas, Ltd.*	Participating shares	6.39%
Nephila Catastrophe Fund*	Participating shares	5.25%
Fund 109*	Participating shares	4.83%
Fund 175*	Participating shares	4.68%
Fund 115*	Participating shares	4.16%
Fund 169*	Participating shares	4.15%
Fund 101*	Participating shares	4.02%
Fund 171*	Participating shares	4.01%
Fund 170*	Participating shares	3.99%
Fund 121*	Participating shares	3.72%
Fund 146*	Participating shares	3.21%
Fund 200*	Participating shares	3.06%
Fund 189*	Participating shares	2.97%
Fund 205*	Participating shares	2.97%
Fund 211*	Participating shares	2.77%
Fund 116*	Participating shares	2.69%
Fund 125*	Participating shares	2.66%
Fund 190*	Participating shares	2.60%
Fund 183*	Participating shares	2.57%
Fund 160*	Participating shares	2.53%
Fund 196*	Participating shares	2.48%
Fund 129*	Participating shares	2.13%
Fund 102*	Participating shares	2.02%
Fund 191*	Participating shares	1.78%
Fund 108*	Participating shares	1.69%

\* Held by other investment funds managed by Northwater Fund Management Inc.

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

### ADDITIONAL PORTFOLIO INFORMATION

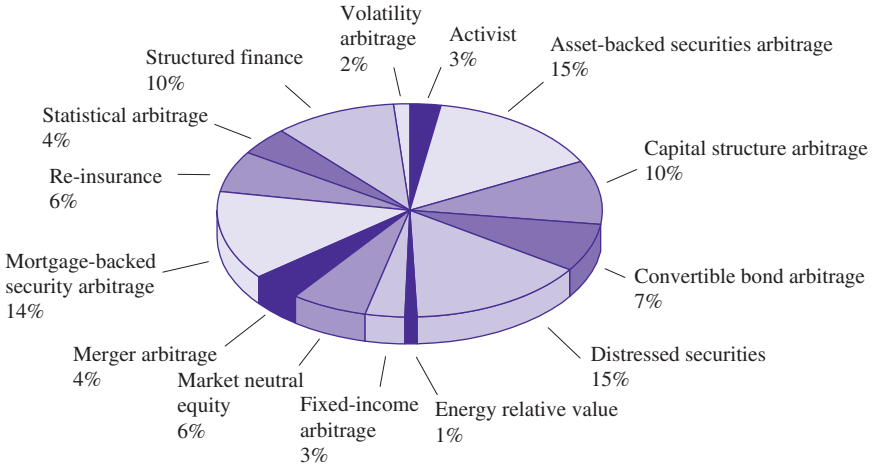
#### Investment Portfolio and Activity

The Trust invests in hedge funds that emphasize sectors of the capital markets that Northwater Capital Management Inc. (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.

The Trust is invested in hedge funds that pursue non-traditional investment strategies and is, therefore, subject to the special risks of investing in these strategies. As at March 31, 2006, the Trust was invested in 47 hedge funds with 43 managers engaged in 14 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. The hedge funds in which the Trust is invested have been established in offshore jurisdictions and prepare annual audited financial statements, in accordance with US or International generally accepted accounting principles (GAAP).

During the three-month period ended March 31, 2006, the Trust placed investments with three new hedge funds (consisting of two distressed securities funds, and one statistical arbitrage fund) and redeemed from three hedge funds (consisting of two capital structure arbitrage funds, and one merger arbitrage fund).

The following chart illustrates the hedge fund holdings by strategy as at March 31, 2006. The multi-strategy hedge funds have been allocated to various hedge fund strategies to reflect their exposure to their constituent strategies. Strategy weights are dynamic and may change from period to period.



### Investment Portfolio Risk Characteristics

The following tables present information for the periods from inception and for the three-month periods ended March 31, 2006 regarding the risk profile of both the Trust and the Trust’s hedge fund holdings.

<u>Trust Statistics</u>	<u>For the period from inception to March 31, 2006</u>
# of positive monthly returns .....	79
# of negative monthly returns .....	25
% of negative months .....	24.0%
Average size of negative months .....	-1.00%
Worst monthly return .....	-11.78% (Aug/98)*

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

### Single Hedge Fund Statistics

**Three-month  
period ended  
March 31, 2006**

# of hedge funds with positive returns <sup>(1)</sup> . . . . .	43
# of hedge funds with negative returns <sup>(1)</sup> . . . . .	4
Average annual hedge fund standard deviation <sup>(2)</sup> . . . . .	3.96%
Average correlation between hedge funds <sup>(3)</sup> . . . . .	0.133

Notes:

- (1) Measured for hedge funds in the portfolio as at March 31, 2006.
- (2) As measured over the past 24 months for hedge funds in the portfolio as at March 31, 2006, excludes hedge funds with less than 24 months of historical returns.
- (3) As measured over the past 24 months for hedge funds in the portfolio as at March 31, 2006, excludes hedge funds with less than 24 months of historical returns.

### Hedge Fund Performance

The following table presents return by investment strategy for the three-month period ended March 31, 2006.

<u>Strategy</u>	<b>Three-month period ended March 31, 2006</b>
Activist . . . . .	4.05%
Asset-backed securities arbitrage . . . . .	2.73%
Capital structure arbitrage . . . . .	2.67%
Convertible bond arbitrage . . . . .	10.10%
Distressed securities arbitrage . . . . .	3.10%
Energy relative value . . . . .	-3.02%
Fixed-income arbitrage . . . . .	3.51%
Merger arbitrage . . . . .	8.21%
Mortgage-backed security arbitrage . . . . .	2.28%
Multi-strategy . . . . .	5.75%
Re-insurance arbitrage . . . . .	0.94%
Statistical arbitrage . . . . .	7.32%
Structured finance . . . . .	3.11%

## Distributions

The following table presents distribution history for the Trust for the most recent two years.

### Distribution History

<u>Record date</u>	<u>Date distribution paid</u>	<u>Character of distribution for tax purposes</u>	<u>Amount per unit</u>
December 31, 2003	January 29, 2004	Return of capital Other income Realized gain	\$0.03119 \$3.04199 <u>\$0.59682</u> \$3.67000
May 31, 2004	June 25, 2004	Return of capital Other income	\$0.00103 <u>\$0.31897</u> \$0.32000
June 30, 2004	July 29, 2004	Return of capital Other income	\$0.00101 <u>\$0.31545</u> \$0.31646
September 30, 2004	October 29, 2004	Return of capital Other income	\$0.00099 <u>\$0.30901</u> \$0.31000
December 31, 2004	January 28, 2005	Return of capital Other income	\$0.00289 <u>\$0.89711</u> \$0.90000
March 31, 2005	April 28, 2005	Return of capital Other income	\$0.20703 <u>\$0.09297</u> \$0.30000
June 30, 2005	July 29, 2005	Return of capital Other income	\$0.20013 <u>\$0.08987</u> \$0.29000
September 30, 2005	October 28, 2005	Return of capital Other income	\$0.20013 <u>\$0.08987</u> \$0.29000
December 31, 2005	January 30, 2006	Return of capital Other income	\$0.19323 <u>\$0.08677</u> \$0.28000
March 31, 2006	April 28, 2006	To be determined	\$0.28000

## NORTHWATER CAPITAL MANAGEMENT INC.

Northwater, a leader in financial innovation since January 1989, offers customized portfolio solutions to the global investment community by providing stable, diversified alpha and precise, low-cost market exposure.

Utilizing its expertise in constructing market-neutral portfolios that seek to generate consistent returns in both normal and extreme markets, Northwater seeks to deliver a reliable source of alpha that can be tailored to meet an investor's active risk budget. In addition, the firm's established indexing capability allows access to the global equity and fixed income markets to complement an investor's unique asset/liability profile. Northwater's proven structuring technology then 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 over a ten year track record in fund of hedge funds, Northwater has steadily grown assets under management to approximately CDN \$10.9 billion total, including CDN \$4.5 billion invested in hedge funds as at December 31, 2005. Northwater has focused on developing, delivering and continuously improving its market-neutral fund of hedge fund portfolios since launching its first such portfolio in 1994.

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

Northwater launched Northwater Market-Neutral Trust, which was the first publicly-listed investment vehicle of its kind in Canada, to invest in a diversified portfolio of market-neutral hedge funds, in 1997. Northwater also advises Northwater Five-Year Market-Neutral Trust and Northwater Top 75 Income Trusts<sup>Plus</sup>, two additional publicly-listed vehicles.

## NORTHWATER MARKET-NEUTRAL TRUST

---

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

## INVESTMENT MANAGER

---

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

## INVESTMENT ADVISOR

---

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

## LEGAL ADVISORS

---

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

## AUDITORS

---

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

## DISTRIBUTION REINVESTMENT PLAN AGENT

---

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

## FOR FURTHER INFORMATION PLEASE CONTACT:

---

Mohamed Khaki or Stephen Foote  
Telephone: (416) 360-5435  
Fax: (416) 360-0671  
E-mail: [mpt@northwatercapital.com](mailto:mpt@northwatercapital.com)

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

TSE Symbol: NMN.UN

Aussi disponible en français







