

**NORTHWATER**

**Northwater Five-Year Market-Neutral Trust  
Consolidated Report for the six-month period ended  
June 30, 2006  
(Unaudited)**





## BACKGROUND

Northwater Five-Year Market-Neutral Trust (the “Trust”) is a closed-end investment trust established under the laws of the Province of Ontario. Consolidated financial statements of the Trust, denominated in Canadian dollars, for the six-month period ended June 30, 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 June 30, 2006, the net asset value of the Trust per unit was \$22.23. For the six-month period ended June 30, 2006, the net asset value per unit increased by 2.71%. During the same time period, the Scotia Capital Universe Bond Index fell by 1.45%, the S&P/TSX Composite Index rose by 4.19% and the S&P 500 in U.S. dollar terms, rose by 2.71% which translates to a loss of 2.22% in Canadian dollar terms as the U.S. dollar weakened in the six months. The Trust made distributions of \$0.875 per unit during the period.

Central banks around the world tightened rates in the first half of 2006 in response to inflationary forces and strong economic growth. The Bank of Canada rate rose by 1.00% over the six month period to 4.50%. Market participants responded to the reduction in liquidity by shedding risk in May and June, predominantly in global equities. This sell-off was felt most acutely in emerging markets, Japan and Nordic countries.

The portfolio of market-neutral hedge funds managed by Northwater to which the Trust has exposure performed well for the period. Higher realized volatility in asset prices enlarged the opportunity set for many hedge fund strategies in contrast to the relatively serene environment of 2004 and 2005. Many strategies have performed well over the last six months, including our newest strategy, activist investing.

Distressed securities managers have continued to produce strong results and convertible arbitrage managers have experienced a rebound in performance so far in 2006. The energy relative value strategy has continued to struggle but we hope to see better performance in the latter half of the year.

Credit spreads have tightened in many asset-backed securities markets and at the same time the fundamentals have deteriorated, especially for mortgage credit. We are taking advantage of this situation to reduce the strategy weight after five years of excellent results. Increased allocations to strategies such as statistical arbitrage and fixed income arbitrage reflect our positive outlook for volatility over the next few years.

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 the period, Northwater continued to actively manage the Trust's hedge fund portfolio. During the six-months ended June 30, 2006, six funds were removed for both declining strategy returns and ineffective implementation, while seven new funds 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.

August 23, 2006

## MANAGEMENT REPORT OF FUND PERFORMANCE

This Management Report of Fund Performance contains financial highlights but does not contain the complete consolidated financial statements of Northwater Five-Year Market-Neutral Trust (the “Trust”). A copy of the consolidated financial statements of the Trust for the six-month period ended June 30, 2006 is attached to this report for your reference.

Security holders may also 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](http://www.northwatercapital.com) or the SEDAR website at [www.sedar.com](http://www.sedar.com).

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 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.

As a result of the introduction of a new accounting standard by the Canadian Institute of Chartered Accountants (Accounting Guideline 15 – Consolidation of Variable Interest Entities), the financial statements of the Trust include the accounts of Northwater Five-Year Market-Neutral Fund Limited, a Cayman Islands exempt company (the “Fund”) on a consolidated basis. The Trust does not have an ownership interest in the Fund and continues to be exposed to the majority of the economic risks and benefits of the Fund through a forward purchase and sale agreement (the “Forward”). The Forward is discussed further in the section on Investment Strategies.

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 (“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 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.

As a result of the introduction of a new accounting standard by the Canadian Institute of Chartered Accountants (Accounting Guideline 15 – Consolidation of Variable Interest Entities), the Forward is not reflected in the consolidated financial statements. The economic impact of the Forward is reflected in the consolidated financial statements through the consolidation of 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 June 30, 2006 was 141% (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 1.9%.

### *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 June 30, 2006, financial leverage employed by the Trust was 1.35% (December 31, 2005 was 0.85%).

## Risks

The following tables present information for the period from inception and for the six-month periods ended June 30, 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.

<u>Trust Statistics</u>	<u>For the period from inception to June 30, 2006</u>	<u>For the period from inception to June 30, 2005</u>
# of positive monthly returns . . . . .	20	10
# of negative monthly returns . . . . .	4	2
% of negative months . . . . .	16.7%	16.7%
Average size of negative months . . . . .	-0.50%	-0.63%
Worst monthly return . . . . .	-1.07%	-1.07%
	<u>Six-month period ended June 30,</u>	
<u>Single Hedge Fund Statistics</u>	<u>2006</u>	<u>2005</u>
# of hedge funds with positive returns <sup>(1)</sup> . . . . .	42	35
# of hedge funds with negative returns <sup>(1)</sup> . . . . .	4	13
Average annual hedge fund standard deviation <sup>(2)</sup> . . . . .	3.92%	3.52%
Average correlation between hedge funds <sup>(2)</sup> . . . . .	0.12	0.16

(1) Measured for hedge funds in the Hedge Fund Portfolio of the Fund as at June 30, 2006 and June 30, 2005, respectively.

- (2) As measured over the past 24 months for hedge funds in the Hedge Fund Portfolio of the Fund as at June 30, 2006 and June 30, 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 six-month period ended June 30, 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](http://www.sedar.com).

## Results of Operations

During the six-month period ended June 30, 2006, the Trust posted a return of 2.71% (six-month period ended June 30, 2005: 2.87%), taking into account the distributions made during the period. Distributions during the period totaled \$2,650,550 or \$0.875 per Unit.

During the six-month period ended June 30, 2006, the Fund, to which the Trust has exposure through the Forward, placed investments with seven new hedge funds (consisting of two distressed securities funds, two statistical arbitrage funds and one fund in each of the energy relative value, asset-backed securities arbitrage, and structured finance strategies) and redeemed from six hedge funds (consisting of three capital structure arbitrage funds, one distressed securities fund, one merger arbitrage fund and one multi-strategy). The statistical arbitrage and multi-strategy funds made the biggest contribution to the Fund in the six-month period ended June 30, 2006 while the re-insurance and energy relative value strategies were the weakest performers.

The Fund's exposure to the Swap had a negative impact on the performance of the Fund in the six-month period ended June 30, 2006 (six-month period ended June 30, 2005: positive contribution from interest rate swap). The mark-to-market valuation of the interest rate swap held by the Fund decreased by U.S. \$1,130,655 during the six-month period ended June 30, 2006 (six-month period ended June 30, 2005: increase of U.S. \$1,029,098) due to a increase in mid-term interest rates.

The following table presents the return by investment strategy of the Hedge Fund Portfolio held by the Fund for the six-month periods ended June 30, 2006 and June 30, 2005.

<b>Strategy</b>	<b>Six-month period ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
Activist .....	8.54%	—
Asset-backed securities arbitrage .....	6.18%	6.03%
Capital structure arbitrage .....	2.94%	-3.06%
Convertible bond arbitrage .....	5.23%	-5.82%
Distressed securities .....	6.73%	2.64%
Energy relative value .....	2.66%	-5.12%
Fixed-income arbitrage .....	5.56%	1.94%
Merger arbitrage .....	4.19%	5.35%
Mortgage-backed security arbitrage .....	5.10%	5.60%
Multi-strategy .....	9.09%	2.49%
Re-insurance .....	1.99%	4.21%
Statistical arbitrage .....	10.30%	-1.48%
Structured finance .....	5.73%	4.88%

The Trust had borrowings in the amount of \$896,844 as at June 30, 2006 through a revolving loan facility with a Canadian financial institution. The financial leverage as at June 30, 2006 was 1.35%. The Trust has employed the loan to fund short-term operating needs.

The Trust was required to make purchases of 155,300 units under its repurchase and cancellation program as the units of the Trust for the six-month period ended June 30, 2006 were offered for sale at less than 95.0% of the net asset value (six-month period ended June 30, 2005; no units were repurchased). Over the six-month period ended June 30, 2006, this program contributed 0.35% to the overall return of the Trust (six-month period ended June 30, 2005: 0% contribution).

### **Related Party Transactions**

Northwater Fund Management Inc., (the “Manager”), is responsible for the day-to-day administration, portfolio management and unitholder services to the Trust. In exchange for these services, the Manager is entitled to an annual fee of 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.

During the six-month period ended June 30, 2006, the management fee and service fee expense were \$51,872 and \$101,988 respectively, and the management fee and service fee payable by the Trust as at June 30, 2006 were \$25,567 and \$51,045 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 six-month period ended June 30, 2006, the advisory fee charged was in the amount of \$567,543 (U.S. \$502,144) and as at June 30, 2006, the advisory fee payable was \$183,105 (U.S. \$164,648).

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.

## Financial Highlights

The following tables show selected key financial information about the Trust and are intended to help understand the Trust’s consolidated financial performance for the six-month period ended June 30, 2006, for the year ended December 31, 2005 and for the period from June 30, 2004 to December 31, 2004. The information for 2004 and 2005 is derived from the Trust’s unaudited consolidated financial statements. The information for 2006 is derived from the Trust’s unaudited consolidated financial statements.

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

	For the six-month period ended June 30, 2006	For the year ended December 31,	
		2005	2004
Net Asset Value, beginning of period . . . . .	\$22.47	\$23.89	\$23.75
<b>Increase (decrease) from operations:</b>			
Total revenue . . . . .	0.10	—	0.05
Total expenses . . . . .	(0.43)	(0.46)	(0.22)
Realized gains (losses) for the period . . . . .	0.13	0.52	—
Unrealized gains (losses) for the period . . . . .	0.76	0.24	1.52
<b>Total increase (decrease) from operations<sup>(1)</sup> . . .</b>	<b>0.56</b>	<b>0.30</b>	<b>1.35</b>
<b>Distributions:</b>			
From income (excluding dividends) . . . . .	—	—	—
From capital gains . . . . .	—	—	—
Return of capital . . . . .	—	1.75	0.875
Total Annual Distributions <sup>(2)</sup> . . . . .	0.875	1.75	0.875
Net Asset Value at end of period . . . . .	\$22.23	\$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 reconciliation of opening and closing net asset value per unit.

## Ratios and Supplemental Data

	<b>For the six-month period ended June 30, 2006</b>	<b>For the year ended December 31,</b>	
		<b>2005</b>	<b>2004</b>
Net assets (000's) <sup>(1)</sup> . . . . .	\$ 66,474	\$ 70,702	\$ 77,173
Number of units outstanding <sup>(1)</sup> . . . . .	2,990,900	3,146,200	3,230,000
Management expense ratio <sup>(2)</sup> . . . . .	11.56%	11.75%	18.02%
Management expense ratio before waivers or absorptions . . . . .	11.56%	11.75%	18.02%
Portfolio turnover rate <sup>(3)</sup> . . . . .	7.84%	62.33%	—
Trading expense ratio <sup>(4)</sup> . . . . .	0.02%	0.00%	0.02%
Closing market price or pricing NAV, end of period . . . . .	\$ 22.23	\$ 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 and Fund but also reflects 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, for the year ended December 31, 2005 and for the six-month period ended June 30, 2006 added 9.66%, 9.80% 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. Management continues to receive the audited financial statements for the year 2005 and will reflect the total expenses of the underlying hedge funds once all of such information has been received. The expenses together with estimates for hedge funds with year-ends other than December 31, 2004 have been prorated based on the relative percentage of the hedge 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 and Other Fees

The Trust paid to the Manager a management fee and service fee of \$57,872 and \$101,988 respectively for the six-month period ended June 30, 2006. 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 the Manager to registered dealers and brokers.

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.

## Past Performance

### General

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

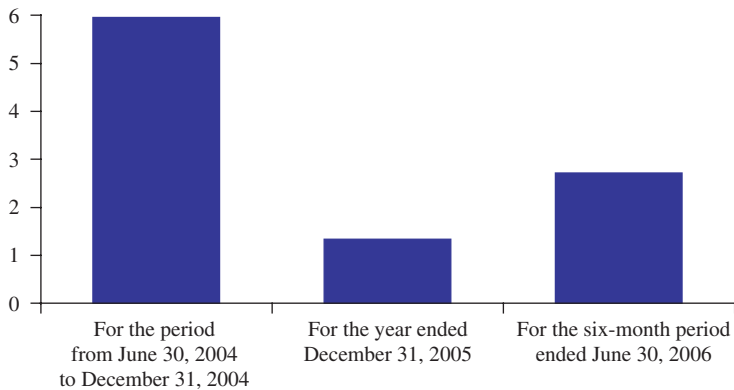
- (a) the performance information shown assumes that all distributions made by the Trust in the periods shown were reinvested in additional securities of the Trust;

- (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.

	<u>Since inception*</u>	<u>Past year</u>	<u>Past six months</u>
Northwater Five-Year Market-Neutral Trust . . . . .	5.02%	1.34%	2.71%
S&P/TSX Composite Index . . . . .	18.84%	24.13%	4.19%
Scotia Capital 91 day T-Bill Index . . . . .	2.75%	2.58%	1.79%
Scotia Capital Universe Bond Index . . . . .	5.47%	6.46%	-1.45%

\* 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<sup>(1)</sup>

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).

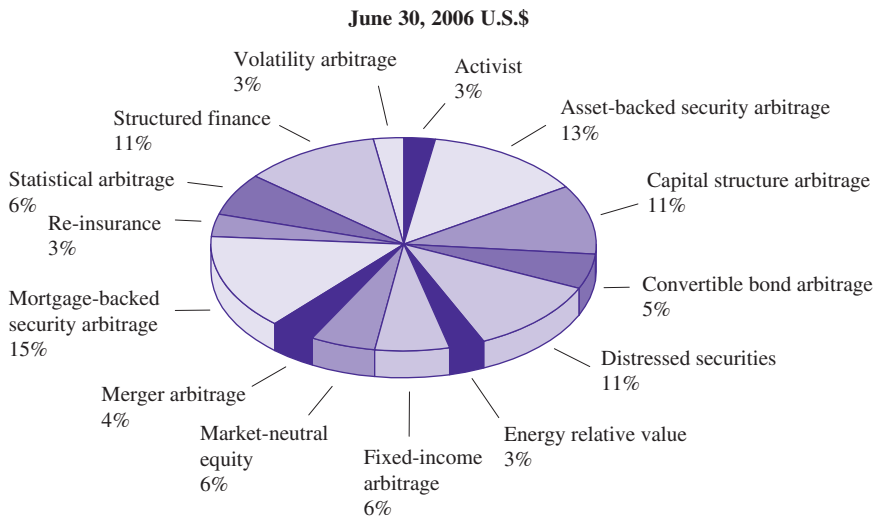
During the six-month period ended June 30, 2006, the Fund placed investments with seven new hedge funds (consisting of two distressed securities funds, two statistical arbitrage funds and one fund in each of the energy relative value, asset-backed securities arbitrage, and structured finance strategies) and redeemed from six hedge funds (consisting of three capital structure arbitrage funds, one distressed securities fund, one merger arbitrage and one multi-strategy fund) (year ended December 31, 2005: the Trust placed investments with 10 new hedge funds and redeemed from eight hedge funds).

### Asset Allocation by Investment Strategy

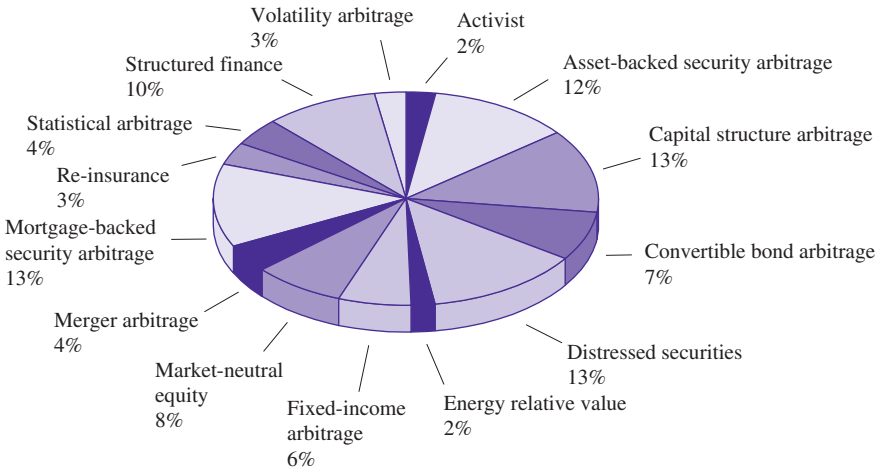
The following table presents information regarding the Hedge Fund Portfolio held by the Fund to which the Trust has exposure through the Forward. The multi-strategy funds have not been allocated to any of the underlying hedge fund strategies set out in this table.

Strategy	As at June 30, 2006			As at December 31, 2005		
	No. of	Fair Value		No. of	Fair Value	
	Hedge Funds	(in U.S.\$)		Hedge Funds	(in U.S.\$)	
Activist	1	\$ 2,250,881	3%	1	\$ 2,073,720	3%
Asset-backed security arbitrage	5	11,207,712	13%	4	9,565,142	12%
Capital structure arbitrage	2	3,478,854	4%	5	6,698,173	8%
Convertible bond arbitrage	2	1,450,172	2%	2	3,047,662	4%
Distressed securities	6	8,822,691	10%	5	9,200,942	11%
Energy relative value	2	1,608,763	2%	1	797,457	1%
Fixed-income arbitrage	2	4,657,107	6%	2	4,411,745	5%
Merger arbitrage	1	1,892,145	2%	2	4,100,405	5%
Mortgage-backed security arbitrage	4	12,279,311	14%	4	10,404,229	13%
Multi-strategy	9	21,848,789	26%	10	21,130,153	25%
Re-insurance	2	2,880,772	3%	2	2,824,523	3%
Statistical arbitrage	2	2,206,057	3%	—	—	—
Structured finance	8	9,981,232	12%	7	8,460,352	10%
	<u>46</u>	<u>\$84,564,486</u>	<u>100%</u>	<u>45</u>	<u>\$82,714,503</u>	<u>100%</u>

The chart below illustrates the hedge fund holdings by strategy of the Fund as at June 30, 2006 and 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.



December 31, 2005 U.S.\$



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 June 30, 2006 and December 31, 2005.

<u>Strategy</u>	<u>As at June 30, 2006</u>	<u>As at December 31, 2005</u>
Activist	3.77%	2.38%
Asset-backed securities arbitrage	7.00%	4.49%
Capital structure arbitrage	3.88%	4.30%
Convertible bond arbitrage	2.28%	3.06%
Distressed securities	4.92%	3.08%
Energy relative value	1.78%	0.92%
Fixed-income arbitrage	4.50%	2.91%
Merger arbitrage	3.17%	2.62%
Mortgage-backed security arbitrage	8.92%	5.85%
Multi-strategy	9.18%	6.00%
Re-insurance	3.48%	2.35%
Statistical arbitrage	1.85%	—
Structured finance	3.16%	2.01%

The following table lists the largest 25 hedge funds by fair value to which the Trust has exposure through the Forward as at June 30, 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.

<b>Top 25 Investments</b>	<b>Type of Investment</b>	<b>Cost</b>	<b>Fair Value</b>	<b>Percentage of Net Assets</b>
D.E. Shaw Composite				
International Fund* . . . . .	Trust units	\$4,670,820	\$6,105,612	9.18%
New Ellington Overseas, Ltd.* . . .	Participating shares	5,004,450	5,931,122	8.92%
New Ellington Credit Overseas, Ltd.* . . . . .	Participating shares	3,892,350	4,650,952	7.00%
DPFM Multi Limited* . . . . .	Participating shares	3,113,880	3,336,918	5.02%
Fund 101* . . . . .	Participating shares	2,731,959	3,268,383	4.92%
Fund 169* . . . . .	Participating shares	2,703,162	3,137,180	4.72%
Fund 146* . . . . .	Participating shares	2,669,040	3,103,973	4.67%
Fund 103* . . . . .	Participating shares	2,669,040	3,014,903	4.54%
Fund 140* . . . . .	Participating shares	2,669,040	2,992,311	4.50%
Fund 109* . . . . .	Participating shares	2,092,301	2,754,500	4.14%
Fund 130* . . . . .	Participating shares	2,224,241	2,715,458	4.08%
Fund 170* . . . . .	Participating shares	2,399,484	2,581,152	3.88%
Fund 200* . . . . .	Participating shares	2,335,410	2,566,598	3.86%
Fund 121* . . . . .	Participating shares	2,224,200	2,545,246	3.83%
Fund 183* . . . . .	Participating shares	2,112,990	2,539,785	3.82%
Fund 209* . . . . .	Participating shares	2,224,200	2,503,205	3.77%
Fund 184* . . . . .	Participating shares	2,335,410	2,460,088	3.70%
Fund 190* . . . . .	Participating shares	2,224,200	2,399,375	3.61%
Fund 158* . . . . .	Participating shares	2,783,494	2,311,922	3.48%
Fund 189* . . . . .	Participating shares	2,001,780	2,310,420	3.48%
Fund 191* . . . . .	Participating shares	1,890,570	2,186,857	3.29%
Fund 181* . . . . .	Participating shares	1,890,570	2,104,254	3.17%
Fund 108* . . . . .	Participating shares	1,556,940	2,102,244	3.16%
Fund 205* . . . . .	Participating shares	1,668,150	1,771,284	2.66%
Fund 199* . . . . .	Participating shares	1,445,730	1,572,587	2.37%

\* 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 June 30, 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.

<u>Share Investments</u>	<u>Type of Investment</u>	<u>Percentage of Net Assets</u>
Angiotech Pharmaceuticals Inc. ....	Common shares	4.16%
ATI Technologies Inc. ....	Common shares	5.48%
Bombardier Inc. ....	Common shares	8.32%
Celestica Inc. ....	Common shares	4.46%
Cognos Inc. ....	Common shares	4.87%
Forzani Group Ltd. ....	Common shares	8.43%
Glamis Gold Ltd. ....	Common shares	11.58%
Kinross Gold Corp. ....	Common shares	11.26%
Lionore Mining Intl Ltd. ....	Common shares	8.90%
Martinrea International Inc. ....	Common shares	9.09%
Nortel Networks Corp. ....	Common shares	3.05%
Research In Motion Ltd. ....	Common shares	4.67%
RONA Inc. ....	Common shares	4.75%
Western Oil Sands Inc. ....	Common shares	11.89%

- (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.

### 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 six-month period ended June 30, 2006, the net asset value of the Trust fluctuated between \$22.23 per unit and \$22.91 per unit after taking into account distributions (six-month period ended June 30, 2005: between \$23.69 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 six-month period ended June 30, 2006 (six-month period ended June 30, 2005: between \$23.10 per unit and \$26.22 per unit).

## Distributions

During the six-month period ended June 30, 2006, distributions totaling \$0.8750 per unit and \$2,650,550 in aggregate were declared (six-month period ended June 30, 2005: \$0.8750 per unit and \$2,826,250 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.

## Distribution History

<u>Record date</u>	<u>Date distribution paid</u>	<u>Character of distribution for tax purposes</u>	<u>Amount per unit</u>
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, 2006	To be determined	\$0.4375
June 30, 2006	July 14, 2006	To be determined	\$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.

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 six-month period ended June 30, 2006, the Trust purchased 155,300 units for cancellation under these programs (six-month period ended June 30, 2005: no units were repurchased).

## MANAGEMENT'S RESPONSIBILITY

The accompanying consolidated 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 consolidated 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 consolidated 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 consolidated financial statements.

The image shows two handwritten signatures in blue ink. The signature on the left is 'Benita Warmbold' and the signature on the right is 'Shauna Cassidy'.

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

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

August 23, 2006

**NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST**

Consolidated Statements of Net Assets

	<b>As at June 30, 2006 (unaudited)</b>	<b>As at December 31, 2005 (unaudited)</b>
<b>Assets</b>		
Cash and short-term investments (cost: 2006 – \$2,552,434; 2005 – \$7,417,810) . . . . .	\$ 2,555,590	\$ 7,417,810
Hedge fund investments – at fair value (note 3) (cost: 2006 – \$82,433,452; 2005 – \$88,508,529) . . . . .	94,044,165	96,622,947
Hedge fund redemptions receivable . . . . .	1,300	296,082
Interest rate swap – at fair value (note 4) . . . . .	—	353,261
Swap interest receivable (note 4) . . . . .	—	243,509
Settlement receivable on currency forwards . . . . .	129,843	17,569
	<u>96,730,898</u>	<u>104,951,178</u>
<b>Liabilities</b>		
Audit, legal and custody fees payable . . . . .	167,429	117,304
Service fee payable (note 7) . . . . .	51,045	117,935
Management and advisory fee payable (note 7) . . . . .	208,671	337,023
Advisory board fees payable . . . . .	22,536	—
Interest rate swap – at fair value (note 4) . . . . .	824,277	—
Hedge fund investments – sale in advance . . . . .	834,075	—
Forward financing fee payable . . . . .	—	207,232
Distribution payable (note 9) . . . . .	1,308,519	1,376,463
Bank loan (note 8) . . . . .	900,000	599,840
Due to counterparty (note 6) . . . . .	25,940,147	31,493,763
	<u>30,256,699</u>	<u>34,249,560</u>
<b>Net assets</b> . . . . .	<u>\$66,474,199</u>	<u>\$ 70,701,618</u>
<b>Net assets and unitholders' equity (note 5)</b>		
Unit capital . . . . .	70,488,846	74,148,921
Retained earnings (deficit) . . . . .	(4,014,647)	(3,447,303)
Total . . . . .	<u>\$66,474,199</u>	<u>\$ 70,701,618</u>
<b>Number of units outstanding (note 5)</b> . . . . .	<u>2,990,900</u>	<u>3,146,200</u>
<b>Net asset value per unit</b> . . . . .	<u>\$ 22.23</u>	<u>\$ 22.47</u>

Signed on behalf of the Trustee,  
Northwater Fund Management Inc.

Per: 

Per: 

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

**NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST**

Consolidated Statements of Operations

	<b>For the six-month period ended June 30,</b>	
	<b>2006 (unaudited)</b>	<b>2005 (unaudited)</b>
<b>Investment income</b>		
Income on interest rate swap . . . . .	\$ 140,778	\$ 620,922
Interest . . . . .	114,376	66,917
	<u>255,154</u>	<u>687,839</u>
<b>Expenses</b>		
Service fees (note 7) . . . . .	101,988	122,940
Forward financing fee payable (note 7) . . . . .	379,470	439,727
Management fees (note 7) . . . . .	51,872	62,164
Advisory fees (note 7) . . . . .	567,543	678,848
Audit fees . . . . .	51,720	33,760
Advisory board fees . . . . .	10,000	10,000
Custodian fees . . . . .	46,659	47,415
Legal fees . . . . .	16,753	26,093
Security holder reporting costs . . . . .	—	29,057
Loan interest and standby fees . . . . .	12,950	—
Other fees . . . . .	11,933	10,554
	<u>1,250,888</u>	<u>1,460,558</u>
<b>Net investment loss</b> . . . . .	<u>(995,734)</u>	<u>(772,719)</u>
<b>Realized and unrealized gain or loss on investments</b>		
Net realized gain (loss) on:		
Hedge funds . . . . .	1,467,656	41,170
Interest rate swap . . . . .	(98,390)	—
Currency forwards . . . . .	40,555	(54,525)
Change in unrealized appreciation (depreciation) on:		
Hedge funds . . . . .	3,496,295	1,974,931
Interest rate swap . . . . .	(1,178,023)	1,271,574
Currency forwards . . . . .	124,909	(33,127)
Currency translations and other costs on forward contract . . . . .	<u>(1,155,567)</u>	<u>(240,890)</u>
<b>Realized and unrealized gain on investments for the period</b> . . . . .	<u>\$ 2,697,435</u>	<u>\$2,959,133</u>
<b>Net income for the period</b> . . . . .	<u>\$ 1,701,701</u>	<u>\$2,186,414</u>
<b>Net income per unit for the period*</b> . . . . .	<u>\$ 0.56</u>	<u>\$ 0.67</u>

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

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

**NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST**

Consolidated Statements of Changes in Net Assets

	<u>For the six-month period ended June 30,</u>	
	<u>2006 (unaudited)</u>	<u>2005 (unaudited)</u>
<b>Net assets – beginning of the period</b> .....	\$70,701,618	\$77,173,384
<b>Net income for the period</b> .....	<u>1,701,701</u>	<u>2,186,414</u>
<b>Unit Transactions (note 5)</b>		
Units cancelled .....	(3,278,570)	—
	<u>(3,278,570)</u>	<u>—</u>
<b>Distribution to unitholders (note 9)</b> .....	<u>(2,650,550)</u>	<u>(2,826,250)</u>
<b>Net assets – end of the period</b> .....	<u>\$66,474,199</u>	<u>\$76,533,548</u>

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

**NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST**

Consolidated Statements of Cash Flows

	For the six-month period ended June 30,	
	2006 (unaudited)	2005 (unaudited)
<b>Cash flows from operating activities</b>		
Net income from operations . . . . .	\$ 1,701,701	\$ 2,186,414
Items not affecting cash:		
Change in unrealized depreciation (appreciation) on hedge funds . . . . .	(3,496,295)	(1,974,932)
Change in unrealized depreciation (appreciation) on interest rate swap . . . . .	1,178,023	(1,271,574)
Change in unrealized depreciation (appreciation) on currency forwards . . . . .	(124,909)	33,127
Realized loss (gain) on hedge funds . . . . .	(1,467,656)	(41,170)
Changes in non-cash working capital:		
Change in payable to counterparty . . . . .	4,225,381	(32,806,157)
Change in other payables . . . . .	504,262	(58,661)
Purchase of hedge funds . . . . .	(10,285,184)	(11,683,122)
Purchase of common shares . . . . .	(2,810,059)	(15,415,119)
Proceeds on sale of hedge funds . . . . .	13,452,993	4,713,412
Proceeds on settlement of common shares . . . . .	4,768,736	17,317,703
	<u>7,646,993</u>	<u>(39,000,079)</u>
<b>Cash flows from financing activities</b>		
Payment of distributions . . . . .	(2,718,494)	(2,826,250)
Loan advance . . . . .	300,160	199,531
Issuance of fund shares . . . . .		33,314,560
Redemption of fund shares paid in advance . . . . .	(6,812,309)	(3,624,546)
Cancellation of units . . . . .	(3,278,570)	
Payment of offering costs . . . . .		(461,241)
	<u>(12,509,213)</u>	<u>26,602,054</u>
Net increase (decrease) in cash and short-term investments . . . .	<u>(4,862,220)</u>	<u>(12,398,025)</u>
Cash and short-term investments at the beginning of the period . . . . .	<u>\$ 7,417,810</u>	<u>\$ 14,500,806</u>
<b>Cash and short-term investments at the end of the period . . . . .</b>	<u><b>\$ 2,555,590</b></u>	<u><b>\$ 2,102,781</b></u>
Supplementary information:		
Interest paid . . . . .	\$ 19,195	\$ 1,563

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

**NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST**

Consolidated Statement of Investment Portfolio

As at June 30, 2006

<b>Hedge Fund portfolio</b>	<b>No. of shares/ Face value</b>	<b>Cost</b>	<b>Fair/ Market value</b>	<b>Percentage of investment portfolio</b>
Activist .....		\$ 2,212,244	\$ 2,503,205	
Asset-backed security arbitrage .....		10,763,364	12,464,097	
Capital structure arbitrage .....		3,603,320	3,868,834	
Convertible bond arbitrage .....		1,410,374	1,612,736	
Distressed securities .....		8,407,683	9,811,715	
Energy relative value .....		1,737,939	1,789,105	
Fixed-income arbitrage .....		4,535,101	5,179,169	
Merger arbitrage .....		1,880,408	2,104,254	
Mortgage-backed security arbitrage .....		11,835,507	13,655,822	
Multi-strategy .....		20,448,056	24,298,038	
Re-insurance .....		3,653,337	3,203,706	
Structured finance .....		2,212,244	2,453,356	
Statistical arbitrage .....		9,733,875	11,100,128	
		<u>82,433,452</u>	<u>94,044,165</u>	<u>97.35%</u>
<b>Total investments</b> .....			<u>94,044,165</u>	<u>97.35%</u>
<b>Cash</b> .....		<u>2,552,434</u>	<u>2,555,590</u>	<u>2.65%</u>
<b>Total investment portfolio</b> .....			<u>96,599,755</u>	<u>100.00%</u>
<b>Net liabilities</b> .....			<u>(30,125,556)</u>	
<b>Net assets and unitholders' equity</b> .....			<u>66,474,199</u>	
<b>Common share portfolio*</b>				
Angiotech Pharmaceuticals Inc. ....	212,500	4,771,539	2,766,750	
ATI Technologies Inc. ....	224,400	4,763,672	3,639,768	
Bombardier Inc. B .....	1,778,341	4,623,686	5,530,641	
Celestica Inc. ....	280,445	2,810,059	2,964,304	
Cognos Inc. ....	103,100	4,770,426	3,238,371	
Forzani Group Ltd. ....	335,744	4,028,928	5,606,925	
Glamis Gold Ltd. ....	181,918	4,798,997	7,698,770	
Kinross Gold Corp. ....	615,015	4,834,018	7,484,733	
Lionore Mining Intl Ltd. ....	976,650	4,980,915	5,918,499	
Martineau International Inc. ....	800,077	5,096,490	6,040,581	
Nortel Networks Corp. ....	816,613	3,679,455	2,025,200	
Research In Motion Ltd. ....	39,895	3,508,951	3,103,831	
RONA Inc. ....	157,366	2,340,373	3,155,188	
Western Oil Sands Inc. C/A .....	255,492	4,939,512	7,904,922	
		<u>\$59,947,021</u>	<u>67,078,483</u>	
less value pledged under Forward to counterparty (note 6 and Schedule 1) .....			<u>\$(67,078,483)</u>	

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

**Schedule 1 – Forward foreign exchange contracts:**

<b>Contracts to buy (sell) Canadian dollars</b>	<b>Proceeds in (payment of) U.S. dollars</b>	<b>Settlement date</b>	<b>Settlement amount in excess of (deficiency to) market value in U.S. dollars</b>	<b>Credit rating of counterparty*</b>
\$(4,466,046)	\$3,900,000	July 13, 2006	\$116,165	R1 – mid
(200,818)	180,000	July 13, 2006	590	R1 – mid

\* Standard & Poor's Rating Service.

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

**NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST**

Notes to Consolidated Financial Statements

For the six-month periods ended June 30, 2006 and June 30, 2005

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**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. These consolidated financial statements include the accounts of Northwater Five-Year Market-Neutral Fund Limited (the “Fund”), which is an exempt company incorporated under the *Companies Law (2003 Revision)* of the Cayman Islands on May 7, 2004. Northwater Fund Management Inc. 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 Trust issued additional units on December 31, 2004 through a secondary offering. The Fund began operations on June 30, 2004. 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 (the “Forward”) to achieve a return based on a diversified portfolio of market-neutral hedge funds.

As a result of the introduction of a new accounting standard by the Canadian Institute of Chartered Accountants (Accounting Guideline 15 – Consolidation of Variable Interest Entities), the financial statements of the Trust include the accounts of Northwater Five-Year Market-Neutral Fund Limited, a U.S. dollar denominated Cayman Islands exempt company (the “Fund”) on a consolidated basis. The Trust does not have an ownership interest in the Fund and continues to be exposed to the majority of the economic risks and benefits of the Fund through the Forward. The Forward is discussed further in note 6.

**2. Summary of Significant Accounting Policies**

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

The Trust has implemented the requirements of Accounting Guideline 15 – Consolidation of Variable Interest Entities for the first time during the six-month period ended June 30, 2006 with retroactive application to the comparative amounts for prior periods.

#### (a) Principles of Consolidation

These consolidated financial statements include the accounts of the Trust and the Fund. The financial statements of the Trust and the Fund have been consolidated pursuant to Accounting Guideline 15 – Consolidation of Variable Interest Entities as the Trust is exposed to a majority of the economic risks of the Fund through the Forward.

#### (b) 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.

Investments in market-neutral hedge funds are valued on the basis of the definitive net asset values reported by the administrators or the portfolio managers of such funds on the Valuation Date or, if not available, the most recent provisional net asset values based on preliminary returns reported by the administrators or the portfolio managers of such funds. The difference between fair value and cost is shown as an unrealized gain or loss on hedge fund investments. Average cost is used to compute realized and unrealized gains and losses.

The value of the interest rate swap is the gain or loss, if any, that would be realized if, on the Valuation Date the swaps were “closed out”. The difference between fair value and cost is shown as an unrealized gain or loss on the interest rate swap.

The carrying value of the currency forward is the difference between the value of the currency forward at the Valuation Date and the value on the date the currency forward originated. When a currency forward

expires or is closed out, a gain or loss is recognized and is recorded as income or loss in the Consolidated Statement of Operations.

(c) **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.

(d) **Use of Estimates**

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires the Trust to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

(e) **Comparative Figures**

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

### 3. **Investment in Market-Neutral Hedge Funds**

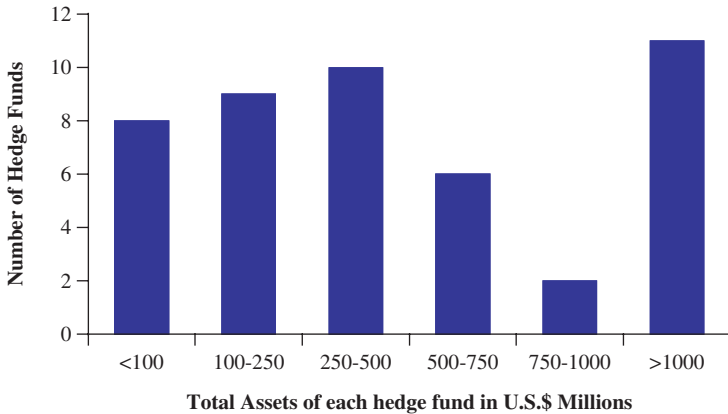
The Trust has exposure through the Forward to a diversified portfolio of market-neutral hedge funds owned by the Fund. As part of its investment strategy, the Fund invests in a diversified portfolio of market-neutral hedge funds. The market-neutral hedge funds included in the Fund's portfolio are organized and domiciled in non-U.S. jurisdictions consisting primarily of Bermuda, Cayman Islands, British Virgin Islands and the Bahamas. These market-neutral hedge funds are managed by independent portfolio managers who are compensated for their services by the respective market-neutral hedge funds they manage. Such compensation generally consists of an asset-based advisory fee, generally ranging from 1% to 2% annually, and a performance-based incentive fee, generally ranging from 10% to 20% of net profits earned above a high-water mark. Compensation paid to independent portfolio managers of the market-neutral hedge funds is not separately computed and disclosed by the Fund but rather is reflected in the valuation of each market-neutral hedge fund. Redemption provisions for the market-neutral hedge funds will vary ranging generally from 30 days' notice to 180 days' notice and may be subject to lock-up provisions.

The following table summarizes investment transactions during the periods:

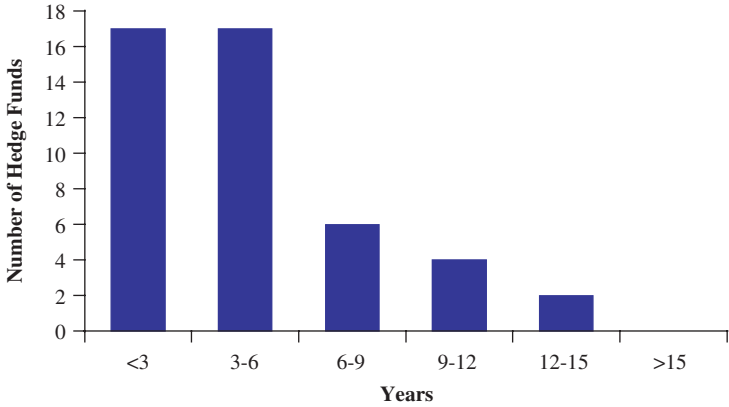
	<u>For the six-month period ended June 30,</u>	
	<u>2006</u>	<u>2005</u>
	(in U.S. dollars)	
<b>Investments at cost – beginning of the period</b> . . . . .	\$ 75,768,120	\$57,381,397
Cost of investments purchased . . . . .	9,100,000	32,650,363
Cost of investments sold . . . . .	(10,343,427)	(4,955,696)
<b>Investments at cost – end of the period</b> . . . . .	74,524,693	85,076,064
Unrealized appreciation of investments . . . . .	10,039,793	3,778,081
<b>Market value of investments – end of the period</b> . . . . .	<u>\$ 84,564,486</u>	<u>\$88,854,145</u>
Proceeds of investments sold . . . . .	\$ 11,641,962	\$ 4,989,015
Cost of investments sold . . . . .	(10,343,427)	(4,955,696)
<b>Net realized gain on investments</b> . . . . .	<u>\$ 1,298,535</u>	<u>\$ 33,319</u>

In addition to the interest rate swap (note 4) and the currency forwards (note 6), the Fund may also have had exposure to derivatives at June 30, 2006 and June 30, 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.

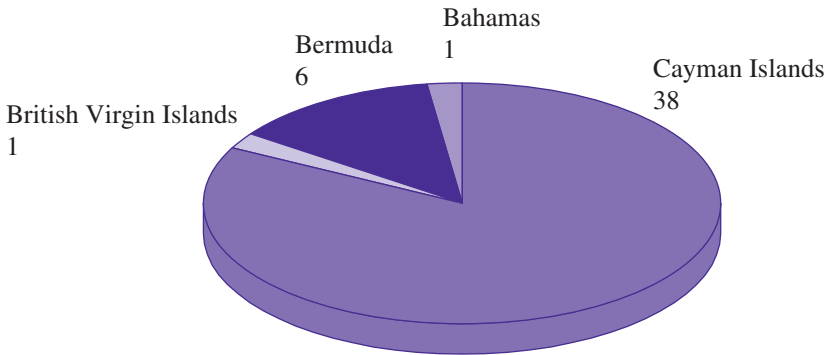
The following table shows the hedge funds held by the Fund as at June 30, 2006 categorized by the June 30, 2006 size of each hedge fund.



The following table shows the hedge funds as at June 30, 2006 categorized by the years since inception of each hedge fund.



The following chart illustrates the hedge fund holdings by jurisdiction of organization as at June 30, 2006.



#### 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 4.30%. As a result, if mid-term rates were to decrease (increase) by 1%, the value of the Fund would increase (decrease) by approximately 1.9%.

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 June 30, 2006 was \$70,441,300 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 155,300 units during the six-month period ended June 30, 2006 (six-month period ended June 30, 2005: no units were repurchased).

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 relevant periods:

<u>Six-month period ended June 30, 2006</u>	<u>Units Outstanding</u>	<u>Unit Capital</u>	<u>Retained Earnings (Deficit)</u>	<u>Unitholders' Equity</u>
<b>Balance –</b>				
<b>December 31, 2005</b> . . . . .	3,146,200	\$74,148,921	\$(3,447,303)	\$70,701,618
Increase (decrease) in net assets from operations for the period . . . . .	—	—	1,701,701	1,701,701
Units issued during the period . . . . .	—	—	—	—
Units cancelled during the period . . . . .	(155,300)	(3,660,075)	381,505	(3,278,570)
Distributions . . . . .			(2,650,550)	(2,650,550)
<b>Balance –</b>				
<b>June 30, 2006</b> . . . . .	<u>2,990,900</u>	<u>\$70,488,846</u>	<u>\$(4,014,647)</u>	<u>\$66,474,199</u>

<u>Six-month period ended June 30, 2005</u>	<u># Units</u>	<u>Unit Capital</u>	<u>Retained Earnings (Deficit)</u>	<u>Unitholders' Equity</u>
<b>Balance –</b>				
<b>December 31, 2004</b> . . . . .	3,230,000	\$76,123,900	\$1,049,484	\$77,173,384
Increase (decrease) in net assets				
from operations for the period . . .	—	—	2,186,414	2,186,414
Units issued during the period . . . .	—	—	—	—
Units cancelled during the period . .	—	—	—	—
Distributions . . . . .	—	—	(2,826,250)	(2,826,250)
<b>Balance –</b>				
<b>June 30, 2005</b> . . . . .	<u>3,230,000</u>	<u>\$76,123,900</u>	<u>\$ 409,648</u>	<u>\$76,533,548</u>

## 6. Forward Agreement

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 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 June 30, 2006 was 141% (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 less the costs of leverage.

The following table summarizes the amount due to the Counterparty under the terms of the Forward:

	<u>June 30, 2006</u>	<u>December 31, 2005</u>
Investment by Counterparty in the Fund, net of redemptions . . . . .	\$ 93,695,490	\$101,694,534
Due from Counterparty for common share portfolio, net of repayments . . . . .	(67,078,483)	(66,715,061)
Unrealized gain (loss) on forward contract . . . . .	<u>(676,860)</u>	<u>(3,485,710)</u>
Net amount due to Counterparty . . . . .	<u>\$ 25,940,147</u>	<u>\$ 31,493,763</u>

The notional amounts of the Forward as at June 30, 2006 are in the amount of U.S. \$29,559,301 and Canadian \$60,092,691 (December 31, 2005: U.S. \$31,654,828 and Canadian \$64,352,801). During the six-month period ended June 30, 2006, the Counterparty redeemed 525.1562 participating shares of the Fund for \$6,812,309 (U.S. \$5,909,487) and paid \$4,768,736 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 June 30, 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 1.9%. The interest rate swap has a maturity date of June 30, 2009.

## 7. 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 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 six-month period ended June 30, 2006, the advisory fee charged was in the amount of \$567,543 (U.S. \$502,144) (six-month period ended June 30, 2005: \$678,848 (U.S. \$549,399)).

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, 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).

## 8. 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 six-month period ended June 30, 2006, the bank loan balance varied between \$0 and \$2,900,000 (year ended December 31, 2005: between \$0 and \$1,800,000).

## 9. Distributions

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

During the six-month period ended June 30, 2006, distributions of \$0.875 per unit and \$2,650,550 in aggregate were declared by the Trust (six-month period ended June 30, 2005: \$0.8750 per unit and \$2,826,250 in aggregate).

## 10. 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).

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

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

With more than ten years of experience in fund of hedge funds, Northwater has steadily grown assets under management to approximately CDN \$10.6 billion total, including CDN \$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, 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<sup>Plus</sup>, launched in 2005.

## NORTHWATER FIVE-YEAR MARKET-NEUTRAL TRUST

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## INVESTMENT ADVISOR OF NORTHWATER FIVE-YEAR MARKET-NEUTRAL FUND LIMITED

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