Private Funds
CFO

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Navigating private funds' outsourcing imperatives

Not only is the private fund operating environment increasingly complex, but outsourcing choices facing CFOs are too.

Operational pressures are mounting on funds investing across multiple strategies and geographies on behalf of an increasingly large and diverse investor base demanding real-time, data-driven reporting. Add to the mix tightened liquidity, rising sensitivity to costs and artificial intelligence disruption, and CFOs are reviewing increasingly varied and nuanced outsourcing options.

"The world today, contrasted with 10 or even five years ago, is a much more complicated place," says John Stephens, CFO at secondaries firm Pomona Capital. "There's been a lot of product innovation across private equity over the past 10 years, including rated feeders, collateralized fund obligations and insurance-dedicated funds, which increases the level of end-user delivery and introduces an additional layer of operating complexity. Specifically for our firm, we've scaled and developed different kinds of products, for example, in the mass affluence space, which heightens operational intensity."

And then, added to rising compliance requirements that come with diversifying fund structures, LPs too are increasingly sophisticated and demanding. Stephens adds: "They ask more in-depth questions so they can respond to their stakeholders and meet their portfolio management needs, which requires us to respond in kind."

As operational pressures mount, for Stephens, deciding what functions to keep in-house and what to outsource is a matter of filling gaps in technical expertise that the firm would find difficult to build or acquire – for instance, compliance testing and tax consulting. "Tax dynamics in a secondary strategy can be complicated to track, allocate and assess."

In a tough fundraising environment, how to structure your team and whether to hire at the management company level or charge outsourced work to fund expenses is an increasingly complex strategic consideration, notes Katie Twomey, senior vice-president of finance and operations at

Illumen Capital.

The firm operates with a team of 10 and, like many of its peers, outsources its fund administration and accounting, HR, legal counsel and some compliance functions, as well as IT and cybersecurity.

At Balbec Capital, CFO Christina Houghton says the decision to outsource is largely driven by the nature of the work. If a task is more routine, repeatable and rules-based it can often be outsourced to a third party. However, a complex task, such as producing the summary conclusion for an accounting treatment for a multi-part credit transaction, requires internal expertise.

CFOs are "under increasing pressure to manage headcount and do more with less," Houghton notes. Key to addressing that challenge is new technology that automates tasks, including the most notable development: the adoption of AI-powered tools.

Being artificial

For all CFOs, regardless of fund size or strategy, the proliferation of AI tools promising efficiencies, greater speed and lowered costs is at front of mind when making outsourcing decisions. "New AI tools are extraordinarily exciting," says Stephens. "We're in the midst of a revolution right now, and in a year's time, everything is going to look different."

Previously, a firm might have bought one software package as a holistic IT solution, but the introduction of new AI tools means Pomona has engaged several third-party providers along the value chain, "centered on an internal data effort that we're managing with the help of some third-party expertise," says Stephens. "It's a different model than we saw five or 10 years ago."

Blake Cholost, deputy CFO at mid-market firm Kinderhook Industries, notes that in the past, outsourcing choices were driven by labor cost considerations and the desire to outsource as much as possible. "Now we're at a point where fund administrators are such an established pillar of a firm's operating infrastructure, it creates a different kind of risk. That's prompting some firms to move to a hybrid outsourcing approach, where they retain control of their data." What's enabling this revision of the outsourcing model? "Advances in AI," he says.

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Retaining ownership of the firm's data is seen as increasingly vital. "If you don't have full control and insight into your data, you're going to be at a disadvantage if AI shifts from the automation of routine tasks to making judgment-based decisions, including waterfall calculations, scenario modeling and valuation markups," says Cholost.

The development of data management systems and governance frameworks to support this shift marks a significant expansion of the CFO role. "The CFO is in a unique position where they see the bigger picture, and how data and technology integrates across the firm, which allows them to identify opportunities for enhancement," says Houghton. "But a typical CFO's background is not in technology. That's where having an outsourced provider at the forefront of data architecture developments, and one who understands what tools are available, is important."

Illumen is engaging its existing IT provider to lead the firm's implementation of an AI strategy. Key to that decision is the vendor's track record with AI implementation, its familiarity with the AI models the team wants to use and its knowledge of the firm's internal systems, Twomey says.

"We want to ensure that as we implement AI solutions, we do that in a secure way and that none of our data leaks into other models, or that our current permissions are [inadvertently] replicated in the solution we adopt."

Keeping up

As managers increasingly implement AI, service providers need to keep pace. "Firms that selected their partners several years ago, when AI was not top of mind, are reliant on those service providers to implement AI enhancements," notes Houghton.

However, looking forward, if those providers fail to adopt AI innovations, "then no matter how deeply embedded they are, other providers leaning into AI advancements will offer a value proposition that could be sufficiently different and compelling enough to make switching worthwhile.

"If you're selecting a service provider today, you should absolutely be asking about their AI roadmap."

Cholost agrees: "If you're going to partner with a fund admin, you need to make sure that they are investing in the right technology to provide a product not just for this year, but for the next five to 10 years."

"Over the next five years, work such as drafting documents, scheduling board meetings, general corporate governance and bookkeeping will be materially

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AI cybercrime

While AI promises significant efficiencies to fund managers and their service providers, it is also empowering cybercriminals.

As the sophistication of AI-facilitated cyberattacks increases, firms need to ensure their cybersecurity safeguards and those of their vendors are robust.

"With AI, it's going to get scarier," says Kinderhook's Cholost, who notes that phishing emails in which you could spot a spelling or grammar error, or odd e-mail addresses, have been superseded by fake videos of real people.

"Over the past two years, we've definitely ramped up our engagement with our IT provider in terms of cybersecurity initiatives," says Illumen's Twomey. This includes conducting cybersecurity risk assessments, social engineering campaigns and phishing tests. When assessing vendors for their cybersecurity readiness, "the most important piece is the security of our data," Twomey says. "If they are leveraging AI, how are they making sure that our data is secure and private? What safeguards do they have in place? What are their cyber and AI policies?"

The challenge is to balance security needs against the expediency of sharing data, says Valor's Phillips. To prevent unauthorized access and data breaches, "the key thing is to build robust systems with as many controls as you reasonably can without losing too much operational efficiency."

impacted by AI," expects Matthew Phillips, head of finance and operations at Valor Real Estate Partners.

For Phillips, given the firm's focus on industrial real estate, it's important that its third-party provider is adequately resourced and an expert user of the same industry-specific software products. "We want a sophisticated, tech-savvy administrator. We have our priorities, and we work with our fund admin to implement them. That could be introducing a new software solution that we believe would benefit both of us. Technology is evolving with AI, and whether administrators evolve too is the question.

"To some degree, AI is a risk to administrators because headcount and therefore costs should decrease, potentially impacting revenues."

However, Phillips notes that "administrators need to adopt technology quickly, because there will be winners and losers from that process. Using AI, some administrators will operate a lot more cost-efficiently than others, and that will be attractive."

The alternative to relying on a provider to upgrade their systems with the latest tools is to bring some of the work back in-house. This option is prompting managers to reassess the buy or build equation. "Historically, lean back offices have decided to buy, not build. To meet growing LP and regulatory demand for transparency, now teams can leverage AI to build internally, while retaining control of their data," Cholost says.

"In the past, managers often hired fund administrators because they had a technology stack that was too expensive for managers to buy," notes Houghton. "With the rapid evolution of AI and the growing accessibility of new software, we've arrived at a genuine inflection point."

However, as CFOs grapple with increasingly multifaceted outsourcing choices and a variety of evolving models enabled by AI, some things remain constant: LPs still seek third-party verification of core back-office workstreams. Managers have yet to see any AI-driven reduction in the cost of outsourced services. And choosing the right service provider is as essential as ever. ■