NORTHWATER

Northwater Five-Year Market-Neutral Trust
December 31, 2006
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, 2006 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, 2006, the net asset value of the Trust per unit was $23.07. For the one year period ended December 31, 2006, return of the Trust was 10.84%. During the same time period, the Scotia Capital Universe Bond Index increased by 4.06%, the S&P/TSX Composite Index rose by 17.26% and the S&P 500 in U.S. dollar terms, rose by 15.79% which translates to a gain of 16.08% in Canadian dollar terms as the U.S. dollar strengthened during the period. The Trust made distributions of $1.75 per unit during the period.

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

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

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

The Manager continues to actively manage the composition of the Trust's hedge fund portfolio. During the year ending December 31, 2006, 14 funds were removed for both declining strategy returns and ineffective implementation, while nine new funds were added to strategies widely represented across the portfolio. Northwater remains focused on improving the portfolio by refining its stable of managers and adding managers in market-neutral strategies that are expected to deliver strong risk-adjusted returns consistent with the investment objectives.

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

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

March 16, 2007

MANAGEMENT REPORT OF FUND PERFORMANCE

This Management Report of Fund Performance contains financial highlights but does not contain the complete financial statements of Northwater Five-Year Market-Neutral Trust (the “Trust”). A copy of the financial statements of the Trust for the year ended December 31, 2006 is attached to this report for your reference.

Security holders may contact us using one of following methods and may, at no cost, request a copy of the Trust’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 or by writing to us at Northwater Fund Management Inc., Suite 4700, BCE Place, Bay Wellington Tower, 181 Bay street, P.O. Box 794, Toronto, Ontario, M5J 2T3. You may also visit our website at www.northwatercapital.com or the SEDAR website at *www.sedar.com.*

Northwater Five-Year Market-Neutral 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 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 Objective and Strategies

Investment Objectives

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.

Investment Strategies

The Trust has invested the net proceeds of its offering in a portfolio of common shares of Canadian public companies (the "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 (the "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, 2006 was 143% (December 31, 2005 was 144%). In establishing the Hedge Fund Portfolio "mix," 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 1.7%.

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 evolved and continue to evolve with the Investment Advisor's experience in market-neutral hedge fund investing and in managing complex derivative strategies.
2. the use of an established operational infrastructure necessary for managing complex fund of market-neutral hedge fund and derivative strategies. The Investment Advisor has built a team of investment professionals and developed robust portfolio and risk management systems and tools essential to managing a sophisticated fund of market-neutral hedge funds.
3. a progressive global search for market-neutral strategies consistent with the Investment Advisor's investment beliefs and the 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.

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, 2006, financial leverage employed by the Trust was nil (December 31, 2005 was 0.85%).

Risks

The following tables present information for the period from inception and for the years ended December 31, 2006 and 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, 2006**	**For the period from inception to December 31, 2005**
# of positive monthly returns	24	13
# of negative monthly returns	6	5
% of negative months	20.00%	27.8%
Average size of negative months	-0.78%	-0.85%
Lowest monthly return	-1.55%	-1.55%

Single Hedge Fund Statistics	**Year ended December 31, 2006**	**Year ended December 31, 2005**
# of hedge funds with positive returns(1)	40	38
# of hedge funds with negative returns(1)	0	7
Average annual hedge fund standard deviation(2)	3.55%	3.78%
Average correlation between hedge funds(2)	0.10%	0.152%

(1) Measured for hedge funds in the Hedge Fund Portfolio of the Fund as at December 31, 2006 and December 31, 2005, respectively.

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

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

Results of Operations

For the year ended December 31, 2006, the Trust posted a return of 10.84% (year ended December 31, 2005: 1.29%), taking into account the distributions made during the period. Distributions during the period totaled $5,170,332 or $1.75 per Unit.

The Fund's exposure to the Swaps had a negative impact on the performance of the Fund in the year ended December 31, 2006 (year ended December 31, 2005: negative contribution). The mark-to-market valuation of the interest rate swaps held by the Fund decreased by USD $41,502 during the year ended December 31, 2006 (year ended December 31, 2005: decrease of USD $1,038,805).

The Trust had borrowings in the amount of nil as at December 31, 2006 (December 31, 2005: $599,840) through a revolving loan facility with a Canadian financial institution. The financial leverage as at December 31, 2006 was nil% (December 31, 2005: 0.85%). The Trust has employed the loan to fund short-term operating needs.

The Trust purchased 302,900 units under its repurchase and cancellation programs of the units of the Trust for the year ended December 31, 2006 (year ended December 31, 2005; 83,800 units were repurchased). Over the year ended December 31, 2006, this program contributed 0.82% to the overall return of the Trust (year ended December 31, 2005: 0% contribution).

Summary of Investment Portfolio(1)

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, which may include strategies to which the Fund is exposed through its investment in multi-strategy hedge funds. The hedge funds to which the Trust has exposure have been established in offshore jurisdictions and prepare annual audited financial statements, in accordance with US or International generally accepted accounting principles (GAAP).

During the year ended December 31, 2006, the Fund placed investments with nine new hedge funds (consisting of three distressed securities, two statistical arbitrage, two structured finance, one energy relative value, and one asset-backed security) and redeemed from 14 hedge funds (consisting of four capital structure arbitrage, two convertible bond arbitrage, three distressed securities, one merger arbitrage, two multi-strategy, one structured finance and one energy relative value) (year ended December 31, 2005: the Trust placed investments with 10 new hedge funds and redeemed from eight hedge funds).

The following table presents the return by investment strategy of the Hedge Fund Portfolio held by the Fund for the years ended December 31, 2006 and December 31, 2005.

Strategy	Year ended December 31, 2006	Year ended December 31, 2005
Activist	24.77%	3.69%
Asset-backed securities arbitrage	13.22%	10.09%
Capital structure arbitrage	8.29%	1.80%
Convertible bond arbitrage	8.31%*	-2.69%
Distressed securities	17.62%	6.70%
Energy relative value	9.67%	-9.37%
Fixed-income arbitrage	8.98%	5.96%
Merger arbitrage	14.07%	18.54%
Mortgage-backed security arbitrage	9.80%	8.86%
Multi-strategy	17.40%	7.81%
Re-insurance	9.48%	-14.09%
Statistical arbitrage	12.72%	-2.55%
Structured finance	11.83%	10.10%

* Represents the return for the period January 1, 2006 to September 30, 2006

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. The multi-strategy funds have not been allocated to any of the underlying hedge fund strategies set out in this table.

Strategy	As at December 31, 2006 No. of Hedge Funds	Fair Value (in U.S. Dollars)		As at December 31, 2005 No. of Hedge Funds	Fair Value (in U.S. Dollars)	
Activist	1	$ 2,587,354	3%	1	$ 2,073,720	3%
Asset-backed security arbitrage	5	9,291,026	12%	4	9,565,142	12%
Capital structure arbitrage	1	849,904	1%	5	6,698,173	8%
Convertible bond arbitrage	—	—	—	2	3,047,662	4%
Distressed securities	5	8,701,946	11%	5	9,200,942	11%
Energy relative value	1	1,160,011	1%	1	797,457	1%
Fixed-income arbitrage	2	4,807,792	6%	2	4,411,745	5%
Merger arbitrage	1	2,071,410	3%	2	4,100,405	5%
Mortgage-backed security arbitrage	4	12,828,580	17%	4	10,404,229	13%
Multi-strategy	8	20,139,742	26%	10	21,130,153	25%
Re-insurance	2	3,092,212	4%	2	2,824,523	3%
Statistical arbitrage	2	2,254,373	3%	—	—	—
Structured finance	8	10,500,011	13%	7	8,460,352	10%
	40	$78,284,361	100%	45	$82,714,503	100%

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 Trust as at December 31, 2006 and December 31, 2005.

Strategy	As at December 31, 2006	As at December 31, 2005
Activist	4.59%	3.43%
Asset-backed securities arbitrage	5.44%	6.46%
Capital structure arbitrage	1.51%	6.19%
Convertible bond arbitrage	—	4.40%
Distressed securities	4.97%	4.43%
Energy relative value	2.06%	1.32%
Fixed-income arbitrage	4.90%	4.18%
Merger arbitrage	3.68%	3.77%
Mortgage-backed security arbitrage	9.84%	8.42%
Multi-strategy	9.21%	8.63%
Re-insurance	3.94%	3.38%
Statistical arbitrage	2.16%	—
Structured finance	3.52%	2.90%

The following table lists the largest 25 hedge funds by fair value to which the Trust has exposure through the Forward as at December 31, 2006. 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 period-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 are used consistently in the Fund's reporting.

Top 25 Investments	Type of Investment	Cost	Fair Value	Percentage of Net Assets
New Ellington Overseas, Ltd.*	Participating shares	5,236,650	6,456,500	9.84%
D.E Shaw Composite, Ltd.*	Participating shares	4,186,016	6,040,300	9.21%
CRC, Ltd.*	Participating shares	2,828,586	3,566,200	5.44%
Tempo Fund, Ltd.*	Participating shares	2,792,880	3,433,660	5.24%
West Side Offshore Partners*	Participating shares	2,792,880	3,327,780	5.07%
Citadel Kensington Global Strategies Fund, Ltd.*	Participating shares	3,038,733	3,326,540	5.07%
Fund 109*	Participating shares	2,189,382	3,260,288	4.97%
Fund 140*	Participating shares	2,792,880	3,212,024	4.90%
Fund 209*	Participating shares	2,327,400	3,010,904	4.59%
Fund 200*	Participating shares	2,443,770	2,910,423	4.44%
Fund 121*	Participating shares	2,327,400	2,850,087	4.35%
Fund 183*	Participating shares	2,211,030	2,818,169	4.30%
Fund 190*	Participating shares	2,327,400	2,642,090	4.03%
Fund 131*	Participating shares	2,912,645	2,586,727	3.94%
Fund 101*	Participating shares	1,898,326	2,563,766	3.91%
Fund 189*	Participating shares	2,094,660	2,502,232	3.82%
Fund 181*	Participating shares	1,978,290	2,410,500	3.68%
Fund 191*	Participating shares	1,978,290	2,282,803	3.63%
Fund 108*	Participating shares	1,629,180	2,310,778	3.52%
Fund 171*	Participating shares	1,646,087	2,002,473	3.05%
Fund 175*	Participating shares	1,849,469	1,990,163	3.03%
Fund 205*	Participating shares	1,745,550	1,968,791	3.00%
Fund 199*	Participating shares	1,512,810	1,770,221	2.70%
Fund 208*	Participating shares	1,629,180	1,679,909	2.56%
Fund 116*	Participating shares	1,632,246	1,658,099	2.53%

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

The Trust also has holdings in the following common shares as at December 31, 2006. 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
Alliance Atlantis Common-B	Common shares	9.61%
Angiotech Pharmaceuticals Inc	Common shares	3.11%
Axcan Pharma Inc	Common shares	6.94%
Bombardier Inc B	Common shares	10.71%
Celestica Inc	Common shares	3.88%
Cognos Inc	Common shares	7.79%
Dorel Industries-Cl B	Common shares	7.10%
Forzani Group Ltd.	Common shares	9.81%
Kinross Gold Corp.	Common shares	8.17%
Lionore Mining Intl Ltd.	Common shares	14.52%
Martinrea International Inc.	Common shares	10.77%
Nortel Networks Corp	Common shares	3.89%
Research In Motion Ltd	Common shares	9.06%
RONA Inc	Common shares	5.04%
Western Oil Sands Inc Cl/A	Common shares	8.14%

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

Financial Highlights

The following tables show selected key financial information about the Trust and are intended to help understand the Trust's financial performance for the years ended December 31, 2006 and 2005, and for the period ended December 31, 2004.

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

	For the year ended December 31,		For the period from June 30 to December 31, 2004
	2006	**2005**	
Net Asset Value, beginning of period	$22.47	$23.89	$23.75
Increase (decrease) from operations:			
Total revenue	0.01	—	0.05
Total expenses	(0.41)	(0.46)	(0.22)
Realized gains (losses) for the period	1.25	0.52	—
Unrealized gains (losses) for the period	1.29	0.24	1.52
Total increase (decrease) from operations[(1)]	2.14	0.30	1.36
Distributions:			
From income (excluding dividends)	—	—	—
From capital gains	—	—	—
Return of capital	1.75	1.75	0.875
Total Annual Distributions[(2)]	1.75	1.75	0.875
Net Asset Value at end of period	$23.07	$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 are 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 reconciliation of opening and closing net asset value per unit.

Ratios and Supplemental Data

	For the year ended December 31,		For the period from June 30 to December 31, 2004
	2006	2005	
Net assets (000's)(1)	$ 65,587	$ 70,702	$ 77,173
Number of units outstanding(1)	2,843,300	3,146,200	3,230,000
Management expense ratio(2)	7.27%	11.75%	18.02%
Management expense ratio before waivers or absorptions	7.27%	11.75%	18.02%
Portfolio turnover rate(3)	10.61%	62.33%	—
Trading expense ratio(4)	0.00%	0.00%	0.02%
Closing market price or pricing NAV, end of period	$ 20.56	$ 20.50	$ 26.40

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

(2) Management expense ratio is based on total expenses for the stated period and is expressed as an annualized percentage of month-end average net assets during the period. Please note that the management expense ratio includes not only the expenses of the Trust itself but also reflects an estimate of expenses to which the underlying hedge funds were subject. The management expense ratio of the underlying hedge funds included in the above ratios for the year ended December 31, 2006 added 5.47 % (2004 and 2005: 8.50%) to the expense ratio of the Fund. 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 periods ended December 31, 2005 and 2004, respectively. These statements represent the most recent audited information available. The expenses together with estimates for hedge funds with year-ends other than December 31 have been prorated based on the relative percentage of the hedge fund held by the Fund at the end of the respective period. Performance fees incurred by the underlying hedge funds can vary significantly from period to period based on such factors as the market conditions, fund strategy, manager performance and the timing of redemptions. As a result, the expense ratio of the underlying funds for the prior year may be significantly different than the actual expenses incurred by these underlying hedge funds for the current period.

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

Past Performance

General

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

(a) the performance information shown assumes that all distributions made by the Trust in the periods shown were reinvested in additional securities of the Trust;

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

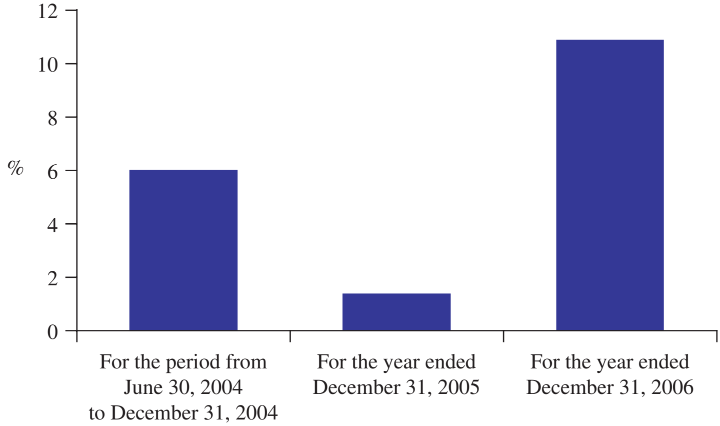
(c) how the Trust has performed in the past does not necessarily indicate how it will perform in the future.

Year-by-Year Returns

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

(a) the bar chart shows the Trust's annual performance for each of the years shown, and illustrates how the Trust'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	7.21%	10.84%
S&P/TSX Composite Index	20.36%	17.26%
Scotia Capital 91 day T-Bill Index	3.07%	3.98%
Scotia Capital Universe Bond Index	6.65%	4.06%

* 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 three 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.

Management Fees and Related Party Transactions

The Manager, is responsible for the day-to-day administration, portfolio management and unitholder services to the Trust. In exchange for these services, the Manager is entitled to an annual management fee 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 fee is paid monthly in arrears.

The Trust also pays to the Manager a service fee of 0.30% per annum of the net assets of the Trust, accrued monthly, and calculated based on the net asset value of the Trust 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.

During the year ended December 31, 2006, the management fee and service fee expense were $111,785 and $210,187 respectively, and the management fee and service fee payable by the Trust as at December 31, 2006 were $26,336 and $53,024 respectively.

Other Fees

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 that may vary based on the value of the Common Share Portfolio, calculated and paid quarterly in arrears.

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, 2006, the net asset value of the Trust fluctuated between $22.23 per unit and $23.30 per unit after taking into account distributions (year ended December 31, 2005: between $22.47 per unit and $24.44 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 $19.50 and $21.51 during the year ended December 31, 2006 (year ended December 31, 2005: between $20.21 per unit and $26.22 per unit).

Distributions

During the year ended December 31, 2006, distributions totaling $1.75 per unit and $5,170,332 in aggregate were declared (year ended December 31, 2005: $1.75 per unit and $5,615,838 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 declaration of trust and the tax laws then in effect. There can be no assurance that income tax laws will not be changed in a manner that adversely affects the Trust or distributions paid by the Trust and the Manager will continue to monitor any changes in the tax laws as they occur.

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

Distribution History

Record Date	Payment date	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
March 31, 2006	April 13, 2005	Return of capital	$0.4375
June 30, 2006	July 14, 2006	Return of capital	$0.4375
September 30, 2006	October 13, 2006	Return of capital	$0.4375
December 31, 2006	January 15, 2007	Return of capital	$0.4375

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.

On August 21, 2006, 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 290,645 of the units of the Trust, representing 10% of the public float of the Trust then outstanding during the period from August 30, 2006 to August 29, 2007. In accordance with exchange rules and by-laws, the Trust may not pay more than the most recent market price for the units purchased. Units purchased under the bid are cancelled.

During the year ended December 31, 2006, the Trust purchased 302,900 units for cancellation under these programs (year ended December 31, 2005: 83,800 units were repurchased) at a total cost of $6,293,840.

NORTHWATER FIVE YEAR MARKET-NEUTRAL TRUST ADVISORY BOARD REPORT

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

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

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

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

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

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

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

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

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

Jeffrey D. Francoz

Ann Marshall

MANAGEMENT'S RESPONSIBILITY

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

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

PricewaterhouseCoopers LLP are the external auditors of the Trust. They have audited the financial statements in accordance with Canadian generally accepted auditing standards to enable them to express to the unitholders their opinion on the financial statements. Their report is set out on page 23.

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

SHAUNA CASSIDY, CFA
Vice-President
Northwater Fund Management Inc.

March 16, 2007

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

We have audited the statement of investment portfolio of Northwater Five-Year Market-Neutral Trust as at December 31, 2006, the statements of net assets of as at December 31, 2006 and 2005 and the statements of operations, changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Trust as at December 31, 2006 and 2005 and the results of its operations, the changes in its net assets and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants
Toronto, Ontario
March 16, 2007

NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST

Statements of Net Assets

	As at December 31, 2006	As at December 31, 2005
Assets		
Cash and short-term investments (cost: 2006 – $1,208,149; 2005 – $2,902,330)	$ 1,211,636	$ 2,902,330
Common shares – at fair value (note 3) (cost: 2006 – $57,164,521; 2005 – $65,441,552)	77,760,371	66,715,061
Unrealized gain on forward contract (note 6)	—	3,485,710
	78,972,007	73,103,101
Liabilities		
Unrealized loss on forward contract (note 6)	12,001,389	—
Audit, legal and custody fees payable	40,507	52,784
Service fees payable (note 7)	53,024	117,935
Management and advisory fees payable (note 7)	26,336	29,053
Advisory board fees payable	20,276	18,176
Forward financing fee payable	—	207,232
Distribution payable (note 9)	1,243,944	1,376,463
Bank loan (note 8)	—	599,840
	13,385,476	2,401,483
Net assets	$65,586,531	$70,701,618
Net assets and unitholders' equity (note 5)		
Unit capital	$67,010,243	$74,148,921
Retained earnings (deficit)	(1,423,712)	(3,447,303)
Total	$65,586,531	$70,701,618
Number of units outstanding (note 5)	2,843,300	3,146,200
Net asset value per unit	$ 23.07	$ 22.47

Signed on behalf of the Trustee,

Northwater Fund Management Inc.

Per: Benita Warmbold

Per: [illegible]

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

NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST

Statements of Operations

	For the year ended December 31,	
	2006	**2005**
Investment income		
Other interest income	$ 24,177	$ 12,151
	24,177	12,151
Expenses		
Service fees (note 7)	210,187	240,847
Forward financing fees (note 7)	723,678	861,099
Management fees (note 7)	111,785	121,799
Audit fees	61,302	33,891
Advisory board fees	12,450	20,000
Custodian fees	14,542	8,872
Legal fees	18,576	28,513
Security holder reporting costs	31,177	132,549
Loan interest and standby fees	32,146	18,535
Other fees	—	14,238
	1,215,843	1,480,343
Net investment loss	(1,191,666)	(1,468,192)
Realized and unrealized gain or loss on investments		
Net realized gain (loss) on:		
Common shares	3,704,517	1,666,077
Foreign Currency	992	—
Change in unrealized appreciation (depreciation) on:		
Common shares	19,322,341	(2,201,676)
Forward contract (note 6)	(15,487,099)	2,964,003
Realized and unrealized gain on investments for the year	7,540,751	2,428,404
Increase in net assets from operations for the year	$ 6,349,085	$ 960,212
Increase in net assets from operations per unit for the year*	$ 2.14	$ 0.30

* Based on the average number of units outstanding 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,	
	2006	**2005**
Net assets – beginning of the year	$70,701,618	$77,173,384
Increase in net assets from operations for the year	6,349,085	960,212
Unit Transactions (note 5)		
Units cancelled	(6,293,840)	(1,816,140)
	(6,293,840)	(1,816,140)
Distribution to unitholders (note 9)		
Return of capital	(5,170,332)	(5,615,838)
	—	(5,615,838)
Net assets – end of the year	$65,586,531	$70,701,618

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,	
	2006	2005
Cash flows from operating activities		
Increase in net assets from operations	$ 6,349,085	$ 960,212
Items not affecting cash:		
Change in unrealized depreciation (appreciation) on common shares	(19,322,341)	2,201,676
Change in unrealized depreciation (appreciation) on currency forwards	15,487,099	(2,964,003)
Realized loss (gain) on common shares	(3,704,517)	(1,666,077)
Changes in non-cash working capital:		
Change in payables	(285,037)	139,754
Purchase of common shares	(15,788,012)	(44,135,691)
Proceeds on sale of common shares	27,769,560	51,885,096
	10,505,837	6,420,967
Cash flows from financing activities		
Loan advance	(599,840)	599,840
Repurchase of trust units	(6,293,840)	(1,816,140)
Distribution paid to trust unitholders	(5,302,851)	(5,652,500)
Payment of offering costs	—	(461,241)
	(12,196,531)	(7,330,041)
Net increase (decrease) in cash and short-term investments	(1,690,694)	(909,074)
Cash and short-term investments at the beginning of the period	2,902,330	3,811,404
Cash and short-term investments at the end of the period	$ 1,211,636	$ 2,902,330
Supplementary information:		
Interest paid	31,986	6,695

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, 2006

	Maturity date	No. of shares/ Face value	Cost	Fair/ Market value	Percentage of total investments
Common share portfolio					
Alliance Atlantis Common-B		124,920	$ 4,325,979	$ 6,305,962	7.99%
Angiotech Pharmaceuticals Inc		212,500	4,771,531	2,037,875	2.58%
Axcan Pharma Inc		274,492	4,325,994	4,551,077	5.76%
Bombardier Inc B		1,778,341	4,623,686	7,024,447	8.90%
Celestica Inc		280,445	2,810,059	2,546,441	3.22%
Cognos Inc		103,100	4,770,426	5,108,605	6.47%
Dorel Industries-Cl B		147,594	4,325,980	4,655,115	5.89%
Forzani Group Ltd.		335,744	4,028,928	6,436,212	8.15%
Kinross Gold Corp.		387,882	3,048,753	5,360,529	6.79%
Lionore Mining Intl Ltd.		718,950	3,666,645	9,526,088	12.07%
Martinrea International Inc.		593,833	3,782,716	7,066,613	8.95%
Nortel Networks Corp		81,661	3,679,455	2,554,356	3.23%
Research In Motion Ltd		39,895	3,508,951	5,944,355	7.53%
RONA Inc		157,366	2,340,373	3,304,686	4.18%
Western Oil Sands Inc Cl/A		163,192	3,155,045	5,338,010	6.76%
Investments			$57,164,521	$ 77,760,371	98.47%
Cash			112,285	112,285	0.14%
Short-term investments					
Commercial Paper – Paccar Financial	Jan 5, 2007	1,100,000	1,095,864	1,099,351	1.39%
Cash and Short-term investments			1,208,149	1,211,636	1.53%
Total investment portfolio			58,372,670	78,972,007	100.00%
Net liabilities				(13,385,476)	
Net assets and unitholders' equity				65,586,531	

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

NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST

Notes to Financial Statements
For the years ended December 31, 2006 and December 31, 2005

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. Northwater Fund Management Inc. (the "Manager") acts as Trustee of the Trust and RBC Dexia Investor Services Trust ("RBC Dexia") acts as Custodian for the Trust. The Trust began operations on June 30, 2004 when it completed its initial public offering. The Northwater Five-Year Market-Neutral Fund Limited (the "Fund") began operations on June 30, 2004. 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 (the "Common Share Portfolio") are combined with a forward contract (the "Forward") 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.

Effective February 23, 2007 the Accounting Standards Board amended AcG-15, Consolidation of Variable Interest Entities and AcG-18, Investment Companies to exclude investment companies from the requirement to consolidate variable interest entities. The Amendment is effective for fiscal periods ending on or after September 30, 2007 with earlier adoption encouraged.

The Trust has early adopted this amendment and the December 31, 2006 financial statements have been prepared in accordance with the revised standard. As a result the accounts Northwater Five-Year Fund Limited, have not been included in these financial statements. The Trust does not have an ownership interest in the Fund and continues to be exposed to the majority of the economic risk and benefits of the Fund through the Forward.

(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 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 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. Distribution income is recorded on ex-dividend date or ex-distribution date on a gross basis.

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 based on the change in valuation of Northwater Five-Year 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 costs of leverage. The investments in market-neutral hedge funds held by Northwater Five-Year 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) Foreign Currency Translation

Assets and Liabilities in foreign currencies are translated into Canadian dollars at the rate of exchange prevailing at the end of the period. Revenues and expenses denominated in foreign currencies are translated using the average exchange rate for the year. Unrealized gains and losses arising from translation of the fund are included as currency translation.

(c) 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.

(d) Comparative Figures

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

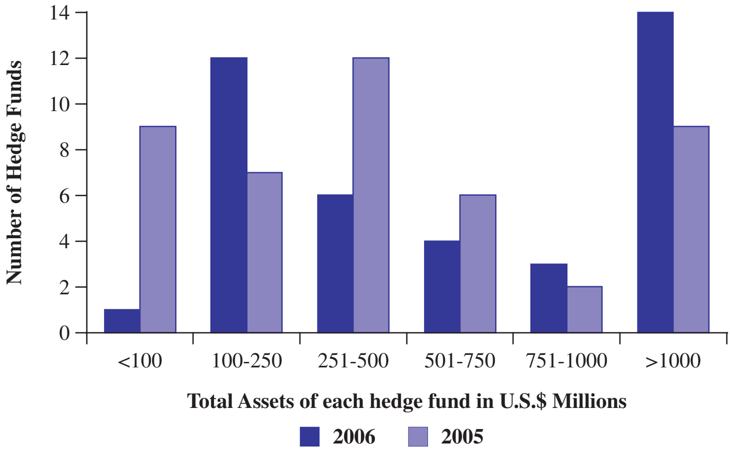
3. Investment in Common Shares

The following table summarizes investment transactions during the years ended December 31, 2006 and 2005:

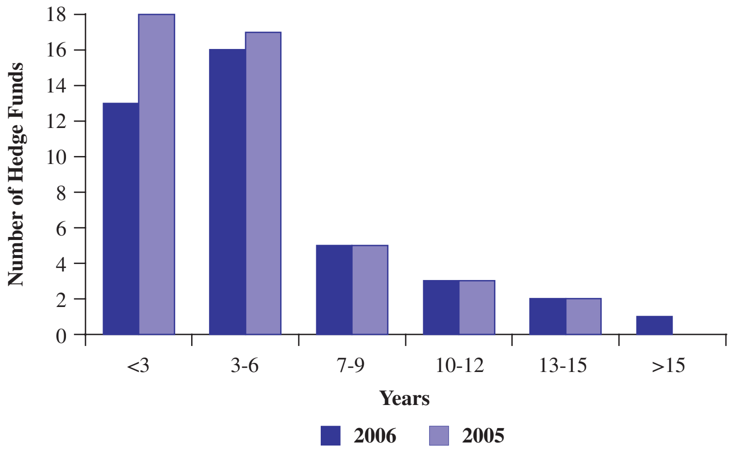
	For the year ended December 31, 2006	For the year ended December 31, 2005
Common shares at cost – beginning of the year	$ 65,441,552	$ 71,524,880
Cost of common shares purchased	15,788,012	44,135,691
Cost of common shares sold	(24,065,043)	(50,219,019)
Common shares at cost – end of the year	57,164,521	65,441,552
Unrealized appreciation on common shares	20,595,850	1,273,509
Market value of common shares – end of the year	$ 77,760,371	$ 66,715,061
Proceeds of common shares sold	$ 27,769,560	$ 51,885,096
Cost of common shares sold	(24,065,043)	(50,219,019)
Net realized gain on common shares	$ 3,704,517	$ 1,666,077

In addition to the interest rate swaps (note 4) and the currency forwards (note 6), the Fund may also have had exposure to derivatives at December 31, 2006 and 2005, through its direct investments in market-neutral hedge funds. The Fund bears the risk of loss in the market-neutral hedge funds only to the extent of its investment in such funds.

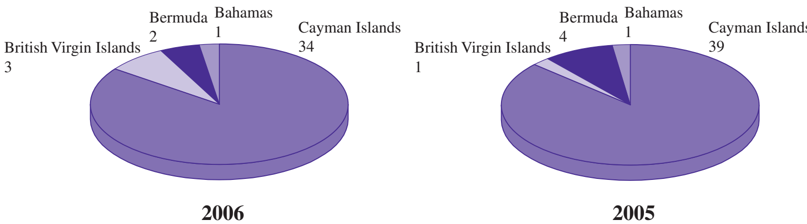
The following table shows the hedge funds held by the Fund as at December 31, 2006 and 2005 categorized by the size of each hedge fund.



The following table shows the hedge funds held by the Fund as at December 31, 2006 and 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, 2006 and 2005.



4. Interest Rate Swap

The Fund has swapped an exposure to a floating money market rate with a U.S. Bank (the "Counterparty") in return for receiving a fixed rate of 4.37%. As a result, if mid-term rates were to decrease (increase) by 1%, the value of the Fund would increase (decrease) by approximately 1.7%.

The Counterparty to the swaps has a credit rating of AA-. The credit worthiness of the Counterparty was reviewed prior to entering into the swap and is monitored on a regular basis.

The notional amount of the interest rate swaps as at December 31, 2006 was $66,963,300 with a maturity date of June 30, 2009 (December 31, 2005: total $76,000,000 with a maturity date of June 30, 2009).

5. Unitholders' Equity

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

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

302,900 units during the year ended December 31, 2006 (year ended December 31, 2005: 83,800 units were repurchased) at a cost of $6,923,691.

Unitholders' equity is comprised of unit capital and retained earnings. The following table shows the transactions for unit capital and retained earnings (deficit) during the years ended December 31, 2006 and 2005:

Year ended December 31, 2006	Units Outstanding	Unit Capital	Retained Earnings (Deficit)	Unitholders' Equity
Balance – December 31, 2005	3,146,200	$74,148,921	$(3,447,303)	$70,701,618
Increase (decrease) in net assets from operations for the period			6,349,085	6,349,085
Units issued during the period			—	—
Units cancelled during the period	(302,900)	(7,138,678)	844,838	(6,293,840)
Distributions	—	—	(5,170,332)	(5,170,332)
Balance – December 31, 2006	2,843,300	$67,010,243	$(1,423,712)	$65,586,531

Year ended December 31, 2005	Units Outstanding	Unit Capital	Retained Earnings (Deficit)	Unitholders' Equity
Balance – December 31, 2004	3,230,000	$76,123,900	$ 1,049,484	$77,173,384
Increase (decrease) in net assets from operations for the period	—	—	960,212	960,212
Units cancelled during the period	(83,800)	(1,974,979)	158,839	(1,816,140)
Distributions	—	—	(5,615,838)	(5,615,838)
Balance – December 31, 2005	3,146,200	$74,148,921	$(3,447,303)	$70,701,618

6. Forward Agreement

The Trust has entered into a forward agreement (the "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 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, 2006 was 143% (December 31, 2005 actual exposure was 144%). 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 less the 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.

The notional amounts of the Forward as at December 31, 2006 are in the amount of U.S. $26,510,645 and Canadian $53,894,915 (December 31, 2005: U.S. $31,654,828 and Canadian $64,352,801). During the year ended December 31, 2006, the Counterparty redeemed 1,289 participating shares of the Fund for $16,854,988 (U.S. $14,839,804) and paid $11,981,522 to the Trust as a result of a reduction in the notional amounts of the Forward and in return for partial settlement of the common share portfolio.

The creditworthiness of the Counterparty was reviewed prior to the transaction and is monitored on a regular basis pursuant to credit standards established by the Manager. As at December 31, 2006 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 1.7%. The interest rate swap has a maturity date of June 30, 2009.

7. Management, Advisory and Other Fees

The Trust retained 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 exchange 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, 2006, the advisory fee charged was in the amount of $1,105,293 (U.S. $977,902) (year ended December 31, 2005: $1,311,077 (US$1,084,679).

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, 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 6).

8. Bank Loan

The Trust has a revolving loan facility with a U.S. 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, 2006, the bank loan balance varied between nil and $2,900,000 (year ended December 31, 2005: between nil and $1,800,000).

The average rate of interest paid on the loan for the year was 5.04%.

9. Distributions

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

During the year ended December 31, 2006, distributions of $1.75 per unit and $5,170,332 in aggregate were declared by the Trust (year ended December 31, 2005: $1.75 per unit and $5,615,838 in aggregate).

10. Income Taxes

As at December 31, 2006, the Trust qualifies as a “mutual fund trust” within the meaning of the *Income Tax Act* (Canada) (the “Tax Act”). 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, 2006, the Trust had $2,980,583 available in non-capital loss carryforwards (December 31, 2005: $2,519,000) with expiry dates commencing in 2011 and no capital loss carryforwards (December 31, 2005: nil).

11. Indemnities

The Trust enters into various agreements that contain indemnity provisions, whereupon payment by the Trust may become due upon the occurrence of certain events 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 as a result of the Counterparty holding 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. The Trust is unable to estimate the maximum potential liability for these indemnities, as the agreements do not specify a maximum amount and the amounts that may be required to be paid are dependent upon the outcome of future contingent events, the nature and likelihood of which cannot be determined at this time.

NORTHWATER CAPITAL MANAGEMENT INC.

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

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

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

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

Northwater also acts as an advisor to the following two closed-ended funds listed on the TSX:

- Northwater Market-Neutral Trust, the first publicly-listed investment vehicle of its kind in Canada to invest in a diversified portfolio of market-neutral hedge funds, which was launched in 1997; and
- Northwater Top 75 Income Trusts^Plus, launched in 2005.

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TSE Symbol: NYF.UN

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