NORTHWATER

Northwater Five-Year Market-Neutral Trust
December 31, 2005
Annual Report

BACKGROUND

Northwater Five-Year 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, 2005 are included in this report.

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MESSAGE TO UNITHOLDERS FROM THE INVESTMENT ADVISOR

The Northwater Five-Year Market-Neutral Trust (the ''Trust'') is a closed-end fund traded on the Toronto Stock Exchange under the symbol NYF.UN that delivers the return of both a diversified portfolio of market-neutral hedge funds and a fixed-for-floating interest rate swap by way of a forward agreement. As at December 31, 2005, the net asset value of the Trust per unit was $22.47. For the year, the net asset value per unit increased by 1.29%. During the same time period, the Scotia Capital Universe Bond Index rose by 6.46%, the S&P/TSX Composite Index rose by 24.13% and the S&P 500 rose by 4.91% in U.S. dollar terms which translates to a gain of 1.82% in Canadian dollar terms as the U.S. dollar weakened throughout the year. The trust made distributions of $1.75 during the year.

The Trust's exposure to the fixed-for-floating interest rate swap had a negative impact on the Trust's 2005 return by approximately 1.6% as Canadian mid-term interest rates rose steadily from their lows in the summer of 2005. Specifically, the Canadian 4 year swap rate ended the year at 4.16%, up from both the June low of 3.25% and last year's closing level of 3.69%. The U.S. Federal Open Market Committee continued its tightening policy throughout the year as inflationary concerns were driven by strong economic data and rising energy prices. The Bank of Canada increased its key policy rate in each of the last three scheduled dates in 2005. These moves largely impacted short rates, causing both the Canadian and U.S. yield curves to flatten.

The Trust's portfolio of market-neutral hedge funds experienced moderate returns for 2005. Mortgage-backed security arbitrage, structured finance, asset-backed securities arbitrage and distressed securities funds delivered consistently strong returns throughout the year. Manager skill combined with increased trading opportunities and a healthy credit market proved favorable to these strategies which represent over 40% of the portfolio. Multi-strategy managers were strong contributors due to their depth and breadth of talent, and ability to move capital quickly and opportunistically.

Re-insurance was a negative contributor during the year due to losses attributable to hurricanes Katrina, Rita and Wilma. Re-insurance pricing has become favorable in the wake of last year's hurricane season, and as such we have maintained our allocation to this strategy. Energy relative value and statistical arbitrage also delivered negative returns in 2005.

We continue to reduce our allocation to traditional strategies such as convertible bond arbitrage, merger arbitrage and fixed-income arbitrage in favor of structured finance and distressed securities funds.

Northwater remains committed to looking for new funds in non-traditional areas of the hedge fund universe and managers with proven track records and hedging skills in both the activist and energy relative value space.

During 2005, Northwater continued to actively manage the Trust's hedge fund portfolio. During the year 8 funds were removed for both declining strategy returns and ineffective implementation while 10 new fund's were added to strategies widely represented across the portfolio. Northwater continues to focus on improving the portfolio by refining its stable of managers and adding managers in market neutral strategies that are expected to deliver strong risk-adjusted returns consistent with the investment objectives.

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

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

February 28, 2006

ANNUAL MANAGEMENT REPORT OF FUND PERFORMANCE

This Annual Management Report of Fund Performance contains financial highlights but does not contain the complete annual financial statements of the investment fund. A copy of the annual financial statements of the investment fund has been attached to this report for your reference.

Security holders may also contact us using one of following methods to 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 at no cost by calling toll-free 1-888-429-8774, by writing to us at Northwater Fund Management Inc., Suite 4700, BCE Place, Bay Wellington Tower, 181 Bay Street, P.O. Box 794, Toronto, Ontario, M5J 2T3 or by visiting our website at www.northwatercapital.com or SEDAR at *www.sedar.com*.

Investment Objective and Strategies

The investment objectives of Northwater Five-Year Market-Neutral Trust (the ''Trust'') are:

1. Distributions: to pay to Unitholders quarterly tax-efficient cash distributions of $0.4375 per Unit ($1.75 per annum to yield 7% on the subscription price of $25.00 per Unit);
2. Low Correlation: to ensure that the performance of the Trust has a low correlation with major equity and fixed income markets over the life of the Trust;
3. Low Volatility: to achieve a low volatility, which is expected to be similar to that of a mid-term bond portfolio and less than one-half that of major equity markets; and
4. Capital Repayment: to return to Unitholders at least the original subscription price of the Units of $25.00 per Unit on or about June 30, 2009.

The Trust has invested the net proceeds of its offering in a portfolio of common shares of Canadian public companies (''Common Share Portfolio''). The Trust has entered into a forward purchase and sale agreement (the ''Forward'') with a U.S. bank (the ''Counterparty'') that has a long term credit rating of AA-. The Forward provides the Trust with exposure to the performance of Northwater Five-Year Market-Neutral Fund Limited (the Fund), an exempt company formed under the laws of The Cayman Islands and advised by the Investment Advisor, in exchange for the return of the Common Share Portfolio. Pursuant to the Forward, the Common Share Portfolio has been pledged to the Counterparty.

The Trust's valuation is not affected by the change in the market value of the Common Share Portfolio as gains or losses are offset by the Forward. The Trust's return is based on its exposure, through the Forward, to the Fund.

The Fund holds a diversified portfolio of market-neutral hedge funds (''Hedge Fund Portfolio''). The target exposure to the Hedge Fund Portfolio is equivalent to 150% of the net asset value of the Trust. The actual exposure as at December 31, 2005 was 144% (December 31, 2004 was 147%). In establishing the Hedge Fund Portfolio ''mix,'' Northwater Capital Management Inc. (the ''Investment Advisor'') seeks out strategies that have a low correlation with one another, thereby increasing the benefits of diversification and reducing expected volatility. There can be no assurance that the Trust's performance will exhibit strong risk-adjusted returns. The Investment Advisor believes, however, that the Trust's exposure to the Fund, which holds a well-diversified portfolio of market-neutral hedge funds, should result in the returns of the Trust having a low correlation with major equity and fixed income markets and a low volatility. The additional exposure provided by the leverage in the Forward will increase the risk to unitholders and will not enhance returns in the event that the Hedge Fund Portfolio declines in value.

Through the Forward, the Trust also has exposure to interest rate swaps (the ''Swaps'') entered into by the Fund. The Trust is expected to earn a blended fixed rate of 4.30% over its life plus the returns in excess of money market rates earned by exposure to the diversified portfolio of market-neutral hedge funds. The Trust has exposure to changes in mid-term interest rates. For example, if mid-term interest rates were to decrease (increase) by 1%, the value of the Trust would increase (decrease) by approximately 3.2%.

The Trust is entitled to borrow up to 10% of the net asset value for purposes of funding redemptions of units, purchases of units in the market and payment of expenses.

As at December 31, 2005, financial leverage employed by the Trust was 0.85% (December 31, 2004 was 0%).

Risks

The risks of investing in the Trust remain as discussed in the Trust's prospectus. A copy of the prospectus of the Trust is available by visiting Sedar at www.sedar.com. The below highlight the key risks of the Trust.

1. no assurance of achieving investment objectives and no guaranteed rate of return

2. limited operating history
3. fluctuation in net asset value and trading price of the Trust
4. reliance on key personnel by Northwater Capital Management Inc., the Investment Advisor of the Trust
5. potential conflicts of interest with respect to the Investment Advisor
6. taxation of the Trust and unitholders
7. fluctuation in prices and market movements in units or shares of offshore hedge funds
8. illiquid securities
9. legal and statutory rights
10. unitholder liability
11. hedge funds include fees
12. compliance and risk management systems
13. possible negative impact of regulation of hedge funds
14. status of the Trust
15. leverage
16. interest rate changes and sensitivity of market price of units to interest rates
17. performance and marketability of hedge fund portfolio
18. no guarantee of market-neutrality
19. turnover
20. international investments
21. counterparty risk
22. risks of commodity futures
23. currency hedging
24. competition
25. general market history
26. Fund director conflict of interest
27. overall investment risk
28. indemnification of hedge funds by the Fund

Results of Operations

During 2005, the Trust posted a return of 1.29% taking into account distributions made during the year. Distributions during 2005 totaled $5,615,838 or $1.75 per Unit.

During 2005, Northwater Five-Year Market-Neutral Fund Limited (the ''Fund''), to which the Trust has exposure through a forward purchase and sale agreement, placed investments with 10 new hedge funds (consisting of four structured finance funds, two multi-strategy funds, one energy relative value fund, one capital structure arbitrage fund, one asset-backed security arbitrage fund and one activist fund) and redeemed from 8 hedge funds (consisting of two energy relative value funds, two fixed-income arbitrage funds, one asset-backed security arbitrage fund, one convertible bond arbitrage fund, one statistical arbitrage fund and one multi-strategy fund).

The Trust had borrowings in the amount of $599,840 as at December 31, 2005 through a revolving loan facility with a Canadian financial institution. The financial leverage as at December 31, 2005 was 0.85%. The Trust has employed the loan to fund short term operating needs.

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 return for these services, the Manager is entitled to an annual fee of 0.15% of the net assets of the Trust, calculated on the last Valuation Date of each month. The fee is paid monthly in arrears.

A service fee of 0.30% per annum of the net assets of the Trust, is payable to the Manager calculated on the last Valuation Date of each quarter. The service fee will be applied by the Manager to pay a service fee to registered dealers for services they provide to unitholders. The fee is accrued monthly and calculated and paid quarterly in arrears.

During the year ended December 31, 2005, the management fee and service fee expense were $121,799 and $240,847 respectively, and the management fee and service fee payable by the Trust as at December 31, 2005 were $29,053 and $117,935 respectively.

Northwater Five-Year Market-Neutral Fund Limited (the ''Fund'') also pays to the Investment Advisor an advisory fee of 1.15% per annum of the net assets of the Fund calculated and accrued monthly, and paid monthly in arrears. For the year ended December 31 2005, the advisory fee charged was in the amount of U.S. $1,084,679 and as at December 31, 2005, the advisory fee payable was U.S. $263,639.

Financial Highlights

The following tables show selected key financial information about the Trust and are intended to help understand the Trust's financial performance for the period from June 30, 2004 to December 31, 2004 and for the year ended December 31, 2005. This information is derived from the Trust's audited annual financial statements.

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

	2005	2004
Net Asset Value, beginning of period	$23.89	$23.75
Increase (decrease) from operations:		
Total revenue	—	0.05
Total expenses	(0.46)	(0.22)
Realized gains (losses) for the period	0.52	—
Unrealized gains (losses) for the period	0.24	1.52
Total increase (decrease) from operations(1)	0.30	1.35
Distributions:		
From income (excluding dividends)	—	—
From capital gains	—	—
Return of capital	1.75	0.875
Total Annual Distributions(2)	1.75	0.875
Net Asset Value at December 31 of year shown	$22.47	$23.89

(1) Net asset value and distributions are based on the actual number of units outstanding at the relevant time. The increase / decrease from operations is based on the weighted average number of units outstanding over the financial period.

(2) Distributions were paid in cash.

(3) It is not intended that the Trust's Net Asset Value per Unit table act as a continuity of opening and closing net asset value per unit.

Ratios and Supplemental Data

	2005	2004
Net assets (000's)(1)	$ 70,702	$ 77,173
Number of units outstanding(1)	3,146,200	3,230,000
Management expense ratio(2)	11.75%	18.02%
Management expense ratio before waivers or absorptions	11.75%	18.02%
Portfolio turnover rate(3)	62.33%	—
Trading expense ratio(4)	0.00%	0.02%
Closing market price or pricing NAV, December 31	$ 20.50	$ 26.40

(1) This information is provided as at December 31 of the year shown.

(2) Management expense ratio is based on total expenses for the stated period and is expressed as an annualized percentage of month-end average net assets during the period. Please note that the management expense ratio include not only the expenses of the Trust and Fund but also reflect expenses to which the underlying hedge funds were subject. The expense ratio of the underlying hedge funds held by Northwater Five-Year Market-Neutral Fund Limited (the Fund) plus the expenses of the Fund included in the above ratios for the period ended December 31, 2004 and for the year ended December 31, 2005 added 9.66% and 9.80%, respectively to the expense ratio of the Trust.

This annualized expense ratio has been calculated using the total expenses of the underlying hedge funds, invested in by the Fund, per their annual audited financial statements for the year ended December 31, 2004. These statements represent the most recent audited information available. The expenses together with estimates for hedge funds with year- ends other than December 31, 2004 have been prorated based on the relative percentage of the hedge fund held by the Fund at December 31, 2004. Performance fees incurred by the underlying hedge funds can vary significantly from period to period based on such factors as the market conditions, fund strategy and manager performance. 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.

Included in the management expense ratios for the period ended December 31, 2004 are agents' fees and issue costs which have increased the ratio by 5.25% and 1.29%, respectively. These costs are one time expenses associated with the offering of the Trust to the public.

(3) The Trust's portfolio turnover rate indicates how actively the Trust's portfolio adviser manages its portfolio 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.

(4) The trading expense ratio represents total commissions and other portfolio transaction costs expressed as an annualized percentage of monthly average net assets during the period.

Management Fees

Northwater Fund Management Inc. paid the Trust a management fee and service fee of $121,799 and $240,847 respectively for the year ended December 31, 2005. The management fee is calculated as 0.15% per annum of the net asset value of the Trust, as of the close of business on each month-end valuation date. The service fee is calculated as 0.30% per annum of the net asset value of the Trust, as of the close of business on each quarter-end valuation date. The service fee was paid by Northwater Fund Management Inc. to registered dealers and brokers.

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 investment fund in the periods shown were reinvested in additional securities of the investment fund;

(b) the performance information does not take into account sales, and distribution charges that would have reduced returns or performance; and

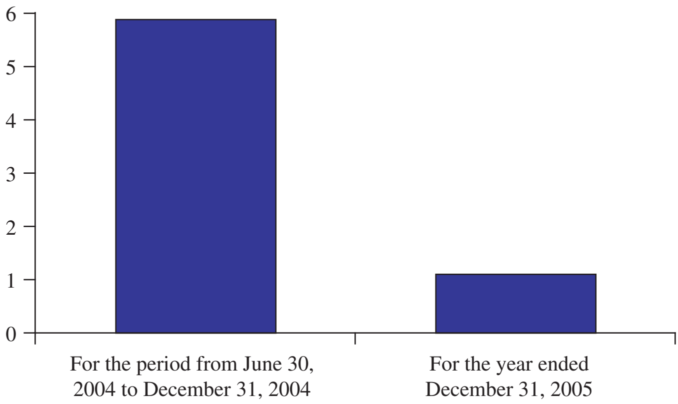
(c) how the investment fund has performed in the past does not necessarily indicate how it will perform in the future.

Year-by-Year Returns

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

(a) the bar chart shows the investment fund’s annual performance for each of the years shown, and illustrates how the investment fund’s performance has changed from year to year; and

(b) the bar chart shows, in percentage terms, how much an investment made on the first day of each financial year would have grown or decreased by the last day of each financial year.



Annual Compound Returns

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

	Since inception*	Past year
Northwater Five-Year Market-Neutral Trust	4.82%	1.29%
S&P/TSX Composite Index	22.48%	24.13%
Scotia Capital 91 day T-Bill Index	2.47%	2.58%
Scotia Capital Universe Bond Index	8.41%	6.46%

* inception date of the Trust is June 30, 2004.

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 3 month T-Bills would perform.

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

Summary of Investment Portfolio(1)

The following table presents information regarding the hedge funds to which the Trust has exposure through a forward purchase and sale agreement including 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 December 31, 2005. The multi-strategy funds may invest in multiple investment strategies.

	Asset allocation by hedge fund strategy As at December 31, 2005			Largest individual hedge fund holding for each individual strategy As at December 31, 2005
Strategy	No. of Hedge Funds	Fair Value (in U.S. dollars)	Percentage	Percentage of Net Assets of the Trust
Activist	1	$ 2,073,720	3%	3.43%
Asset-backed securities arbitrage	4	9,565,142	12%	6.46%
Capital structure arbitrage	5	6,698,173	8%	6.19%
Convertible bond arbitrage	2	3,047,662	4%	4.40%
Distressed securities	5	9,200,942	11%	4.43%
Energy relative value	1	797,457	1%	1.32%
Fixed-income arbitrage	2	4,411,745	5%	4.18%
Merger arbitrage	2	4,100,405	5%	3.77%
Mortgage-backed security arbitrage	4	10,404,229	13%	8.42%
Multi-strategy	10	21,130,153	25%	8.63%
Re-insurance	2	2,824,523	3%	3.38%
Structured finance	7	8,460,352	10%	2.90%
	45	$82,714,503	100%	57.50%

The following table lists the largest 25 hedge funds by fair value to which the Trust has exposure through a forward purchase and sale agreement as at December 31, 2005. The Trust will disclose the names of those hedge funds to which it has exposure 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.

Top 25 Investments	Type of Investment	Cost	Fair Value	Percentage of Net Assets
D.E. Shaw Composite International Fund *	Trust units	$4,906,230	$6,101,384	8.63%
New Ellington Overseas, Ltd. *	Participating shares	5,256,675	5,952,179	8.42%
Ellington Credit Fund, Ltd. *	Participating shares	4,088,525	4,570,535	6.46%
CQS Capital Structure Arbitrage Feeder Fund Limited *	Participating shares	4,205,340	4,373,960	6.19%
Fund 101 *	Participating shares	2,869,650	3,133,082	4.43%
Fund 169 *	Participating shares	2,839,402	3,117,669	4.41%
Fund 125 *	Participating shares	2,803,560	3,108,490	4.40%
Fund 146 *	Participating shares	2,803,560	3,099,030	4.38%
Fund 103 *	Participating shares	2,803,560	3,004,419	4.25%
Fund 140 *	Participating shares	2,803,560	2,955,854	4.18%
Fund 109 *	Participating shares	2,197,754	2,709,102	3.83%
Fund 102 *	Participating shares	1,985,855	2,668,541	3.77%
Fund 184 *	Participating shares	2,453,115	2,634,664	3.73%
Fund 130 *	Participating shares	2,336,300	2,600,221	3.68%
Fund 175 *	Participating shares	2,336,300	2,559,723	3.62%
Fund 200 *	Participating shares	2,453,115	2,543,580	3.60%
Fund 121 *	Participating shares	2,336,300	2,504,875	3.54%
Fund 183 *	Participating shares	2,219,485	2,450,380	3.47%
Fund 211 *	Participating shares	2,336,300	2,422,416	3.43%
Fund 158 *	Participating shares	2,923,783	2,390,543	3.38%
Fund 189 *	Participating shares	2,102,670	2,283,702	3.23%
Fund 161 *	Participating shares	1,635,410	2,203,123	3.12%
Fund 191 *	Participating shares	1,985,855	2,197,726	3.11%
Fund 181 *	Participating shares	1,985,855	2,121,348	3.00%
Fund 108 *	Participating shares	1,635,410	2,046,829	2.90%

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

The Trust also has holdings in the following common shares as at December 31, 2005. The Trust does not have economic exposure to these holdings as these common shares have been sold forward by the Trust for a price based on the return of a portfolio of hedge funds.

Share Investments	Type of Investment	Percentage of Net Assets
RONA Inc.	Common shares	4.77%
Western Oil Sands Inc.	Common shares	10.05%
Bombardier B	Common shares	6.94%
Glamis Gold Ltd.	Common shares	8.23%
Kinross Gold Corp.	Common shares	9.34%
Lionore Mining International Ltd.	Common shares	6.84%
Cognos Inc.	Common shares	5.91%
Nortel Networks Corp.	Common shares	5.88%
Canfor Corp.	Common shares	6.04%
ATI Technologies Inc.	Common shares	6.28%
Angiotech Pharmacuticals Inc.	Common shares	4.61%
Research in Motion Ltd.	Common shares	4.33%
Martinrea International Inc.	Common shares	7.36%
Forzani Group Ltd.	Common shares	7.78%

(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 has exposure. On a quarterly basis, an updated listing of holdings will be available.

SUPPLEMENTARY INFORMATION

Northwater Five-Year Market-Neutral Trust (the ''Trust'') is managed by Northwater Fund Management Inc. (the ''Manager''). The Manager is responsible for managing the business and administering the Trust pursuant to the provisions of the declaration of trust as well as for monitoring of the Trust's investment portfolio. The Manager has retained Northwater Capital Management Inc. (the ''Investment Advisor'') to provide investment advice and manage the Trust's investment portfolio in accordance with the Trust's investment objectives. In fulfilling its responsibilities, the Manager must ensure 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.

All amounts noted throughout this report are in Canadian dollars unless otherwise specifically indicated.

Investment Management Process

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

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

1. The development of a multi-faceted set of investment beliefs, which serve as a framework for identifying appropriate market-neutral strategies and the managers that employ those strategies. These investment beliefs have and continue to evolve with the Investment Advisor's experience in market-neutral hedge fund investing and in managing complex derivative strategies.

2. The use of an established operational infrastructure necessary for managing complex market-neutral and derivative strategies. The Investment Advisor has built a team of investment professionals and developed robust portfolio and risk management systems and tools essential to managing a sophisticated fund of market-neutral hedge funds.

3. A progressive global search for market-neutral strategies consistent with the Investment Advisor's investment beliefs and the Hedge Fund Portfolio's investment criteria of market-neutrality and strong risk-adjusted returns. The Investment Advisor's search focuses on managers who have demonstrated expertise in consistently implementing these strategies.

4. A comprehensive quantitative and qualitative assessment of hedge fund managers who employ market-neutral strategies that adhere to the Investment Advisor's investment beliefs and the objectives of the Hedge Fund Portfolio.

5. The use of specific quantitative procedures, including screens that attempt to identify consistency and adaptability, market-neutrality, and portfolio fit, which are integral to the Investment Advisor's investment process. Various portfolio construction techniques are used, including mathematical optimization, statistical process control and factor analysis.

6. An ongoing qualitative assessment of existing and prospective hedge fund managers, including hedge fund manager reviews involving on-site interviews, monthly portfolio reviews and various industry references. The goal of this process is to fully understand the hedge fund manager's investment strategy and risk management processes. The Investment Advisor also seeks to ascertain the strength of a hedge fund manager's competitive advantage, its investment team and its business plan.

7. The construction of a diversified model portfolio across 14 market-neutral strategies. This is a dynamic process.

8. A comprehensive due diligence process that typically must be completed before the Investment Advisor recommends an investment. This process includes on-site interviews conducted by investment professionals from the Investment Advisor, an all-inclusive strategy and operational due diligence report, a legal review of the offering documentation, an analysis of the hedge fund's financial statements, an assessment of the fees charged by the hedge fund's manager and an examination of any administrative or other costs associated with making the investment. Rigorous monitoring and due diligence continues once a hedge fund is added to the Hedge Fund Portfolio. This process includes regular discussions with the hedge fund manager, multiple on-site interviews each year, continual quantitative and

qualitative assessments and monthly review of the hedge fund's role within the Investment Advisor's model portfolio.

The Investment Advisor manages and advises client accounts in addition to the Trust and the Fund. 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.

Investment Portfolio and Activity

The Trust has obtained exposure to a portfolio of market-neutral hedge funds through the Forward. The Hedge Fund Portfolio emphasizes 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.

The Hedge Fund Portfolio is invested in hedge funds that pursue non-traditional investment strategies and is, therefore, subject to the special risks of investing in these strategies. For this reason, the Investment Advisor seeks to diversify the Hedge Fund Portfolio across 14 broad investment strategies. The hedge funds that the Trust has exposure to have been established in offshore jurisdictions and prepare annual audited financial statements, in accordance with US or International generally accepted accounting principles (GAAP).

During the year ended December 31, 2005, investments were placed with 10 new hedge funds (consisting of four structured finance funds, two multi-strategy funds, one energy relative value fund, one capital structure arbitrage fund, one asset-backed security arbitrage fund and one activist fund) and redeemed from 8 hedge funds (consisting of two energy relative value funds, two fixed-income arbitrage funds, one asset-backed security arbitrage fund, one convertible bond arbitrage fund, one statistical arbitrage fund and one multi-strategy fund) (period from June 30, 2004 to December 31, 2004, investments were placed with 43 hedge funds).

As at December 31, 2005, the Hedge Fund Portfolio included investments in 45 hedge funds with 41 managers (December 31, 2004: 43 hedge funds with 39 managers) engaged in 14 market-neutral or hedged investment strategies. The Investment Advisor believes that this wide array of hedge fund investments has created broad diversification through which the Trust seeks to achieve its risk/return objectives and market neutrality.

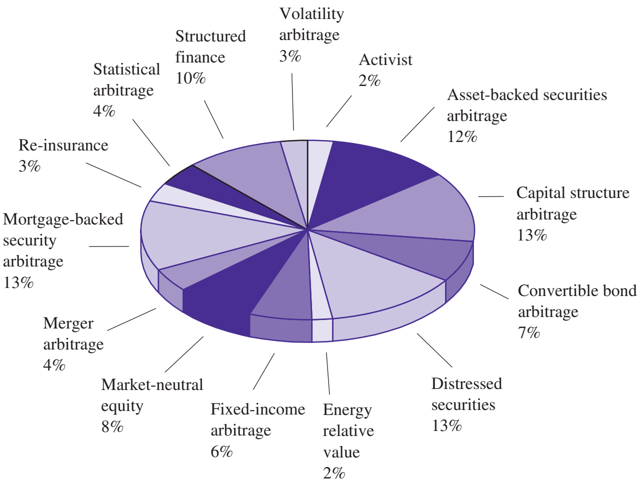
Asset Allocation by Investment Strategy

The following table presents information regarding the Hedge Fund Portfolio held by the Fund to which the Trust has exposure through the Forward.

Hedge Fund Portfolio Exposure

Strategy	As at December 31, 2005 No. of Hedge Funds	Fair Value (in U.S. dollars)		As at December 31, 2004 No. of Hedge Funds	Fair Value (in U.S. dollars)	
Activist	1	$ 2,073,720	3%	—	—	—
Asset-backed securities arbitrage	4	9,565,142	12%	5	$ 8,024,230	13%
Capital structure arbitrage	5	6,698,173	8%	3	5,660,546	10%
Convertible bond arbitrage	2	3,047,662	4%	3	4,352,578	7%
Distressed securities	5	9,200,942	11%	4	6,582,534	11%
Energy relative value	1	797,457	1%	2	1,940,669	3%
Fixed-income arbitrage	2	4,411,745	5%	4	4,803,193	8%
Merger arbitrage	2	4,100,405	5%	2	1,466,163	2%
Mortgage-backed security arbitrage	4	10,404,229	13%	4	5,793,546	10%
Multi-strategy	10	21,130,153	25%	9	12,531,886	22%
Re-insurance	2	2,824,523	3%	2	3,573,589	6%
Statistical arbitrage	—	—	—	1	802,900	1%
Structured finance	7	8,460,352	10%	4	4,029,311	7%
	45	$82,714,503	100%	43	$59,561,145	100%

The chart below illustrates the hedge fund holdings by strategy of the Fund as at December 31, 2005. The Fund's multi-strategy hedge funds have been allocated to the various hedge fund strategies to reflect their exposure to their constituent strategies. Strategy weights are dynamic and may change from period to period.



The following table presents the largest individual hedge fund holding for each investment strategy of the Fund as a percentage of the total net asset value of the Fund as at December 31, 2005 and December 31, 2004.

Strategy	As at December 31, 2005	As at December 31, 2004
Activist	2.38%	—
Asset-backed securities arbitrage	4.49%	3.83%
Capital structure arbitrage	4.30%	3.98%
Convertible bond arbitrage	3.06%	2.24%
Distressed securities	3.08%	3.18%
Energy relative value	0.92%	1.57%
Fixed-income arbitrage	2.91%	2.04%
Merger arbitrage	2.62%	1.12%
Mortgage-backed security arbitrage	5.85%	4.21%
Multi-strategy	6.00%	4.48%
Re-insurance	2.35%	4.14%
Statistical arbitrage	—	1.20%
Structured finance	2.01%	2.23%

Risk Characteristics

The following tables present information for the period from inception to December 31, 2005 and 2004, for the period from June 30, 2004 to

December 31, 2004 and for the year ended December 31, 2005 regarding elements of the risk profile of both the Trust and the Trust's exposure to the Hedge Fund Portfolio held by the Fund, which the Manager believes to be relevant.

Trust Statistics	For the period from inception to December 31, 2005	For the period from inception to December 31, 2004
# of positive monthly returns	13	5
# of negative monthly returns	5	1
% of negative months	27.8%	16.7%
Average size of negative months	-0.85%	-0.18%
Worst monthly return	-1.56%	-0.18%

Single Hedge Fund Statistics	Year ended December 31, 2005	Period from June 30, 2004 to December 31, 2004
# of hedge funds with positive returns(1)	38	36
# of hedge funds with negative returns(1)	7	7
Average annual hedge fund standard deviation(2)	3.78%	3.44%
Average correlation between hedge funds(3)	0.152%	0.147

(1) Measured for hedge funds in the Hedge Fund Portfolio of the Fund as at December 31, 2005 and December 31, 2004 respectively.

(2) As measured over the past 24 months for hedge funds in the Hedge Fund Portfolio of the Fund as at December 31, 2005 and December 31, 2004 respectively, excludes hedge funds with less than 24 months of historical returns.

(3) As measured over the past 24 months for hedge funds in the Hedge Fund Portfolio of the Fund as at December 31, 2005 and December 31, 2004 respectively, excludes hedge funds with less than 24 months of historical returns

Review of Financial Results

Performance

During the year ended December 31, 2005, the Trust posted a return of 1.29% (period from June 30, 2004 to December 31, 2004: 5.94%), taking into account the distributions made during the year. Exposure to the merger arbitrage, structured finance and asset-backed securities arbitrage strategies contributed positively to the Trust for the year ended December 31, 2005 while the re-insurance and energy relative value strategies were the weakest performers. The Trust's exposure to the interest rate swap decreased the positive performance of the Trust in the year ended December 31, 2005 by approximately -1.60% (period from June 30, 2004 to December 31, 2004: increase of 2.63%). The mark-to-market valuation of the interest rate swap held by the Fund decreased by U.S. $1,038,805 during the year ended December 31, 2005 (period from

June 30, 2004 to December 31, 2004: increase of U.S. $1,341,216) due to a increase in mid-term interest rates.

The Trust was required to make purchases of 83,800 units under its repurchase and cancellation program as the units of the Trust for the year ended December 31, 2005 were offered for sale at less than 95.0% of the net asset value (period from June 30, 2004 to December 31, 2004; no units were repurchased). Over the year ended December 31, 2005, this program did not contribute to the overall return of the Trust (period from June 30, 2004 to December 31, 2004: 0% contribution).

The following table presents the return by investment strategy of the Hedge Fund Portfolio held by the Fund for the year ended December 31, 2005, and for the period from June 30, 2004 to December 31, 2004.

Strategy	Year ended December 31, 2005	For the period from June 30, 2004 to December 31, 2004
Activist	3.69%	—
Asset-backed securities arbitrage	10.09%	5.11%
Capital structure arbitrage	1.80%	3.13%
Convertible bond arbitrage	-2.69%	1.49%
Distressed securities	6.70%	10.05%
Energy relative value	-9.37%	12.93%
Fixed-income arbitrage	5.96%	-2.33%
Merger arbitrage	18.54%	4.23%
Mortgage-backed security arbitrage	8.86%	3.52%
Multi-strategy	7.81%	5.25%
Re-insurance	-14.09%	-0.96%
Statistical arbitrage	-2.55%	0.01%
Structured finance	10.10%	4.86%

Net Asset Value and Price Per Unit

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

The Trust's net asset value per unit is calculated and reported monthly. During the year ended December 31, 2005, the net asset value of the Trust fluctuated between $22.47 per unit and $24.44 per unit after taking into account distributions (period from June 30, 2004 to December 31, 2004: between $23.28 per unit and $24.12 per unit).

The market price for units of the Trust is determined by the actions of buyers and sellers in the market. The daily closing price of the units fluctuated between $20.21 and $26.22 during the year ended December 31, 2005 (period from June 30, 2004 to December 31, 2004: between $24.60 per unit and $26.40 per unit).

Distributions

During the year ended December 31, 2005, distributions totaling $1.75 per unit and $5,615,838 in aggregate were declared (period from June 30, 2004 to December 31, 2004: $0.8750 per unit and $2,520,000 in aggregate). This represents a 7% return on the initial subscription price of $25.00 per unit consistent with the targeted annual yield for the Trust of 7%.

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

Distribution History

Record date	Date distribution paid	Character of distribution for tax purposes	Amount per unit
September 30, 2004	October 15, 2004	Return of capital	$0.4375
December 31, 2004	January 14, 2005	Return of capital	$0.4375
March 31, 2005	April 15, 2005	Return of capital	$0.4375
June 30, 2005	July 15, 2005	Return of capital	$0.4375
September 30, 2005	October 14, 2005	Return of capital	$0.4375
December 31, 2005	January 13, 2006	Return of capital	$0.4375

Fees

Management fees of 0.15% per annum of the net asset value of the Trust are calculated and paid monthly in arrears by the Trust to the Manager.

The Trust pays to the Manager a service fee of 0.30% per annum of the net assets of the Trust, accrued monthly, and calculated on the last Valuation Date of each quarter. The service fee is applied by the Manager to pay a service fee to registered dealers for services they provide to unitholders, including investment advice and account statements, based on the number of units held by clients of such dealers at the end of the relevant quarter. The fee is accrued monthly and calculated and paid quarterly in arrears.

The Trust pays forward fees of approximately 0.55% per annum of the U.S. notional amount and 0.90% per annum of the Canadian notional amount to the Counterparty of the Forward plus the leverage costs that may vary based on the value of the Common Share Portfolio, calculated and paid quarterly in arrears.

The Fund also pays to the Investment Advisor an advisory fee of 1.15% per annum of the net assets of the Fund calculated and accrued monthly, and paid monthly in arrears.

Purchases for Cancellation

Under its declaration of trust, the Trust is required to make purchases of units of up to 2.5% of the outstanding units per quarter if the price at which the units are offered for sale is less than 95.0% of the current net asset value per unit as at the close of business on the preceding valuation date.

In September 2004, 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 253,000 of the units of the Trust, representing 10% of the public float of the Trust then outstanding. In accordance with exchange rules and by-laws, the Trust may not pay more than the most recent market price for the units purchased. Units purchased under the bid are cancelled.

During the year ended December 31, 2005, the Trust purchased 83,800 units for cancellation under these programs (period from June 30, 2004 to December 31, 2004: no units were repurchased).

REPORT TO UNITHOLDERS FROM THE ADVISORY BOARD

The advisory board (the ''Advisory Board'') to the Trust is pleased to report on its activities for the year ended December 31, 2005.

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

- To monitor, consider and provide impartial judgment on all potential and perceived conflicts of interest referred to the Advisory Board by the Manager;
- To monitor, consider and provide impartial judgment with respect to any related party transactions referred to the Advisory Board by the Manager;
- To receive and review periodic reports provided to the Advisory Board by the Manager about: (i) the operation and performance of the Trust generally, (ii) compliance with the Investment Guidelines of the Trust, and (iii) compliance with the material contracts of the Trust; and
- If appropriate, to review and advise upon any other matter required by the declaration of trust dated June 18, 2004 (the ''Declaration of Trust'') and by applicable securities laws, regulations and rules.

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

During the year ended December 31, 2005, the members of the Advisory Board held three meetings. Mr. Francoz and Ms. Marshall attended all of the meetings held by the Advisory Board.

Activities discussed during the period ended December 31, 2005 included a review of the reporting requirements related to the introduction of National Instrument 81-106, review of periodic reports on the performance and the composition of the investment portfolio of the Trust, compliance with Investment Guidelines, and the presentation of certain information in the quarterly and annual reports.

The Advisory Board reports that management of the Manager has been open and cooperative, permitting the members to review such documents and speak to such members of management of the Manager as deemed necessary by the Advisory Board in order to properly execute their responsibilities as set out in the Advisory Board Mandate.

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

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

Jeffrey D. Francoz

Ann Marshall

MANAGEMENT'S RESPONSIBILITY

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

The Manager maintains appropriate processes to ensure that relevant and reliable financial information is produced. The financial statements have been prepared in accordance with accounting principles generally accepted in Canada and include certain amounts that are based on estimates and judgments. The significant accounting policies that management believes are appropriate for the Trust are described in note 2 to the financial statements.

PricewaterhouseCoopers LLP are the external auditors of the Trust. They have audited the financial statements in accordance with Canadian generally accepted auditing standards to enable them to express to the unitholders their opinion on the financial statements. Their report is set out on page 26.

Benita Warmbold

BENITA M. WARMBOLD, CA
Managing Director and
Chief Financial Officer
Northwater Fund Management Inc.

Eve N Jedrzejewska

EVE N. JEDRZEJEWSKA, CA, CFA
Vice-President
Northwater Fund Management Inc.

March 10, 2006

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

We have audited the statement of investment portfolio as at December 31, 2005 and the statements of net assets of Northwater Five-Year Market-Neutral Trust (the Trust) as at December 31, 2005 and 2004, and the statements of operations, changes in net assets and cash flows for the year ended December 31, 2005 and for the period from June 30, 2004 (commencement of operations) to December 31, 2004. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Trust as at December 31, 2005 and 2004 and the results of its operations, the changes in its net assets and its cash flows for the year ended December 31, 2005 and for the period from June 30, 2004 (commencement of operations) to December 31, 2004 in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants
Toronto, Ontario
March 31, 2006

NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST

Statements of Net Assets
As at December 31, 2005 and 2004

	2005	2004
Assets		
Cash and short-term investments		
(cost: 2005 – $2,902,330, 2004 – $3,800,027)	$ 2,902,330	$ 3,811,404
Common shares – at fair value (note 3)		
(cost: 2005 – $65,441,552, 2004 – $71,524,880)	66,715,061	75,000,065
Unrealized gain on forward contract (note 5)	3,485,710	521,707
	73,103,101	79,333,176
Liabilities		
Audit, legal and custody fees payable	70,960	49,590
Service fee payable (note 6)	117,935	61,955
Management fee payable (note 6)	29,053	10,329
Forward financing fee payable	207,232	163,552
Distribution payable (note 8)	1,376,463	1,413,125
Bank loan (note 7)	599,840	—
Offering costs payable	—	461,241
	2,401,483	2,159,792
Net assets	$70,701,618	$77,173,384
Net assets and unitholders' equity (note 4)		
Unit capital	74,148,921	76,123,900
Retained earnings (deficit)	(3,447,303)	1,049,484
Total	$70,701,618	$77,173,384
Number of units outstanding (note 4)	3,146,200	3,230,000
Net asset value per unit	$ 22.47	$ 23.89

Signed on behalf of the Trustee,

Northwater Fund Management Inc.

Per:

Per:

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

NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST

Statement of Operations

	For the year ended December 31, 2005	For the period from June 30, 2004 to December 31, 2004
Investment income		
Interest	$ 12,151	$ 141,463
	12,151	141,463
Expenses		
Service fees (note 6)	240,847	109,221
Forward fees (note 6)	861,099	267,376
Management fees (note 6)	121,799	50,324
Audit fees	33,891	34,777
Directors' fees	20,000	20,000
Custodian fees	8,872	4,750
Legal fees	28,513	8,073
Security holder reporting costs	132,549	33,946
Loan interest and standby fees	18,535	31,793
Other fees	14,238	8,611
	1,480,343	568,871
Net investment loss	(1,468,192)	(427,408)
Realized and unrealized gain or loss on investments		
Net realized gain on:		
Common shares	1,666,077	—
Change in unrealized appreciation (depreciation) on:		
Common shares	(2,201,676)	3,475,185
Forward contract	2,964,003	521,707
Realized and unrealized gain on investments for the period	2,428,404	3,996,892
Increase in net assets from operations for the period	$ 960,212	$3,569,484
Increase in net assets from operations per unit for the period*	$ 0.30	$ 1.36

* Based on the average number of units outstanding of 3,219,650 (2004 – 2,630,000) for the period.

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

NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST

Statements of Changes in Net Assets

	For the year ended December 31, 2005	For the period from June 30, 2004 to December 31, 2004
Net assets – beginning of the period	$77,173,384	—
Increase in net assets from operations for the period	960,212	$ 3,569,484
Unit Transactions (note 4)		
Units issued	—	77,173,900
Units cancelled	(1,816,140)	—
Offering costs deducted	—	(1,050,000)
	(1,816,140)	76,123,900
Distribution to unitholders (note 8)		
Return of capital	(5,615,838)	(2,520,000)
	(5,615,838)	(2,520,000)
Net assets – end of the period	$70,701,618	$77,173,384

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

NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST

Statements of Cash Flows

	For the year ended December 31, 2005	For the period from June 30, 2004 to December 31, 2004
Cash flows from operating activities		
Increase in net assets from operations	$ 960,212	$ 3,569,484
Items not affecting cash:		
Change in unrealized appreciation/depreciation on common shares	2,201,676	(3,475,185)
Change in unrealized appreciation on forward contract	(2,964,003)	(521,707)
Net realized gain on common shares	(1,666,077)	—
Changes in non-cash working capital:		
Change in payables	139,754	285,426
Purchase of common shares	(44,135,691)	(71,524,880)
Proceeds on sale of common shares	51,885,096	—
	6,420,967	(71,666,862)
Cash flows from financing activities		
Payment of distributions	(5,652,500)	(1,106,875)
Loan advance	599,840	—
Issuance of units	—	77,173,900
Cancellation of units	(1,816,140)	—
Payment of offering costs	(461,241)	(588,759)
	(7,330,041)	75,478,266
Net increase (decrease) in cash and short-term investments	(909,074)	3,811,404
Cash and short-term investments at the beginning of the period	3,811,404	—
Cash and short-term investments at the end of the period	$ 2,902,330	$ 3,811,404
Supplementary information:		
Interest paid	$ 6,695	$ 21,001

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

NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST

Statement of Investment Portfolio
As at December 31, 2005

	No. of shares/ Face value	Cost	Fair/Market value	Percentage of investment portfolio
Common share portfolio				
RONA Inc.*	157,366	$ 2,340,373	$ 3,375,501	4.62%
Western Oil Sands Inc.*	255,492	4,939,512	7,105,232	9.72%
Bombardier Inc. B *	1,778,341	4,623,686	4,908,221	6.71%
Glamis Gold Ltd.*	181,918	4,798,997	5,815,918	7.96%
Kinross Gold Corp.*	615,015	4,834,018	6,605,261	9.04%
Lionore Mining International Ltd.*	976,650	4,980,915	4,834,418	6.61%
Cognos Inc.*	103,100	4,770,426	4,180,705	5.72%
Nortel Networks Corp.*	1,170,704	5,274,900	4,155,999	5.69%
Canfor Corp.*	317,836	5,641,589	4,268,537	5.84%
ATI Technologies Inc.*	224,400	4,763,672	4,443,120	6.08%
Angiotech Pharmacuticals Inc.*	212,500	4,771,539	3,259,750	4.46%
Research in Motion Ltd.*	39,845	3,508,951	3,061,941	4.19%
Martinrea International Inc.*	800,077	5,096,490	5,200,501	7.11%
Forzani Group Ltd.*	424,707	5,096,484	5,499,956	7.51%
		65,441,552	66,715,061	91.26%
Unrealized gain on forward contract (note 5)		—	3,485,710	4.77%
Total investments		65,441,552	70,200,771	96.03%
Cash		2,902,330	2,902,330	3.97%
Total investment portfolio		$68,343,882	73,103,101	100.00%
Net liabilities			(2,401,483)	
Net assets and unitholders' equity			$70,701,618	

* Securities held as part of the forward agreement and pledged to the counterparty.

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

NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST

Notes to Financial Statements
For the year ended December 31, 2005 and for the period from June 30, 2004 to December 31, 2004

1. Establishment and Operations of the Trust

The Northwater Five-Year Market-Neutral Trust (the ''Trust'') is a closed-end investment trust established under the laws of the Province of Ontario pursuant to a declaration of trust made as of June 18, 2004. Northwater Fund Management Inc. acts as Trustee. The Royal Trust Company (''Royal Trust'') acts as Custodian. The Trust began operations on June 30, 2004 when it completed its initial public offering. The Trust issued additional units on December 31, 2004 through a secondary offering. The Trust's units are listed on the Toronto Stock Exchange under the symbol NYF.UN. The Trust will terminate on or about June 30, 2009 (the ''Termination Date''), and the net assets will be distributed pro rata to the unitholders unless an alternative later termination date is approved by a two-thirds majority vote of the unitholders at a meeting called for this purpose.

The assets of the Trust, invested in cash, short-term investments and common shares (''Common Share Portfolio'') are combined with a forward contract to achieve a return based on a diversified portfolio of market-neutral hedge funds.

2. Summary of Significant Accounting Policies

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

(a) Investments

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

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

The Common Share Portfolio consisting of common shares listed on a public securities exchange are valued at their closing sale price on each Valuation Date. Common shares not traded on that date are valued at the average of the closing bid and ask or the latest available sale price. Realized gains and losses are calculated using the average cost.

The value of the forward contract is the gain or loss, if any, that would be realized if, on the Valuation Date, the forward contract was ''closed out''. The difference between fair value and cost is shown as an unrealized gain or loss on investments. The value of the forward contract is determined based on the change in valuation of Northwater Five-Year Market-Neutral Fund Limited, which invests in a diversified portfolio of market-neutral hedge funds, and on the change in value of the Common Share Portfolio less the leverage costs. The investments in market-neutral hedge funds held by Northwater Five-Year Market-Neutral Fund Limited are valued on the basis of the definitive net asset values reported by the administrators or the portfolio managers of such funds on the Valuation Date or, if not available, the most recent provisional net asset values based on preliminary returns reported by the administrators or the portfolio managers of such funds.

(b) 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.

(c) Comparative Figures

Certain of the 2004 comparative figures have been reclassified to conform to the 2005 financial statement presentation.

3. Investment in Common Shares

The following table summarizes investment transactions during the relevant periods:

	For the year ended December 31, 2005	For the period from June 30, 2004 to December 31, 2004
Common shares at cost – beginning of the period	$ 71,524,880	$ —
Cost of common shares purchased	44,135,691	71,524,880
Cost of common shares sold	(50,219,019)	—
Common shares at cost – end of the period	65,441,552	71,524,880
Unrealized appreciation on common shares	1,273,509	3,475,185
Market value of common shares – end of the period	$ 66,715,061	$75,000,065
Proceeds of common shares sold	$ 51,885,096	$ —
Cost of common shares sold	(50,219,019)	—
Net realized gain on common shares	$ 1,666,077	$ —

During the year ended December 31, 2005, total commissions and other transactions costs paid or payable to dealers by the Trust was in the amount of $300 (period from June 30, 2004 to December 31, 2004: $5,968).

4. Units Issued and Outstanding

The authorized capital of the Trust consists of an unlimited number of non-redeemable units. Units are transferable and represent an equal, undivided interest in the net assets of the Trust. All units are of the same class with equal rights and privileges. Each unit is entitled to one vote at any meeting of unitholders and to equal participation in any distributions made by the Trust. Fractional units will not be issued.

The Trust, through its initial public offering in June 2004, realized gross proceeds of $63,250,000 based on the issuance of 2,530,000 units. Agents' fees of $3,320,600 and issue costs of $850,000 were incurred in connection with the offering.

A secondary offering in December 2004 realized gross proceeds of $18,200,000 based on the issuance of 700,000 units. Agents' fees of $955,500 and issue costs of $200,000 were incurred in connection with the offering.

Under the declaration of trust, the Trust is required to make purchases of units of up to 2.5% of the outstanding units per quarter if the price at which the units offered in the market is less than 95.0% of the net asset value per unit as at the close of business on the preceding Valuation Date. In addition, the Trust may purchase units whenever they are offered for sale at less than their net asset value. Under a normal course issuer bid and the Trust's quarterly market support obligation, the Trust purchased 83,800 units during the year ended December 31, 2005 (period from June 30, 2004 to December 31, 2004: no units were repurchased).

The following unit transactions took place during the relevant periods:

	For the year ended December 31, 2005	For the period from June 30, 2004 to December 31, 2004
Balance of units outstanding – beginning of the period	3,230,000	—
Units issued during the period	—	3,230,000
Units cancelled during the period	(83,800)	—
Balance of units outstanding – end of the period	3,146,200	3,230,000

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

	For the year ended December 31, 2005	For the period from June 30, 2004 to December 31, 2004
Unit capital – beginning of the period	$76,123,900	$ —
Gross proceeds from units issued during the period net of agents' fees	—	77,173,900
Stated value of units repurchased	(1,974,979)	—
Offering costs	—	(1,050,000)
Unit capital – end of the period	$74,148,921	$76,123,900

	For the year ended December 31, 2005	For the period from June 30, 2004 to December 31, 2004
Retained earnings – beginning of the period	$ 1,049,484	$ —
Increase in net assets from operations for the period	960,212	3,569,484
Stated value in excess of cost of units repurchased	158,839	—
Distribution to unitholders	(5,615,838)	(2,520,000)
Retained earnings/(deficit) – end of the period	$ (3,447,303)	$ 1,049,484

5. Forward Contract

The Trust has entered into a forward agreement (''Forward'') with a U.S. Bank (the ''Counterparty'') to obtain exposure to a diversified portfolio of market-neutral hedge funds (the ''Hedge Fund Portfolio'') and an interest rate swap through the performance of Northwater Five-Year Market-Neutral Fund Limited (the ''Fund''), a Cayman Islands exempt company. The target exposure to the Hedge Fund Portfolio is equal to 150% of the net asset value of the Trust. The actual exposure as at December 31, 2005 was 144% (December 31, 2004 actual exposure was 147%.The Trust has purchased and pledged to the Counterparty the Common Share Portfolio listed on the Statement of Investment Portfolio. The Trust has agreed to deliver the Common Share Portfolio to the Counterparty, on or about the Termination Date, in exchange for the redemption proceeds of the Fund less the leverage provided by the Counterparty in order to provide the exposure to the Fund and related costs of leverage. As a result, the value of the Forward is determined based on the change in the valuation of the Fund and the Common Share Portfolio less the costs of leverage.

The notional amount of the Forward as at December 31, 2005 was the aggregate amounts of Canadian $64,352,801 and U.S. $31,654,828 (December 31, 2004: Canadian $71,499,998 and U.S. $35,785,713).

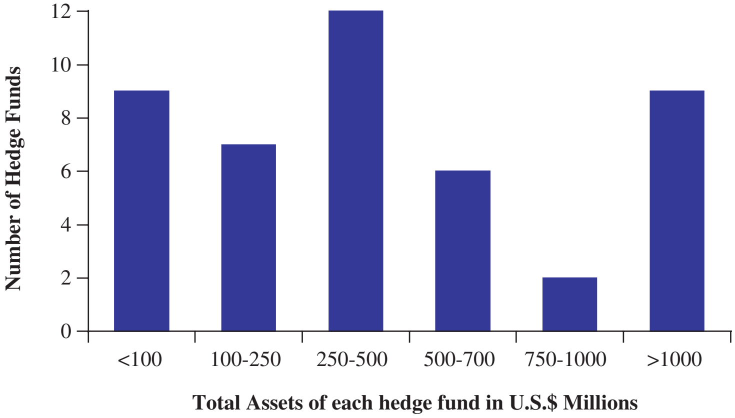
The Trust's net asset value is not affected by the changes in the market value of the Common Share Portfolio as any decrease (increase) in the value of the Common Share Portfolio will be offset by a corresponding increase (decrease) in the value of the Forward.

As at December 31, 2005 and December 31, 2004, the Trust had exposure, through the Forward, to hedge funds in the following strategies:

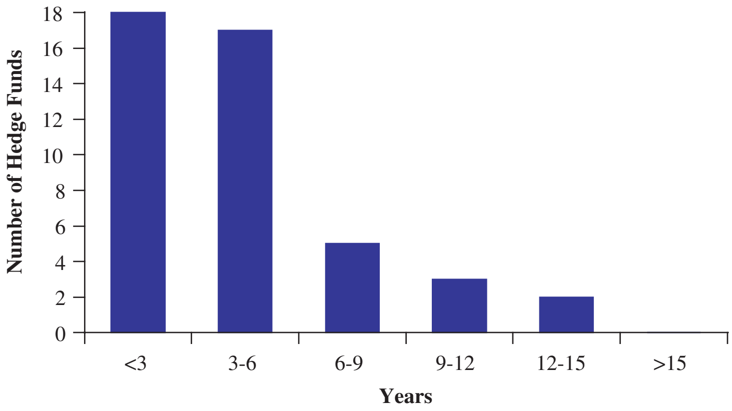
Strategy	December 31, 2005	December 31, 2004
Activist	2.38%	—
Asset-backed securities arbitrage	10.98%	11.53%
Capital structure arbitrage	7.69%	8.13%
Convertible bond arbitrage	3.50%	6.25%
Distressed securities	10.56%	9.46%
Energy relative value	0.92%	2.79%
Fixed-income arbitrage	5.06%	6.90%
Merger arbitrage	4.71%	2.11%
Mortgage-backed security arbitrage	11.94%	8.32%
Multi-strategy	24.26%	18.01%
Re-insurance	3.24%	5.13%
Statistical arbitrage	—	1.15%
Structured finance	9.72%	5.79%

As at December 31, 2005, the Fund's portfolio consisted of 94.96% (December 31, 2004: 85.57%) hedge fund investments, 4.44% (December 31, 2004: 12.5%) cash holdings, 0.01% currency forward settlement (December 31, 2004: 0%) and 0.59% (December 31, 2004: 1.93%) interest rate swap.

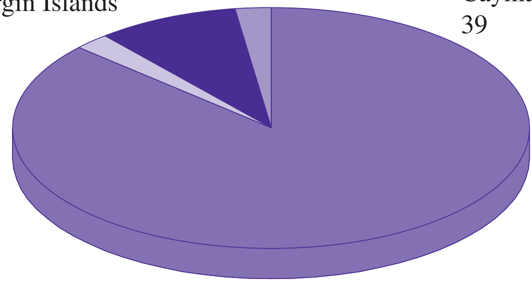
The following table shows the hedge funds held by the Fund as at December 31, 2005 categorized by the December 31, 2005 size of each hedge fund.



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



The following chart illustrates the hedge fund holdings of the Fund by jurisdiction of organization as at December 31, 2005.



The creditworthiness of the Counterparty was reviewed prior to the transaction and is monitored on a regular basis pursuant to the credit standards established by the Manager. As at December 31, 2005 the credit rating of the counterparty was AA-. The Trust is exposed to monies to be received from the Counterparty at the maturity of the Forward. The Forward provides for the Trust's ability to terminate the Forward if the credit rating of the Counterparty goes below a certain threshold.

The Trust, through its exposure to the interest rate swap in the Fund, has exposure to changes in mid-term interest rates. For example, if mid-term interest rates were to decrease (increase) by 1%, the value of the Trust would increase (decrease) by approximately 3.2%. The interest rate swap has a maturity date of June 30, 2009.

6. Management, Advisory and Other Fees

The Trust retained Northwater Fund Management Inc. (the ''Manager'') under a management agreement dated June 18, 2004. Northwater Capital Management Inc. (the ''Investment Advisor''), a Company formed under the laws of Ontario, Canada, acts as the advisor for 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 Investment 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 Investment Advisor is a member of the U.S. National Futures Association (the ''NFA'').

The Manager is responsible for the day-to-day administration, portfolio management and unitholder services of the Trust. In return for these services, the Manager is entitled to an annual fee of 0.15% of the net assets of the Trust, calculated on the last Valuation Date of each month. The fee is paid monthly in arrears.

The Fund also pays to the Investment Advisor an advisory fee of 1.15% per annum of the net assets of the Fund calculated and accrued monthly, and paid monthly in arrears. For the year ended December 31, 2005, the advisory fee charged was in the amount of U.S. $1,084,679 (period from June 30, 2004 to December 31, 2004: U.S. $312,568).

A service fee of 0.30% per annum of the net assets of the Trust, is payable to the Manager calculated on the last Valuation Date of each quarter. The service fee will be applied by the Manager to pay a service fee to registered dealers for services they provide to unitholders. The fee is accrued monthly and calculated and paid quarterly in arrears.

Forward fees of approximately 0.55% per annum of the U.S. notional amount and 0.90% per annum of the Canadian notional amount are payable to the Counterparty of the Forward which the Trust has exposure through a forward purchase and sale agreement, plus the leverage costs that may vary based on the value of the Common Share Portfolio, calculated and paid quarterly in arrears. The leverage costs have been included in the Statement of Operations as part of the value of the forward contract (see note 5).

7. Bank Loan

The Trust has a revolving loan facility with a Canadian financial institution (the ''Bank''). The facility entitles the Trust to borrow funds in Canadian dollars up to an amount not exceeding the lesser of $6,000,000 or 10% of the net asset value of the Trust for the purposes of funding the redemptions of units, purchases of units in the market and payment of expenses. 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. A general security interest in the assets of the Trust has been provided in favour of the Bank.

During the year ended December 31, 2005, the bank loan balance varied between $0 and $1,800,000 (period from June 30, 2004 to December 31, 2004: no loan outstanding).

8. Distributions

The Trust pays quarterly distributions to unitholders of $0.4375 per unit.

During the year ended December 31, 2005, distributions of $1.75 per unit and $5,615,838 in aggregate were declared by the Trust (period from June 30, 2004 to December 31, 2004: $0.8750 per unit and $2,520,000 in aggregate).

9. Income Taxes

As at December 31, 2005, the Trust qualifies as a ''mutual fund trust'' within the meaning of the *Income Tax Act* (Canada) (the ''Tax Act''). In determining its income for tax purposes, the Trust intends to treat gains or losses on the disposition of securities in the Common Share Portfolio under the Forward as capital gains and losses. As all of the net taxable income of the Trust, including net realized gains from its investment, 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, 2005, the Trust had $2,519,000 available in non-capital loss carryforwards (December 31, 2004: $915,000) with expiry dates commencing in 2011 and no capital loss carryforwards (December 31, 2004: $0).

10. Indemnities

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

1) in priority to all and any rights of the Manager or of the unitholders, an indemnity to the trustee and each of its directors, officers,

employees and agents, other than the Manager, in respect of any liability and all costs, charges and expenses sustained or incurred in respect of any action, suit or proceeding that is proposed or commenced and all other expenses, costs or charges, sustained or incurred in respect of the administration or termination of the Trust including any taxes, penalties and interest in respect of unpaid taxes and all other liabilities and charges of any nature whatsoever;

2) an indemnity to the transfer agent against any and all actions and suits against any and all losses, damages, costs, charges, counsel fees, payments, expenses and liabilities arising directly or indirectly out of its agency relationship to the Trust;

3) an indemnity to the Counterparty against any costs, claims, expenses, liabilities, demands, damages, losses, actions or proceedings of any kind arising from the Counterparty being a holder of the common share portfolio;

4) an indemnity to the custodian, its affiliates, subsidiaries and agents, and their directors, officers and employees against all legal fees, judgments and amounts paid in settlement, actually and reasonably incurred arising in connection with custodial or sub-custodial services provided except to the extent incurred as a result of breach of the standard of care;

5) an indemnity to the trustee, a manager, an affiliate of the trustee or manager or a unitholder, against all liabilities and expenses reasonably incurred in connection with any action, suit or proceeding to which any such person may be made a party by reason of being or having been an indemnified party;

6) an indemnity to the Bank and its officers, directors, employees and agents against any reasonable costs, charges and expenses incurred or any claim or losses suffered arising out of (i) the preparation, execution and delivery of preservation of rights, refinancing, renegotiation or restructuring of the loan documents and any related amendment , waiver or consent (ii) any advice of counsel as to the rights and duties of the Bank with respect to the administration of the credit facility (iii) a default of the Trust under any loan document and (iv) any proceedings brought against the Bank due to its entering into any of the loan documents and performing its obligations, and

7) an indemnity to the Trust's auditors with respect to any fraudulent acts or omissions by the Trust, or misrepresentations made or willful defaults caused by the Trust resulting in claims against the Trust's

auditors and in connection with third party claims made against the Trust's auditors relating to the services provided to the Trust by its auditors except as such claims may have resulted from the intentional neglect, misconduct or fraudulent behavior of the Trust's auditors.

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

NORTHWATER CAPITAL MANAGEMENT INC.

Northwater, 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 generate consistent returns in both normal and extreme markets, Northwater delivers 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 achieves 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 Market-Neutral Trust which was launched in 1997 and is also advised by Northwater was the first publicly-listed investment vehicle of its kind in Canada to invest in a diversified portfolio of market-neutral hedge funds. Northwater also advises Northwater Five-Year Market-Neutral Trust and Northwater Top 75 Income Trusts Plus, two additional publicly-listed vehicles.

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