

## **Module 5 – Chapter 8 – Money Flow Index (MFI)**

The Money Flow Index (MFI) is a technical oscillator that measures the inflow and outflow of money into a security over a specific period. Conceptually similar to the Relative Strength Index (RSI), the MFI also operates on a scale of 0 to 100. However, while RSI focuses on price changes, MFI incorporates volume, thereby providing a more comprehensive view of buying and selling pressure.

### **What it is and what it shows**

MFI is calculated using the typical price for each period and the volume for that period. The idea is to ascertain how much conviction there is in each price move; high volume moves are given more weight than low volume moves.

To compute the MFI:

- 1) **Calculate the Typical Price:** Typical Price =  $(\text{High} + \text{Low} + \text{Close}) / 3$
- 2) **Calculate the Money Flow:** Money Flow = Typical Price  $\times$  Volume
- 3) **Accumulate Positive and Negative Money Flow:** If today's typical price is greater than yesterday's, it's

considered positive money flow. If it's less, it's negative money flow.

4) **Calculate the Money Flow Ratio:** Money Flow Ratio = Positive Money Flow Over 'n' Days / Negative Money Flow Over 'n' Days

5) **Compute the MFI:**  $MFI = 100 - (100 / (1 + \text{Money Flow Ratio}))$

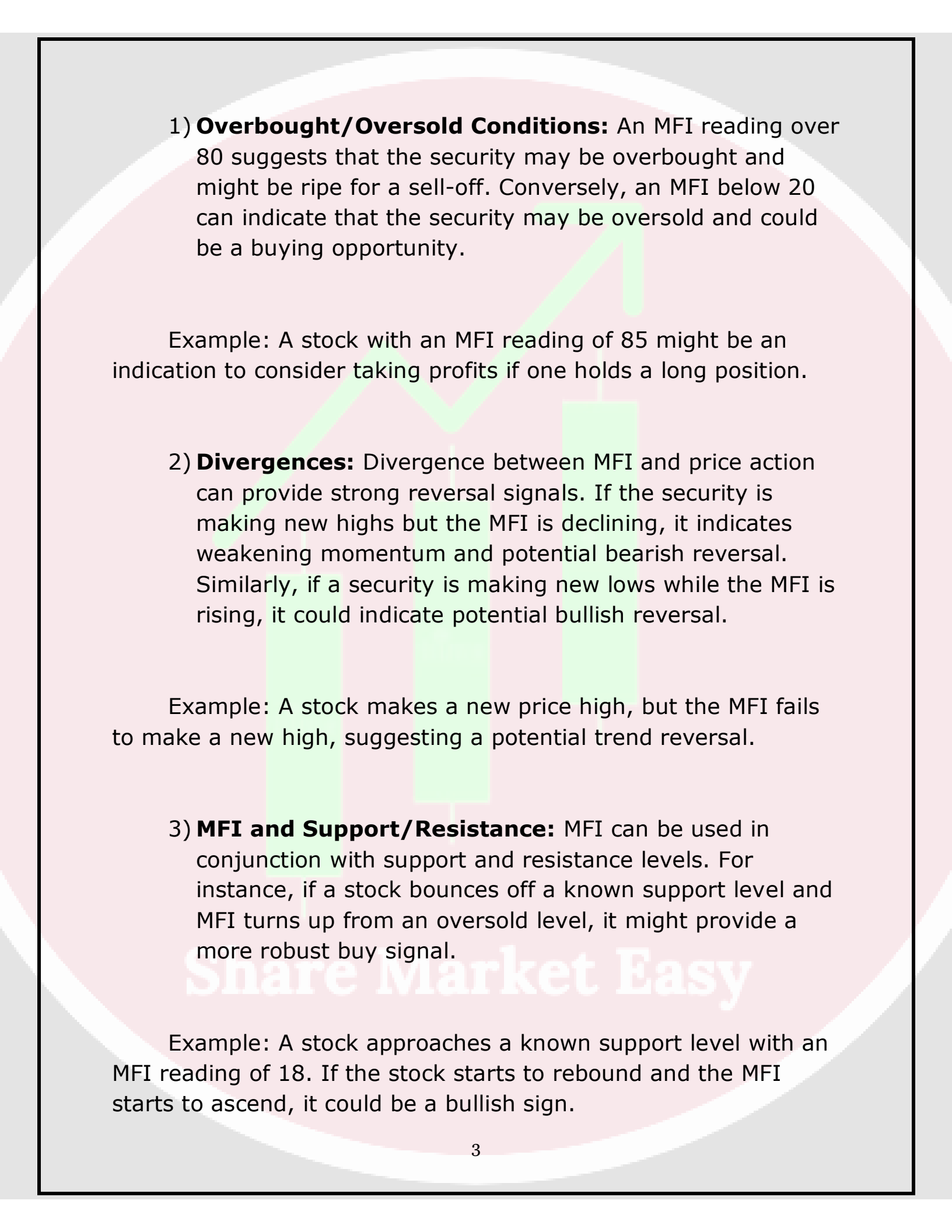
In terms of its readings:

An MFI above 80 is considered overbought, indicating that the security might be in a state of overvaluation.

An MFI below 20 is considered oversold, signaling a potential undervaluation of the security.

### **How to trade it**

MFI offers various potential strategies for traders:

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- 1) **Overbought/Oversold Conditions:** An MFI reading over 80 suggests that the security may be overbought and might be ripe for a sell-off. Conversely, an MFI below 20 can indicate that the security may be oversold and could be a buying opportunity.

Example: A stock with an MFI reading of 85 might be an indication to consider taking profits if one holds a long position.

- 2) **Divergences:** Divergence between MFI and price action can provide strong reversal signals. If the security is making new highs but the MFI is declining, it indicates weakening momentum and potential bearish reversal. Similarly, if a security is making new lows while the MFI is rising, it could indicate potential bullish reversal.

Example: A stock makes a new price high, but the MFI fails to make a new high, suggesting a potential trend reversal.

- 3) **MFI and Support/Resistance:** MFI can be used in conjunction with support and resistance levels. For instance, if a stock bounces off a known support level and MFI turns up from an oversold level, it might provide a more robust buy signal.

Example: A stock approaches a known support level with an MFI reading of 18. If the stock starts to rebound and the MFI starts to ascend, it could be a bullish sign.

4) **Trend Confirmations:** In a strongly trending market, MFI can serve as a confirmation tool. If a stock is in an uptrend and MFI remains above 50, it confirms the strength of the trend.

In conclusion, the Money Flow Index is a powerful tool that incorporates both price and volume to offer traders insights into buying and selling pressure. Like all indicators, it's essential to use MFI in conjunction with other tools and analysis techniques to refine trade signals and manage risk.

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**An example of the MFI**

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